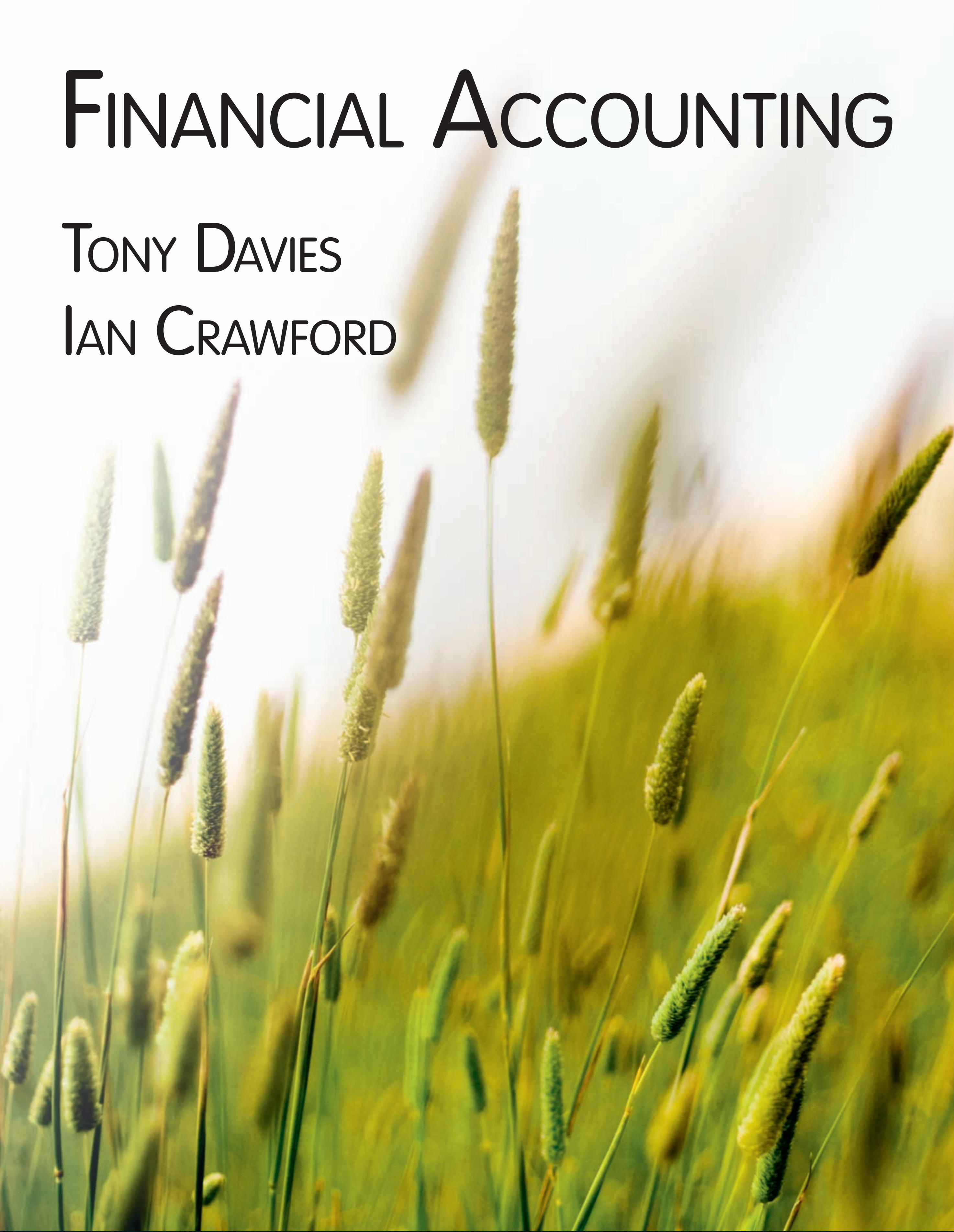
Financial Accounting

Tony Davies
Ian Crawford



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TONY DAVIES
and
IAN CRAWFORD

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This book is dedicated to Nina

Preface

Financial Accounting has two key aims. One aim is to provide undergraduates, postgraduates and others with a book about financial accounting in a practical business context that is clear and easy to understand. In *Financial Accounting* we have maintained a rigorous approach and full coverage of all the theoretical and technical aspects of accounting, together with their practical application. At the same time, we have tried to remove the fear and intimidation that sometimes accompanies this subject, by making it more user-friendly and a little more fun to study.

The other aim is to provide a comprehensive and flexible teaching and learning resource, with a wide range of study and assessment material supported by an 'easy to use' accessible website. There are links between each of the chapters, which follow a structure that has been designed to facilitate effective teaching and learning of financial accounting in a progressive way. Alternatively, each chapter may be used on a standalone basis; chapters may also be excluded if they relate to subjects that are not essential for a specific module. For example, double-entry bookkeeping covered in Chapter 2 is a topic that may or may not be a requirement of some modules that may be referred to as required.

Accounting is of critical importance in the support of all business activities. The formal study of accounting is exciting because it introduces a toolkit that enables a better understanding of the performance of businesses, and the decisions and problems they face. These issues are discussed daily by managers and in the media. This textbook provides you with the toolkit and shows you how to apply it in practice, utilising a comprehensive range of learning features, illustrative examples and assessment material to support and reinforce your study.

This textbook is aimed primarily at students who are not majoring in accounting, but who are undertaking an introductory-level module as part of their degree or diploma course in business management, economics or any other subject. *Financial Accounting* is a tightly written, clear and engaging text which distils the core principles of financial accounting for those students who may not have the luxury of devoting all their time to its study.

Content and structure

Each topic in *Financial Accounting* has been carefully researched to closely follow the typical current requirements of introductory undergraduate and MBA modules. The text assumes no prior knowledge of the subject, starting at square one and taking you step-by-step through the concepts and application of techniques, with clear explanations and numerous worked examples.

This textbook is primarily about financial accounting, which is broadly concerned with the recording and analysis of historical financial data, the presentation of financial information, and compliance with current legislation, and accounting rules and standards. Another branch of accounting, management accounting, uses financial and non-financial information and also provides information for the costing of products for the valuation of inventories, the pricing of products and services, and the planning, control and decision-making functions. It is mainly involved in the support of the management of an organisation in dealing with current problems and in the evaluation of the future outcomes of various different scenarios and decisions.

Financial Accounting includes coverage of some contemporary issues and topics of growing importance, for example:

- IFRS and IASs reporting requirements
- corporate governance
- sustainability reporting.

Chapter 1 begins with an introduction to the fundamentals of accounting and the next four chapters deal with the recording and classification of accounting transactions and the three key financial statements: income statement (profit and loss account); balance sheet; statement of cash flows (cash flow statement), and in particular those relating to limited companies. In most respects these also apply to other profit-making and not-for-profit organisations in both the private and public sectors.

Chapter 2 shows how commercial transactions are accounted for. It is about the system used to record accounting transactions and accounting data and provides the fundamental basis for the further analysis and reporting of financial information. It provides an introduction to double-entry bookkeeping. Bookkeeping is a process that records accounting data in a way that allows subsequent preparation of financial reports in appropriate formats which inform shareholders and others about the financial position and the financial performance of the business.

Chapter 3 begins with an introduction to the preparation of simple financial statements and then goes on to look in detail at the balance sheet.

Chapter 4 looks in detail at the income statement. It looks at how to recognise that a profit (or loss) has been made and how it is linked with the balance sheet and statement of cash flows.

Chapter 5 deals with the statement of cash flows, which shows from where an organisation has received cash during an accounting period and how cash was used.

In Chapter 6 we broaden the scope of our study of accounting to provide an introduction to corporate governance. This is a topic that has become increasingly important as the behaviour of directors and managers towards their shareholders and to society in general receives greater and greater attention and comes under closer and closer scrutiny by investors, the media, governments and the general public. The burden also lies with management to run businesses in strict compliance with statutory, regulatory and accounting requirements, so it is crucial that directors are aware of the rules and codes of practice in place to regulate the behaviour of directors of limited companies.

Chapter 7 is headed *Financial statements analysis*. The three financial statements provide information about business performance. Much more may be gleaned about the performance of the business through further analysis of the financial statements, using financial ratios and other techniques, for example trend analysis, industrial analysis and inter-company analysis.

Chapter 8 looks at the analysis and interpretation of the annual report and accounts of a business. It uses the report and accounts for the year ended 31 March 2011 of Johnson Matthey Plc to illustrate the type of financial and non-financial information provided by a major UK public company.

Chapter 9 deals primarily with long-term, external sources of business finance for investment in businesses. This relates to the various types of funding available to business, including the raising of funds from the owners of the business (the shareholders) and from lenders external to the business. This chapter includes evaluation of the costs of the alternative sources of capital, which may be used in the calculation of the overall cost of capital that may be used by companies as a basis for the discount rate to evaluate proposed investments in capital projects.

This text has been written primarily for non-specialist students, and so each chapter aims to help students understand the broader context and relevance of financial accounting in the business environment. Every chapter provides comprehensive examples and commentary on company activity, including at least one press extract. Companies featured include: Birmingham City FC; Persimmon; Thorntons; and EasyDate. In addition, two of the chapters feature extracts and analysis of the report and accounts 2011 of Johnson Matthey Plc.

Using this book

To support your study and reinforce the topics covered, we have included a comprehensive range of learning features and assessment material in each chapter, including:

- learning objectives
- introduction
- highlighted key terms
- fully worked examples
- integrated progress checks
- key points summary
- questions
- discussion points
- exercises.

Within each chapter we have also included numerous diagrams and charts that illustrate and reinforce important concepts and ideas. The Guided Tour of the Book that follows (on pages xx–xxii) summarises the purpose of these learning features and the chapter-end assessment material. To gain maximum benefit from this text and to help you succeed in your study and exams, you are encouraged to familiarise yourself with these elements now, before you start the first chapter.

Accounting is essentially a 'hands-on' subject; just reading about it is not enough. Believe us, from our own experience we know that repeated practice of examples and exercises is the only way to become proficient in its techniques. You may think that reading through this book or your lecture notes, highlighting the odd sentence and gliding through the worked examples, progress checks and chapter-end questions and exercises, will instil the knowledge and expertise required to pass your exams. This would be a big mistake. Active learning needs to be interactive: if you haven't followed a topic or an example, go back and work through it again; try to think of other examples to which particular topics may be applied. The only way to check that you have a comprehensive understanding of things is to attempt all the integrated progress checks and worked examples, and the chapter-end assessment material, and then to compare with the text and answers provided. Fully worked solutions are given for each worked example, and solutions to about 45% of the chapter-end exercises (those with their numbers in colour) are provided in Appendix 2. Additional self-assessment material is available on the book's accompanying website.

Case studies

The book includes three case studies that may be tackled either individually or as a team. The case studies are a little more weighty than the chapter-end exercises; in addition, they integrate many of the topics included in the chapters in each part of the text to which they relate, although not exclusively. Each case study therefore gives you an opportunity to apply the knowledge and techniques gained from each part of the book, and to develop these together with the analytical skills and judgement required to deal with real-life business problems. Additional cases are provided on the accompanying website.

We hope this textbook will enhance your interest, understanding and skills. Above all, relax, learn and enjoy!

Guided tour of the book

Learning objectives

Listed at the start of each chapter, these bullet points identify the core learning outcomes you should have acquired after completing each chapter.

Learning objectives

Completion of this chapter will enable you to:

- outline the uses and purpose of accounting and the practice of accountancy
- explain the development of the conceptual frameworks of accounting
- outline the contents of the UK Statement of Principles (SOP)
- explain the main UK accounting concepts and accounting and financial reporting standards
- appreciate the meaning of true and fair view
- consider the increasing importance of international accounting standards
- explain what is meant by financial accounting, management accounting and financial management
- illustrate the different types of business entity: sole traders, partnerships, private limited companies, public limited companies
- explain the nature and purpose of financial statements
- identify the wide range of users of financial information
- consider the issues of accountability and financial reporting.

Introduction

This section gives you a brief overview of the coverage and purpose of each chapter, and how it links to the previous chapter.

Introduction

This chapter begins by explaining what is sometimes referred to as the dual aspect rule. This rule recognises that for all transactions there is a two-sided effect within the entity. A manager in a non-accounting role may not be expected to carry out the recording of transactions in this way, but an appreciation of how accounting data has been recorded will be extremely helpful in the interpretation of financial information. We will go on to describe the processes that deal with the two sides of each transaction, the 'debits' and 'credits' of double-entry bookkeeping.

Don't worry if at first these topics seem a little difficult and confusing. They will become clearer as we follow through some transactions step-by-step into the accounts of a business and show how these accounts are kept in balance.

The chapter continues with an introduction to the way in which each of the accounts is held in what are termed the books of account and ledgers of the business. The balances on all the accounts in an entity are summarised in what is called a trial balance. The trial balance may be adjusted to allow for payments in advance, charges not yet received, and other adjusting entries. From this information we will show how to prepare a simple income statement, balance sheet and statement of cash flows.

This chapter refers to some of the accounting concepts introduced in Chapter 1. In that context we will look at the time period chosen by a business, to which the financial reporting relates – the accounting period.

Key terms

These are colour-highlighted the first time they are introduced, alerting you to the core concepts and techniques in each chapter. A full explanation is contained in the glossary of key terms section at the end of the book.

3. Profitability

A number of financial indicators and ratios may be considered to assess the profitability of the company, which may include:

- gross profit (or gross margin) to sales
- return on sales (ROS)
- **return on capital employed (ROCE)**, or **return on investment (ROI)**.

4. Efficiency

The efficiency of the company may be considered in terms of its:

- **operating cycle** – its receivables **collection days**, **payables days** and **inventories days**
- asset turnover
- **vertical analysis** of its income statement (which we will look at in Chapter 8).

In a vertical analysis of the income statement (which may also be applied to the balance sheet) each item is expressed as a percentage of the total sales. The vertical analysis provides evidence

Worked examples

The numerous worked examples in each chapter provide an application of the learning points and techniques included within each topic. By following and working through the step-by-step solutions, you have an opportunity to check your knowledge at frequent intervals.

Worked example 6.1

Directors of companies are concerned with the important issues of agency-related problems and their impact. What is the basis of discussions they may have to consider what actions they may implement to try and minimise the impact of such problems?

Their discussions may include the following:

- The agency problem emerges when directors or managers make decisions that are inconsistent with the objective of shareholder wealth maximisation.
- There are a number of alternative approaches a company can adopt to minimise the possible impact of such a problem, which may differ from company to company. In general, such approaches would range between:
  - – the encouragement of goal congruence between shareholders and managers through the monitoring of managerial behaviour and the assessment of management decision outcomes and
  - – the enforcement of goal congruence between shareholders and managers through the incorporation of formalised obligations and conditions of employment into management contracts.

Any such approach would invariably be associated with some form of remuneration package to include an incentive scheme to reward managers, such as performance-related pay, or executive share options.

Progress checks

Each topic within each chapter includes one or more of these short questions that enable you to check and apply your understanding of the preceding key topics before you progress to the next one in the chapter.

Progress check 3.4

Which of the following do you think may be classified as liabilities or shareholders' equity within a balance sheet, and under which headings should they appear?

- bank overdraft
- computer
- five-year bank loan
- amounts owed by customers
- accruals
- amounts owed to suppliers
- ordinary shares
- share premium

Press extracts

Included in every chapter, these topical extracts feature real company examples from the press, including commentary that highlights the practical application of accounting and finance in the business environment.

Anything you can do I can do better

On Mar. 12, victims of Bernard Madoff's Ponzi scheme finally had one of their wishes come true. After a judge denied bail, Madoff is going directly to jail, and he isn't passing 'go'. But Madoff's victims still want answers.

They want to know where the money went. They want to know who else was involved. And they want to know how they got scammed.

At the courthouse, many victims said there were no warning signs and Madoff himself, in his courtroom statement, backed them up on at least one count. 'The clients receiving trade confirmations and account statements had no way of knowing by reviewing these documents that I had never engaged in the transactions', Madoff said during his guilty plea.

Maybe not. But to Harry Markopolos, the risk manager who alerted the SEC to Madoff's fraud in 1999 to no avail, the foul play seemed obvious. Madoff was supposedly using a complex trading system to generate returns, a strategy he dubbed the 'split-strike conversion strategy'. He would buy stocks in the Standard & Poor's 100 and sell options to reduce volatility. But Markopolos' firm was running a similar strategy and couldn't match the returns. A look at the returns was all it took for Markopolos to know something was up.

Preying on a Community

Markopolos had plenty of incentive to doubt Madoff; he was a competitor irked by Madoff's claims of too-good-to-be-true returns. For most of Madoff's clients, the math that Markopolos employed would have been out of their league. Some Madoff investors were sophisticated enough that they might have dug deeper into their statements and trade confirmations. A quick comparison of their returns with those of the actual markets might have been enough to tip them off that at least some of the trades were phony. Some of them might have realized that the average returns were too high and too constant, based on the mathematical probabilities. 'If the standard deviation is too low and the mean too high, something is wrong', says Utpal Bhattacharya, fi-

built an image of a successful businessman whose family's financial-services roots went back to 1932. In fact, his banking empire consisted of a Montserrat bank founded in 1986 that had its license revoked by the local government. Go back further, and Stanford filed for bankruptcy not once, but twice.

Victims of Tom Petters, the mastermind behind another recent Ponzi scheme in Minnesota that cost investors $2 billion, didn't check out basic claims, such as Petters' assertion that he was a major supplier to Sam's Club. He wasn't, which the investors could have figured out if they'd picked up the phone and made a call.

Madoff's investors might have been able to determine if their trades were legitimate if they'd checked how a stock or option traded on any given day. Even something as trivial as the accounting firm can be a tip-off. Both Madoff and Stanford used tiny accounting firms that would have been hard-pressed to handle the job. 'Investors have to do their own due diligence', says Gregory Hays, managing principal of Atlanta-based Hays Financial Consulting. 'They need to make sure what they're investing in is accurate.'

Investors also should dig into the firm and the background of its managers. A quick check on the Financial Industry Regulatory Authority, or FINRA, Web site could alert investors to a black mark on an adviser's record. Its Broker Check function alerts investors to any regulatory proceedings against an adviser, from bad record-keeping to misuse of client funds for firms and advisers. If the firm doesn't have a solid explanation, it could be time to look elsewhere.

The Defense of Skepticism

Even a quick search of Google can be revealing, yet it's a step few victims take. It would have revealed accusations from the 1990s that Madoff was front-running his customers, that is, buying or selling shares before filling their orders. The charges may amount to nothing. 'But', says Billy Procida, founder of William Procida Inc., a turnaround

Summary of key points

Following the final section in each chapter there is a comprehensive summary of the key points in terms of the learning outcomes listed at the start of each chapter. These allow you to check that you understand all the main points covered before moving on to the next chapter.

Summary of key points

- The main aims of a business performance review are to provide an understanding of the business and provide an interpretation of results.
- Care must be taken in reviewing business performance, primarily because of lack of consistency in definitions and changes in economic conditions.
- An important area of business performance review is the use of ratio analysis looking at profitability, efficiency, liquidity, investment and growth, and financial structure.
- Cash flow and cash ratios are becoming increasingly as important as profit and profitability ratios in the measurement of business performance.
- There is no best way of evaluating financial performance and there are advantages and disadvantages in using earnings per share or cash flow as the basis of measurement.
- Earnings before interest, tax, depreciation and amortisation (EBITDA) is sometimes used as an approximate measure of a cash flow performance.

Questions

These are short narrative-type questions that encourage you to review and check your understanding of all the key topics. There are typically 7 to 10 of these questions at the end of each chapter.

Assessment material

Questions

Q7.1 (i) Who is likely to carry out a business performance review?
(ii) Describe what may be required from such reviews giving some examples from different industries and differing perspectives.

Q7.2 (i) Outline how the business performance review process may be used to evaluate the position of a dot.com company like Amazon UK.
(ii) What are the limitations to the approach that you have outlined?

Q7.3 How is ratio analysis, in terms of profitability ratios, efficiency ratios, liquidity ratios, investment ratios and financial structure ratios used to support the business review process?

Q7.4 Why should we be so careful when we try to compare the income statement of a limited company with a similar business in the same industry?

Q7.5 (i) Why does profit continue to be the preferred basis for evaluation of the financial performance of a business?
(ii) In what ways can cash flow provide a better basis for performance evaluation, and how may cash flow be approximated?

Discussion points

This section typically includes 2 to 4 thought-provoking ideas and questions that encourage you to critically apply your understanding and/or further develop some of the topics introduced in each chapter, either individually or in team discussion.

Discussion points

D8.1 'The annual reports and accounts prepared by the majority of UK plcs serve to ensure that shareholders, and other stakeholders, are kept very well informed about the affairs of their businesses.' Discuss.

D8.2 'In the global competitive world in which we live, company directors should be able to exercise their full discretion as to the amount of information they disclose in their annual reports and accounts. If they are not allowed this discretion in disclosure, their companies may be driven out of business by their competitors, particularly foreign competitors who may not have the restriction of such extensive reporting requirements.' Discuss.

D8.3 'The main reason that companies increasingly include sustainability reports in their annual reports and accounts is to change the views of users and regulators about the activities in which their businesses are engaged, in order to pre-empt and avoid any negative or harmful reactions.' Discuss this statement by drawing on examples of the type of businesses to which this might apply.

(Hint: You may wish to research British Gas, as well as Johnson Matthey Plc, to provide material for this discussion.)

Exercises

These comprehensive examination-style questions are graded by their level of difficulty, and also indicate the time typically required to complete them. They are designed to assess your knowledge and application of the principles and techniques covered in each chapter. There are typically 6 to 8 exercises at the end of each chapter. Full solutions to the colour-highlighted exercise numbers are provided in Appendix 2 to allow you to self-assess your progress.

Exercises

Solutions are provided in Appendix 2 to all exercise numbers highlighted in colour.

Level I

E9.1 *Time allowed – 30 minutes*

A critically important factor required by a company to make financial decisions, for example the evaluation of investment proposals and the financing of new projects, is its cost of capital. One of the elements included in the calculation of a company's cost of capital is the cost of equity.

(i) Explain in simple terms what is meant by the 'cost of equity capital' for a company.

The relevant data for Normal plc and the market in general are given below.

Normal plc	
Current price per share on the London Stock Exchange	£1.20
Current annual dividend per share	£0.10
Expected average annual growth rate of dividends	7%
β beta coefficient for Normal plc's shares	0.5
The market	
Expected rate of return on risk-free securities	8%
Expected return on the market portfolio	12%

(ii) Calculate the cost of equity capital for Normal plc, using two alternative methods:
(a) the Capital Asset Pricing Model (CAPM)
(b) a dividend growth model of your choice.

E9.2 *Time allowed – 30 minutes*

Normal plc pays £20,000 a year interest on an irredeemable debenture, which has a nominal value of £200,000 and a market value of £160,000. The rate of corporation tax is 30%.

Glossary of key terms

At the end of the book a glossary of key terms in alphabetical order provides full definitions of all main terms that have been introduced. The numbers of the pages on which key term definitions appear are colour-highlighted in the index.

Glossary of key terms

accountancy The practice or profession of accounting.

accounting The classification and recording of monetary transactions, the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date, and the monetary projection of future activities arising from alternative planned courses of action.

accounting adjustments Accounting entries that do not arise from the basic transactions of cash and invoices. Adjusting entries are made for depreciation, bad and doubtful debts, closing inventories, prepayments, and accruals.

accounting concepts The principles underpinning the preparation of accounting information. Fundamental accounting concepts are the broad basic assumptions which underlie the periodic financial statements of business enterprises.

accounting period The time period covered by the accounting statements of an entity.

accounting policies The specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position (FRS 18 and Companies Act).

Accounting Standards Board (ASB) A UK standard-setting body set up in 1990 to develop, issue and withdraw accounting standards. Its aims are to 'establish and improve standards of financial accounting and reporting, for the benefit of users, preparers and auditors of financial information'.

accounts payable (or **purchase ledger**) A subsidiary ledger that contains all the personal accounts of each individual supplier or vendor, and records every transaction for goods and services with each supplier since the start of their relationship with the company. The total of the balances on each individual supplier account at any time is reflected in an accounts payable control account within the general ledger, and is reported in the balance sheet as trade payables.

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Figure 8.2 from Johnson Matthey Plc year-end 31 March share price 2002 to 2011, Johnson Matthey Plc.

Text

Article on page 8 from 'Birmingham's place in Europe threatened by financial concerns', *The Guardian*, 15/04/2011 (James, S); Article on page 39 from 'Greek crisis deepens with S & P downgrade; worry about true scale of undisclosed military spending adds to concerns', *Daily Telegraph*, 17/12/2009 (Evans-Pritchard, A), copyright © Telegraph Media Group Limited; Article on page 98 from 'Persimmon returns to profit after revaluation', *Daily Telegraph*, 03/03/2010 (Midgely, D), copyright © Telegraph Media Group Limited; Article on page 99 from 'The value of 5,000 years of history? £51m', *Daily Telegraph*, 25/05/2010 (Butterworth, M), copyright © Telegraph Media Group Limited; Article on pages 141–2 from 'Anger grows at the Thorntons board as UK's famous chocolate brand goes stale', *The Observer*, 08/05/2011 (Clark, A); Article on page 229 from 'The small cases that will have a big influence on the way we work: Gary Slapper reflects on the deaths that have led to the change in corporate manslaughter law', *The Times*, 11/07/2009 (Slapper, G); Article on page 245 from 'Farewell then . . . floppy discs', *Daily Mail*, 28/04/2010 (Beanland, C); Article on page 255 from 'Late payments mean bigger write-offs for small business', *Daily Express*, 15/04/2010 (Gribben, R), copyright © Telegraph Media Group Limited; Article on page 313 from 'Cars and the road to growth', *The Times*, 25/11/2010 (Waller, M); Article on page 346 from 'Online dating site seeks to woo investors', *Daily Telegraph*, 18/05/2010 (Smith, P), copyright © Telegraph Media Group Limited;

Extract on pages 282–310 from ‘Chairman’s Statement’ and various extracts from Johnson Matthey Annual Report and Accounts 2011; Extracts on pages 194–212 from Annual Report & Accounts 2011, Johnson Matthey, We are grateful to Johnson Matthey Plc for their kind permission to use these extracts from their Report and Accounts 2011 as an excellent example of information provided to shareholders by a major UK plc.

The Financial Times

Article on page 15 from ‘Push for accounting convergence threatened by EU reform drive’, *Financial Times*, 05/04/2010 (Saunderson, R).

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1

The importance of financial accounting

Contents

Learning objectives

Completion of this chapter will enable you to:

- outline the uses and purpose of accounting and the practice of accountancy
- explain the development of the conceptual frameworks of accounting
- outline the contents of the UK Statement of Principles (SOP)
- explain the main UK accounting concepts and accounting and financial reporting standards
- appreciate the meaning of true and fair view
- consider the increasing importance of international accounting standards
- explain what is meant by financial accounting, management accounting and financial management
- illustrate the different types of business entity: sole traders, partnerships, private limited companies, public limited companies
- explain the nature and purpose of financial statements
- identify the wide range of users of financial information
- consider the issues of accountability and financial reporting.

Introduction

This chapter explains why accounting and finance are such key elements of business life. Both for aspiring accountants, and those of you who may not continue to study accounting and finance beyond the introductory level, the fundamental principles of accounting and the ways in which accounting is regulated to protect owners of businesses, and the public in general, are important topics. A broad appreciation will be useful not only in dealing with the subsequent text, but also in the context of the day-to-day management of a business.

This chapter will look at why accounting is needed and how it is used and by whom. Accounting and finance are wide subjects, which often mean many things to many people. They are broadly concerned with the organisation and management of financial resources. Accounting and accountancy are two terms which are sometimes used to mean the same thing, although they more correctly relate separately to the subject and the profession.

Accounting and accountancy are generally concerned with measuring and communicating the financial information provided from accounting systems, and the reporting of financial results to shareholders, lenders, creditors, employees and Government. The owners or shareholders of the wide range of business entities that use accounting may be assumed to have the primary objective of maximisation of shareholder wealth. Directors of the business manage the resources of the business to meet shareholders' objectives.

Accounting operates through basic principles and rules. This chapter will examine the development of conceptual frameworks of accounting, which in the UK are seen in the Statement of Principles (SOP). We will discuss the rules of accounting, which are embodied in what are termed accounting concepts and accounting standards.

Over the past few years there has been an increasing focus on trying to bring together the rules, or standards, of accounting that apply in each separate country, into one set of accounting standards. For example, with effect from January 2005 all the stock exchange listed companies within the European Union were required to comply with one such set of accounting standards relating to the way in which they report financial information. We will discuss how this may affect the topics we shall be covering in this book.

We will consider the processes used in accounting and look at an overview of the financial statements used in financial reporting, and the way in which financial reporting is used to keep shareholders informed. The timely and accurate disclosure of accounting information is a fundamental requirement in the preparation of appropriate statements of the financial performance and the financial position of a business. Directors and managers are responsible for running businesses and their accountability to shareholders is maintained through their regular reporting on the activities of the business.

A large number of accounting concepts and terms are used throughout this book, the definitions of which may be found in the glossary of key terms at the end of the book.

What is accounting, and what are its uses and purposes?

The original, basic purposes of **accounting** were to classify and record monetary transactions (see Chapter 2) and present the financial results of the activities of an entity, in other words the scorecard that shows how the business is doing. The accounting profession has evolved and accounting techniques have been developed for use in a much broader business context. To look at the current nature of accounting and the broad purposes of accounting systems we need to consider the three questions these days generally answered by accounting information:

■ how are we doing, and are we doing well or badly?	**a scorecard (like scoring a game of cricket, for example)**
■ which problems should be looked at?	**attention-directing**
■ which is the best alternative for doing a job?	**problem-solving**

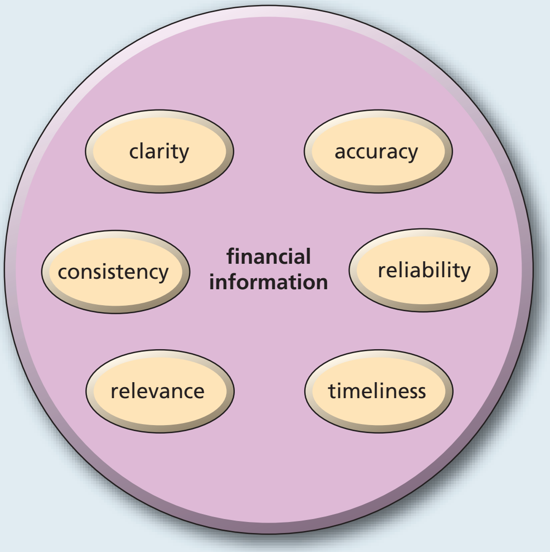
Although accountants and the accounting profession have retained their fundamental roles they have grown into various branches of the profession, which have developed their own specialisms and responsibilities.

Accounting is a part of the information system within an organisation (see Chapter 2, which explains double-entry **bookkeeping**, and how data are identified, recorded and presented as information in the ways required by the users of financial information). Accounting also exists as a service function, which ensures that the financial information that is presented meets the needs of the users of financial information. To achieve this, accountants must not only ensure that information is accurate, reliable and timely but also that it is relevant for the purpose for which it is being provided, consistent for comparability, and easily understood (see Figure 1.1).

In order to be useful to the users of financial information, the accounting data from which it is prepared, together with its analysis and presentation, must be:

- accurate – free from error of content or principle
- reliable – representing the information that users believe it represents
- timely – available in time to support decision-making
- relevant – applicable to the purpose required, for example a decision regarding a future event or to support an explanation of what has already happened

Figure 1.1 Features of useful financial information



- consistent – the same methods and standards of measurement of data and presentation of information to allow like-for-like comparison
- clear – capable of being understood by those for whom the information has been prepared.

In the next few sections we will see just how important these features are, and the ways they are included in the development of various **conceptual frameworks of accounting**, and the accounting policies selected by companies.

The conceptual frameworks of accounting

How can the credibility and usefulness of accounting and financial information be ensured? Accounting operates within a framework. This framework is constantly changing and evolving as new problems are encountered, as new practices and techniques are developed, and the objectives of users of financial information are modified and revised.

The search for a definitive conceptual framework, a theoretical accounting model, which may deal with any new accounting problem that may arise, has resulted in many conceptual frameworks having been developed in a number of countries worldwide. The basic assumption for these conceptual frameworks is that **financial statements** must be useful. The general structure of conceptual frameworks deals with the following six questions:

1. What is the purpose of financial statement reporting?
2. Who are the main users of accounting and financial information?
3. What type of financial statements will meet the needs of these users?
4. What type of information should be included in financial statements to satisfy these needs?
5. How should items included in financial statements be defined?
6. How should items included in financial statements be recorded and measured?

In 1989 the **International Accounting Standards Board (IASB)** issued a conceptual framework that largely reflected the conceptual framework of the Financial Accounting Standards Board of the USA issued in 1985. This was based on the ideas and proposals made by the accounting profession since the 1970s in both the USA and UK. In 1999 the **Accounting Standards Board (ASB)** in the UK published its own conceptual framework called the **Statement of Principles (SOP)** for financial reporting.

Progress check 1.1

What is meant by a conceptual framework of accounting?

The Statement of Principles (SOP)

The 1975 Corporate Report was the first UK attempt at a conceptual framework. This, together with the 1973 Trueblood Report published in the USA, provided the basis for the conceptual framework issued by the IASB in 1989, referred to in the previous section. It was followed by the publication of the SOP by the ASB in 1999. The SOP is a basic structure for determining objectives, in which there is a thread from the theory to the practical application of accounting standards to transactions that are reported in published accounts. The SOP is not an accounting standard and its use is not mandatory, but it is a statement of guidelines; it is, by virtue of the subject, constantly in need of revision.

The SOP identifies the main users of financial information as:

- investors
- lenders
- employees
- suppliers
- customers
- Government
- the general public.

The SOP focuses on the interests of investors and assumes that each of the other users of financial information is interested in or concerned about the same issues as investors.

The SOP consists of eight chapters that deal with the following topics:

1. The objectives of financial statements, which are fundamentally to provide information that is useful for the users of that information.
2. Identification of the entities that are required to provide financial statement reporting by virtue of the demand for the information included in those statements.
3. The qualitative characteristics required to make financial information useful to users:
   - **materiality** (inclusion of information that is not material may distort the usefulness of other information)
   - relevance
   - reliability
   - comparability (enabling the identification and evaluation of differences and similarities)
   - comprehensibility.
4. The main elements included in the financial statements – the ‘building blocks’ of accounting such as assets and liabilities.

5. When transactions should be recognised in financial statements.
6. How assets and liabilities should be measured.
7. How financial statements should be presented for clear and effective communication.
8. The accounting by an entity in its financial statements for interests in other entities.

The UK SOP can be seen to be a very general outline of principles relating to the reporting of financial information. The SOP includes some of the basic concepts that provide the foundations for the preparation of financial statements. These accounting concepts will be considered in more detail in the next section.

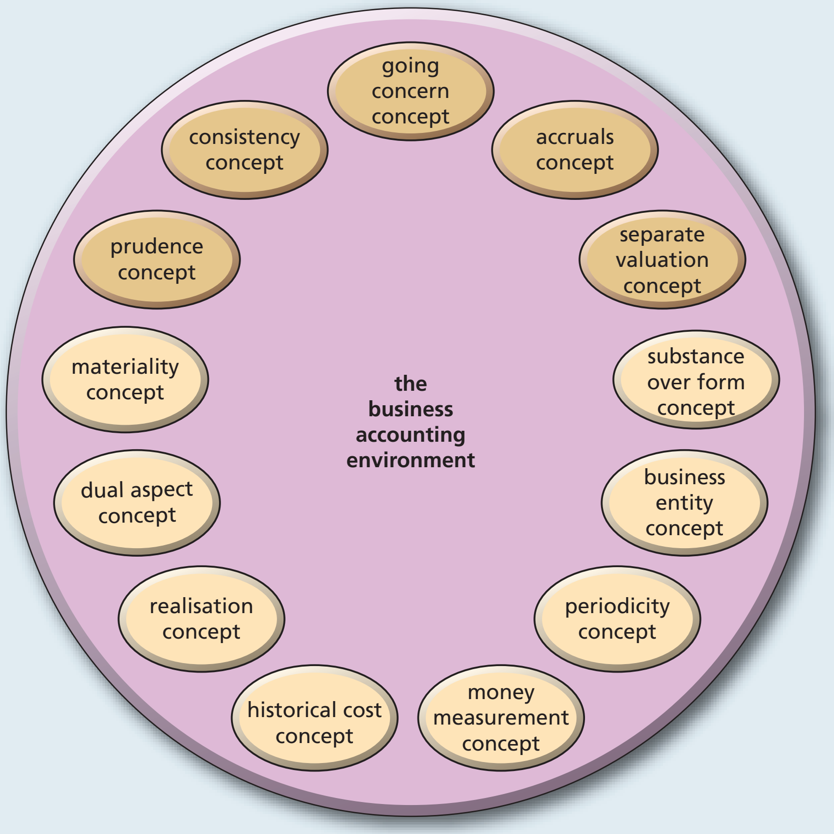
Progress check 1.2

What are the aims of the UK Statement of Principles and how does it try to achieve these aims?

Accounting concepts

The accounting framework revolves around the practice of accounting and the accountancy profession, which is bounded by rules, or concepts (see Figure 1.2, in which the five most important

Figure 1.2 Accounting concepts



concepts are shown in a darker colour) of what data should be included within an accounting system and how that data should be recorded.

Accounting concepts are the principles underpinning the preparation of accounting information relating to the ethical rules, boundary rules and recording and measurement rules of accounting. Ethical rules, or principles, are to do with limiting the amount of judgement (or indeed creativity) that may be used in the reporting of financial information. Boundary rules are to do with which types of data, and the amounts of each, that should be held by organisations, and which elements of financial information should be reported. Recording and measurement rules of accounting relate to how the different types of data should be recorded and measured by the organisation.

Fundamental accounting concepts are the broad, basic assumptions, which underlie the periodic financial accounts of business enterprises. The five most important concepts, which are discussed in FRS 18, Accounting Policies, are as follows.

The prudence concept

Prudence means being careful or cautious. The **prudence concept** is an ethical concept that is based on the principle that revenue and profits are not anticipated, but are included in the income statement only when realised in the form of either cash or other assets, the ultimate cash realisation of which can be assessed with reasonable certainty. Provision must be made for all known liabilities and expenses, whether the amount of these is known with certainty or is a best estimate in the light of information available, and for losses arising from specific commitments, rather than just guesses. Therefore, companies should record all losses as soon as they are known, but should record profits only when they have actually been achieved in cash or other assets.

The consistency concept

The **consistency concept** is an ethical rule that is based on the principle that there is uniformity of accounting treatment of like items within each accounting period and from one period to the next. However, as we will see in Chapter 3, judgement may be exercised as to the application of accounting rules to the preparation of financial statements. For example, a company may choose from a variety of methods to calculate the **depreciation** of its machinery and equipment, or how to value its inventories. Until recently, once a particular approach had been adopted by a company for one accounting period then this approach should normally have been adopted in all future accounting periods, unless there were compelling reasons to change. The ASB now prefers the approaches adopted by companies to be revised by them, and the ASB encourages their change, if those changes result in showing a truer and fairer picture. If companies do change their approaches then they have to indicate this in their annual reports and accounts.

The going concern concept

The **going concern concept** is a boundary rule that assumes that the entity will continue in operational existence for the foreseeable future. This is important because it allows the original, historical costs of assets to continue to be used in the balance sheet on the basis of their being able to generate future income. If the entity was expected to cease functioning then such assets would be worth only what they would be expected to realise if they were sold off separately (their break-up values) and therefore usually considerably less.

Birmingham City's financial blues

Birmingham City face the threat of being denied their licence to play in Europe next season if they cannot convince the Premier League and the Football Association that their finances are not a major cause for concern.

The Premier League is set to hold discussions with the Birmingham board this month before deciding in conjunction with the FA whether they should be granted a Uefa licence and allowed to play in the Europa League, for which they qualified after winning the Carling Cup.

It is understood that a final decision on Birmingham's participation is not expected to be made until the middle of next month, when representatives from the governing bodies meet to determine which clubs meet the criteria for a licence. Uefa delegates its licensing scheme to national associations, meaning that Birmingham will need to satisfy the FA and the Premier League that they can meet their financial liabilities for the year ahead.

This time last year Portsmouth, FA Cup finalists, were told that they would not be allowed to compete in the Europa League after the FA and the Premier League decided against endorsing their application for a Uefa licence. Portsmouth, however, had failed to submit their application on time and were in administration with debts of £119m. Birmingham's situation is far different, although there are genuine concerns at the Premier League, who have additional reasons for wishing to ask questions of the St Andrew's board.

Under the disclosure rules brought in after the collapse of Portsmouth last year, clubs must submit 'independently audited accounts to the Premier League by 1 March each year with requirements to note any material qualifications or issues raised by auditors'. Clubs are also required to submit 'future financial information' to the Premier League by 31 March each year that 'will act as an improved early warning system should any club take undue financial risks which may have consequences for future financial stability'.

As the accounts for Birmingham City football club and their parent company, Birmingham International Holdings, included qualifications in their audit reports about both companies' ability to continue as a 'going concern', the Premier League wish to learn more information about Birmingham's financial position, the ownership structure at the club and recent share activity.

A spokesman for the Premier League said: 'Under our financial criteria all the clubs have to submit future financial information. There are a number of triggers that would result in us taking a closer look at a club's financial circumstances, such as an "emphasis of matter" (e.g. a doubt on the club's ability to continue as a going concern) on the accounts. This could result in measures being placed upon a club to ensure its sustainability going forward.'

Under the new rules, which were approved in 2009, the Premier League has a range of sanctions available to it for clubs that fall into financial difficulties, including a transfer embargo, a ban on player contracts being extended or improved, or the enforced sale of players. Carson Yeung, who yesterday bought 8.6% of the club to increase his stake in Birmingham International Holdings to 24.9%, provided written assurances to the Premier League last year in relation to the club's finances.

Birmingham's fiscal position has come under scrutiny at various points in the past 12 months, including soon after their Carling Cup final victory, when Birmingham International Holdings announced that Yeung was preparing to mortgage his private properties in a cash-raising exercise. The statement to the Hong Kong stock exchange added that without fresh funds the business may suffer 'significant curtailment of its operation'.

It is understood that the Premier League is also interested in whether Birmingham will be able to raise the £24.65m that was outlined in the club's most recent accounts, which were signed off in October.

Peter Pannu, Birmingham's acting chairman, maintains that the club remain on a sound financial footing.

Source: **Birmingham's place in Europe threatened by financial concerns,** by Stuart James © *The Guardian*, 15 April 2011

Even the most high-profile enterprises are not immune to the threat of failure to continue to trade. Carson Yeung, a Hong-Kong businessman, acquired 29.9% of the shares of Birmingham City Football Club in July 2007 through his company Grandtop International Holdings Limited. In August 2009 more shares were purchased giving the holding company more than 90% of the shares. Birmingham City plc (which owns the football club) was re-registered as a private company in November 2009 and the holding company renamed as Birmingham International Holdings the following month. The latest accounts to 30 June 2010, which were signed off in October 2010, show that the club has debts of over £29m, of which £23m is owed to one creditor (HSBC). The bank has a charge over the club's land and buildings, which includes the club's St Andrew's stadium. Birmingham City qualified to play in the 2011/12 season UEFA Europa League, but the Premier League rules state that if doubts should arise over a club's ability to remain a going concern then the licence necessary to enter European competition will not be granted unless documentary evidence is supplied to the Football Association which is accepted as indicative of the club's ability to remain a going concern until the end of the season. Birmingham City's financial position was not helped by their relegation from the Premier League at the end of the 2010/11 season.

The accruals concept

The **accruals concept** (or the matching concept) is a recording and measurement rule that is based on the principle that revenues and costs are recognised as they are earned or incurred, are matched with one another, and are dealt with in the income statement of the period to which they relate, irrespective of the period of receipt or payment. It would be misleading to report profit as the difference between cash received and cash paid during a period because some trading and commercial activities of the period would be excluded, since many transactions are based on credit.

Most of us are users of electricity. We may use it over a period of three months for heating, lighting and running our many home appliances, before receiving an invoice from the electricity supplier for the electricity we have used. The fact that we have not received an invoice until much later doesn't mean we have not incurred a cost for each month. The costs have been accrued over each of those months, and we will pay for them at a later date.

The separate valuation concept

The **separate valuation concept** is a recording and measurement rule that relates to the determination of the aggregate amount of any item. In order to determine the aggregate amount of an asset or a liability, each individual asset or liability that makes up the aggregate must be determined separately. This is important because material items may reflect different economic circumstances. There must be a review of each material item to comply with the appropriate accounting standards:

- IAS 16 (Property, Plant and Equipment)
- IAS 36 (Impairment of Assets)
- IAS 37 (Provisions, Contingent Liabilities and Contingent Assets).

(See the later section, which discusses UK and international accounting and financial reporting standards called **Financial Reporting Standards (FRSs)**, **International Financial Reporting Standards (IFRSs)**, and **International Accounting Standards (IASs)**.)

Note the example of the Millennium Dome 2000 project, which was developed in Greenwich, London, throughout 1999 and 2000 and cost around £800m. At the end of the year 2000 a valuation of the individual elements of the attraction resulted in a total of around £100m.

The further eight fundamental accounting concepts are as follows.

The substance over form concept

Where a conflict exists, the **substance over form concept**, which is an ethical rule, requires the structuring of reports to give precedence to the representation of financial or economic reality over strict adherence to the requirements of the legal reporting structure. This concept is dealt with in IAS 17, Leases. When a company acquires an asset using a finance lease, for example a machine, it must disclose the asset in its balance sheet even though not holding legal title to the asset, whilst also disclosing separately in its balance sheet the amount that the company still owes on the machine. The reason for showing the asset in the balance sheet is because it is being used to generate income for the business, in the same way as a purchased machine. The substance of this accounting transaction (treating a leased asset as though it had been purchased) takes precedence over the form of the transaction (the lease itself).

The business entity concept

The **business entity concept** is a boundary rule that ensures that financial accounting information relates only to the activities of the business entity and not to the other activities of its owners. An owner of a business may be interested in sailing and may buy a boat and pay a subscription as a member of the local yacht club. These activities are completely outside the activities of the business and such transactions must be kept completely separate from the accounts of the business.

The periodicity concept

The **periodicity concept** (or time interval concept) is a boundary rule. It is the requirement to produce financial statements at set time intervals. This requirement is embodied, in the case of UK companies, in the Companies Act 2006 (all future references to the Companies Act will relate to the Companies Act 2006 unless otherwise stated). Both annual and interim financial statements are required to be produced by **public limited companies (plcs)** each year.

Internal reporting of financial information to management may take place within a company on a monthly, weekly, daily, or even an hourly basis. But owners of a company, who may have no involvement in the running of the business or its internal reporting, require the external reporting of their company's accounts on a six-monthly and yearly basis. The owners of the company may then rely on the regularity with which the reporting of financial information takes place, which enables them to monitor company performance, and compare figures year on year.

The money measurement concept

The **money measurement concept** is a recording and measurement rule that enables information relating to transactions to be fairly compared by providing a commonly accepted unit of converting quantifiable amounts into recognisable measures. Most quantifiable data are capable of being converted, using a common denominator of money, into monetary terms. However, accounting deals only with those items capable of being translated into monetary terms, which imposes a limit on the scope of accounting to report such items. You may note, for example, that in a university's balance sheet there is no value included for its human resources, that is its lecturers, managers, and secretarial and support staff.

The historical cost concept

The **historical cost concept** is a recording and measurement rule that relates to the practice of valuing assets at their original acquisition cost. For example, you may have bought a mountain bike two years ago for which you were invoiced and paid £150, and may now be wondering what it is currently worth.

One of your friends may consider it to be worth £175 because they feel that the price of new mountain bikes has increased over the past two years. Another friend may consider it to be worth only £100 because you have used it for two years and its condition has deteriorated. Neither of your friends may be incorrect, but their views are subjective and they are different. The only measure of what your bike is worth on which your friends may agree is the price shown on your original invoice, its historical cost.

Although the historical cost basis of valuation may not be as realistic as using, for instance, a current valuation, it does provide a consistent basis for comparison and almost eliminates the need for any subjectivity.

The realisation concept

The **realisation concept** is a recording and measurement rule and is the principle that increases in value should only be recognised on realisation of assets by arm's-length sale to an independent purchaser. This means, for example, that sales revenue from the sale of a product or service is recognised in accounting statements only when it is realised. This does not mean when the cash has been paid over by the customer; it means when the sale takes place, that is when the product or service has been delivered, and ownership is transferred to the customer. Very often, salespersons incorrectly regard a 'sale' as the placing of an order by a customer because they are usually very optimistic and sometimes forget that orders can get cancelled. Accountants, being prudent individuals, ensure that sales are correctly recorded through the issuing of an invoice when services or goods have been delivered (and installed).

The dual aspect concept

The **dual aspect concept** is the recording and measurement rule that provides the basis for double-entry bookkeeping. It reflects the practical reality that every transaction always includes both the giving and receiving of value. For example, a company may pay out cash in return for a delivery into its warehouse of a consignment of products that it subsequently aims to sell. The company's reduction in its cash balance is reflected in the increase in its inventory of products.

The materiality concept

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged, its significance, in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic that information must have if it is to be useful. The **materiality concept** is the overriding recording and measurement rule, which allows a certain amount of judgement in the application of all the other accounting concepts. The level of materiality, or significance, will depend on the size of the organisation and the type of revenue or cost, or asset or liability being considered. For example, the cost of business stationery is usually charged as an expense regardless of whether or not all the items have been used; it would be pointless to try and attribute a value to such relatively low-cost unused items.

True and fair view

The term **true and fair view** was introduced in the Companies Act 1947, requiring that companies' reporting of their accounts should show a true and fair view. It was not defined in that Act and has not been defined since. Some writers have suggested that conceptually it is a dynamic concept but over the years it could be argued that it has failed, and various business scandals and collapses have occurred without users being alerted. The concept of true and fair was adopted by the European Community Council in its fourth directive, implemented by the UK in the Companies Act 1981, and subsequently in the implementation of the seventh directive in the Companies Act 1989 (sections 226 and 227). Conceptually the directives require additional information where individual provisions are insufficient.

In practice true and fair view relates to the extent to which the various principles, concepts and standards of accounting have been applied. It may therefore be somewhat subjective and subject to change as new accounting rules are developed, old standards replaced and new standards introduced. It may be interesting to research the issue of derivatives and decide whether the true and fair view concept was invoked by those companies that used or marketed these financial instruments, and specifically consider the various collapses or public statements regarding losses incurred over the past few years. Before derivatives, the issue which escaped disclosure in financial reporting under true and fair view was leasing.

UK accounting and financial reporting standards

A number of guidelines, or standards (some of which we have already discussed), have been developed by the accountancy profession to ensure truth, fairness and consistency in the preparation and presentation of financial information.

A number of bodies have been established to draft accounting policy, set accounting standards, and to monitor compliance with standards and the provisions of the Companies Act. The Financial Reporting Council (FRC), whose chairman is appointed by the Secretary of State for Business, Innovation and Skills and the Bank of England, develops accounting standards policy and gives guidance on issues of public concern. The ASB, which is composed of members of the accountancy profession, and on which the Government has an observer status, has responsibility for development, issue and withdrawal of accounting standards.

The accounting standards are called Financial Reporting Standards (FRSs). Up to 1990 the accounting standards were known as **Statements of Standard Accounting Practice (SSAPs)**, and were issued by the Accounting Standards Committee (ASC), the forerunner of the ASB. Although some SSAPs have now been withdrawn there are, in addition to the new FRSs, a large number of SSAPs that are still in force.

The ASB is supported by the Urgent Issues Task Force (UITF). Its main role is to assist the ASB in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. The UITF also deals with issues that need to be resolved more quickly than through the issuing of an accounting standard. A recent example of this was the guidance on the accounting aspects of a recent EU directive which makes producers of electrical equipment responsible for financing waste management costs of their products, such as the costs of collection, treatment and environmentally sound disposal. The Financial Reporting Review Panel (FRRP) reviews comments and complaints from users of financial information. It enquires into the annual accounts of companies where it appears that the requirements of the Companies Act, including the requirement that annual accounts shall show a true and fair view, might have been breached. The Stock Exchange rules covering financial disclosure of publicly quoted companies require such companies to comply with accounting standards and reasons for non-compliance must be disclosed.

Pressure groups, organisations and individuals may also have influence on the provisions of the Companies Act and FRSs (and SSAPs). These may include some Government departments (for example HM Revenue & Customs and the Office of Fair Trading) in addition to the Department for Business, Innovation and Skills (BIS) and employer organisations such as the Confederation of British Industry (CBI), and professional bodies like the Law Society, Institute of Directors, and Chartered Management Institute.

There are therefore many diverse influences on the form and content of company accounts. In addition to legislation, standards are continually being refined, updated and replaced and further enhanced by various codes of best practice. As a response to this the UK Generally Accepted Accounting Practice (UK GAAP), first published in 1989, includes all practices that are considered to be permissible or legitimate, either through support by statute, accounting standard or official pronouncement, or through consistency with the needs of users and of meeting the fundamental requirement to present a true and fair view, or even simply through authoritative support in the accounting literature. UK GAAP is therefore a dynamic concept, which changes in response to changing circumstances.

Within the scope of current legislation, best practice and accounting standards, each company needs to develop its own specific **accounting policies**. Accounting policies are the specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position. Examples are the various alternative methods of valuing inventories of materials, or charging the cost of a machine over its useful life, that is, its depreciation.

The accounting standard that deals with how a company chooses, applies and reports on its accounting policies is called FRS 18, Accounting Policies, and was issued in 2000 to replace SSAP 2, Disclosure of Accounting Policies. FRS 18 clarified when profits should be recognised (the realisation concept), and the requirement of 'neutrality' in financial statements in neither overstating gains nor understating losses (the prudence concept). This standard also emphasised the increased importance of the going concern concept and the accruals concept. The aims of FRS 18 are:

- to ensure that companies choose accounting policies that are most suitable for their individual circumstances, and incorporate the key characteristics stated in Chapter 3 of the SOP
- to ensure that accounting policies are reviewed and replaced as necessary on a regular basis
- to ensure that companies report accounting policies, and any changes to them, in their annual reports and accounts so that users of that information are kept informed.

Whereas FRS 18 deals with the disclosure by companies of their accounting policies, FRS 3, Reporting Financial Transactions, deals with the reporting by companies of their financial performance. Financial performance relates primarily to the income statement, whereas financial position relates primarily to the balance sheet. FRS 3 aims to ensure that users of financial information get a good insight into the company's performance during the period to which the accounts relate. This is in order that decisions made about the company may be made on an informed basis. FRS 3 requires the following items to be included in company accounts to provide the required level of reporting on financial performance (all to be discussed in greater detail in Chapter 4 which is about the income statement, and Chapter 8, which looks at published reports and accounts):

- analysis of sales, cost of sales, operating expenses and profit before interest
- exceptional items
- extraordinary items
- statement of recognised gains and losses (a separate financial statement along with the balance sheet, income statement and statement of cash flows).

Progress check 1.3

What is meant by accounting concepts and accounting standards, and why are they needed? Give some examples.

International accounting standards

The International Accounting Standards Committee (IASC), set up in 1973, which is supported by each of the major professional accounting bodies, fosters the harmonisation of accounting standards internationally. To this end each UK FRS (Financial Reporting Standard) includes a section explaining its relationship to any relevant international accounting standard.

There are wide variations in the accounting practices that have been developed in different countries. These reflect the purposes for which financial information is required by the different users of that information, in each of those countries. There is a different focus on the type of information and the relative importance of each of the users of financial information in each country. This is because each country may differ in terms of:

- who finances the businesses – individual equity shareholders, institutional equity shareholders, debenture holders, banks, etc.
- tax systems either aligned with or separate from accounting rules
- the level of government control and regulation
- the degree of transparency of information.

The increase in international trade and globalisation has led to a need for convergence, or harmonisation, of accounting rules and practices. The IASC was created in order to develop international accounting standards, but these have been slow in appearing because of the difficulties in bringing together differences in accounting procedures. Until 2000 these standards were called International Accounting Standards (IASs). The successor to the IASC, the IASB (International Accounting Standards Board), was set up in April 2001 to make financial statements more comparable on a worldwide basis. The IASB publishes its standards in a series of pronouncements called International Financial Reporting Standards (IFRSs). It has also adopted the body of standards issued by the IASC, which continue to be designated IASs.

The former chairman of the IASB, Sir David Tweedie, who retired in June 2011, said that 'the aim of the globalisation of accounting standards is to simplify accounting practices and to make it easier for investors to compare the financial statements of companies worldwide'. He also said that 'this will break down barriers to investment and trade and ultimately reduce the cost of capital and stimulate growth' (*Business Week*, 7 June 2004). On 1 January 2005 there was convergence in the mandatory application of the IFRSs by listed companies within each of the European Union member states. The impact of this should be negligible with regard to the topics covered in this book, since UK accounting standards have already moved close to international standards. The reason for this is that the UK SOP was drawn up using the 1989 IASB conceptual framework for guidance. A list of current IFRSs and IASs is shown in Appendix 1 at the end of this book.

At the time of writing this book, major disagreements between the EU and accountants worldwide over the influence of the EU on the process of developing International Accounting Standards are causing concern that the dream of the globalisation of accounting standards may not be possible (see the article below from the 5 April 2010 edition of the *Financial Times*).

FT

Who controls the IASB?

The European Union's new internal market commissioner has proposed reforms to the body that sets international accounting rules, infuriating accountants and potentially scotching fragile hopes of global convergence.

In an apparent power grab by Brussels, Michel Barnier has suggested future funding of the International Accounting Standards Board might depend on whether it bows to political pressure from the European Commission to make changes to its governance.

Mr Barnier's suggestion, made at a meeting of top accountants and regulators in London, stunned the accounting community by raising questions about IASB independence during crucial talks to establish an international set of accounting rules.

The Group of 20 most industrialised nations last September pledged support for a single set of accounting standards to improve capital flows and reduce cross-border arbitrage in response to the financial crisis. However, achieving consensus is proving increasingly difficult.

Crucially, many European policymakers believe prudential regulators should be more involved in IASB governance so that accounting can be used as a tool for financial stability.

But accountants and business leaders – particularly in the US and Japan – argue that accounts should not be the subject of regulatory intervention but should focus on providing an accurate snapshot of a company's value.

During an increasingly tense meeting on future funding for the IASB, Mr Barnier said that "the two issues of financing and governance can be linked".

"We want to see more issuers – more banks and more companies – and more prudential regulators represented on the governing board [of the IASB]", he said.

Mr Barnier went on to say that it was "premature" to expect the EU to increase its annual £4.3m ($6.5m) budget contribution for the IASB. Moreover, Brussels intended to reconsider its funding annually.

Senior accountants said Mr Barnier's salvo could bring Brussels into conflict with the US and Asia and derail the convergence process.

More than 110 countries, including most of Europe and Asia, use the International Financial Reporting Standards drawn up by the IASB. US companies continue to report under Generally Accepted Accounting Principles while regulators consider whether to endorse IFRS.

Source: **Push for accounting convergence threatened by EU reform drive,** by Rachel Sanderson © *Financial Times*, 5 April 2010

Progress check 1.4

What is the significance of the International Financial Reporting Standards (IFRSs) that have been issued by the IASB?

Worked example 1.1

Young Fred Osborne decided that he would like to start to train to become an accountant. Some time after he had graduated (and after an extended backpacking trip across a few continents) he registered with the Chartered Institute of Management Accountants (CIMA). At the same time Fred started employment as part of the graduate intake in the finance department of a large engineering group. The auditors came in soon after Fred started his job and he was intrigued and a little confused at their conversations with some of the senior accountants. They talked about accounting concepts and this standard and that standard, SSAPs, FRSs, and IFRSs, all of which meant very little to Fred. Fred asked his boss, the Chief Accountant Angela Jones, if she could give him a brief outline of the framework of accounting one evening after work over a drink.

Angela's outline might have been something like this:

- Accounting is supported by a number of rules, or concepts, that have evolved over many hundreds of years, and by accounting standards to enable consistency in reporting through the preparation of financial statements.
- Accounting concepts relate to the framework within which accounting operates, ethical considerations and the rules relating to measurement of data.
- A number of concepts relate to the boundaries of the framework: business entity; going concern; periodicity.
- A number of concepts relate to accounting principles or ethics: consistency; prudence; substance over form.
- A number of concepts relate to how data should be measured and recorded: accruals; separate valuation; money measurement; historical cost; realisation; materiality; dual aspect.
- Accounting standards are formulated by a body comprised of members of the accounting institutes (Accounting Standards Board – ASB) and are guidelines which businesses are recommended to follow in the preparation of their financial statements.
- The original standards were the Statements of Standard Accounting Practice (SSAPs) which have been and continue to be superseded by the Financial Reporting Standards (FRSs).
- The aim of the SSAPs/FRSs is to cover all the issues and problems that are likely to be encountered in the preparation of financial statements and they are the authority to ensure that 'financial statements of a **reporting entity** give a true and fair view of its state of affairs at the balance sheet date and of its profit or loss for the financial period ending on that date' (as quoted from the ASB foreword to *Accounting Standards*).
- SSAPs were promulgated by the Accounting Standards Committee (ASC) and FRSs are promulgated by the ASB.
- In recent years the International Accounting Standards Board (IASB), which is an independent standard-setting board based in the UK, has sought to develop a set of high-quality globally accepted financial reporting standards based upon clearly articulated accounting principles.
- From 2005 all listed companies in the EU have been required to prepare their financial statements in accordance with the standards of the IASB, which are called International Financial Reporting Standards (IFRSs).

There is considerable convergence between the international and UK standards and indeed the ASB develops and amends its standards in the light of IFRSs.

Financial accounting, management accounting and financial management

The provision of a great deal of information, as we shall see as we progress through this book, is mandatory; it is needed to comply with, for example, the requirements of Acts of Parliament, and HM Revenue & Customs. However, there is a cost of providing information that has all the features that have been described, which therefore renders it potentially useful information. The benefits from producing information, in addition to mandatory information, should therefore be considered and compared with the cost of producing that information to decide on which information is 'really' required.

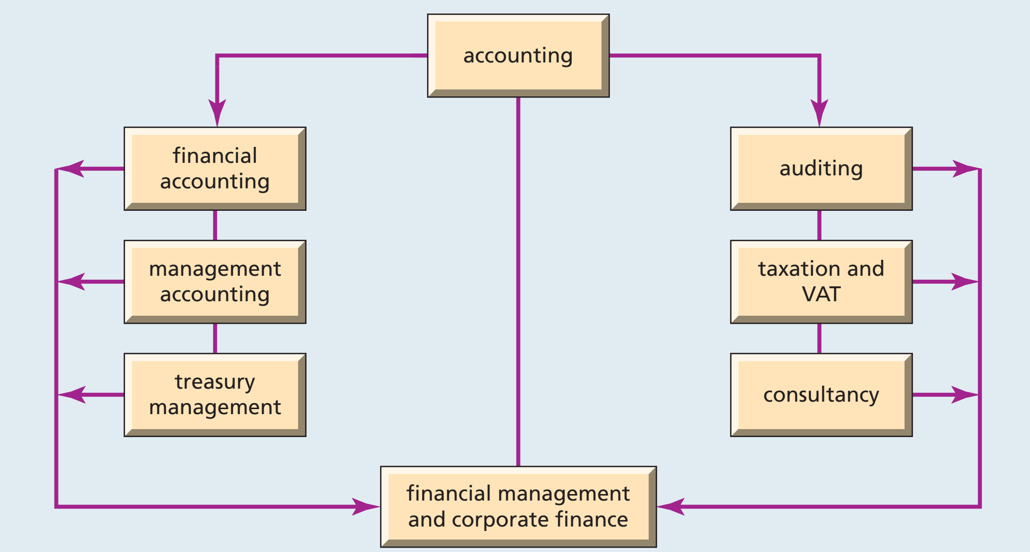
Accountants may be employed by accounting firms, which provide a range of accounting-related services to individuals, companies, public services and other organisations. Alternatively, accountants may be employed within companies, public services and other organisations. Accounting firms may specialise in **audit**, corporate taxation, personal taxation, VAT, or consultancy (see the right-hand column of Figure 1.3). Accountants within companies, public service organisations etc., may be employed in the main functions of **financial accounting**, **management accounting**, and **treasury management** (see the left-hand column of Fig. 1.3), and also in general management. Accounting skills may also be required in the areas of **financial management** and corporate finance. Within companies this may include responsibility for investments, and the management of cash and foreign currency risk. External to companies this may include advice relating to mergers and acquisitions, and Stock Exchange **flotations**.

Financial accounting

Financial accounting is primarily concerned with the first question answered by accounting information, the scorecard function. Taking a car-driving analogy, financial accounting makes greater use of the rear-view mirror than the windscreen; financial accounting is primarily concerned with historical information.

Financial accounting is the function responsible in general for the reporting of financial information to the owners of a business, and specifically for preparation of the periodic external reporting of financial information, statutorily required, for shareholders. It also provides similar information as required for Government and other interested third parties, such as potential

Figure 1.3 Branches of accounting



investors, employees, lenders, suppliers, customers and financial analysts. Financial accounting is concerned with the three key financial statements: the **balance sheet**; **income statement**; **statement of cash flows**. It assists in ensuring that financial statements are included in published reports and accounts in a way that provides ease of analysis and interpretation of company performance.

The role of financial accounting is therefore concerned with maintaining the scorecard for the entity. Financial accounting is concerned with the classification and recording of the monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and their presentation, by means of income statements, balance sheets and statements of cash flows, during and at the end of an **accounting period**.

Within most companies, the financial accounting role usually involves much more than the preparation of the three main financial statements. A great deal of analysis is required to support such statements and to prepare information both for internal management and in preparation for the annual audit by the company's external **auditors**. This includes sales analyses, bank reconciliations, and analyses of various types of expenditure.

A typical finance department has the following additional functions within the financial accounting role: control of **accounts payable** to suppliers (the **purchase ledger**); control of **accounts receivable** from customers (the **sales ledger**), and credit control; control of cash (and possible wider treasury functions) including cash payments, cash receipts, managers' expenses, petty cash and banking relationships. The financial accounting role also usually includes responsibility for payroll, whether processed internally or by an external agency. However, a number of companies elect to transfer the responsibility for payroll to the personnel, or human resources department, bringing with it the possibility of loss of **internal control**.

The breadth of functions involved in financial accounting can require the processing of high volumes of data relating to purchase invoices, supplier payments, sales invoices, receipts from customers, other cash transactions, petty cash, employee expense claims and payroll data. Control and monitoring of these functions therefore additionally requires a large number of reports generated by the accounting systems, for example:

- analysis of trade receivables (debtors): those who owe money to the company – by age of debt
- analysis of trade payables (creditors): those to whom the company owes money – by age of invoice
- sales analyses
- cheque and automated payments
- records of non-current assets
- invoice lists.

Management accounting

Past performance is never a totally reliable basis for predicting the future. However, the vast amount of data required for the preparation of financial statements, and maintenance of the further subsidiary accounting functions, provides a fertile database for use in another branch of accounting, namely management accounting.

Management accounting is primarily concerned with the provision of information to managers within the organisation for product costing, planning and control, and decision-making, and is to a lesser extent involved in providing information for external reporting.

The functions of management accounting are wide and varied. Whereas financial accounting is primarily concerned with past performance, management accounting makes use of historical data, but focuses almost entirely on the present and the future. Management accounting is involved with the scorecard role of accounting, but in addition is particularly concerned with the other two areas of accounting, namely problem-solving and attention-directing. These include cost analysis, decision-making, sales pricing, forecasting and budgeting, all of which will be discussed later in this book.

Financial management

Financial management has its roots in accounting, although it may also be regarded as a branch of applied economics. It is broadly defined as the management of all the processes associated with the efficient acquisition and deployment of both short- and long-term financial resources. Financial management assists an organisation's operations management to reach its financial objectives. This may include, for example, responsibility for corporate finance and treasury management, which is concerned with cash management, and the management of interest rate and foreign currency exchange rate risk.

The management of an organisation generally involves the three overlapping and interlinking roles of strategic management, risk management and operations management. Financial management supports these roles to enable management to achieve the financial objectives of the shareholders. Financial management assists in the reporting of financial results to the users of financial information, for example shareholders, lenders and employees.

The responsibility of the finance department for financial management includes the setting up and running of reporting and control systems, raising and managing funds, the management of relationships with financial institutions, and the use of information and analysis to advise management regarding planning, policy and capital investment. The overriding requirement of financial management is to ensure that the financial objectives of the company are in line with the interests of the shareholders; the underlying fundamental objective of a company is to maximise shareholder wealth.

Financial management, therefore, includes both accounting and treasury management. Treasury management includes the management and control of corporate funds, in line with company policy. This includes the management of banking relationships, borrowings and investment. Treasury management may also include the use of the various financial instruments, which may be used to hedge the risk to the business of changes in interest rates and foreign currency exchange rates, and advising on how company strategy may be developed to benefit from changes in the economic environment and the market in which the business operates. This book will identify the relevant areas within these subjects, which will be covered as deeply as considered necessary to provide a good introduction to financial management.

As management accounting has continued to develop its emphasis on decision-making and strategic management, and broaden the range of activities that it supports, it has now come to be regarded as an integral part of financial management.

Worked example 1.2

A friend of yours is thinking about pursuing a career in accounting and would like some views on the major differences between financial accounting, management accounting and financial management.

The following notes provide a summary that identifies the key differences.

Financial accounting: The financial accounting function deals with the recording of past and current transactions, usually with the aid of computerised accounting systems. Of the various reports prepared, the majority are for external users, and include the income statement, balance sheet, and the statement of cash flows. In a plc, such reports must be prepared at least every 6 months, and must comply with current legal and reporting requirements.

Management accounting: The management accounting function works alongside the financial accounting function, using a number of the day-to-day financial accounting reports from the accounting system. Management accounting is concerned largely with looking at current issues and problems and the future in terms of decision-making and forecasting, for example the consideration of 'what if' scenarios during the course of preparation of forecasts and budgets. Management accounting outputs are mainly for internal users, with much confidential reporting, for example to the directors of the company.

Financial management: Financial management may include responsibilities for corporate finance and the treasury function. This includes the management and control of corporate funds, within parameters specified by the board of directors. The role often includes the management of company borrowings, investment of surplus funds, the management of both interest rate and exchange rate risk, and giving advice on economic and market changes and the exploitation of opportunities. The financial management function is not necessarily staffed by accountants. Plcs report on the treasury activities of the company in their periodic reporting and financial review.

Some of the important functions in which management accounting and financial management may be involved include:

- forecasting revenues and costs
- planning activities
- managing costs
- identifying alternative sources and costs of funding
- managing cash
- negotiations with bankers
- evaluation of investments
- measurement and control of performance
- union negotiations
- negotiating with government
- costing compliance with social, environmental and sustainability requirements.

Progress check 1.5

What are the main differences between financial accounting, management accounting and financial management?

Accounting and accountancy

Accounting is sometimes referred to as a process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information, and also to provide information, which is potentially useful for making economic and social decisions. The term 'accounting' may be defined as:

- the classification and recording of monetary transactions
- the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date
- the monetary projection of future activities arising from alternative planned courses of action.

Accounting processes are concerned with how data are measured and recorded and how the accounting function ensures the effective operation of accounting and financial systems. Accounting processes follow a system of recording and classification of data, followed by summarisation of financial information for subsequent interpretation and presentation. An accounting system is a series of tasks and records of an entity by which the transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions.

Most companies prepare an accounting manual that provides the details and responsibilities for each of the accounting systems. The accounting manual is a collection of accounting instructions governing the responsibilities of persons, and the procedures, forms and records relating to preparation and use of accounting data.

There may be separate accounting manuals for the constituent parts of the accounting system, for example:

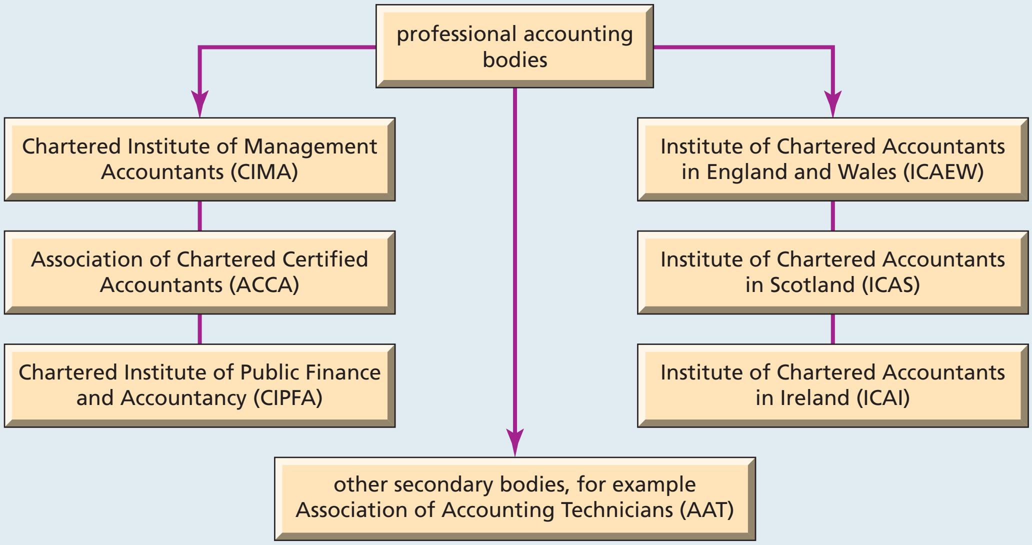
- financial accounting manual – general ledger and coding
- management accounting manual – budget and cost accounting
- financial management/treasury manual – bank reconciliations and foreign currency exposure management.

Accountancy is defined as the practice of accounting. A **qualified accountant** is a member of the accountancy profession, and in the UK is a member of one of the six professional accountancy bodies (see Figure 1.4). An accountant becomes qualified within each of these institutes through passing a large number of extremely technically demanding examinations and completion of a mandatory period of three years' practical training. The examination syllabus of each of the professional bodies tends to be very similar; each body provides additional emphasis on specific areas of accounting.

Chartered Management Accountants (qualified members of CIMA) receive their practical training in industrial and commercial environments, and in the public sector, for example the NHS. They are involved in practical accounting work and development of broader experience of strategic and operational management of the business. Certified Accountants (qualified members of ACCA) and Chartered Accountants (qualified members of ICAEW, ICAS, or ICAI) usually receive training while working in a practising accountant's office, which offers services to businesses and the general public, but may also receive training while employed in industrial and commercial organisations. Training focuses initially on auditing, and may then develop to include taxation and general business advice. Many accountants who receive training while specialising in central and local government usually, but not exclusively, are qualified members of CIPFA.

There are also a number of other accounting bodies like the Association of Accounting Technicians (AAT), Association of International Accountants, and Association of Authorised Public Accountants. The AAT, for example, provides bookkeeping and accounting training through examination and

Figure 1.4 The professional accounting bodies



experience to a high level of competence, but short of that required to become a qualified accountant. Treasury management is served by the Association of Corporate Treasurers (ACT). This qualification has tended to be a second qualification for accountants specialising in corporate funding, cash and working capital management, interest rate and foreign currency exchange rate risk management. In the same way, the Institute of Taxation serves accountants who are tax specialists.

Progress check 1.6

What services does accounting offer and why do businesses need these services?

Worked example 1.3

Of which professional bodies are accountants likely to be members if they are employed as auditors, or if they are employed in the industrial and commercial sectors, or if they are employed in local government?

The following list of each of the types of professional accounting bodies links them with the sort of accounting they may become involved in.

Chartered Institute of Management Accountants (CIMA): management accounting and financial accounting roles with a focus on management accounting in the industrial and commercial sectors, and strategic and operational management

Institutes of Chartered Accountants (ICAEW, ICAS, ICAI): employment within a firm of accountants, carrying out auditing, investigations, taxation and general business advice – possible opportunities to move into an accounting role in industry