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FINANCIAL ACCOUNTING

JILL COLLIS

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PREFACE TO FINANCIAL ACCOUNTING

With tuition fees at a high level, many students find the purchase of a traditional textbook is something that they have to compromise on, and either rely on the lecturer's handouts or borrow books from the library or friends. Unfortunately, this approach is rarely successful as it can only provide a partial and superficial understanding of the subject. This is particularly true of accounting, which many students find difficult.

The book is part of Palgrave's 'Business Briefings' series. It is designed to be succinct, but cover the basics of the subject. This means it is likely to be much more affordable. Students will still need to consult other texts to widen their knowledge of the subject, but this book offers a good introduction and can easily be used for revision purposes.

Most accounting courses taught in universities and colleges follow a syllabus that reflects the professional exams taken by accountants. This book covers the main topics associated with financial accounting in a logical sequence. It starts by explaining the accountancy profession and the nature and purpose of accounting, and setting the business context. It then moves on to explain the double-entry bookkeeping system and how the trial balance provides data for preparing the annual financial statements. This is followed by an explanation of the fundamental accounting principles, the main elements of the regulatory framework and the conceptual framework that underpins the development of International Financial Reporting Standards. Sequential chapters take the reader through the preparation of financial statements for a small company. Attention then switches to the preparation of consolidated financial statements for a group entity. The focus on large companies continues in the final chapter, which explains the techniques used to analyse published financial statements.

Each chapter has the same structure:

Objectives
Introduction
Main content
Key points
Revision questions

The main content of each chapter explains the basics of the topic, and case studies are used as examples or to show how the techniques are applied. The case studies are chosen to reflect business reality and some are real business cases.

The key points section is a useful summary of the chapter and will be invaluable as part of a revision strategy. The revision questions are based on the material covered in the chapter and should allow the reader to gauge his or her understanding of the concepts and techniques covered. Solutions and indicative model answers to these questions can be found at the end of the book as well as on the companion website: www.palgrave.com/companion/Collis-Financial-Accounting.

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1

INTRODUCTION TO FINANCIAL ACCOUNTING

1.1 OBJECTIVES

This chapter provides an introduction to accounting in a business context, and financial accounting in particular. After studying this chapter, you should be able to:

- Identify the main professional accountancy bodies.
- Explain the need for a code of ethics for professional accountants.
- Explain the nature and purpose of accounting.
- Distinguish between financial accounting and management accounting.
- Compare different types of business entity.

1.2 THE ACCOUNTANCY PROFESSION

A professional accountant in the UK or the Republic of Ireland must pass a number of rigorous examinations set by one of the recognised accountancy bodies and pay an annual subscription to become a member of that body. The examinations cover a wide range of topics such as business and finance, financial and management accounting, financial reporting, auditing, taxation, law, business strategy and financial management. Table 1.1 shows the worldwide membership of the chartered accountancy bodies, plus one other body that offers a recognised audit qualification, at 31 December 2014.

Once qualified, accountants can set up in practice on their own or with partners, or seek employment in an existing accountancy practice. Others may choose to work as accountants in industry and commerce, or in the public or voluntary sectors. Some accountants qualify with a view to working in the family business, and those with entrepreneurial ideas may choose to start a new enterprise.

Large businesses are likely to have sufficient resources to employ a number of accounting and finance specialists, whereas medium-sized entities may employ one

Table 1.1 Worldwide membership of UK and Irish accountancy bodies

	Number	%
Association of Chartered Certified Accountants (ACCA)	174,227	36
Institute of Chartered Accountants in England and Wales (ICAEW)	144,167	30
Chartered Institute of Management Accountants (CIMA)	99,942	20
Chartered Accountants Ireland (CAI)	23,778	5
Institute of Chartered Accountants in Scotland (ICAS)	20,401	4
Chartered Institute of Public Finance and Accountancy (CIPFA)	13,327	3
Association of International Accountants (AIA)	9,250	2
Total	485,092	100

Source: FRC, 2015, p. 11

accountant who is responsible for financial and management accounting functions, supported by other staff, such as a credit controller and bookkeeper. Very small entities often find it more cost effective to use an external accountant.

Professional accountants have a duty to serve the public interest because they are involved in the preparation and auditing of published financial information. Accountants and auditors are guided in their work by a code of ethics. *Ethics* are moral principles that underpin what is considered right and wrong in society, and how people should behave (Waite, 2012).

Activity
How ethical are you? Imagine you came out of a restaurant and found that the waiter had not charged you for your dessert. Would you go back and tell him?

You have to ask yourself whether you would be happy to tell everyone (not just your friends, but your family and your teachers or boss) and how you would defend your actions if you were challenged. An ethical person would go back and tell the waiter or the manager, so the correct answer is 'Yes'. The important thing to realise is that ethics are not always about what other people might do, but about honesty and personal integrity.

The need for high values and consistent, ethical behaviour across the accountancy profession led to the development of an international code of ethics by the International Ethics Standards Board of Accountants (IESBA). The *Code of Ethics for Professional Accountants* (the IESBA Code) is published by the *International Federation of Accountants (IFAC)*, which is an association of professional bodies of accountants throughout the world. IFAC was founded in 1977 and in 2014 had 172 members and associates in 129 countries and jurisdictions, representing approximately 2.5 million accountants (including those in Table 1.1).

The IESBA Code requires a professional accountant to comply with five fundamental principles (IESBA, 2013, para 100.5):

(a) Integrity – to be straightforward and honest in all professional and business relationships.
(b) Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional judgments.
(c) Professional Competence and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.
(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships, and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.
(e) Professional Behavior – to comply with relevant laws and regulations and to avoid any action that discredits the profession.

Activity
Jane Goodfellow is an accountant at Vinyl Products Ltd. She recently noticed that the price of one of the materials used in the production process had gone up significantly, and this coincided with a change of supplier. When she tried asking the purchasing manager, Simon Buckfast, about it, he more or less told her to mind her own business, adding, "I've known the managing director of this new supplier for years and, in any case, it's my job to decide which suppliers we use!" Around this time, Jane also noticed that Simon had started driving an expensive new car to work. She suspects that the two events are connected, which might indicate fraud. Should she (a) turn a blind eye, (b) challenge Simon further, or (c) discuss the matter with another senior manager?

The facts are that the cost of materials has risen as a result of changing the supplier and Simon is responsible for the decision. Jane has an ethical dilemma because she is concerned about Simon's dismissive response, weak justification for the change in supplier, and luxurious new car. She suspects fraud and wonders what the best action would be. To ensure that she behaves with integrity, objectivity and professional competence, she should take action (b) followed by (c) if necessary.

1.3 NATURE AND PURPOSE OF ACCOUNTING

In its broadest form, accounting is a service provided to those who need financial information. In everyday language, *accounting* for something means giving an explanation or report on something. The following definition is taken from the *Oxford Dictionary of Accounting*.

> ***Definition***
> Accounting is the process of identifying, measuring, recording and communicating economic transactions.
>
> Source: Law, 2010, p. 6

This book is concerned with the role of accounting in the private sector rather than public or voluntary contexts, so *economic transactions* refer to the money-making activities of the business that are directed at creating wealth for the owner(s). We will now examine each stage in the accounting process:

- Identifying economic transactions is fairly straightforward in most cases. Examples include selling goods and services to customers, paying employees, purchasing inventories (goods for resale) and buying equipment (for use in the business) from suppliers. It is also important to distinguish between the economic transactions of the business and the personal economic transactions of the owner(s) and manager(s). Thus, the first stage in the accounting process leads to the classification of the economic transactions of the business into categories, such as purchase, sales revenue and salaries.
- Measuring economic transactions in monetary terms is convenient. It also makes it easier to aggregate, summarise and compare transactions.
- Recording economic transactions is essential. Traditionally transactions were recorded in handwritten books of accounts known as ledgers, but today most businesses record transactions in a computerised accounting system. Small businesses may use spreadsheets or a simple accounting software package, but larger businesses with a wider range and volume of transactions use sophisticated software that may form part of an enterprise resource planning system.

- Communicating economic transactions is achieved by generating a variety of financial statements from the records in the accounting system. These are presented in a format that summarises a particular financial aspect of the business.

Activity
A business buys 5 litres of paint and 20 metres of timber, and employs a carpenter for two days to build shelves in an office. Paint costs £4 per litre, timber costs £2.50 per metre and the carpenter charges £50 per day. What is the total cost of the shelves?

The cost can be calculated in a number of stages. You need to multiply the cost of paint per litre by the amount used. You also need to multiply the cost of timber per metre by the amount used. Finally, you need to calculate the cost of employing the carpenter by multiplying his daily rate by the number of days. The order in which you work out the figures does not matter, as long as you arrive at three figures which, when added together, make up the total cost of the job:

	£
Cost of paint (£4 × 5 litres)	20
Cost of timber (£2.50 × 20 metres)	50
Cost of labour (£50 × 2 days)	100
Total cost of the shelves	170

In more complex examples it is not so easy to identify and measure the economic events in monetary terms. We will be looking at some of these problems in subsequent chapters.

The *purpose of accounting* in the private sector is to provide financial information that helps the business achieve its objectives. This might be to maximise profits or to make sufficient profit to maintain the lifestyle desired by the owner(s).

1.4 OVERVIEW OF FINANCIAL ACCOUNTING

Accounting can be divided into two main branches: financial accounting and management accounting. The purpose of *financial accounting* is to provide financial information to meet the needs of external users (those not involved in managing the business). On the other hand, the purpose of *management accounting* is to provide managers with financial and other quantitative information to help them carry out their responsibilities for planning, controlling and decision making. The emphasis is on providing information to internal users that will help the business entity achieve its financial objectives. Unlike financial accounting, management accounting is not governed by regulations.

> ***Definition***
> Financial accounting is the branch of accounting concerned with classifying, measuring and recording the economic transactions of an entity in accordance with established principles, legal requirements and accounting standards. It is primarily concerned with communicating a true and fair view of the financial performance and financial position of an entity to external parties at the end of the accounting period.
>
> Source: Collis, Holt and Hussey, 2012, p. 15

The term *true and fair view* implies that the financial statements produced at the end of an accounting period (usually one year) are a faithful representation of the entity's economic activities. The financial statements of limited liability entities are drawn up within a regulatory framework and are prepared using a number of accounting concepts which have been established as general principles. Generally, an entity's financial statements are considered to give a true and fair view if they comply with the regulatory framework and accounting principles. We will discuss this in the next chapter.

Financial accounting can be divided into the following main activities:

- *Bookkeeping* focuses on the recording of business transactions. Most small businesses use spreadsheets or standard accounting software, while large businesses are more likely to need tailor-made software.
- *Accounts preparation* involves the compilation of financial statements for external users, such as shareholders, tax authorities, lenders or major suppliers and customers.
- *Auditing* involves a thorough examination of the entity's financial systems and records, tangible assets, management and employees, suppliers, customers and other business contacts. Auditors conduct compliance tests to assess the effectiveness of the systems of financial control and substantive tests to assess the completeness, ownership, existence, valuation and disclosure of the information in the accounting records and financial statements.

- *Corporate recovery* covers the provision of insolvency services and advice to companies in financial difficulty.
- *Advisory services* such as advice on taxation, raising finance, investment, pension planning, treasury management, IT and human resource management, or advice on running a business.

Although accounting can be divided into financial and management accounting, you should not be misled into thinking that there is no relationship between these two activities as they both draw on the same data. However, there are some important differences, which relate to the level of detail and timing of the information produced. Financial accounting operates on the basis of an annual reporting cycle, and the preparation of the financial statements of limited liability entities is highly regulated to ensure that external users receive high quality, reliable information. However, the annual report and accounts is not published until some months after the end of the financial year. By contrast, management accounting is not regulated at all, which means the information can be provided to internal users in the form they want it and as often as they want it. In both large and small businesses, detailed management accounting information for each activity in each part of the business is produced on a weekly, monthly or quarterly basis. If the periodic management accounts for the different parts of a business were aggregated, the totals would be very similar to the figures in the financial accounts, although there would be some differences. For example, the financial accounts would contain information on finance costs (such as interest paid on loans) and taxation, whereas the management accounts are likely to contain more estimated figures.

1.5 TYPES OF BUSINESS ENTITY

In the UK the legal form of businesses in the *private sector* can be classified into three main types:

- Sole proprietorships.
- Partnerships.
- Companies and other incorporated entities.

At the start of 2014, the number of private sector enterprises in the UK reached a record level of 5.2 million. Figure 1.1 shows how they were dispersed among the three main categories.

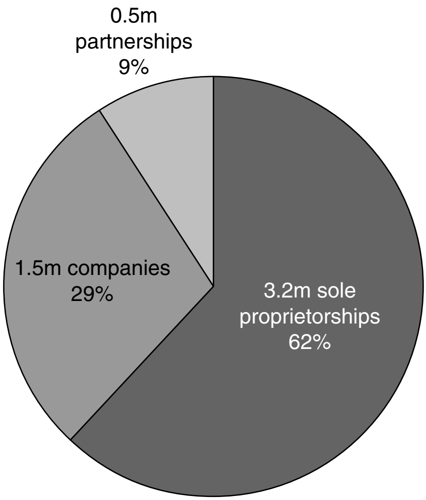

Figure 1.1 UK private sector enterprises by legal status
Source: BIS, 2014a, Table 3

The size of private sector enterprises ranges from very small businesses, such as sole proprietorships and one person companies with no employees, to large international companies with thousands of owners and employees. Of the total of 5.2 million businesses in the UK, 99.9% were small (fewer than 50 employees) or medium-sized (fewer than 250 employees) (BIS, 2014b, p. 1). In addition to providing a living for their owners, these small and medium-sized entities (SMEs) contributed to the economy by providing 60% of employment and 47% of turnover in the private sector.

The majority of smaller entities are owner-managed and family-owned (SBS, 2004; Collis, 2008). In larger businesses, it is more likely that ownership and control will become separated, and the owners will appoint managers to run the business on their behalf. Businesses also differ in terms of their legal status and in the groups of people who are likely to be interested in financial information about them.

To a large extent, the range of users of the financial information depends on the size of the business. For example, financial information relating to a small shop is likely to be used only by the owner-manager and the tax authorities, whereas financial information relating to a large international company will be of interest not only to managers within the business but also to investors, lenders, suppliers, customers and other external parties, such as competitors. Each user group needs financial information for a different purpose. A manager working in a division of a large company is likely to require detailed information in order to run the department, a bank lending officer contemplating lending £1 million to a business is likely to need information for assessing the lending risk and a supplier will need information for assessing the risk of supplying goods and/or services on credit to the business.

Accounting provides important financial information that helps businesses achieve their economic objectives. Some business owners want to increase their wealth by maximising profit while others simply want to make sufficient profit to maintain a certain lifestyle.

Sole proprietorships

The majority of businesses are *sole proprietorships*. A sole proprietorship is an unincorporated entity owned by one person who is in business with a view to making a profit. The business may be providing a service (for example, a window cleaner, hairdresser or business consultant), trading goods (for example a newsagent, florist or grocer) or making goods (for example, a cabinet maker, potter or dress designer). Alternatively, it may have activities in the primary sector (agriculture, forestry or fishing). The owner may run the business alone or employ staff.

The owner of a sole proprietorship has *unlimited liability*, which means that he or she is personally liable for any debts the business may incur. This liability extends beyond any original investment and could mean the loss of personal assets. There are no legal formalities to set up this type of business, but an entrepreneur wanting to start a sole proprietorship may experience difficulty in obtaining finance, as the capital is restricted to what he or she has available to invest, supplemented by what he or she can borrow. The owner must keep accounting records, but there is no obligation to disclose financial information to the public.

Partnerships

There are two types of *partnership*: unincorporated, ordinary partnerships and limited liability partnerships (LLPs). An *unincorporated partnership* is an entity in which two or more people join together in business with a view to making a profit. Unincorporated partnerships are a popular form of business for professional firms such as accountants, doctors, dentists and solicitors. The partners may run the business alone or employ staff.

The owners of an unincorporated partnership (the partners) have joint and several liability, which means they have unlimited liability for each other's acts in terms of any debts the business may incur. This liability extends beyond any original investment and could mean the loss of personal assets. The capital is restricted to what the partners have to invest, supplemented by what they can borrow. The *Business Names Act 1985* requires the names of the partners to be shown on business stationery, but they need not be used in the business name. The partners must keep accounting records, but there is no obligation to disclose financial information to the public.

The relationship between partners should be formalised in a partnership agreement. In the absence of a partnership agreement, or if the agreement does not cover a point in dispute, the *Partnership Act 1890* provides the following rules:

- Partners share equally in the profits or losses of the partnership.
- Partners are not entitled to receive salaries.
- Partners are not entitled to interest on their capital.
- Partners may receive interest at 5% per annum on any advances over and above their agreed capital.
- A new partner may not be introduced unless all the existing partners consent.
- A retiring partner is entitled to receive interest at 5% per annum on his or her share of the partnership assets retained in the partnership after his or her retirement.
- On dissolution of the partnership, the assets of the firm must be used first to repay outside creditors, second to repay partners' advances, and third to repay partners' capital. Any residue on dissolution should be distributed to the partners in the profit-sharing ratio (equally unless specified otherwise in the partnership agreement).

You may think that the partners do not need an agreement, because the Partnership Act 1890 sets out the relationship in case of dispute. However, relying on the Act means the rules of a standard agreement would be applied, which may not be appropriate to the circumstances.

Activity

Indicate which of these characteristics apply to the following types of business:

	Sole proprietorship	**Partnership**
(a) The entity is an unincorporated business	❑	❑
(b) There is no maximum number of owners	❑	❑
(c) There are no formalities involved when starting the business	❑	❑
(d) There should be a contract of agreement	❑	❑
(e) Accounting records must be kept	❑	❑

What sole proprietorships and unincorporated partnerships have in common is their unincorporated status, which means their owners have unlimited liability for any debts or losses incurred by the business. Of course, there is only one owner of a sole proprietorship, who is solely responsible, whereas the responsibility is shared in a partnership. A partnership can also raise more capital than a sole proprietorship because there it has at least two owners (there is no maximum number of partners). For the same reason, a greater range of skills is likely to be available in a partnership. There are no formalities involved in setting up a sole proprietorship, but the relationship between partners should be formalised in a partnership agreement. All businesses, regardless of legal status, must keep accounting records.

A *limited liability partnership (LLP)* is a partnership that through the process of incorporation acquires a legal status that is separate from that of its owners. An important advantage of an LLP is that each partner's liability for the debts and losses incurred by the business is limited to the amount of his or her investment in the business. There are two main exceptions to this limited liability:

- If a partner of an LLP is personally at fault, he or she may have unlimited liability if he or she accepted a personal duty of care or a personal contractual obligation.
- If an LLP becomes insolvent, the partners can be required to repay any property withdrawn from the LLP (including profits and interest) in the two years prior to insolvency. This applies where the partner could not reasonably have concluded that insolvency was likely.

LLPs are allowed to organise themselves internally in the same way as an unincorporated partnership, but the regulations that apply to them are similar to the requirements for companies. If one of the partners dies, his or her shares can be transferred to someone else and the business continues. On the other hand, when a partner in an unincorporated partnership dies, the partnership ceases. If the remaining partners want the business to continue, they need to form a new partnership, with or without additional partners.

Limited companies

The majority of limited liability entities are *limited companies*. A limited company is a business that through the process of incorporation acquires a legal status that is separate from that of its owners. The most common form of incorporation in the UK is through registration under the Companies Act 2006 (CA2006). The capital invested in the business is raised by selling shares to investors (hence the term *shareholder*), who are known as members. The capital invested in any type of business can be supplemented by loans and other forms of finance, such as trade credit from suppliers. Trade credit does not provide additional cash, but allows money already in the business to be used for other purposes until it is needed to pay creditors.

CA2006 defines a company as a limited company if the liability of its members is limited by its constitution. The company may be limited by shares or by guarantee. It is limited by shares if the members' liability is limited to the amount (if any) unpaid on the shares held by them. It is limited by guarantee if the members' liability is limited to such amount as they undertake to contribute to the assets of the company in the event of it being wound up.

> ***Definition***
> Limited liability refers to the extent to which members of a limited company or LLP are liable for payment of the debts of the business.

Limited companies can be divided into *private companies* and *public companies*. More than 99% are private companies. A private company is any company that is not a public company. A public company is a company limited by shares or limited by guarantee and having share capital. Most companies are start as private limited companies. If a company grows sufficiently large, its owners may decide to convert it into a public company under the re-registration procedure in CA2006. This allows the company to obtain a listing on a stock exchange and raise large amounts of capital. There are around 2,600 companies listed on the London Stock Exchange. Listed companies are important because they make a substantial contribution to the economy. Table 1.2 (opposite) compares the main characteristics of public and private companies in the UK.

Figure 1.2 summarises the different types of business entity we have described.

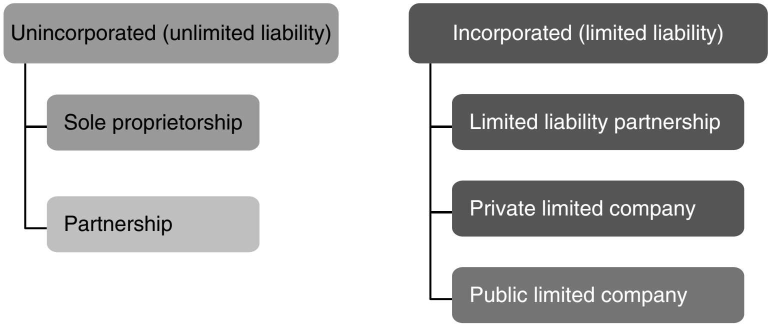

Figure 1.2 Types of business entity

Table 1.2 Main features of public and private companies

Public company	Private company
Must state in its memorandum of association that it is a public company	Defined as a company that is not a public company
Name must end with 'Public Limited Company' or 'PLC'	Name must end with 'Limited' or 'Ltd' or the Welsh equivalent
Can offer shares for sale on a stock exchange	Shares can be only be offered for sale privately
Must have at least one natural person not under 16 years of age as a director	Does not apply
Must have a company secretary (person or corporate) and hold an annual general meeting with members to pass resolutions	Does not apply
Must keep accounting records and publish financial statements complying with the Companies Act and accounting standards	Must keep accounting records and publish financial statements complying with the Companies Act and accounting standards
Must publish an annual report and accounts within 6 months of accounting year end	Must publish an annual report and accounts within 9 months of accounting year end
Extensive financial disclosure	Extent of financial disclosure depends on size and public interest

1.6 KEY POINTS

A professional accountant in the UK must pass a number of rigorous examinations set by one of the recognised accountancy bodies and pay an annual subscription to become a member of that body. Accounting can be divided into two main branches. Financial accounting focuses on providing financial information to be communicated to external users. Management accounting focuses on providing financial information to internal users. It is used by managers for planning, controlling and decision making to help the business achieve its financial objectives.

There are a number of different legal forms of business in the UK. An unincorporated enterprise can be a sole proprietorship or a partnership; an incorporated business can take the form of a limited liability partnership or a limited liability company. A limited liability company can be registered as a private company or a public company. The legal form of the business has financial implications in terms of ability to raise capital, disclosure of financial information and the owners' responsibility for the debts incurred by the business.

REVISION QUESTIONS

1. Describe how a student can become a qualified professional accountant and explain the need for a code of ethics for professional accountants.
2. Describe the key elements of the definition of accounting.
3. Compare and contrast the two main branches of accounting.
4. Explain the advantages and disadvantages of a setting up a one person business as a private limited company rather than a sole proprietorship.
5. Discuss the main differences between a public limited company and a private limited company in the UK, paying particular attention to the financial implications.