After reading this chapter you should be able to:

1. explain the meaning of the key terms and concepts listed at the end of the chapter;
2. describe the nature and functions of double-entry bookkeeping and financial accounting;
3. discuss the objectives and limitations of company annual accounts;
4. identify the users of annual reports and describe their information needs;
5. describe the legislation and other rules governing the contents of company annual reports;
6. describe the current institutional framework relating to the setting and enforcement of accounting standards.
The nature and functions of financial accounting

Financial accounting may be defined as the process of designing and operating an information system for collecting, measuring and recording an enterprise’s transactions, and summarizing and communicating the results of these transactions to users to facilitate making financial/economic decisions.

The first part of this definition, relating to collecting and recording transactions, refers to double-entry bookkeeping, which consists of maintaining a record of the nature and money value of the transactions of an enterprise. In many organizations this may be done using a computer. The second part of the definition, relating to communicating the results, refers to preparing final accounts and statements from the books of account (or any other system of recording), showing the profit earned during a given period and the financial state of affairs of a business at the end of that period.

These two functions of financial accounting may be broken down further as described below.

The recording and control of business transactions

This includes records of the following:

1. The amount of cash and cheques received, for what and from whom.
2. The amount of cash and cheques paid, for what and to whom. Records of money received and paid are kept so that the enterprise knows how much money it has at any time.
3. Assets, expenses and goods purchased on credit. This is so that the enterprise knows to whom it owes money and how much. These are referred to as creditors.
4. Assets and goods sold on credit. This is so that the enterprise knows who owes it money and how much. These are referred to as debtors.

The accountant has been traditionally regarded as the ‘holder of the purse strings’ and responsible for ‘safeguarding’ the assets of the enterprise. The control aspect of this function includes ensuring that the correct amounts are paid to those entitled to them at the appropriate time, collecting the enterprise’s debts when due, safeguarding against fraud and misappropriation of assets such as goods or cash. The latter function is often referred to as internal control.

To maintain accuracy in recording

Double-entry bookkeeping is generally regarded as the most accurate method of bookkeeping, primarily because each transaction is entered in the books twice. This duplication, referred to as a form of internal check, highlights any errors.

To meet the requirements of the law

The law, in the form of the Companies Acts, states that companies must keep proper records of their transactions and send their shareholders a set of annual final accounts. There is also tax legislation that requires sole traders and partnerships to provide the Inland Revenue with details of their income and expenditure. The self assessment procedure used by the Inland Revenue allows traders to deduct various expenses from their income in arriving at their
taxable profit. There is thus a financial incentive for all businesses to maintain records of their transactions.

**To present final accounts to the owners of the business**

These comprise a profit and loss account showing the amount of profit and thus the financial performance of a business for a given period, and a balance sheet showing its financial position at the end of that period. The latter will include the following items:

1. The amount of cash and money at the bank.
2. Other assets that the business owns, such as goods for resale, vehicles and machinery.
3. Debtors and creditors.
4. The amount of capital that has been invested in the business by its owner(s).
5. Any money that has been borrowed by the business.

In the case of a sole trader, these final accounts show the owner his or her ‘earnings’ for the period and may be used to evaluate the profitability of the business. However, they are often primarily used to determine the owner’s tax liability. Final accounts perform similar functions in the case of companies. However, company final accounts are also designed to give information to third parties to enable them to evaluate the profitability and financial stability of the company. These include prospective shareholders, trade unions and employees, creditors and those who have lent the company money, government departments and social pressure groups. This is discussed further later.

This function of financial accounting is often referred to as **stewardship**, which may be defined as the accountability of an enterprise’s management for the resources entrusted to them. **Accountability** refers to the management’s responsibility to provide an account/report on the way in which the resources entrusted to them have been used.

**To present other financial reports and analyses**

This includes the use of ratios to evaluate the following matters:

1. The profitability of the business.
2. The level of activity and productivity.
3. The solvency and liquidity position (i.e. whether the business will be able to pay its debts).
4. The efficiency of credit control procedures.
5. The efficiency of stock control procedures.

**To facilitate the efficient allocation of resources**

Viewing the function of financial accounting at a more general, abstract level, its ultimate **raison d’être** is usually described as being to facilitate the efficient and effective allocation of resources. This is generally given a macroeconomic interpretation as providing information to investors so that capital is directed towards more efficient firms. A less common but similar interpretation would be to extend this to providing information to prospective employees so that labour is directed towards more efficient firms. The same interpretation could also
be extended to other potential users of final accounts and providers of resources in a broad sense that embraces quality of life and environmental considerations, etc. This would include others such as bank lenders, creditors/suppliers, the government and the public in general.

This function of financial accounting can also be viewed at a microeconomic or individual firm level. One of the main purposes of financial accounting may be said to be to enable an organization’s management to operate the enterprise efficiently and effectively. This embraces at least three of the functions referred to above, namely, the recording and control of business transactions, accuracy in recording and the preparation of final accounts (for management use). However, this function of accounting is more commonly attributed to management accounting, particularly in larger organizations.

Management accounting can be defined as the provision of information to an organization’s management for the purposes of planning, control and decision making. The latter includes production, marketing, investment and financing decisions.

Learning Activity 1.1

Imagine that you are in business in a small general store or as a plumber. Prepare a list of the financial information about the business that you would expect to be able to obtain from your records. Compare this with the above and consider any differences.

The objectives of company final accounts

As explained above, one of the main functions of financial accounting is the preparation of final accounts, also commonly referred to as financial statements. These consist of a profit and loss account and a balance sheet. In the case of companies, the final accounts are often referred to as published accounts. These are sent to shareholders in the form of a pamphlet known as the annual or corporate report. It is therefore usual to discuss the objectives of company final accounts in terms of the functions of annual reports.

The function of annual reports is related to beliefs about the role of business organizations in society and their objectives. Up until about the mid-1970s the accountancy profession took the view that the primary objective of a business enterprise was to maximize its profit and the wealth of its shareholders. This was reinforced by disciplines such as economics that gave prominence to the classical theory of the firm. The function of annual reports was thus regarded as being to provide information about the profitability and financial position of a company to those with whom it has a capital contractual relationship, namely shareholders and loan creditors.

However, during the 1970s there was a swing in society’s beliefs towards the idea that business enterprises exist for the benefit of the community as a whole. Similarly, developments in disciplines such as economics and modern organization theory cast doubt on whether profit maximization was a meaningful description of business objectives. For example, Herbert Simon argues that business enterprises are ‘satisficers’, that is, they seek to earn a satisfactory level of profit. Also, a survey of large UK companies undertaken by the accountancy profession found that ‘the majority view of those replying to the survey seems to be that their primary objective is to make a profit for the benefit of a number of groups. It is not the majority view that the maximization of shareholder’s profit is the primary objective.’
Other respondents to this survey described their primary objective as being survival, or in terms of the service that they provide.

It follows from this that enterprises are accountable to a number of different groups (employees, the public, etc.), and that the function of annual reports is to provide each of them with information. This is the view taken by The Corporate Report,¹ which is the UK accountancy bodies’ most detailed statement on the function/objective of annual reports, their users and the information that they need. It is not mandatory, but represents one of the most comprehensive pieces of published work in this area, and has probably led to a number of new developments in accounting practices as well as more recent UK statements on these matters that are described later in this chapter.

The basic philosophy of The Corporate Report is reflected in the need for what is called public accountability which is described as follows: ‘there is an implicit responsibility to report publicly ... incumbent on every entity whose size or format renders it significant; ... we consider the responsibility to report publicly (referred to ... as public accountability) is separate from and broader than the legal obligation to report and arises from the custodial role played in the community by economic entities; ... they are involved in the maintenance of standards of life and the creation of wealth for and on behalf of the community.’

The ‘custodial role’ of business enterprises refers to their responsibility to use the assets with which they have been entrusted to create wealth and maintain the standard of living, and other considerations such as the quality of the environment. It follows from this notion of public accountability that the objective or function of annual reports is: ‘to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information.’ ‘Reasonable rights’ is defined as follows: ‘A reasonable right to information exists where the activities of an organisation impinge or may impinge on the interest of a user group.’

A similar study of the function of annual reports was undertaken in 1973 by the American Institute of Certified Public Accountants (AICPA); this is known as The Objectives of Financial Statements.² This document emphasizes the use to which the information is put: ‘The basic objective of financial statements is to provide information useful for making economic decisions.’ It also regards annual reports as principally intended for those groups who only have access to limited information about the enterprise: ‘An objective of financial statements is to serve primarily those users who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principal source of information about an enterprise’s economic activities.’

The most recent pronouncement by the UK accountancy profession on the objective of financial statements is in the Statement of Principles for Financial Reporting prepared by the Accounting Standards Board (ASB) in 1999.³ It is similar to the material in The Corporate Report¹ but contains some significant developments. The main parts of this document are reproduced below.

The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions.

That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user. Present and potential investors need information about the reporting entity’s financial performance and financial position that is useful to them in evaluating the entity’s ability to generate cash (including the timing and certainty of its generation) and in assessing the entity’s financial adaptability.
The financial performance of an entity comprises the return it obtains on the resources it controls, the components of that return and the characteristics of those components.

An entity’s financial position encompasses the economic resources it controls, its financial structure, its liquidity and solvency, its risk profile and risk management approach, and its capacity to adapt to changes in the environment in which it operates.

Information about the ways in which an entity generates and uses cash in its operations, its investment activities and its financing activities provides an additional perspective on its financial performance—one that is largely free from allocation and valuation issues.

An entity’s financial adaptability is its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities.

The users of annual reports and their information needs

The users of annual reports identified in *The Corporate Report* are¹ as follows:

1. The equity investor group, including existing and potential shareholders.
2. The loan creditor group, including existing and potential holders of debentures and loan stock, and providers of short-term secured and unsecured loans and finance.
3. The employee group, including existing, potential and past employees.
4. The analyst–adviser group, including financial analysts and journalists, economists, statisticians, researchers, trade unions, stockbrokers and other providers of advisory services such as credit rating agencies.
5. The business contact group, including customers, trade creditors and suppliers and, in a different sense, competitors, business rivals and those interested in mergers, amalgamations and takeovers.
6. The government, including tax authorities, departments and agencies concerned with the supervision of commerce and industry, and local authorities.
7. The public, including taxpayers, ratepayers, consumers and other community and special interest groups such as political parties, consumer and environmental protection societies and regional pressure groups.

Each of the above groups is said by *The Corporate Report* to have certain ‘information needs’. These are described below with respect to each group of users.

The equity investor group

A basic premise in *The Corporate Report* is that ‘investors require information to assist in reaching share trading decisions ... and in reaching voting decisions at general meetings. ... In particular investors will wish to make judgments concerning likely movements in share prices [and] likely levels of future dividend payments.’ Similarly, the US *Objectives of Financial Statements* says that ‘An objective of financial statements is to provide information useful to investors ... for predicting potential cash flows to them’. Thus, according to *The Corporate Report* investors require information for the following purposes:

1. To evaluate the performance of the entity and its management, and assess the effectiveness of the entity in achieving its objectives.
2 To assess the economic stability and vulnerability of the reporting entity including its liquidity (i.e. whether it will have enough money to pay its debts), its present or future requirements for additional capital, and its ability to raise long- and short-term finance.

3 To estimate the value of users’ own or other users’ present or prospective interests in or claims on the entity.

4 To ascertain the ownership and control of the entity.

5 To estimate the future prospects of the entity, including its capacity to pay dividends and to predict future levels of investment.

Accountants have traditionally regarded published accounts as fulfilling two main functions: (1) stewardship; and (2) facilitating share trading and lending decisions. The concept of stewardship roughly corresponds with everyday usage of the word and refers to the directors’ responsibility to account for the uses to which they have put the shareholders’ investment. This is the one function of published accounts on which most accountants agree. The Corporate Report does not discuss this as such but rather emphasizes the share-trading and decision-making function of annual reports. However, it is debatable whether past data are likely to be useful in predicting future profits, dividends or share prices. The literature on efficient market theory suggests that the content of annual reports has little, if any, predictive value. Published accounts may therefore only perform a stewardship and feedback function.

The loan creditor group

According to The Corporate Report, ‘the information needs of loan creditors are similar in many respects to the needs of equity investors. If their securities are listed on a stock exchange they will have to make trading decisions.’ However, certain information will be of particular relevance, such as that relating to:

1 The present and likely future cash position, since this will determine whether the company will be able to pay the annual interest on loans and repay the moneys borrowed as and when they become due.

2 The economic stability and vulnerability of the company in so far as this reflects the risk of possible default in repayment of moneys borrowed by the company.

3 Prior claims on the company’s assets in the event of its going into liquidation.

The employee group

The Corporate Report states that the right of the employee group to information arises because ‘the reporting entity has a responsibility for the future livelihood and prospects of its employees’. Employees will require information to enable them to assess the security of employment and the prospects for promotion. They may also require information for the purpose of wage bargaining. Such information may relate to ‘the ability of the employer to meet wage demands, management’s intentions regarding employment levels, locations and working conditions, the pay, conditions and terms of employment of various groups of employees and the contributions made by employees in different divisions. In addition, employees are likely to be interested in indications of the position, progress and prospects of the employing enterprise as a whole and about individual establishments and bargaining units.’ Some companies produce employee reports that usually contain a summary of the year’s trading results in a simplified form.
The analyst–adviser group

According to *The Corporate Report*, ‘the information needs of the analyst–adviser group are likely to be similar to the needs of the users who are being advised. For example, the information needs of stockbrokers are likely to be similar to the needs of investors and those of trade unions are likely to be similar to the needs of employees.’ *The Corporate Report* also makes the point that this group, because of their expertise, will tend to demand more elaborate information than other groups.

The business contact group

This consists of the following groups:

1. **Customers.** These may be concerned about the reporting entity’s continued existence because of its importance as a source of supply, particularly where long-term contracts for the supply of goods have been entered into. Similarly, if the reporting entity is engaged in construction work, customers will wish to assess the likelihood of its being able to complete long-term contracts. In the case of manufactured goods, such as computers and vehicles, customers will be concerned about the reporting entity’s continued existence because of its warranty obligations and the need for spare parts. Annual reports may thus be useful to customers in assessing the likelihood of the reporting entity’s continued existence.

2. **Suppliers.** Trade creditors will require information relating to the reporting entity’s ability to pay its debts. In addition, they would be concerned about the reporting entity’s continued existence if it is a major customer. A supplier may also have to decide whether to increase its production capacity in order to meet the reporting entity’s future demands.

3. **Competitors and takeover bidders.** The rationale for competitors having a right to information is a little vague but seems to rest on the premise that interfirm comparisons of performance and costs can facilitate improvements in efficiency. Similarly, given that mergers and takeovers of less efficient firms are in the public interest, a case can be made for the disclosure of information to potential bidders.

The government

*The Corporate Report* states that ‘central and local government departments and agencies have a right to information as representatives of the public and other user groups’. The Inland Revenue and HM Customs & Excise have a statutory right to information about the reporting entity for the purpose of assessing its liability to taxation. Furthermore, the ‘government needs information to estimate the effects of existing and proposed levies and other financial and economic measures, to estimate economic trends including balance of payments figures [and] to promote economic efficiency’. In the UK most of this information is collected through special government returns. However, in some other countries corporate reports perform this function.

The public

According to *The Corporate Report* the public has a right to information because of the custodial role that economic entities play in society and the impact that they can have on the community and the environment: ‘Such organisations, which exist with the general consent
of the community, are afforded special legal and operational privileges, they compete for resources of manpower, materials and energy and they make use of community-owned assets such as roads and harbours.

Some members of the public may be concerned about the employment policies of the reporting entity and therefore want information relating to local employment levels or discrimination in employment, for example. Other members of the public may be interested in any plans that the reporting entity has that affect the environment, including issues relating to conservation and pollution. Other matters of a political or moral nature may also be of particular concern to some sections of the community, such as contributions to political organizations, pressure groups or charities, and whether the reporting entity is trading with countries having repressive political regimes. Some of this information must be disclosed under the Companies Acts (i.e. donations to political parties and charities), but _The Corporate Report_ implies that the reporting entity also has a responsibility to make public any matters that might be regarded by the community as of general concern.

**Users and their information needs**

The most recent pronouncement by the UK accountancy profession on the users of financial statements and their information needs is in the _Statement of Principles for Financial Reporting_ prepared by the ASB in 1999. It is similar to the material in _The Corporate Report_ but contains some slight differences, and provides a useful summary of the users and their information needs. The main parts of this document are reproduced below.

a **Present and potential investors** (hereafter generally referred to simply as ‘investors’). In its stewardship role, management is accountable for the safekeeping of the entity’s resources and for their proper, efficient and profitable use. Providers of risk capital are interested in information that helps them to assess how effectively management has fulfilled this role. They are also interested in information that is useful in making decisions about their investment or potential investment in the entity. They are, as a result, concerned with the risk inherent in, and return provided by, their investments, and need information on the entity’s financial performance and financial position that helps them to assess its cash-generation abilities and its financial adaptability.

b **Lenders.** Lenders are interested in information that helps them to assess whether their loans will be repaid, and related interest will be paid, when due. Similarly, potential lenders are interested in information that helps them to decide whether to lend to the entity and on what terms.

c **Suppliers and other trade creditors.** Suppliers and other trade creditors are interested in information that helps them to decide whether to sell to the entity and to assess the likelihood that amounts owing to them will be paid when due.

d **Employees.** Employees are interested in information on their employer’s stability and profitability, with particular reference to that part (for example, the subsidiary or branch) of the entity in which they work. They are also interested in information that enables them to assess their employer’s ability to provide remuneration, employment opportunities, and retirement and other benefits.

e **Customers.** Customers are interested in information about the entity’s continued existence. That is especially so when they have a long-term involvement with, or are dependent on, the entity, as will generally be the case if product warranties are involved or if specialized replacement parts may be needed.
Governments and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information that assists them in regulating the activities of entities, assessing taxation and providing a basis for national statistics. Although much of this information is obtained through special purpose financial reports, its consistency with published general-purpose financial reports such as financial statements often needs to be demonstrated.

The public. Entities affect members of the public in a variety of ways. For example, they may make a substantial contribution to a local economy by providing employment and using local suppliers. The public, including the local community, may therefore be interested in information that is useful in assessing the trends and recent developments in the entity’s prosperity and the range of its activities.

The limitations of financial statements

This section provides a summary of the debate relating to whether financial statements achieve the objective given in the Statement of Principles for Financial Reporting. The debate involves a broad range of issues, and thus will be confined to those addressed in the Statement of Principles for Financial Reporting. There are four main themes. The first is often referred to as the adequacy of financial statements in meeting users’ information needs, and includes a debate about general-purpose versus specific-purpose financial reports. The second relates to problems of classification, aggregation and allocation. The third involves the lack of non-financial information in financial statements. The fourth theme in the debate concerns the use of largely historical information. This includes the use of historical cost accounting, which refers to recording transactions at the price that has been agreed in an arm’s-length transaction. The limitations of historical cost accounting are discussed in depth in Chapters 2 and 23, and problems of classification, aggregation and allocation embrace a wide range of issues discussed throughout the book. This section will thus focus on the first of the above themes.

Some companies voluntarily publish specific-purpose financial reports, each of which is aimed at a particular class or classes of users of financial statements. These include a statement of value added, employment report, employee report, environmental report and simplified financial statements. Some of these are included in the annual report with the financial statements, and others are published as separate documents. However, there is a fundamental presumption underlying most of the authoritative pronouncements on financial reporting that financial statements should be general-purpose documents. This is based on the premise that the main information needs of users other than investors are the same as those of investors. That is, they all need information about the financial performance and financial position of the reporting entity in order to assess its ability to provide rewards (dividends, wages, etc.) and the likelihood of its continued existence, respectively. This is explained in the Statement of Principles for Financial Reporting as follows: ‘That objective (of financial statements) can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user ...: all potential users are interested, to varying degrees, in the financial performance and financial position of the entity as a whole ...’. Therefore, in preparing financial statements, the rebuttable assumption is made that financial statements that focus on the interest that investors have in the reporting entity’s financial performance and financial position will, in effect, also be focusing on the common interest that all users have in that entity’s financial performance and financial position.’
The Corporate Report also acknowledges the common information needs of users, but further recognizes the role of specific-purpose reports, such as some of those mentioned above, in meeting the information needs of users other than investors. This has not been pursued by the ASB in its Statement of Principles for Financial Reporting.

The other three main themes in the debate about the limitations of financial statements, introduced above, are described in the Statement of Principles for Financial Reporting as follows: ‘financial statements have various inherent limitations that make them an imperfect vehicle for reflecting the full effects of transactions and other events on a reporting entity’s financial performance and financial position. For example:

a they are a conventionalised representation of transactions and other events that involves a substantial degree of classification and aggregation and the allocation of the effects of continuous operations to discrete reporting periods.

b they focus on the financial effects of transactions and other events and do not focus to any significant extent on their non-financial effects or on non-financial information in general.

c they provide information that is largely historical and therefore do not reflect future events or transactions that may enhance or impair the entity’s operations, nor do they anticipate the impact of potential changes in the economic environment.

These inherent limitations mean that some information on the financial performance and financial position of the reporting entity can be provided only by general purpose financial reports other than financial statements—or in some cases is better provided by such reports.’

Learning Activity 1.2

Visit the website of a large public limited company and find their latest annual report and accounts. Read through it and make a note of whatever information you find that is likely to be useful to a potential investor. Then draw up a list of any other information that you think would be useful to a potential investor.

The regulatory framework of accounting

The regulatory framework of accounting is a general term used to describe the legislation and other rules that govern the content and format of company final accounts. There is no legislation or other regulations covering the final accounts of sole traders and partnerships. However, it is generally accepted that their accounts should closely follow the rules and regulations relating to companies since these are regarded as ‘best practice’. There are three sources of rules and regulations governing the content and format of company final accounts:

1 The Companies Acts 1985 and 1989, with which all companies are required to comply.

2 The International Stock Exchange, London Admission of Securities to Listing regulations (commonly known as the Yellow Book), with which all companies whose shares are listed on the London Stock Exchange are expected to comply.

3 The accounting standards produced by the Accounting Standards Committee (ASC) and Accounting Standards Board (ASB) with which most (but not all) companies are expected to comply. These are discussed further later.
The UK accountancy profession comprises six major professional accountancy bodies:

1. The Institute of Chartered Accountants in England and Wales (ICAEW).
2. The Institute of Chartered Accountants in Scotland (ICAS).
3. The Institute of Chartered Accountants in Ireland (ICAI).
4. The Association of Chartered Certified Accountants (ACCA).
5. The Chartered Institute of Management Accountants (CIMA).
6. The Chartered Institute of Public Finance and Accountancy (CIPFA).

In 1970 the ICAEW set up the Accounting Standards Steering Committee (ASSC). Subsequently, all the other above professional bodies became members of this committee. Its name was changed in 1975 to the Accounting Standards Committee (ASC). In 1990 the ASC was replaced by the Accounting Standards Board (ASB).

The ASC represented the six major professional accountancy bodies on matters relating to the form and content of company final accounts. It issued accounting standards known as Statements of Standard Accounting Practice (SSAP) with which most company final accounts are still expected to comply. Each of these SSAPs specifies how particular items or transactions are to be treated in the final accounts of companies.

The ASB continues to perform the same function as the ASC, but is more independent of the professional accountancy bodies and has greater power to enforce accounting standards. Before the ASC could issue an SSAP, it required the approval of each of the six professional accountancy bodies. In contrast, the ASB can issue a Financial Reporting Standard (FRS) without approval from any other body.

A more detailed description of the UK institutional framework concerned with the setting of accounting standards is shown diagrammatically in Figure 1.1. It comprises the following bodies.

**The Financial Reporting Council (FRC)**

The FRC is a company limited by guarantee that is financed in approximately equal proportions by its members, which comprise the government, City institutions (such as the London Stock Exchange, and the clearing banks) and the six major professional accountancy bodies. Its chairperson is appointed jointly by the Secretary of State for Trade and Industry and the Governor of the Bank of England.
The FRC has overall responsibility for standard setting in the UK. Its main roles are:
(1) to guide the ASB on work programmes, broad policy matters and issues of public concern;
(2) to ensure that the work of the standard setting bodies is properly financed and carried out
efficiently and effectively; and (3) to act as a proactive voice in public debate and to make
representations to government and the accountancy profession to improve the quality of
relevant legislation and accounting practice.

The Accounting Standards Board (ASB)
The ASB is also a limited company established as a subsidiary of the FRC with a full-time
chairperson and technical director. A subsidiary is a company that is owned and/or con-
trolled by another company. In short, its main role is to develop, issue, revise and withdraw
accounting standards. These are referred to as Financial Reporting Standards (FRS). The
published accounts of most companies are expected to comply with SSAPs and FRSs.

Before the ASB issues a FRS it publishes a Discussion Draft (DD), which later becomes
a Financial Reporting Exposure Draft (FRED). These are essentially proposed standards
which are open to public debate and representations to the ASB. After examining public
representations on a FRED it is often amended by the ASB before being issued as an FRS.

The ASB has published a Statement of Aims which sets out its aims and how it intends to
achieve these aims. The more important parts of this are reproduced below:

‘Aims
The aims of the Accounting Standards Board (the Board) are to establish and improve
standards of financial accounting and reporting, for the benefit of users, preparers, and
auditors of financial information.
The Board intends to achieve its aims by:

1 Developing principles to guide it in establishing standards and to provide a framework
within which others can exercise judgement in resolving accounting issues.
2 Issuing new accounting standards, or amending existing ones, in response to evolving
business practices, new economic developments and deficiencies being identified in
current practice.
3 Addressing urgent issues promptly.’

This may be contrasted with the aims of SSAPs formulated by the ASC in their
Explanatory Foreword to SSAPs, which states that ‘their primary aim is to narrow the areas
of difference and variety in the accounting treatment of the matters with which they deal’.

The Financial Reporting Review Panel (FRRP)
The FRRP is also a subsidiary of the FRC. Its function is to investigate complaints about any
company’s published accounts where these contain an apparent material departure from an
accounting standard and/or the Companies Acts, including in particular the requirement to
show ‘a true and fair view’. If the FRRP decides that the departure results in failure to give a
true and fair view, it will in the first instance request the company to revise its accounts.
Where a company’s directors decline the request, the FRRP is empowered by the Companies
Acts to apply to the court for a declaration that the accounts do not comply with the require-
ments of the Companies Acts and an order requiring the directors of the company to prepare
revised accounts.
The Urgent Issues Task Force (UITF)

The UITF is a committee of the ASB whose members are people of major standing with expertise in financial reporting. It produces what are referred to as consensus pronouncements under the title of Abstracts. The following description of the role of the UITF is taken from the Foreword to UITF Abstracts:

The UITF’s main role is to assist the ASB with important or significant accounting issues where there exists an accounting standard or a provision of companies legislation (including the requirement to give a true and fair view) and where unsatisfactory or conflicting interpretations have developed or seem likely to develop. In such circumstances it operates by seeking a consensus as to the accounting treatment that should be adopted. Such a consensus is reached against the background of the ASB’s declared aim of relying on principles rather than detailed prescription.

The published accounts of companies are expected to comply with the Abstracts issued by the UITF. Abstracts consequently may be taken into consideration by the FRRP in deciding whether financial statements call for review.

Summary

Financial accounting is the process of designing and operating an information system for collecting, measuring and recording business transactions, and summarizing and communicating the results of these transactions to users to facilitate the making of financial/economic decisions. The first part of this definition, relating to collecting and recording business transactions, is called double-entry bookkeeping. The purposes of financial accounting are to record and control the business transactions, maintain accuracy in recording, meet the requirements of the law, present final accounts and other financial reports to the owners of the enterprise, and facilitate the efficient allocation of resources.

The final accounts of companies are often referred to as the published accounts or financial statements, and include a profit and loss account and balance sheet. These are contained in a document called the annual report and accounts. The functions of annual reports are related to society’s beliefs about the objective(s) of business enterprises. The basic philosophy of the accountancy bodies is that of public accountability. This underlies their view of the objective of financial statements as being to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of management and for making economic decisions. These users include investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. Each of these will have particular information needs.

The contents of company financial statements are governed by the regulatory framework. This comprises the Companies Acts, London Stock Exchange regulations, and accounting standards. The latter includes Statements of Standard Accounting Practice (SSAP) issued by the now defunct Accounting Standards Committee (ASC), and Financial Reporting Standards (FRS) issued by the Accounting Standards Board (ASB). The standard-setting process is currently under the control of the Financial Reporting Council (FRC) and also includes a Financial Reporting Review Panel (FRRP) and the Urgent Issues Task Force (UITF).
The Nature and Objectives of Financial Accounting

Key terms and concepts

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References


Review questions

An asterisk after the question number indicates that there is a suggested answer in the Appendix.

1.1 Explain the nature and functions of financial accounting.

1.2 Explain briefly each of the following: internal control; internal check; stewardship; and accountability.

1.3 a Describe the recording and control function of financial accounting.
   b Explain the role of financial accounting with regard to the presentation of final accounts.

1.4 a Outline the objective of financial statements as set out in the ASB *Statement of Principles for Financial Reporting* (1999).
   b Identify the users of financial statements and briefly describe their information needs as set out in the ASB *Statement of Principles for Financial Reporting* (1999).

1.5 a Describe the sources of the rules and regulations that govern the content and format of company final accounts.
   b Outline the institutional framework by which the accountancy profession has influenced the content and format of company final accounts during the last two decades.

1.6 Describe the current institutional framework concerned with the setting and enforcement of accounting standards.

1.7 Explain the aims of the Accounting Standards Board and the means by which it intends to achieve these aims.
1.8 The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions (Statement of Principles for Financial Reporting).

Required:

a State five potential users of company published financial statements, briefly explaining for each one their likely information needs from those statements.

b Briefly discuss whether you think that UK company published financial statements achieve the objective stated above, giving your reasons. Include in your answer two ways in which you think the quality of the information disclosed in financial statements could be improved.

(ACCA)

1.9 The existing procedures for setting accounting standards in the UK were established in 1990.

Required:

a Explain the roles of the following in relation to accounting standards:
   i Financial Reporting Council (FRC)
   ii Accounting Standards Board (ASB)
   iii Financial Reporting Review Panel (FRRP)
   iv Urgent Issues Task Force (UITF).

b Explain how the standard setting authority approaches the task of producing a standard, with particular reference to the ways in which comment or feedback from interested parties is obtained.

c It is possible that there could be a difference between the requirements of Financial Reporting Standards and those of the Companies Acts in preparing financial statements? How may such a difference be resolved?

(ACCA)