Underlying principles: the building blocks

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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 the wealth of their business. 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
What is accounting, and its uses and purposes?

The original, basic purposes of accounting were to classify and record monetary transactions (see Appendix 1) 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 Appendix 1, which explains double-entry bookkeeping, and how data is 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 Fig. 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

standards. For example, with effect from January 2005 all the large companies within the European Union are 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 truthful 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.
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 frameworks of the USA, Canada, Australia, and the UK. 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.

**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 and creditors
- customers and debtors
- 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?

UK accounting concepts

The accounting framework revolves around the practice of accountancy and the accounting profession, which is bounded by rules, or concepts (see Fig. 1.2, in which the five most important concepts are shown shaded) of what data should be included within an accounting system and how that data should be recorded.

Figure 1.2 Accounting concepts

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 included in the Companies Act 1985/89, are as follows.

**The prudence concept**

Prudence means being careful or cautious. The **prudence concept** is an ethical concept, which is based on the principle that revenue and profits are not anticipated, but are included in the profit and loss account 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 stocks of a product. 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.

The National Botanic Garden of Wales faced a threat to its future existence because it had suffered a slump in visitor numbers since it opened as a 2000 Millennium project. This resulted in the attraction having difficulties in generating sufficient cash to meet its operational requirements and to pay the contractors who were developing the gardens.

In March 2004 the National Botanic Garden of Wales was offered a £2.3m package to keep it open. However, the independent trustees of the attraction were warned that the garden had to bring in more money from visitors and private sponsors to secure its future as a going concern.
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 profit and loss account 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 3 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 comprises 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:

- FRS 11 (Impairment of Fixed Assets and Goodwill)
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 another accounting standard FRS 5, Reporting the Substance of Transactions. An example of this is where a company leases an asset, for example a machine, and discloses it 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 1985/1989 (all future references to the Companies Act will relate to the Companies Act 1985/1989 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 6-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 is 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 reporting to 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, its 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 arms-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, correctly record a sale by issuing 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, which it subsequently aims to sell. The company’s reduction in its cash balance is reflected in the increase in its stock 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 (section 226 or 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 accounting 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 Department of Trade and Industry (DTI) 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. A list of all FRSs and SSAPs that are currently in force may be found in Appendix 3 at the end of this book. The website accompanying this book contains the up-to-date position with regard to changes in accounting standards.
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 Y2K problem, which involved ensuring that computerised accounting transactions were not corrupted when we moved from the year 1999 to the year 2000.

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, Inland Revenue, HM Customs & Excise, Office of Fair Trading) in addition to the DTI 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 Practices (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 stocks 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 profit and loss account, 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 (which will all be discussed in greater detail in Chapter 3, which is about the profit and loss account, and Chapter 6, which looks at published reports and accounts):

- analysis of turnover, 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, profit and loss account, and cash flow statement).

**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 designated IASs.

The chairman of the IASB, Sir David Tweedie, has 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 the book, since UK accounting stan-
dards 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 3 at the end of this book.

At the time of writing this book, major disagreements continued about convergence from 1
January 2005. For example, there was disagreement by European banks and insurers concerning the
IASB rules requiring listed companies to record the gains and losses of various derivatives at fair
market value in their published reports and accounts. The French banks, in particular, feared that the
IASB may be imposing Anglo-Saxon views of accounting on the rest of the world! (See ‘When bankers
kept saying NON’, Business Week, 1 March 2004).

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 Gordon Brown 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
Gordon started employment as part of the graduate intake in the finance department of a large
engineering group. The auditors came in soon after Gordon 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 and FRSs, all of which meant very
little to Gordon. Gordon 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.
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, the Inland Revenue, and HM Customs & Excise. 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 Fig. 1.3). Accountants within companies, public service organisations etc., may be employed in the main functions of financial accounting, management accounting, and treasury management.

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).

FRSs are promulgated by the ASB.

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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).

FRSs are promulgated by the ASB.
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 investors, employees, lenders, suppliers, customers, and financial analysts. Financial accounting is concerned with the three key financial statements: the balance sheet; profit and loss account; cash flow statement. 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 profit and loss accounts, balance sheets and cash flow statements, 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 accounts receivable (debtor): those who owe money to the company – by age of debt
- analysis of accounts payable (creditor): those to whom the company owes money – by age of invoice
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. As we shall discover in Part II, 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 inter-linking 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 continues to develop its emphasis on decision-making and strategic management, and broaden the range of activities that it supports, the distinction between management accounting and financial management is slowly disappearing.

The article on page 19 which appeared in the *Daily Telegraph* illustrates some of the important applications of accounting and financial management. These include:

- the planning activities, particularly with regard to restructuring of the business
- negotiations with bankers
- evaluation of investments in new steelworks
- union negotiations
- costs of compliance with environmental requirements.

In February 2004 St Modwen Properties announced it had purchased some of the Corus surplus property, the former Llanwern steelworks site in Wales. They also revealed plans to invest more than...
Corus, the troubled steel producer, is quietly marketing around 7,000 acres of surplus property in a bid to raise funds and streamline its business as it prepares for a radical restructuring of its UK operations.

Corus, formed though a merger of British Steel and Hoogovens of the Netherlands in 1999, requires around £250m to pay for redundancies and investments in its plan to turn around its ailing UK business.

Corus is unable to put a value on its surplus property because of the expensive cleaning up which some sites may require. Corus is legally liable to carry out the remediation work which can sometimes cost more than the value of the site.

Since the merger, Corus has cut around 10,000 jobs in the UK and is planning to cut a further 1,100 as it closes more unprofitable plants. The number of redundancies could rise by another 2,000 if its Teesside steel plant cannot be brought into profit.

However, the company intends to invest in modernising two or three steelworks in the UK in order to boost its output.

Earlier this month Corus announced that it had secured a new £800m debt facility, but the £250m needed for the UK restructuring is likely to come from either a rights issue or from fresh loans.

It is also planning to dispose of most of its US business after years of poor performance.

Philippe Varin, the new Corus chief executive who was appointed three months ago from the French aluminium producer Pechiney, has said the money is required ‘the sooner the better’.

Despite selling several smaller portfolios earlier this year – including one to Threadneedle, the fund manager, for £48m in July – realising the value of its property portfolio is likely to be a slow process.

The company won planning permission in April to redevelop the 1,125 acre site of the former Ravenscraig steelworks in Scotland more than 11 years after the last steel was poured there.

Corus puts land up for sale to raise funds for rescue package, by Edward Simkins and Mary Fagan

© Daily Telegraph, 24 August 2003

£200m in the site over the next 10 years. The project would create 7,000 jobs and lead to a total end value of £750m and they hoped to be on site towards the end of 2005. The acquisition of the Llanwern site was the fifth major land deal St Modwen completed with Corus, which retained a further 1,500 acres at Llanwern, including the operational steelworks.

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 is 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 Fig. 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 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?

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

**Chartered Institute of Public Finance and Accountancy (CIPFA):** accounting role within central government or local government

**Association of Chartered Certified Accountants (ACCA):** employment either within a firm of accountants, carrying out auditing etc., or management accounting and financial accounting roles within commerce/industry

**Association of Corporate Treasurers (ACT):** commercial accounting roles with almost total emphasis on treasury issues: corporate finance; funding; cash management; working capital management; financial risk management

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.
Types of business entity: sole traders; partnerships; limited companies; public limited companies

Business entities are involved either in manufacturing (for example, food and automotive components) or in providing services (for example, retailing, hospitals or television broadcasting). Such entities include profit-making and not-for-profit organisations, and charities. The main types of entity, and the environments in which they operate, are represented in Fig. 1.5

The variety of business entities can be seen to range from quangos (quasi-autonomous non-government organisations) to partnerships to limited companies. Most of the topics covered in this book apply to any type of business organisation that has the primary aim of maximising the wealth of its owners: limited liability companies, both private (Ltd) companies and public (plc) limited companies, sole traders, and partnerships.

Progress check 1.7 What are the different types of business entity? Can you think of some examples of each?

Sole traders

A sole trader entity is applicable for most types of small business. It is owned and financed by one
individual, who receives all the profit made by the business, even though more than one person may work in the business.

The individual sole trader has complete flexibility regarding:

- the type of (legal) activities in which the business may be engaged
- when to start up or cease the business
- the way in which business is conducted.

The individual sole trader also has responsibility for:

- financing the business
- risk-taking
- decision-making
- employing staff
- any debts or loans that the business may have (the responsibility of which is unlimited, and cases of financial difficulty may result in personal property being used to repay debts).

A sole trader business is simple and cheap to set up. There are no legal or administrative set-up costs as the business does not have to be registered since it is not a legal entity separate from its owner. As we shall see, this is unlike the legal position of owners, or shareholders, of limited companies who are recognised as separate legal entities from the businesses they own.

Accounting records are needed to be kept by sole traders for the day-to-day management of the business and to provide an account of profit made during each tax year. Unlike limited companies, sole traders are not required to file a formal report and accounts each year with the Registrar of Companies. However, sole traders must prepare accounts on an annual basis to provide the appropriate financial information for inclusion in their annual tax return for submission to the Inland Revenue.

Sole traders normally remain quite small businesses, which may be seen as a disadvantage. The breadth of business skills is likely to be lacking since there are no co-owners with which to share the management and development of the business.

**Partnerships**

Partnerships are similar to sole traders except that the ownership of the business is in the hands of two or more persons. The main differences are in respect of how much each of the partners puts into the business, who is responsible for what, and how the profits are to be shared. These factors are normally set out in formal partnership agreements, and if the partnership agreement is not specific then the provisions of the Partnership Act 1890 apply. There is usually a written partnership agreement (but this is not absolutely necessary) and so there are initial legal costs of setting up the business.

A partnership is called a firm and is usually a small business, although there are some very large partnerships, for example firms of accountants like PriceWaterhouseCoopers. Partnerships are formed by two or more persons and, apart from certain professions like accountants, architects and solicitors, the number of persons in a partnership is limited to 20.

A partnership:

- can carry out any legal activities agreed by all the partners
- is not a legal entity separate from its partners.

The partners in a firm:

- can all be involved in running the business
- all share the profits made by the firm
**Limited companies**

A **limited company** is a legal entity separate from the owners of the business, which may enter into contracts, own property, and take or receive legal action. The owners limit their obligations to the amount of finance they have put into the company by way of the share of the company they have paid for. Normally, the maximum that may be claimed from shareholders is no more than they have paid for their shares, regardless of what happens to the company. Equally, there is no certainty that shareholders may recover their original investment if they wish to dispose of their shares or if the business is wound up, for whatever reason.

A company with unlimited liability does not give the owners, or members, of the company the protection of limited liability. If the business were to fail, the members would be liable, without limitation, for all the debts of the business.

The legal requirements relating to the registration and operation of limited companies is contained within the Companies Act 1985 as amended by the Companies Act 1989. Limited companies are required to be registered with the Registrar of Companies as either a private limited company (designated Ltd) or a public limited company (designated plc).

**Private limited companies (Ltd)**

Private limited companies are designated as Ltd. There are legal formalities involved in setting up a Ltd company which result in costs for the company. These formalities include the drafting of the company’s Memorandum and Articles of Association (M and A) that describe what the company is and what it is allowed to do, registering the company and its director(s) with the Registrar of Companies, and registering the name of the company.

The shareholders provide the financing of the business in the form of share capital, of which there is no minimum requirement, and are therefore the owners of the business. The shareholders must appoint at least one director of the company, who may also be the company secretary, who carries out the day-to-day management of the business. A Ltd company may only carry out the activities included in its M and A.

Limited companies must regularly produce annual accounts for their shareholders and file a copy with the Registrar of Companies, and therefore the general public may have access to this...
A Ltd company’s accounts must be audited by a suitably qualified accountant, unless it is exempt from this requirement, currently (with effect from 30 March 2004) by having annual sales of less than £5.6m and a balance sheet total of less than £2.8m. The exemption is not compulsory and having no audit may be a disadvantage: banks, financial institutions, customers and suppliers may rely on information from Companies House to assess creditworthiness and they are usually reassured by an independent audit. Limited companies must also provide copies of their annual accounts for the Inland Revenue and also generally provide a separate computation of their profit on which corporation tax is payable. The accounting profit of a Ltd company is adjusted for:

- various expenses that may not be allowable in computing taxable profit
- tax allowances that may be deducted in computing taxable profit.

Limited companies tend to be family businesses and smaller businesses with the ownership split among a few shareholders, although there have been many examples of very large private limited companies. The shares of Ltd companies may be bought and sold but they may not be offered for sale to the general public. Since ownership is usually with family and friends there is rarely a ready market for the shares and so their sale usually requires a valuation of the business.

Public limited companies (plc)

Public limited companies are designated as plc. A plc usually starts its life as a Ltd company and then becomes a plc by applying for a listing of its shares on the Stock Exchange or the Alternative Investment Market, and making a public offer for sale of shares in the company. Plcs must have a minimum issued share capital of (currently) £50,000. The offer for sale, dealt with by a financial institution and the company’s legal representatives, is very costly. The formalities also include the redrafting of the company’s M and A, reflecting its status as a plc, registering the company and its director(s) with the Registrar of Companies, and registering the name of the plc.

The shareholders must appoint at least two directors of the company, who carry out the day-to-day management of the business, and a suitably qualified company secretary to ensure the plc’s compliance with company law. A plc may only carry out the activities included in its M and A.

Plcs must regularly produce annual accounts, which they copy to their shareholders. They must also file a copy with the Registrar of Companies, and therefore the general public may have access to this information. The larger plcs usually provide printed glossy annual reports and accounts which they distribute to their shareholders and other interested parties. A plc’s accounts must be audited by a suitably qualified accountant, unless it is exempt from this requirement by (currently) having annual sales of less than £5.6m and a balance sheet total of less than £2.8m. The same drawback applies to having no audit as applies with a Ltd company. Plcs must also provide copies of their annual accounts for the Inland Revenue and also generally provide a separate computation of their profit on which corporation tax is payable. The accounting profit of a plc is adjusted for:

- various expenses that may not be allowable in computing taxable profit
- tax allowances that may be deducted in computing taxable profit.

The shareholders provide the financing of the plc in the form of share capital and are therefore the owners of the business. The ownership of a plc can therefore be seen to be spread amongst many shareholders (individuals and institutions like insurance companies and pension funds), and the shares may be freely traded and bought and sold by the general public.
An introduction to financial statement reporting

Limited companies produce financial statements for each accounting period to provide adequate information about how the company has been doing. There are three main financial statements –
balance sheet, profit and loss account (or income statement), and cash flow statement. Companies are also obliged to provide similar financial statements at each year end to provide information for their shareholders, the Inland Revenue, and the Registrar of Companies. This information is frequently used by City analysts, investing institutions and the public in general.

After each year end companies prepare their annual report and accounts for their shareholders. Copies of the annual report and accounts are filed with the Registrar of Companies and copies are available to other interested parties such as financial institutions, major suppliers and other investors. In addition to the profit and loss account and cash flow statement for the year and the balance sheet as at the year end date, the annual report and accounts includes notes to the accounts, and much more financial and non-financial information such as company policies, financial indicators, corporate governance compliance, directors’ remuneration, employee numbers, business analysis, and segmental analysis. The annual report also includes an operating and financial review of the business, a report of the auditors of the company, and the chairman’s statement.

The auditors’ report states compliance or otherwise with accounting standards and that the accounts are free from material misstatement, and that they give a true and fair view prepared on the assumption that the company is a going concern. The chairman’s statement offers an opportunity for the chairman of the company to report in unquantified and unaudited terms on the performance of the company during the past financial period and on likely future developments. However, the auditors would object if there was anything in the chairman’s statement that was inconsistent with the audited accounts.

Progress check 1.9 What are the three main financial statements reported by a business? How are business transactions ultimately reflected in financial statements?

Worked Example 1.5

Gordon Brown soon settled into his graduate trainee role in the finance department of the large engineering group, and pursued his CIMA studies with enthusiasm. Although Gordon was more interested in business planning and getting involved with new development projects, his job and his studies required him to become totally familiar with, and to be able to prepare, the financial statements of a company. Gordon was explaining the subject of financial statements and what they involved to a friend of his, Jack, another graduate trainee in human resources. Where? – you have guessed it – over an after-work drink.

Gordon explained the subject of financial statements to Jack, bearing in mind that he is very much a non-financial person.

Limited companies are required to produce three main financial statements for each accounting period with information about company performance for:

- shareholders
- the Inland Revenue
- banks
- City analysts
- investing institutions
- the public in general.
The three key financial statements are the:

(a) balance sheet
(b) profit and loss account (or income statement)
(c) cash flow statement.

(a) **Balance sheet**: a financial snapshot at a moment in time, or the financial position of the company comparable with pressing the 'pause' button on a DVD. The DVD in 'play' mode shows what is happening as time goes on second by second, but when you press 'pause' the DVD stops on a picture; the picture does not tell you what has happened over the period of time up to the pause (or what is going to happen after the pause). The balance sheet is the consequence of everything that has happened up to the balance sheet date. It does not explain how the company got to that position.

(b) **Profit and loss account**: this is the DVD in 'play' mode. It is used to calculate whether or not the company has made a gain or deficit on its operations during the period, its financial performance, through producing and selling its goods or services. Net earnings or net profit is calculated from revenues derived throughout the period between two ‘pauses’, minus costs incurred in deriving those revenues.

(c) **Cash flow statement**: this is the DVD again in ‘play’ mode, but net earnings is not the same as cash flow, since revenues and costs are not necessarily accounted for when cash transfers occur. Sales are accounted for when goods or services are delivered and accepted by the customer but cash may not be received until some time later. The profit and loss account does not reflect non-trading events like an issue of shares or a loan that will increase cash but are not revenues or costs. The cash flow statement summarises cash inflows and cash outflows and calculates the net change in the cash position for the company throughout the period between two ‘pauses’.

**Users of accounting and financial information**

Financial information is important to a wide range of groups both internal and external to the organisation. Such information is required, for example, by individuals outside the organisation to make decisions about whether or not to invest in one company or another, or by potential suppliers who wish to assess the reliability and financial strength of the organisation. It is also required by managers within the organisation as an aid to decision-making. The main users of financial information are shown in Fig. 1.6.

**Progress check 1.10** How many users of financial information can you think of and in what ways do you think they may use this information?
Kevin Green, a trainee accountant, has recently joined the finance department of a newly formed public limited company. Kevin has been asked to work with the company’s auditors who have been commissioned to prepare some alternative formats for the company’s annual report. As part of his preparation for this, Kevin’s manager has asked him to prepare a draft report about who is likely to use the information contained in the annual report, and how they might use such information.

Kevin’s preparatory notes for his report included the following:

- **Competitors** as part of their industry competitive analysis studies to look at market share, and financial strength
- **Customers** to determine the ability to provide a regular, reliable supply of goods and services, and to assess customer dependence
- **Employees** to assess the potential for providing continued employment and assess levels of remuneration
- **General public** to assess general employment opportunities, social, political and environmental issues, and to consider potential for investment
- **Government** VAT and corporate taxation, Government statistics, grants and financial assistance, monopolies and mergers
- **Investment analysts** investment potential for individuals and institutions with regard to past and future performance, strength of management, risk versus reward
- **Lenders** the capacity and the ability of the company to service debt and repay capital
- **Managers/directors** to a certain extent an aid to decision-making, but such relevant information should already have been available internally
- **Shareholders/investors** a tool of accountability to maintain a check on how effectively the
Accountability and financial reporting

When we talk about companies we are generally referring to limited companies, as distinct from sole traders and partnerships (or firms – although this term is frequently wrongly used to refer to companies). As we have discussed, limited liability companies have an identity separate from their owners, the shareholders, and the liability of shareholders is limited to the amount of money they have invested in the company, that is their shares in the company. Ownership of a business is separated from its stewardship, or management, by the shareholders’ assignment to a board of directors the responsibility for running the company. The directors of the company are accountable to the shareholders, and both parties must play their part in making that accountability effective.

The directors of a limited company may comprise one or more professionally qualified accountants (usually including a finance director). The directors of the company necessarily delegate to middle managers and junior managers the responsibility for the day-to-day management of the business. It is certainly likely that this body of managers, who report to the board of directors, will include a further one or more qualified accountants responsible for managing the finance function.

Accountability is maintained by reporting on the financial performance and the financial position of the business to shareholders on both a yearly and an interim basis. The reporting made in the form of the financial statements includes the balance sheet, profit and loss account, and cash flow statement, which will be considered in detail in Part I of this book.

You may question why all the accounting regulation that we have discussed in the earlier sections of this chapter is necessary at all. Well, there are a number of arguments in favour of such regulation:

- It is very important that the credibility of financial statement reporting is maintained so that actual and potential investors are protected as far as possible against inappropriate accounting practices.
- Generally, being able to distinguish between the good and not so good companies also provides some stability in the financial markets.
- The auditors of companies must have some rules on which to base their true and fair view of financial position and financial performance, which they give to the shareholders and other users of the financial statements.

External auditors are appointed by, and report independently to, the shareholders. They are professionally qualified accountants who are required to provide objective verification to shareholders and other users that the financial statements have been prepared properly and in accordance with legislative and regulatory requirements; that they present the information truthfully and fairly; and that they conform to the best accounting practice in their treatment of the various measurements and valuations.

The audit is defined by the Auditing Practices Board (APB) as ‘an independent examination of, and expression of an opinion on, the financial statements of the enterprise’. There is a requirement for all
companies registered in the UK to have an annual audit, except for those companies that (currently) have an annual turnover of less than £5.6m and a balance sheet total of less than £2.8m.

The financial reporting of the company includes preparation of the financial statements, notes and reports, which are audited and given an opinion on by the external auditors. A regulatory framework exists to see fair play, the responsibility for which is held jointly by the Government and the private sector, including the accountancy profession and the Stock Exchange.

The Government exercises influence through bodies such as the Department of Trade and Industry (DTI) and through Parliament by the enactment of legislation, for example the Companies Act. Such legal regulation began with the Joint Stock Companies Act 1844.


It may be argued that the increasing amount of accounting regulation itself stifles responses to changes in economic and business environments, and discourages the development of improved financial reporting. We have already seen that the development of various conceptual frameworks indicates that there is wide disagreement about what constitutes accounting best practice. The resistance to acceptance of international accounting standards may be for political reasons, the rules perhaps reflecting the requirements of specific interest groups or countries.

It is also true that despite increasing accounting regulation there have been an increasing number of well-publicised financial scandals in the USA in particular, where the accounting systems are very much ‘rule-based’, as well as in the UK, Italy, and Japan. However, these scandals have usually been the result of fraudulent activity. This leads to another question as to why the auditors of such companies did not detect or prevent such fraud. The answer is that, despite the widespread perception of the general public to the contrary, auditors are not appointed to detect or prevent fraud. Rather, they are appointed by the shareholders to give their opinion as to whether the financial statements show a true and fair view and comply with statutory, regulatory, and accounting and financial reporting standards requirements.

**Progress check 1.11** In what ways may the reliability of financial reporting be ensured?

**Worked Example 1.7**

You are thinking of changing jobs (within marketing) and moving from a local, well-established retailer that has been in business for over 20 years. You have been asked to attend an interview at a new plc that started up around two years ago. The plc is a retailer via the Internet. Your family has suggested that you investigate the company thoroughly before your interview, paying particular attention to its financial resources. There is a chance the plc may not be a going concern if its business plan does not succeed.

You will certainly want to include the following questions at your interview.

(a) Are any published accounts available for review?

(b) What is the share capital of the company (for example, is it £10,000 or £1,000,000)?
Summary of key points

- The three main purposes of accounting are: to provide records of transactions and a scorecard of results; to direct attention to problems; to evaluate the best ways of solving problems.
- Accountancy is the practice of accounting.
- Conceptual frameworks of accounting have been developed in many countries and the UK conceptual framework is embodied in the Statement of Principles (SOP).
- The framework of accounting is bounded by concepts (or rules) and standards, covering what data should be included within an accounting system and how that data should be recorded.
- International accounting standards have been developed, which should be adopted by listed companies within the European Union with effect from 1 January 2005.
- The main branches of accounting within commercial and industrial organisations are financial accounting, management accounting, treasury management, financial management and corporate finance.
- The main services, in addition to accounting, that are provided by accountants to commercial and industrial organisations are auditing, corporate taxation, personal taxation, VAT advice, and consultancy.
- The large variety of types of business entity includes profit and not-for-profit organisations, both privately and Government owned, involved in providing products and services.
- The four main types of profit-making businesses in the UK are sole traders, partnerships, limited companies (Ltd), and public limited companies (plc).
- Accounting processes follow a system of recording and classifying data, followed by a summarisation of financial information for subsequent interpretation and presentation.
- The three main financial statements that appear within a business’s annual report and accounts, together with the chairman’s statement, directors’ report, and auditors’ report, are the balance sheet, profit and loss account, and cash flow statement.
- There is a wide range of users of financial information external and internal to an organisation. External users include: potential investors; suppliers; financial analysts. Internal users include: managers; shareholders; employees.
- Accountability is maintained by the reporting to shareholders on a yearly and half-yearly basis of sales and other activities and profits or losses arising from those activities, and the audit function.
Questions

Q1.1 (i) How many different types of business entity can you think of?
(ii) In what respect do they differ fundamentally?
Q1.2 (i) Why are accountants required to produce financial information?
(ii) Who do they produce it for and what do they do with it?
Q1.3 Describe the broad regulatory, professional, and operational framework of accounting.
Q1.4 What are conceptual frameworks of accounting?
Q1.5 (i) What are accounting concepts?
(ii) What purpose do they serve?
Q1.6 What is the UK Statement of Principles (SOP)?
Q1.7 (i) What is accountancy?
(ii) What is an accountant?
(iii) What do accountants do?
Q1.8 What do accountants mean by SSAPs and FRSs, and what are they for?
Q1.9 What are IASs and IFRSs and why are they important?
Q1.10 (i) What is financial management?
(ii) How does financial management relate to accounting and perhaps other disciplines?
Q1.11 How do financial statements ensure accountability for the reporting of timely and accurate information to shareholders is maintained?

Discussion points

D1.1 The managing director of a large public limited company stated: ‘I’ve built up my business over the past 15 years from a one man band to a large plc. As we grew we seemed to spend more and more money on accountants, financial managers, and auditors. During the next few months we are restructuring to go back to being a private limited company. This will be much simpler and we can save a fortune on accounting and auditing costs.’ Discuss.

(Hint: You may wish to research Richard Branson and, for example, Virgin Air, on the Internet to provide some background for this discussion.)

D1.2 The managing director of a growing private limited company stated: ‘All these accounting concepts and standards seem like a lot of red tape to me, and we’ve got financial accountants and management accountants as well as auditors. Surely all I need to know at the end of the day is how much we’ve made.’ Discuss.

D1.3 Is accounting objective? Discuss with reference to at least six different accounting concepts.

Exercises

Exercises E1.1 to E1.10 require an essay-type approach. You should refer to the relevant sections in Chapter 1 to check your solutions.
Level I

E1.1 Time allowed – 15 minutes
Discuss the implications of preparation of the profit and loss account if there were no accounting concepts.

E1.2 Time allowed – 30 minutes
At a recent meeting of the local branch of the Women’s Institute they had a discussion about what sort of organisation they were. The discussion broadened into a general debate about all types of organisation, and someone brought up the term ‘business entity’. Although there were many opinions, there was little sound knowledge about what business entities are. Jane Cross said that her husband was an accountant and she was sure he would not mind spending an hour one evening to enlighten them on the subject. Chris Cross fished out his textbooks to refresh his knowledge of the subject and came up with a schedule of all the different business entities he could think of together with the detail of their defining features and key points of difference and similarity.

Prepare the sort of schedule that Chris might have drafted for his talk and identify the category that the Women’s Institute might fall into.

E1.3 Time allowed – 30 minutes
Mary Andrews was an accountant but is now semi-retired. She has been asked by her local comprehensive school careers officer to give a talk entitled: ‘What is an accountant and what is accounting, its use and its purpose?’.

Prepare a list of bullet points that covers everything necessary for Mary to give a comprehensive and easy-to-understand presentation to a group of sixth-formers at the school.

Level II

E1.4 Time allowed – 30 minutes
Accounting standards in general are reasonably clear and unambiguous.

Are there any major areas where accountants may disagree in balance sheet accounting?

E1.5 Time allowed – 30 minutes
Financial statements are produced each year by businesses, using prescribed formats.

Should major plcs be allowed to reflect their individuality in their own financial statements?

E1.6 Time allowed – 45 minutes
Professionals in the UK, for example, doctors, solicitors, accountants etc., normally work within partnerships. Many tradesmen, such as plumbers, car mechanics, carpenters, and so on, operate as sole traders. Software engineers seem to work for corporations and limited companies.

Consider the size of operation, range of products, financing, the marketplace, and the geographical area served, to discuss why companies like Microsoft and Yahoo should operate as plcs.

E1.7 Time allowed – 60 minutes
Bill Walsh has just been appointed Finance Director of a medium-sized engineering company, Nutsan Ltd, which has a high level of exports and is very sensitive to economic changes throughout the UK and the rest of the world. One of the tasks on Bill’s action list is a review of the accounting and finance function.

What are the senior financial roles that Bill would expect to be in place and what are the important functions for which they should be responsible?
E1.8 Time allowed – 60 minutes
The Millennium Dome was opened to the general public in the UK for the year 2000 and was planned to close at the end of 2000 for the site to be used for some other purpose. There were problems financing the construction and the general day-to-day operations. There were many crises reported in the press during 2000. A proposed takeover of the site fell through in September 2000, with various reasons given by the potential acquirer.

You are required to research into the Dome using the BBC, Financial Times and the other serious newspapers, and the Internet, and summarise the financial aspects of the project that you gather. You should focus on the attitudes expressed by the general public, select committees of MPs, Government ministers, the Opposition, the Dome's management, and consider examples of bias, non-timeliness, and lack of transparency.

E1.9 Time allowed – 60 minutes
Conceptual frameworks of accounting have been developed over many years and in many countries.

Explain how these culminated in the publication of the UK Statement of Principles (SOP) in 1999, and discuss the implications of each of the eight chapters.

E1.10 Time allowed – 60 minutes
The International Accounting Standards Board (IASB) decreed the adoption of the International Financial Reporting Standards (IFRSs) by all listed companies within the European Union mandatory with effect from 1 January 2005.

Discuss the practical and political issues surrounding this decision.