

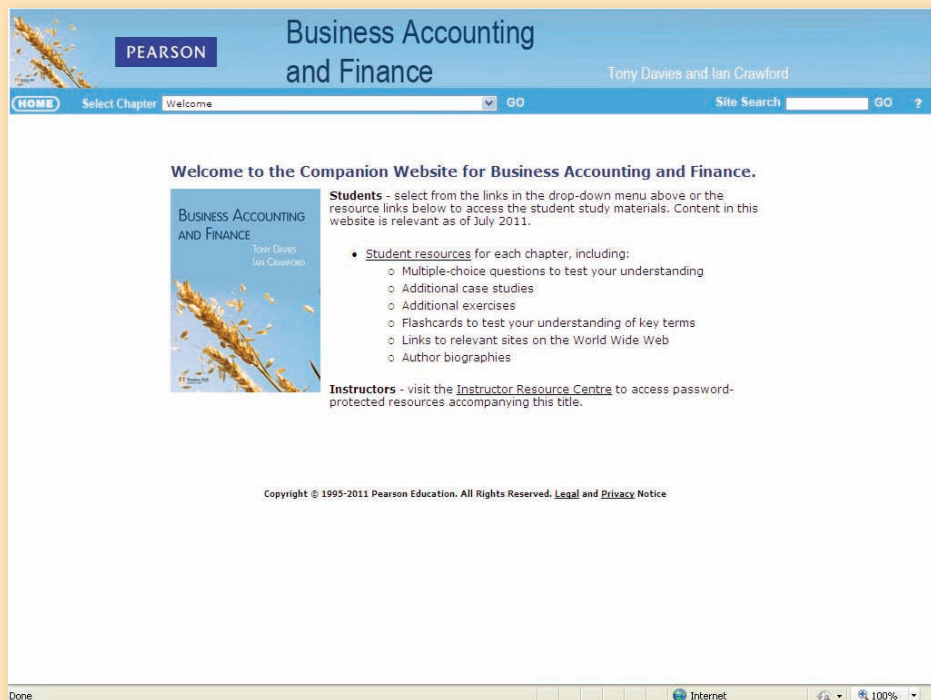
# BUSINESS ACCOUNTING AND FINANCE

TONY DAVIES  
IAN CRAWFORD

# BUSINESS ACCOUNTING AND FINANCE

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**TONY DAVIES**  
and  
**IAN CRAWFORD**



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# Preface



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

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

## Content and structure

The content and structure of the text have been carefully researched to follow closely the typical requirements of introductory undergraduate and MBA modules. This text assumes no prior knowledge of the subject: we start at square one and take you step-by-step through the concepts and application of techniques, with clear explanations and numerous worked examples.

The text comprises 16 chapters, and is structured into two parts. Each of the two parts of the book, and their component chapters, are outlined in the introductory section to each part of the text, and cover the main areas of accounting and finance:

- **financial accounting** which is broadly concerned with the recording and analysis of historical financial data, the presentation of information on financial performance, and compliance with legislation, and accounting rules and standards
- **financial management** which includes management accounting: mainly involved in dealing with current problems and in looking ahead, and includes the roles of costing and pricing of products and services, and support of the planning, control and decision-making functions, and business finance: which includes capital investment decision-making, alternative ways of financing the business, and the management of the assets that the organisation has at its disposal.

A further key objective in writing this text was to provide a flexible study resource. There is a linkage between each of the chapters, which follow a structure that has been designed to facilitate effective learning of the subject in a progressive way. However, each chapter may also be used on a stand-alone basis; equally, chapters may be excluded from study if they relate to subjects that are not essential for a specific course. Therefore, the text is intended to be suitable for modules of either one or two semesters' duration.

Just as the principles and practice of genetics or information technology are steadily progressing, so accounting and finance continue to develop, sometimes in exciting ways. Some of the chapters

introduce topics typically not covered in some more traditional and technical introductory accounting texts, for example corporate governance, sustainability and corporate social responsibility reporting. A number of contemporary issues and areas of increasing importance are also included such as the balanced scorecard and activity based costing.

Given that this text has been written primarily for non-specialist students, each chapter aims to help students understand the broader context and relevance of accounting and finance in the business environment, and how accounting statements and financial information can be used to improve the quality of management decision-making. We have therefore provided numerous examples and commentary on company activity within each chapter, including at least one press extract. Companies featured include Liverpool FC, General Motors, Ryanair, Sony, Royal Bank of Scotland, British Airways, Kraft, Revlon, Berkshire Hathaway, EasyDate, Bosch, and Marks & Spencer. In addition, two of the chapters feature extracts and analysis of the actual Report and Accounts 2010 of Johnson Matthey Plc.

## Using this book

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

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

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

It is easy, but mistaken, to read on cruise control, highlighting the odd sentence and gliding through the worked examples, progress checks and chapter-end questions and exercises. Active learning needs to be interactive: if you haven't followed a topic or an example, go back and work through it again; try to think of other examples to which particular topics may be applied. The only way to check you have a comprehensive understanding of things is to attempt all the integrated progress checks and worked examples, and the chapter-end assessment material, and then to compare with the text and answers provided. Fully worked solutions are given for each worked example, and solutions to about 45% of the chapter-end exercises (those with their numbers in colour) are provided in Appendix 3. Additional self-assessment material is available on the book's accompanying website (see page i).

## Case studies

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

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



# Guided tour of the book



## Learning objectives

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

### Learning objectives

Completion of this chapter will enable you to:

- explain the convention of double-entry bookkeeping
- describe what is meant by 'debit' and 'credit'
- enter business transactions into accounts
- account for closing inventories and other accounting adjustments
- explain the balancing of accounts
- extract a trial balance from a company's accounts
- prepare an income statement, balance sheet and statement of cash flows from a trial balance
- appreciate the concepts of accrual accounting and cash accounting
- explain and account for payments in advance (prepayments) and charges not yet received (accruals)
- appreciate the importance of accounting periods.

## Introduction

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

### Introduction

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

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

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

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

## Key terms

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

### Cash book

The cash book is a book of account that in theory should match exactly with the regular statements issued by the entity's bank. In practice, the cash book is prepared partly from company internally generated **cash payments** information and available information relating to **cash receipts**. Some transactions may appear in the bank account without prior notification, for example bank charges, and so the cash book may also be partly prepared with reference to information from the bank statement.

There is a need to periodically check cash book balances against the balances shown on the bank statements supplied by the bank. The two numbers are rarely the same and so the differences between them need to be reconciled to ensure that cash book balances are correct. The regular preparation of a **bank reconciliation** on at least a monthly basis is therefore a necessary function of the finance department.

There are five main reasons for differences between cash book balances and the balances shown on bank statements:

- cash book arithmetic errors and incorrect postings of receipts and payments
- cash book omissions of items shown on the bank statements such as bank charges, standing orders, direct debits, and dishonoured (returned) cheques

## Worked examples

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

### Worked example 3.2

Mr Bean decides to set up a wholesale business, Ayco, on 1 January 2010. He has his own cash resources for the purpose of setting up the business and has estimated that an initial £50,000 would be required for this purpose. During the first four-week period in business, January 2010, Ayco will enter into the following transactions:

		£	
Week 1	Receipt of cheque from Mr Bean	50,000	
Week 1	Purchase for cash the freehold of a shop	30,000	
Week 1	Purchase for cash the shop fittings	5,000	
Week 2	Cash paid for printing and stationery used	200	
Week 3	Purchases of inventory, from Beeco Ltd, of Ayman toys, payable two months later (12,000 toys at £1 each)	12,000	
Week 3	Sales of Ayman toys to Ceeco Ltd for cash (1,000 toys at £2 each)	2,000	
Week 4	Sales of Ayman toys to Deeco Ltd, receivable one month later (8,000 toys at £2 each)	16,000	
		<b>Week 1</b>	<b>Total</b>
		<b>£</b>	<b>£</b>
Profit and loss account	Sales revenue	0	0
	Cost of sales	0	0



## Progress checks

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

### Progress check 4.6

What are the various methods that may be used to depreciate an asset? Describe two of the most commonly used methods.

The amount of depreciation calculated for an accounting period is charged as a cost reflected in the income statement, the depreciation charge. A corresponding amount is also reflected in an account in the balance sheet, the cumulative depreciation provision account, the effect of which is to reduce the original, historical cost of the non-current assets at the end of each accounting period.

The difference between depreciation cost and other costs such as wages and salaries is that it is not a cash expense, that is it does not represent a cash outflow. The only cash outflow relating to depreciation took place when the asset was originally purchased. The depreciation is really only the 'memory' of that earlier cash outflow.

### Progress check 4.7

Why are assets depreciated and what factors influence the decision as to how they may be depreciated?

## Press extracts

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

The press extract below illustrates the factors involved in (and the implications of) making investment decisions. When Bosch opened its alternator factory in Cardiff in 1989 the decision was aided by the belief that the UK was undergoing a renaissance as an automobile manufacturer. In addition, more than £20m of grants were received by Bosch from the Welsh Development Agency in a bid to

### The impact of high UK costs on investments by large foreign companies

About 900 jobs are to be lost in South Wales as Bosch prepares to shut a car parts factory next year.

The privately owned German engineering group blamed its decision to pull out of Wales on the economic slump, which has hit the car industry hard. The Unite union described the news as a 'terrible blow'.

Management confirmed the closure to workers at the plant in Miskin near Cardiff on Thursday, after a three-month consultation, during which they had to decide whether to shed 300 jobs and carry on with a smaller operation, or close the plant completely in 2011.

The division in charge of the plant will now recommend to the Bosch board that production should be phased out. The consultation is being extended until February as unions and staff try to thrash out redundancy terms.

The factory, which makes alternators for German carmakers including BMW and Daimler, Mercedes-Benz, is scheduled to start in the summer of next year. Production will be transferred to Hungary, where labour costs are 65% of those in Cardiff.

The move is a serious blow to south Wales. The other major employer in the region is Corus, the steelmaker, which itself is cutting more than 1,000 jobs.

several divisions of Bosch, he added: 'Everyone is bitterly disappointed that there's not a hope of something being retained.'

Bosch, which is set to make its first operating loss for six decades, said demand for alternators had dropped dramatically, with sales down 45% last year.

The global recession has hit carmakers around the world, with General Motors and Chrysler going bankrupt last year and needing US government aid to survive. The luxury marques BMW and Daimler both saw sales slip by 13%, according to figures released yesterday, as government scrappage schemes led to a move towards smaller and more fuel-efficient vehicles.

'I deeply regret that we could not find a solution for the Cardiff plant', said Stefan Auenkercher, president of the Bosch starter motors division, who rejected the alternative plan to keep the plant open with the loss of 300 jobs.

'I have spent time in a previous role as plant manager in Cardiff and I know first-hand the dedication and commitment of the employees here. Therefore, this is for me personally one of the toughest decisions in my career.'

The worst economic downturn for many decades had 'left its mark' on the Bosch group, he said. The Welsh assembly government offered

## Summary of key points

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

### Summary of key points

- Standard costing can be used to calculate costs of units or processes that may be used in budgeted costs.
- Not all budgeted amounts are standard amounts, as the latter will be precise by nature, unlike budgeted amounts.
- Standard costing provides the basis for performance evaluation and control from comparison of actual performance against budget through the setting of predetermined cost estimates.
- A flexible budget reflects the costs or revenues expected as a result of changes in activity levels from those planned in the master budget.
- A flexible budget provides a more realistic basis for comparison of actual performance against planned performance.
- Flexible budgets enable comparison of actual costs and revenues on a like-for-like basis through the calculation of differences, or variances.
- Variances are the differences between planned, budgeted or standard costs (or revenues) and actual costs incurred and may be summarised in an operating statement to reconcile budget with actual performance.
- Variances between actual and standard performance may be investigated to explain the reasons for the differences through preparation of a complete analysis of all variances, or alternatively through the use of exception reporting that highlights only significant variances.
- Inaccuracies in original budgets may be identified through planning variances, and actual performance may then be compared with a subsequently revised budget to show operational variances.

## Questions

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

### Assessment material

#### Questions

- Q13.1** How is standard costing used in the preparation of budgets?
- Q13.2** (i) What are the benefits of using standard costing?  
(ii) What type of standard may best ensure that those benefits are achieved?  
(iii) How are standards used to achieve those benefits?
- Q13.3** Describe and illustrate the technique of flexible budgeting.
- Q13.4** (i) What is management by exception?  
(ii) How is variance analysis used to support this technique?
- Q13.5** (i) Outline the main variances that may be reported using the bases of absorption costing and marginal costing.  
(ii) What do these variances tell us about direct labour, direct materials and overhead costs?
- Q13.6** Describe the main reasons why usage and efficiency variances may occur and illustrate these with some examples.
- Q13.7** What are mix and yield variances?
- Q13.8** (i) Explain some of the problems associated with traditional variance reporting.  
(ii) What are planning and operational variances?

## Discussion points

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

### Discussion points

- D13.1** 'We set the budget once a year and then compare the actual profit after the end of the financial year. If actual profit is below budget, then everyone needs to make more effort to ensure this doesn't happen the following year.' Discuss.
- D13.2** 'The standard-setting process is sometimes seen as management's way of establishing targets that demand better and better manufacturing performance.' To what extent do you think that is true, and if it is true how effectively do you think the standard-setting process achieves that objective?
- D13.3** To what extent do you think that the techniques of flexed budgets and variance analysis complicate the otherwise simple process of comparing the various areas of actual performance against budget?
- D13.4** 'Traditional variance analysis tends to focus on cutting costs and increasing output in a way that is detrimental to product and service quality and the longer-term viability of the business.' Discuss.

## Exercises

These comprehensive examination-style questions are graded by their level of difficulty, and also indicate the time typically required to complete them. They are designed to assess your knowledge and application of the principles and techniques covered in each chapter. There are typically 6 to 8 exercises at the end of each chapter. Full solutions to the colour-highlighted exercise numbers are provided in Appendix 3 to allow you to self-assess your progress.

### Exercises

Solutions are provided in Appendix 3 to all exercise numbers highlighted in colour.

#### Level I

**F13.1** Time allowed – 60 minutes

Nilbog Ltd makes garden gnomes. It uses standard costs and has budgeted to produce and sell 130,000 Fishermen (their top-of-the-range gnome) in 2010. Nilbog's budget for the year is phased over 13 four-week periods, and production and sales revenues are spread evenly in the budget.

Budgeted standard costs and selling prices for the Fisherman are:

		£
Direct materials	3 cubic metres at £3.60 per cubic metre	10.80
Direct labour	2 hours at £6.60 per hour	13.20
Variable overheads	2 hours at £2.40 per hour	4.80
Fixed overheads	2 hours at £4.80 per hour	9.60
Standard cost of one Fisherman		38.40
Standard profit		9.60
Standard selling price		48.00

The actual results for period five, a four-week period, were:

Revenue	9,000 Fishermen at £48 each
Production	9,600 Fishermen
Purchase of direct materials	30,000 cubic metres at a cost of £115,200
Direct materials usage	28,000 cubic metres
Direct labour cost	£142,560 for 22,000 hours
Variable overhead	£44,000
Fixed overhead	£100,000

There was no work-in-progress at the start or at the end of period five. Finished goods and materials inventories are valued at standard cost.

## Glossary of key terms

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

### Glossary of key terms

**absorption costing** A method of costing that, in addition to direct costs, assigns all, or a proportion of, production overhead costs to cost units by means of one or a number of overhead absorption rates.

**accountability concept** Management accounting presents information measuring the achievement of the objectives of an organisation and appraising the conduct of its internal activities in that process. In order that further action can be taken, based on this information, it is necessary at all times to identify the responsibilities and performance of individuals within the organisation.

**accountancy** The practice or profession of accounting.

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

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

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

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

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

**accounting rate of return (ARR)** Annual profit divided by investment. It is a form of return on capital employed. Unlike NPV and IRR, it is based on profits, not cash flows.

**accounting standard** Authoritative statement of how particular types of transaction and other events should be reflected in financial statements. Compliance with accounting standards will normally be necessary for financial statements to give a true and fair view (ASB).

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

This book is dedicated to my dad  
Phil Davies

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## The Financial Times

Article on page 17 from Push for accounting convergence threatened by EU reform drive, *Financial Times*, 05/04/2010 (Rachel Sanderson).

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## Part I

# FINANCIAL ACCOUNTING

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## Outline of Part I

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

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

**Chapter 3** looks in detail at the balance sheet.

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

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

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

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

**Chapter 8** looks at the analysis and interpretation of the annual report and accounts of a business. It uses the report and accounts for the year ended 31 March 2010 of Johnson Matthey Plc to illustrate the type of financial and non-financial information provided by a major UK public company.



# 1



## The importance of accounting and finance

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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 shareholder wealth. Directors of the business manage the resources of the business to meet shareholders' objectives.

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

Over the past few years there has been an increasing focus on trying to bring together the rules, or standards, of accounting that apply in each separate country, into one set of accounting

standards. For example, with effect from January 2005 all the stock exchange listed companies within the European Union were required to comply with one such set of accounting standards relating to the way in which they report financial information. We will discuss how this may affect the topics we shall be covering in this book.

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

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

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

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

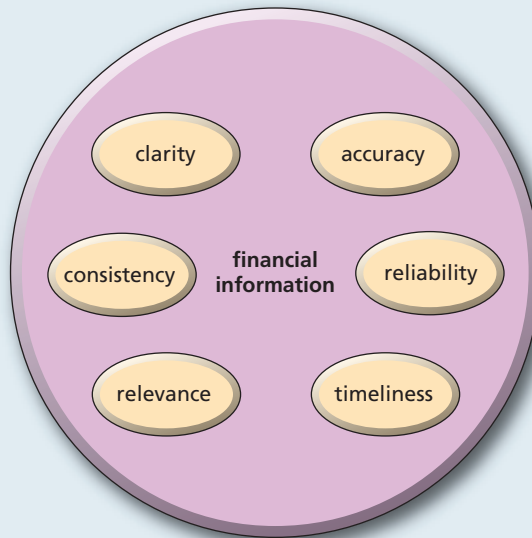
- |   |  |
|---|--|
| ■ how are we doing, and are we doing well or badly? | <b>a scorecard (like scoring a game of cricket, for example)</b> |
| ■ which problems should be looked at?               | <b>attention-directing</b>                                       |
| ■ which is the best alternative for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

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

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

**Figure 1.1** Features of useful financial information

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

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

## The conceptual frameworks of accounting

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

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

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

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

### Progress check 1.1

What is meant by a conceptual framework of accounting?

## The Statement of Principles (SOP)

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

The SOP identifies the main users of financial information as:

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

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

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

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

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

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

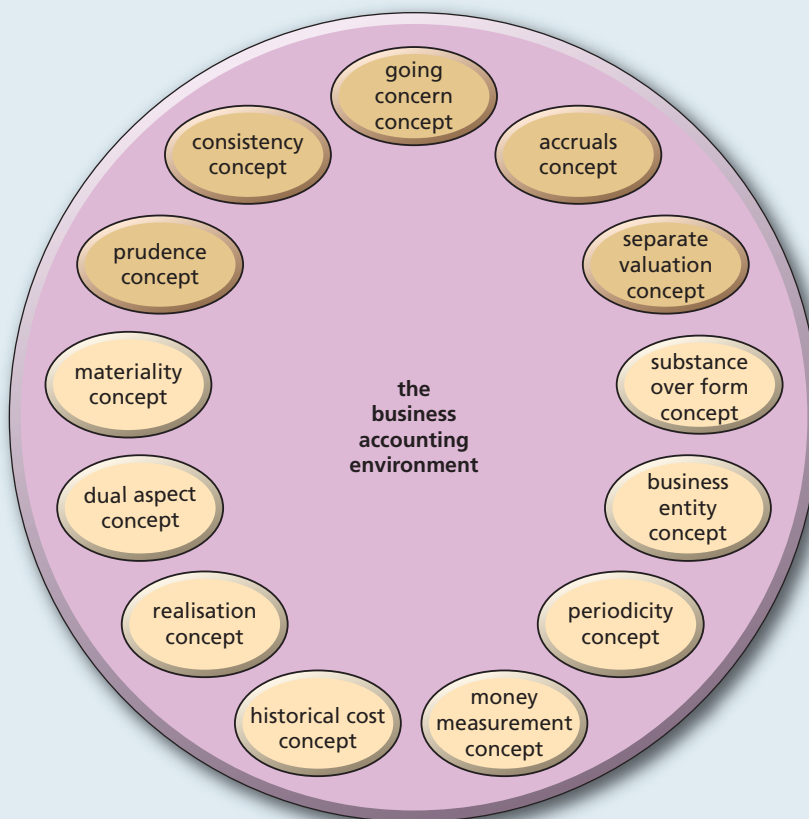
### Progress check 1.2

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

## Accounting concepts

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

**Figure 1.2** Accounting concepts



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

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

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

### *The prudence concept*

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

### *The consistency concept*

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

### *The going concern concept*

The **going concern concept** is a boundary rule that assumes that the entity will continue in operational existence for the foreseeable future. This is important because it allows the original, historical costs of assets to continue to be used in the balance sheet on the basis of their being able to generate future income. If the entity was expected to cease functioning then such assets would be worth only

### Financial mismanagement makes fans see Red

Liverpool chairman Martin Broughton has been forced to offer assurances to the Premier League that the club will fulfil their fixtures next season after their accounts, published yesterday, revealed record losses of £54.9million and soaring debts of £351million.

Broughton, appointed as non-executive chairman last month, had to provide proof that Liverpool could meet strict financial guidelines laid down by the Premier League and Uefa and that they would be able to continue trading as a going concern throughout the 2010–11 campaign.

It is believed the Royal Bank of Scotland, the club's banker, has provided reassurances that Liverpool will have sufficient funds to survive until the sale of owners Tom Hicks's and George Gillett's stakes can be finalised.

Though Broughton, in an interview with the club's television channel, yesterday insisted that process would take 'a matter of months', the publication of Liverpool's financial position will hardly help.

Accounts for the club's holding company for the year ending in July 2009 show spiralling interest payments of £40million, wages breaking the £100million-a-season barrier, a record loss of £54.9million and an increase in the club's debt of £51.5million.

Liverpool now stand £351million (net) in the red. Some £233million of that is owed to the government-owned RBS and the US investment bank Wachovia, while £144.4million is owed to Hicks and Gillett's parent company, Kop Cayman.

Much of Liverpool's losses - increased by £14million to July 2009 - can be attributed to the interest payments on that debt, which have cost the club a little over £40million alone, or almost £110,000 a day.

But the greatest concern is that Liverpool's financial picture can be so bleak in a year when the club's turnover was £185million, an increase of £20million on the previous year, thanks to the television rights and money accrued for last season's second-place finish in the Premier League and run to the Champions League quarter-finals.

Liverpool will finish no higher than sixth in the Premier League this season and were eliminated from the Champions League at the group stage. Though the club remain confident much of that loss will be compensated for by an £80million, four-year sponsorship deal with Standard Chartered, it is believed that some of that money is performance-related.

Twice this year Liverpool were forced to extend their credit facility on a short-term basis with RBS, while auditors KPMG expressed a 'material uncertainty' about the club's ability to continue for the second year running.

Source: **Liverpool slide further into red**, by Rory Smith  
© Daily Telegraph, 8 May 2010

*On 15 October 2010 the US Company New England Sports Ventures completed a £300 million takeover of the club from the former owners, Gillett and Hicks, which effectively cleared the club of all the debt that had been accrued by the former owners.*

what they would be expected to realise if they were sold off separately (their break-up values) and therefore usually considerably less.

Even the most high-profile enterprises are not immune to the threat of failure to continue to trade. In February 2007 American tycoons George Gillett and Tom Hicks acquired Liverpool football club including its £44.8m debts. Both men already owned ice hockey and baseball clubs in the USA and guaranteed to invest £200m in the club. However, much of the capital for the takeover was financed by debt, bringing with it massive interest payments. This together with the club's decline in fortunes in the 2009/2010 season gave rise to grave concerns by the summer of 2010 over the ability of the club to continue to operate over the next season (see the press extract above).



## The accruals concept

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

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

## The separate valuation concept

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

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

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

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

The further eight fundamental accounting concepts are as follows.

## The substance over form concept

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



## *The business entity concept*

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

## *The periodicity concept*

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

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

## *The money measurement concept*

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

## *The historical cost concept*

- ▶ The **historical cost concept** is a recording and measurement rule that relates to the practice of valuing assets at their original acquisition cost. For example, you may have bought a mountain bike two years ago for which you were invoiced and paid £150, and may now be wondering what it is currently worth. One of your friends may consider it to be worth £175 because they feel that the price of new mountain bikes has increased over the past two years. Another friend may consider it to be worth only £100 because you have used it for two years and its condition has deteriorated. Neither of your friends may be incorrect, but their views are subjective and they are different. The only measure of what your bike is worth on which your friends may agree is the price shown on your original invoice, its historical cost.

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

## *The realisation concept*

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



## *The dual aspect concept*

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



## *The materiality concept*

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



## **True and fair view**

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



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

## UK accounting and financial reporting standards

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

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

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

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

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

Industry (CBI), and professional bodies like the Law Society, Institute of Directors, and Chartered Management Institute.

There are therefore many diverse influences on the form and content of company accounts. In addition to legislation, standards are continually being refined, updated and replaced and further enhanced by various codes of best practice. As a response to this the UK Generally Accepted Accounting 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 inventories of materials, or charging the cost of a machine over its useful life, that is, its depreciation.

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

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

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

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

### Progress check 1.3

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

## International accounting standards

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

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

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

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

The 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 this book, since UK accounting standards have already moved close to international standards. The reason for this is that the UK SOP was drawn up using the 1989 IASB conceptual framework for guidance. A list of current IFRSs and IASs is shown in Appendix 2 at the end of this book.

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

FT

## Who controls the IASB?

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

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

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

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

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

But accountants and business leaders – particularly in the US and Japan – argue that accounts

should not be the subject of regulatory intervention but should focus on providing an accurate snapshot of a company's value.

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

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

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

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

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

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

### Progress check 1.4

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

### Worked example 1.1

Young Fred Osborne decided that he would like to start to train to become an accountant. Some time after he had graduated (and after an extended backpacking trip across a few continents) he registered with the Chartered Institute of Management Accountants (CIMA). At the same time Fred started employment as part of the graduate intake in the finance department of a large engineering group. The auditors came in soon after Fred started his job and he was intrigued and a little confused at their conversations with some of the senior accountants. They



talked about accounting concepts and this standard and that standard, SSAPs, FRSs, and IFRSs, all of which meant very little to Fred. Fred asked his boss, the Chief Accountant Angela Jones, if she could give him a brief outline of the framework of accounting one evening after work over a drink.

Angela's outline might have been something like this:

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

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

## Financial accounting, management accounting and financial management

The provision of a great deal of information, as we shall see as we progress through this book, is mandatory; it is needed to comply with, for example, the requirements of Acts of Parliament, and HM Revenue & Customs. However, there is a cost of providing information that has all the features

that have been described, which therefore renders it potentially useful information. The benefits from producing information, in addition to mandatory information, should therefore be considered and compared with the cost of producing that information to decide on which information is 'really' required.

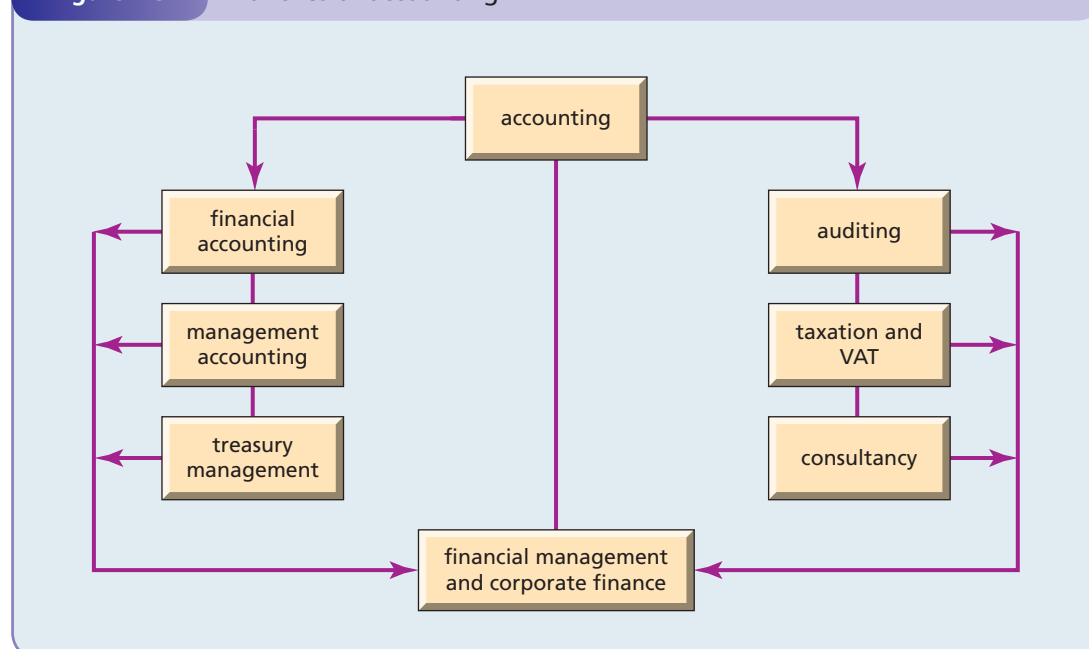
Accountants may be employed by accounting firms, which provide a range of accounting-related services to individuals, companies, public services and other organisations. Alternatively, accountants may be employed within companies, public services and other organisations. Accounting firms may specialise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

## Financial accounting

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

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

**Figure 1.3** Branches of accounting





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

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

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

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

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

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

## Management accounting

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

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

The functions of management accounting are wide and varied. As we shall discover in Part II of this book, 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 has continued to develop its emphasis on decision-making and strategic management, and broaden the range of activities that it supports, it has now come to be regarded as an integral part of financial management.

### **Worked example 1.2**

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

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

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

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

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

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

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

### Progress check 1.5

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

## Accounting and accountancy

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


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

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

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

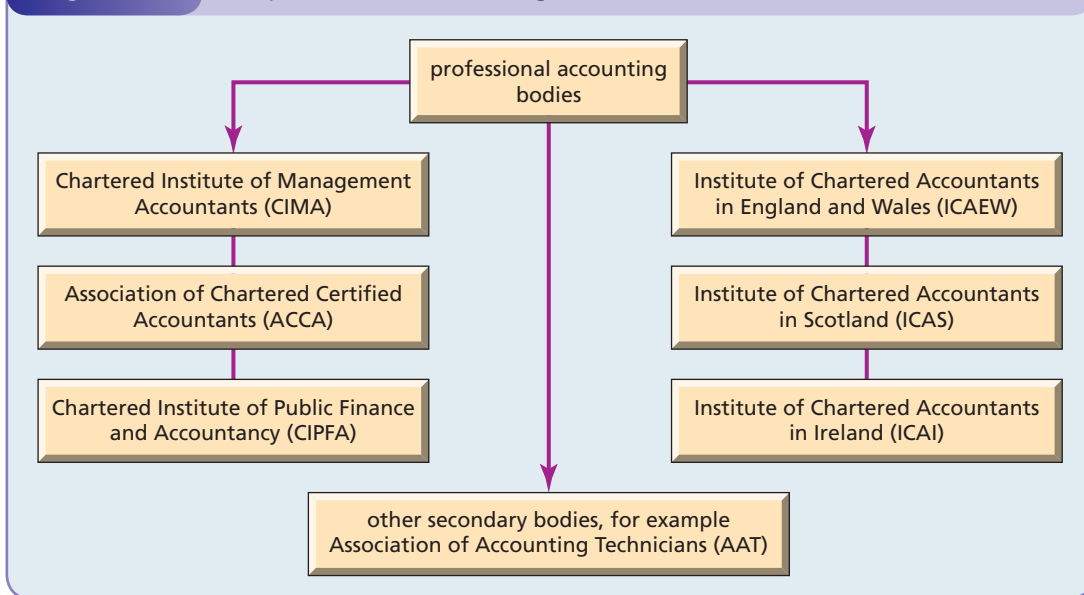
There may be separate accounting manuals for the constituent parts of the accounting system, for example:

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

**Accountancy** is defined as the practice of accounting. A **qualified accountant** is a member of the accountancy profession, and in the UK is a member of one of the six professional accountancy bodies (see 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

**Figure 1.4** The professional accounting bodies

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

### Progress check 1.6

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

### Worked example 1.3

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

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

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

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

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

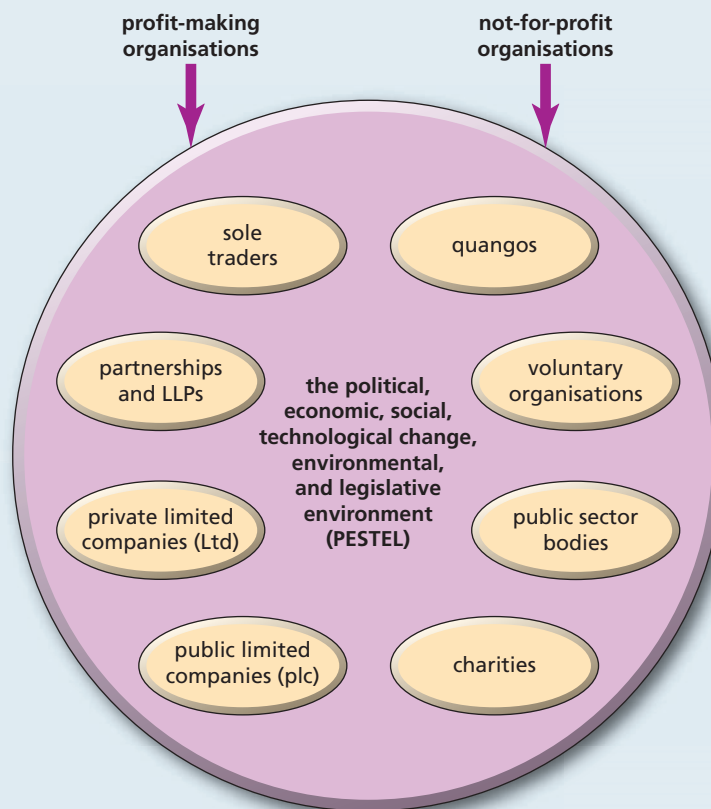
**Association of Chartered Certified Accountants (ACCA):** employment either within a firm of accountants, carrying out auditing etc., or management accounting and financial accounting roles within commerce/industry

**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

## Types of business entity

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 Figure 1.5. The four main types of profit-making organisations are explained in the sections that follow.

**Figure 1.5** Types of business entity



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** (in some countries called the chamber of commerce). 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 HM Revenue & Customs.

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
- are all jointly and severally liable for the debts of the firm
- all have unlimited liability for the debts of the firm (and cases of financial difficulty may result in personal property being used to repay debts)
- are each liable for the actions of the other partners.

Accounting records are needed to be kept by partnerships for the day-to-day management of the business and to provide an account of profit made during each tax year. Unlike limited companies, partnership firms are not required to file a formal report and accounts each year with the Registrar of Companies, but partners must submit annual returns for tax purposes to HM Revenue & Customs.

A new type of legal entity was established in 2001, the limited liability partnership (LLP). This is a variation on the traditional partnership, and has a separate legal identity from the partners, which therefore protects them from personal bankruptcy.

One of the main benefits of a partnership is that derived from its broader base of business skills than that of a sole trader. A partnership is also able to share risk-taking, decision-making and the general management of 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 2006. 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 information. A Ltd company's accounts must be audited by a suitably qualified accountant, unless it is exempt from this requirement, currently (with effect from 6 April 2008) by having annual sales of less than £6.5m and a balance sheet total of less than £3.26m. 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 Her Majesty's Revenue & Customs (HMRC) 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.

The Companies Act 2006 removed the requirement of a private limited company to hold an annual general meeting (AGM). However, if companies' Articles of Association require an AGM, then they must continue to be held unless the Articles are amended. Under the provisions of the Companies Act 2006, directors or 10% of the shareholders of a company may at any time request a general meeting to be held.

## *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 plc's 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. Plcs must also provide copies of their annual accounts for HM Revenue & Customs 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.

### Worked example 1.4

Ike Andoowit is in the process of planning the setting up of a new residential training centre. Ike has discussed with a number of his friends the question of registering the business as a limited company, or being a sole trader. Most of Ike's friends have highlighted the advantages of limiting his liability to the original share capital that he would need to put into the company to finance the business. Ike feels a bit uneasy about the whole question and decides to obtain the advice of a professional accountant to find out:

- (i) the main disadvantages of setting up a limited company as opposed to a sole trader
- (ii) if Ike's friends are correct about the advantage of limiting one's liability
- (iii) what other advantages there are to registering the business as a limited company.

The accountant may answer Ike's questions as follows:

Setting up as a sole trader is a lot simpler and easier than setting up a limited company. A limited company is bound by the provisions of the Companies Act 2006, and for example, may be required to have an independent annual audit. A limited company is required to be much more open about its affairs.

The financial structure of a limited company is more complicated than that of a sole trader. There are also additional costs involved in the setting up, and in the administrative functions of a limited company.

Running a business as a limited company requires registration of the business with the Registrar of Companies.

As Ike's friends have pointed out, the financial obligations of a shareholder in a limited company are generally restricted to the amount he or she has paid for his or her shares. In addition, the number of shareholders is potentially unlimited, which widens the scope for raising additional capital.

It should also be noted that:

- a limited company is restricted in its choice of business name
- if any director or 10% of the shareholders request it, a limited company is required to hold a general meeting at any time
- any additional finance provided for a company by a bank is likely to require a personal guarantee from one or more shareholders.

### Progress check 1.8

There are some differences between those businesses that have been established as sole traders and those established as partnerships, and likewise there are differences between private limited companies and public limited companies. What are these differences, and what are the similarities?

## 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, income statement (or **profit and loss account**), and statement of cash flows. Companies are also obliged to provide similar financial statements at each year end to provide information for their shareholders, HMRC, 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 income statement and statement of cash flows 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

Fred Osborne soon settled into his graduate trainee role in the finance department of the large engineering group, and pursued his CIMA studies with enthusiasm. Although Fred 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. Fred was explaining the subject of financial statements and what they involve to a friend of his, Jack, another graduate trainee in human resources. Where? – you've guessed it – over an after-work drink.

Fred 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:

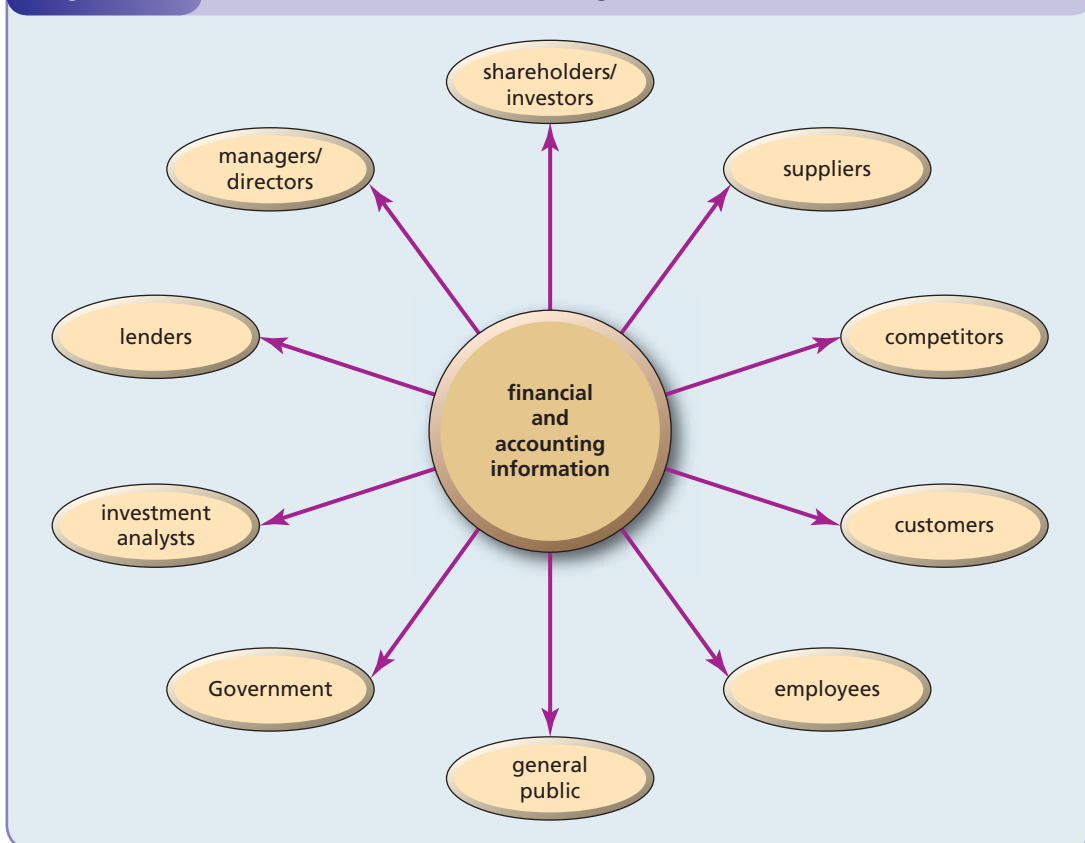
- shareholders
- HMRC
- banks
- City analysts
- investing institutions
- the public in general.

The three key financial statements are the:

- (a) balance sheet
  - (b) income statement (or profit and loss account)
  - (c) statement of cash flows.
- (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) **Income statement:** 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) **Statement of cash flows:** 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 income statement 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 statement of cash flows 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 Figure 1.6.

**Figure 1.6** Users of financial and accounting information**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?

**Worked example 1.6**

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 value added tax (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 directors/managers are running the business, and to assess the financial strength and future developments
- **Suppliers** to assess the long-term viability and whether the company is able to meet its obligations and pay suppliers on an ongoing basis.



## 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, income statement, and statement of cash flows, 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 annual sales revenue of less than £6.5m and a balance sheet total of less than £3.26m.

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 for Business, Innovation and Skills (BIS) and through Parliament by the enactment of legislation, for example the Companies Act. Such legal regulation began with the Joint Stock Companies Act 1844.

Subsequent statutes exerted greater influence on company reporting: the Companies Acts 1948, 1967, 1981 and 1985, amended in 1989. The provisions included in these Acts were consolidated into the Companies Act 2006. The Companies Act 2006 contains the overall current legal framework.

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 £50,000 or £1,000,000)?
- (c) Is the company profitable?
- (d) Does the company have loan commitments?
- (e) Is the company working within its bank overdraft facilities?
- (f) Are any press analyses of the company available?
- (g) What is the current customer base?

The answers may suggest whether the company can continue trading for the foreseeable future.

## 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 Financial Reporting Standards (IFRSs) have been developed, which have been 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, income statement and statement of cash flows.
- 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.



## Assessment material

### 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 have we 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 income statement 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 wouldn't 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, and what are 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 plc's 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*

Wembley Stadium II (the Football Association's replacement for the original iconic Wembley Stadium) was planned to open in 2003 but due to numerous problems financing the construction, problems in the general day-to-day operations, and changes of contractor, it finally opened in March 2007. There were many crises reported in the press during the course of the project and the development finally cost over £1 billion.

**You are required to research into the Wembley Stadium II project 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, Government ministers, and the Football Association 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.**

# 2



## Classifying and recording financial transactions

### Contents

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## Learning objectives

Completion of this chapter will enable you to:

- explain the convention of double-entry bookkeeping
- describe what is meant by 'debit' and 'credit'
- enter business transactions into accounts
- account for closing inventories and other accounting adjustments
- explain the balancing of accounts
- extract a trial balance from a company's accounts
- prepare an income statement, balance sheet and statement of cash flows from a trial balance
- appreciate the concepts of accrual accounting and cash accounting
- explain and account for payments in advance (prepayments) and charges not yet received (accruals)
- appreciate the importance of accounting periods.

## Introduction

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

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

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

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

## Theory and practice of double-entry bookkeeping

■ **Double-entry bookkeeping** has a long history, having been created by the father of modern accounting, the Franciscan monk Luca Pacioli in Italy in the late fifteenth century. His publication, *Summa de Arithmetica, Geometria, Proportioni et Proportionalita* (Everything about Arithmetic, Geometry and Proportion), published in 1494, was the first printed work dealing with algebra and also contained the first text on bookkeeping, entitled *Particularis de Computis et Scripturis*. Bookkeeping

then spread throughout the world by a series of plagiarisms and imitations of Pacioli's work. If Pacioli were around today he would be very disappointed to see the extent to which double-entry has apparently not been practised in Greece in more recent times. During 2009 and 2010 the Greek economy was in severe economic difficulty. It may be significant that a large part of the Greek public sector does not use double-entry bookkeeping at all (see the press extract below).

It is important to remember that the idea of double-entry is a convention. There are two main objectives of bookkeeping: to have a permanent record of transactions; to show the effect of each transaction and the combined effect of all the transactions on the financial position of the entity.

The fundamental idea of double-entry bookkeeping is that all business transactions of a business entity, for example, cash and invoices, should be recorded twice in the entity's business records. It is based on the principle that every financial transaction involves the simultaneous receiving and giving of value, and is therefore recorded twice. Transactions of course involve both services and goods. We

### Look what happens when you neglect double entry!

**S**tandard & Poor's has become the second rating agency to downgrade Greek sovereign debt to near junk levels of BBB1, issuing a withering verdict on spartan plans unveiled this week by premier George Papandreou.

'The downgrade reflects our opinion that the measures to reduce the high fiscal deficit are unlikely, on their own, to lead to a sustainable reduction in the public debt burden. If political considerations and social pressures hamper progress, we could lower the ratings further', it said.

The move came as Spyros Papanikolaou, head of Greece's Public Debt Management Agency, held back-to-back meetings with bankers in London in a bid to stop the crisis spiralling out of control.

Yields on 10-year Greek bonds surged to 5.75pc, a spread of 254 basis points over German Bunds. Borrowing costs are nearing levels that risk setting off an interest compound spiral. The public debt is already 113pc of GDP. S&P said it is likely to reach 138pc by 2012. 'The increasing debt-service burden narrows the scope for debt stabilisation', it said.

Fitch Ratings precipitated the Greek crisis earlier this month with a surprisingly harsh downgrade to BBB1, accompanied by a 'negative outlook'.

It emerged yesterday that Greece had raised euro2bn (£1.77bn) at a premium of 30 basis points in a private placement shortly after the Fitch move, avoiding the public glare of an auction.

To make matters worse, there were fresh concerns yesterday about the true scale of Greek

military spending, which is kept off the books of the debt agency.

'Greek military accounts seem to be regarded as a state secret', said Chris Pryce, Fitch's director of sovereign ratings.

'In every other EU country we can find out how much they spend on defence, but we don't know for Greece. All we know is that their military spending is very large, around 5pc of GDP', he said.

Analysts who have probed deeply into Greek accounts have been astonished to discover that parts of the public sector lack double-entry bookkeeping, 700 years after it was invented by the Venetians.

Given Greece has misled the bond markets and Brussels in the past over its deficits, analysts suspect that Athens may try to hide problems behind a military veil. Mr Papandreou admits that Greece has lost "every shred of credibility".

Greece has already cut defence this year. It announced in September that it would not take delivery of four submarines built by Thyssen-Krupp, alleging technical faults. This has led to accusations Athens is effectively defaulting on a euro520m contract. Last week it cancelled tenders for a flight of maritime aircraft worth up to euro250m.

Source: **Greek crisis deepens with S&P downgrade; worry about true scale of undisclosed military spending adds to concern**, by Ambrose Evans-Pritchard © *Daily Telegraph*, 17 December 2009

shall find out later in this chapter that there are other accounting entries which do not result directly from invoice or cash transactions but which also result in double-entry records being created. These

■ **accounting adjustment** entries relate, for example, to accounting for depreciation, **bad debts**, and **doubtful debts**.

The convention of double-entry assumes that in all business transactions equal and opposite values are exchanged. For example, if a company purchases materials for £1,000 for cash it adds to its inventory of materials to the value of £1,000, but reduces its cash balance also to the value of £1,000. The convention uses two terms for convenience to describe the two aspects of each transaction. These terms are debit and credit.

There is sometimes confusion in the use of the terms debit and credit used in bookkeeping when they are compared with the same terms used on bank statements. Bank statements traditionally refer to a receipt of cash as a credit, whereas a receipt of cash in bookkeeping terms is referred to as a debit. The reason for this is that customer accounts are presented from the bank's point of view; as far as the bank is concerned, account holders are creditors, to whom the bank will eventually have to repay any money deposited by them.

## Debits and credits

The explanation of debits and credits in terms of value received and value given respectively is not perhaps one that provides the clearest understanding. Neither is the explanation that debits are in the left-hand column and credits are in the right-hand column, or debits are on the side of the room closest to the window!

■ Debits and credits do represent certain types of account, as we will see later, in both the balance sheet: **assets** and **liabilities**, and the income statement: **costs** and sales. However, for the purpose of clarity of explanation we shall propose a couple of basic assumptions with which to work from as we go through some elementary accounting entries.

■ If we initially consider all business transactions as either goods or services then it is reasonable to assume (unless we are in a barter society) that all these transactions will ultimately end up with cash (or cash equivalents, such as cheques, bank transfers, etc.) changing hands. We can also assume that all these transactions will involve a document being raised, as a record of the transaction and an indication of the amount of cash that will change hands, namely an invoice. A **purchase invoice** records a purchase from a third party and so it represents an account to be payable at some time. A **sales invoice** records a sale to a third party and so it represents an account to be receivable at some time.

Business entities themselves have a separate identity from the owners of the business. When we consider double-entry bookkeeping we will now assume that all the entries we are discussing relate to those of the business entity, in whatever form the entity takes: sole trader; partnership; limited company; public limited company (see Chapter 1).

For the business entity, we shall define the following business transactions:

Transaction	Accounting entries	
CASH RECEIPT	= DEBIT CASH	and credit something else
CASH PAYMENT	= CREDIT CASH	and debit something else
PURCHASE INVOICE	= CREDIT ACCOUNTS PAYABLE	and debit something else
SALES INVOICE	= DEBIT ACCOUNTS RECEIVABLE	and credit something else

These are definitions within the convention of double-entry bookkeeping, which may be usefully remembered as a basis for establishing whether all further subsequent transactions are either debits or credits. It is suggested that the above four statements are kept filed in permanent memory, as a useful aid towards the understanding of further accounting entries.



## Progress check 2.1

Outline what is meant by double-entry bookkeeping.

An elementary method of representing and clarifying double-entry is known as the T account. We shall use this method to demonstrate double-entry in action using a simple example. (Note that in the UK there are many computerised accounting packages that automate the double-entry for a business, for example Sage. The purpose of this extensive worked example is to illustrate how such transactions take place.)

## Worked example 2.1

Mr Bean decides to set up a wholesale business, Ayco, on 1 January 2010. He has his own cash resources available for the purpose of setting it up and has estimated that an initial £50,000 would be required for this purpose. During the first month in business, January 2010, Ayco (as distinct from Mr Bean) will enter into the following transactions:

	£
Receipt of cheque from Mr Bean	50,000
Purchase the freehold of a shop for cash	30,000
Purchase the shop fittings for cash	5,000
Cash expenses on printing and stationery	200
Purchases of inventory, from Beeco, of Aymen toys, payable two months later (12,000 toys at £1 each)	12,000
Sales of Aymen toys to Ceeco for cash (1,000 toys at £2 each)	2,000
Sales of Aymen toys to Deeco, receivable one month later (8,000 toys at £2 each)	16,000

We shall consider each of these transactions in detail and subsequently represent them in T account format for clarity, with debits on the left and credits on the right of the middle line of the T. We will repeatedly refer to the earlier four key double-entry definitions in order to establish the entries required for each transaction.

### Receipt of cheque from Mr Bean £50,000 – transaction 1

Ayco will have needed to open a bank account to pay in the money received from Mr Bean. This represents a receipt of cash of £50,000 to Ayco, and so:

**Debit cash account** **£50,000 and credit what?**

This money represents the capital that Mr Bean, as the sole investor in the business, has invested in Ayco and so the account is called the capital account. So:

<b>Debit cash account</b>	<b>£50,000</b>
<b>Credit capital account</b>	<b>£50,000</b>



### Worked example 2.2

#### Purchase for cash the freehold of a shop £30,000 – transaction 2

This represents a cash payment for the purchase of a shop, something which is called a non-current asset: an asset acquired for retention by the entity for the purpose of providing a service to the business, and not held for resale in the normal course of trading.

**Credit cash account** **£30,000 and debit what?**

A payment of cash of £30,000 is a credit to the cash account, and so:

<b>Credit cash account</b>	<b>£30,000</b>
<b>Debit non-current assets – shop account</b>	<b>£30,000</b>

### Worked example 2.3

#### Purchase for cash the shop fittings £5,000 – transaction 3

This represents a cash payment for the shop fittings, which are also non-current assets, but a different category of non-current asset from the freehold shop.

A payment of cash of £5,000 is a credit to the cash account, and so:

<b>Credit cash account</b>	<b>£5,000</b>
<b>Debit non-current assets – fittings account</b>	<b>£5,000</b>

### Worked example 2.4

#### Cash expenses on printing and stationery £200 – transaction 4

This represents a payment of cash of £200 by Ayco in the month, and so:

**Credit cash account** **£200 and debit what?**

This money was paid out on day-to-day expenses that have been made to support the business, and is a charge for printing and stationery expenses. So:

<b>Credit cash account</b>	<b>£200</b>
<b>Debit printing and stationery expenses account</b>	<b>£200</b>

### Worked example 2.5

#### Purchases of inventory, from Beeco, of Aymen toys, payable two months later £12,000 – transaction 5

This represents a purchase on credit from Beeco. An invoice is assumed to have been received from Beeco along with the receipt of inventory. The invoice from Beeco is a purchase invoice for £12,000 to Ayco, and so:

**Credit accounts payable** **£12,000 and debit what?**

This represents a purchase of inventory which are goods held for resale, and so:

<b>Credit accounts payable</b>	<b>£12,000</b>	
<b>Debit inventories account</b>	<b>£12,000</b>	a purchase of inventory may alternatively be initially debited to the purchases account and then subsequently transferred to the inventories account.

### Worked example 2.6

#### Sales of Aymen toys to Ceeco for cash £2,000 – transaction 6

This represents a sale for cash to Ceeco. An invoice will be issued by Ayco to Ceeco along with the delivery of inventory. The invoice to Ceeco is a sales invoice for £2,000 from Ayco, and so:

<b>Debit accounts receivable</b>	<b>£2,000</b>	<b>and credit what?</b>
----------------------------------	---------------	-------------------------

This represents sales of inventory which are called sales, or sales revenue, and so:

<b>Debit accounts receivable</b>	<b>£2,000</b>
<b>Credit sales revenue account</b>	<b>£2,000</b>

But as a cash sale this sales invoice is being paid immediately with a cash receipt of £2,000, and so:

<b>Debit cash account</b>	<b>£2,000</b>	<b>and credit what?</b>
---------------------------	---------------	-------------------------

This £2,000 is immediately paying accounts receivable, and so

<b>Debit cash account</b>	<b>£2,000</b>
<b>Credit accounts receivable</b>	<b>£2,000</b>

which means that on this transaction the net balance of accounts receivable is zero.

This transaction may be short cut by directly crediting the sales revenue account and debiting cash. However, it is normally recorded in the way described in order to create and record a value added tax (VAT) sales invoice.

### Worked example 2.7

#### Sales of Aymen toys to Deeco, receivable one month later £16,000 – transaction 7

This represents sales on credit to Deeco. An invoice will be issued by Ayco to Deeco along with the delivery of inventory.

The invoice to Deeco is a sales invoice for £16,000 from Ayco, and so as above:

<b>Debit accounts receivable</b>	<b>£16,000</b>
<b>Credit sales revenue account</b>	<b>£16,000</b>

This is different from the transaction in Worked example 2.6 because the account receivable will not be paid until the following month.

## Closing inventories adjustment

■ In the Ayco example, one further accounting entry needs to be considered, which relates to the inventory of toys sold during the period. It is called a **closing inventories** adjustment, which is illustrated in Worked example 2.8.

### Worked example 2.8

We represented the purchase of 12,000 toys into the inventory of Ayco as a debit of £12,000 to the inventories account. Ayco sold 1,000 toys for cash and 8,000 toys on credit. The physical inventory of 12,000 toys at 31 January 2010 has therefore been reduced to only 3,000 ( $12,000 - 1,000 - 8,000$ ). We may value these units that are left in inventory at cost, for the purpose of this example, at  $3,000 \times £1$ , or £3,000. Ayco sold a total of 9,000 units during January at a selling price of £2 per unit. These 9,000 units cost £1 each and so these sales have cost Ayco £9,000: cost of sales £9,000. A double-entry accounting transaction is necessary to represent this for two reasons: to show the cost of the 9,000 toys that matches the sale of 9,000 toys; to ensure that the inventories account represents only the physical toys that are actually held in inventory.

The entries for the original purchase of inventory were:

<b>Credit accounts payable</b>	<b>£12,000</b>
<b>Debit inventories account</b>	<b>£12,000</b>

We know that the inventories account should now be £9,000 less than the original £12,000, representing the £9,000 cost of sales. Therefore we need to credit the inventories account to reduce it and debit something else. The something else is the cost of sales account.

#### Transaction 8

<b>Credit inventories account</b>	<b>£9,000</b>
<b>Debit cost of sales account</b>	<b>£9,000</b>

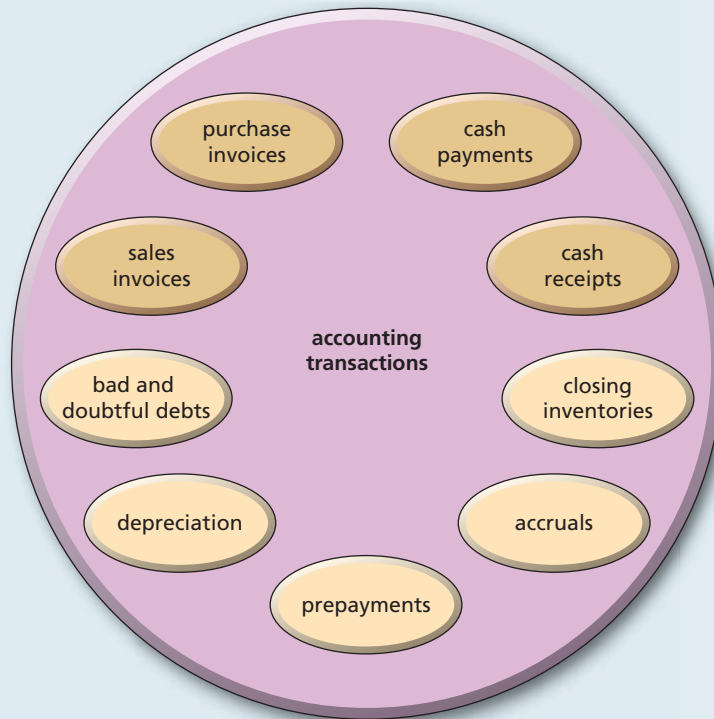
## Accounting adjustments

The diagram in Figure 2.1 includes all the main types of accounting transactions that may be recorded in an accounting system. The shaded items represent the prime entries (the first record of transactions) and cash entries. The non-shaded items are the five main accounting adjustment entries.

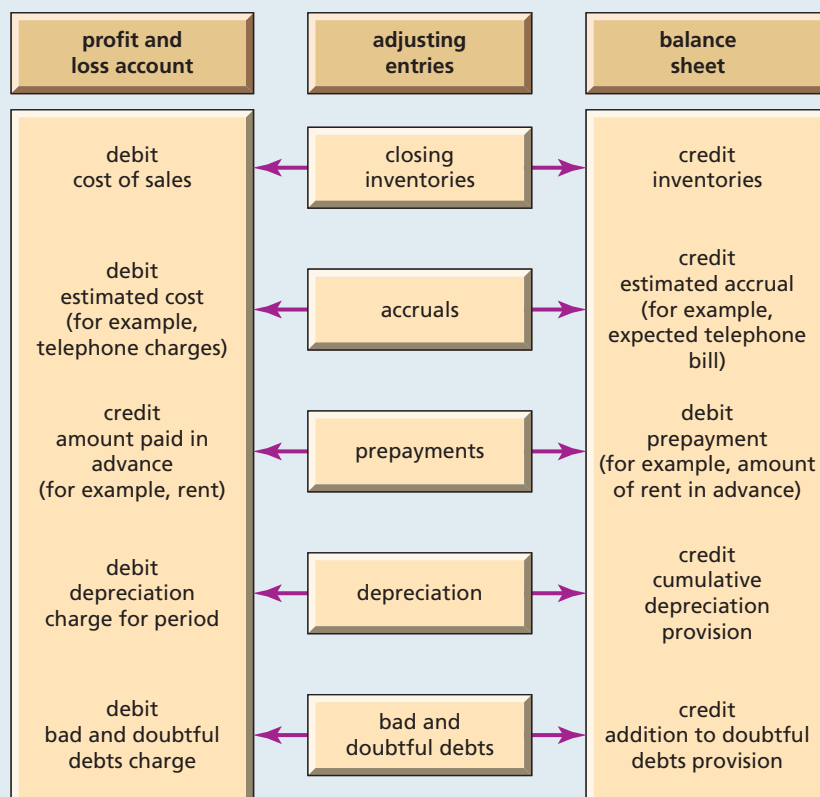
■ The closing inventories adjustment, illustrated in Worked example 2.8, is one of the five main accounting adjustment entries that are shown in Figure 2.2, which may or may not be incorporated into the **trial balance**.

■ Accounting adjustments are made to the trial balance and prior to preparation of the income statement and balance sheet. The other four adjusting entries are **accruals** and **prepayments** (covered later in this chapter), depreciation, and bad and doubtful debts and the **doubtful debt provision** (which are covered together with further detail on closing inventories in Chapter 4).

Each of the T accounts for Ayco in Figure 2.3 shows the detailed movement through the month and each account represents the balance on each account at the 31 January 2010, the end of the first month of trading.

**Figure 2.1** Accounting transactions**Figure 2.2**

The five accounting adjustments and their impact on the profit and loss account and the balance sheet



**Figure 2.3** T account representation of the January 2010 transactions of Ayco**Figures in £****share capital**

transaction 1		50,000
balance c/f	50,000	
	50,000	50,000
balance b/f @ 1/2/10		50,000

**cash book**

transaction 1	50,000	
transaction 2		30,000
transaction 3		5,000
transaction 4		200
transaction 6	2,000	
balance c/f		16,800
	52,000	52,000
balance b/f @ 1/2/10	16,800	

**non-current assets – shop**

transaction 2	30,000	
balance c/f		30,000
	30,000	30,000
balance b/f @ 1/2/10	30,000	

**non-current assets – fittings**

transaction 3	5,000	
balance c/f		5,000
	5,000	5,000
balance b/f @ 1/2/10	5,000	

**printing and stationery – expenses**

transaction 4	200	
balance c/f		200
	200	200
balance b/f @ 1/2/10	200	

**accounts payable**

transaction 5		12,000
balance c/f	12,000	
	12,000	12,000
balance b/f @ 1/2/10		12,000

**inventories**

transaction 5	12,000	
transaction 8		9,000
balance c/f		3,000
	12,000	12,000
balance b/f @ 1/2/10	3,000	

**sales revenue**

transaction 6		2,000
transaction 7		16,000
balance c/f	18,000	
	18,000	18,000
balance b/f @ 1/2/10		18,000

**accounts receivable**

transaction 6	2,000	
transaction 6		2,000
transaction 7	16,000	
balance c/f		16,000
	18,000	18,000
balance b/f @ 1/2/10	16,000	

**cost of sales**

transaction 8	9,000	
balance c/f		9,000
	9,000	9,000
balance b/f @ 1/2/10	9,000	

### Progress check 2.2

Explain broadly what is meant by accounting adjustment entries.

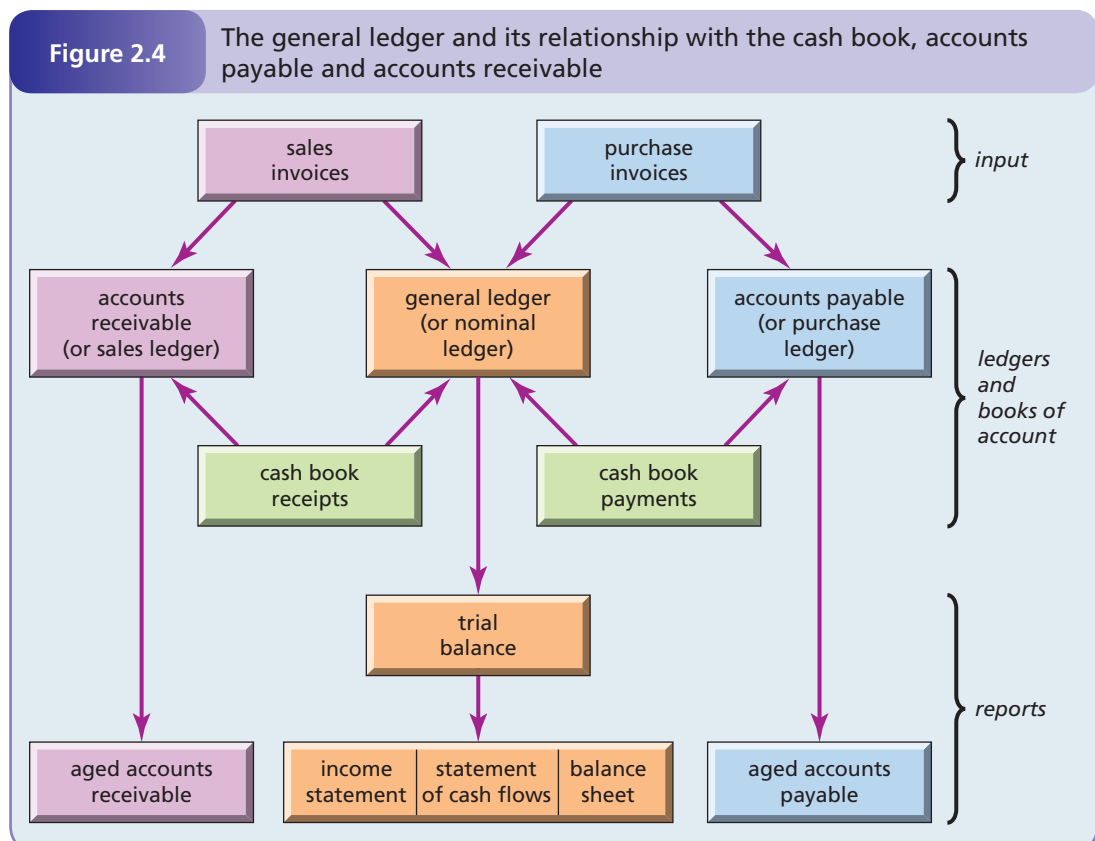
## Books of account and the ledgers in action

We saw in the previous section how the principle of double-entry bookkeeping operates to record the detail of transactions. We represented these records in T accounts to provide some clarity in seeing how each entry has been made and the interrelation of the entries. In practice, accounting records are kept along the same lines but in books of account and ledgers rather than T accounts on a piece of paper. The old-fashioned manually prepared ledgers maintained by companies have long since been superseded by **computerised accounting systems**. Nevertheless, the same principles apply and the same books of account and ledgers are maintained albeit in an electronic format.

The chart shown in Figure 2.4 shows the relationship between the main ledger, the general ledger (or nominal ledger) and the other books of account, and subsidiary ledgers:

- **cash book** (receipts and payments)
- **purchase invoice daybook** and accounts payable (or purchase ledger)
- **sales invoice daybook** and accounts receivable (or sales ledger).

It also shows the main sources of data input for these ledgers and the basic reporting information produced out of these ledgers and books of account.



Source: Based on *CIMA Official Terminology*, 2005 ed., CIMA Publishing, Elsevier p.58.

## General ledger

In smaller businesses, wages and salaries data are usually recorded in the cash book and subsequently posted to the general ledger. In larger companies, wages and salaries usually have their own ledgers and control accounts in the general ledger.

➡ The main ledger of any company, in which the results of all transactions made by the entity are recorded, is called the **general ledger** or nominal ledger. This ledger is set up to include all accounts whether they are assets, liabilities, sales (or revenues), or costs (or expenses). The detail of every transaction finds its way into this ledger, or is posted to it (to use the technical term), in much the same way as we saw in the T accounts. The general ledger may be said to be the collection of every T account within the entity.

Within the general ledger one account or more will be established to represent cash transactions (including cheques, drafts, bank transfers, etc.). These entries are posted to the general ledger from the analysis of entries made into the cash book. The cash book is a book of original entry maintained to show the detail of all receipts and payments made by the entity; it records the dates, values and unique references of all receipts and payments, and what they are for. These include, for example, payment of salaries, receipts from customers, purchase of non-current assets, etc.

## Cash book

➡ The cash book is a book of account that in theory should match exactly with the regular statements issued by the entity's bank. In practice, the cash book is prepared partly from company internally generated **cash payments** information and available information relating to **cash receipts**. Some transactions may appear in the bank account without prior notification, for example bank charges, and so the cash book may also be partly prepared with reference to information from the bank statement.

➡ There is a need to periodically check cash book balances against the balances shown on the bank statements supplied by the bank. The two numbers are rarely the same and so the differences between them need to be reconciled to ensure that cash book balances are correct. The regular preparation of a **bank reconciliation** on at least a monthly basis is therefore a necessary function of the finance department.

There are five main reasons for differences between cash book balances and the balances shown on bank statements:

- cash book arithmetic errors and incorrect postings of receipts and payments
- cash book omissions of items shown on the bank statements such as bank charges, standing orders, direct debits, and dishonoured (returned) cheques
- timing differences where cheques have been written and issued and entered in the cash book but have not yet been presented to the bank for payment at the date of the bank statement
- timing differences where cheques received have been entered in the cash book but have not yet been credited to the bank account at the date of the bank statement
- errors and overcharges made by the banks included in their statements but not reflected in the cash book (do not assume that bank statements are always correct: it is very important to always check interest and bank charges calculations in detail on a monthly basis, to identify errors and overcharges made by the banks).

All differences between the cash book and bank statement balance must be identified and any errors and omissions corrected in the cash book so that the updated cash book balance may be

reconciled with the bank statement balance as follows:

	<b>balance per cash book</b>
plus:	<b>cheques paid but not yet presented</b>
minus:	<b>receipts not yet credited</b>
=	<b>balance per bank statement</b>

Each payment and each receipt is posted from the cash book to the cash account in the general ledger as a credit or debit to cash. The opposite entry, either debit or credit, is posted at the same time to its relevant account in the general ledger, for example accounts payable, printing and stationery expenses, accounts receivable, etc. In the days when accounting ledgers were maintained manually such postings were made weekly or monthly. With computerised, integrated accounting systems postings may be made simultaneously to the cash book and the general ledger from the same source but avoiding any duplication of effort.

It is most important that the balance on the cash book, the net of all receipts and payments, at all times equals the balance of the cash book represented in the cash account within the general ledger, and that all the opposite entries have also been posted to their relevant accounts. In this way, the equality of total debits and total credits is maintained. The use of computerised accounting systems should guarantee this.

### Worked example 2.9

The debit balance on the cash book of Renfrew Ltd at 31 May 2010 is £4,800, but the bank statement at the same date shows a balance of £6,768. A comparison of the company's cash book with the bank statements has identified the following differences at 31 May 2010:

Cheques received amounting to £1,986 have been entered in the cash book prior to 31 May 2010 and paid into the bank but have not been credited to Renfrew's account until 5 June.

Cheques paid amounting to £4,364 have been entered in the cash book but not presented for payment and shown on the bank statement until after 31 May 2010.

Bank charges of £180 have been included in the bank statement but have not been entered in the cash book.

Dividends received of £220 appear on the bank statement but have not been entered into the cash book.

A cheque received from a credit customer for £450 was entered in the cash book and paid into the bank, but on 30 May this was returned unpaid because the customer had fled to South America.

First, we need to make the appropriate corrections to the cash book.

		<b>£</b>
	balance per cash book	4,800
plus:	dividends received	220
minus:	bank charges	180
	returned cheque	450
		<u>4,390</u>



We can now prepare a bank reconciliation as at 31 May 2010.

		£
	balance per cash book	4,390
plus:	cheques paid but not yet presented	4,364
minus:	receipts not yet credited	<u>1,986</u>
	balance per bank statement	<u>6,768</u>

## Accounts payable

Payables are recorded in a ledger, the accounts payable account, which represents all supplier account balances owed by the entity. Within the general ledger one account or more (control accounts) will be established to represent trade payables transactions, the purchases by the entity for which invoices have been rendered by suppliers, or vendors. All supplier invoices are recorded in accounts payable and analysed into the various items of expense by allocating them to a specific general ledger control account. These entries are debited to the appropriate general ledger accounts from the analysis of supplier invoices that are posted to accounts payable. The totals of these entries are credited to the control account representing accounts payable in the general ledger.

The accounts payable ledger is maintained to show the detail of all invoices received from and cash paid to suppliers. In addition to its functions of posting the totals of invoices to the accounts payable control account in the general ledger, and the analysis of what the invoices represent to the appropriate accounts in the general ledger, accounts payable may be analysed to show all invoices, credit notes, cash payments, etc. and grouped by supplier.

Payments made to suppliers are recorded in the cash book, and are credited to the cash account and debited to the accounts payable control account in the general ledger. They are also recorded in detail by amount, date and supplier within the trade payables supplier accounts. In this way it can be seen that the total balances at any one time of all supplier accounts within accounts payable equal the balance on the accounts payable control account in the general ledger.

## Accounts receivable

Receivables are recorded in another ledger – the accounts receivable account, which represents all customer account balances owed to the entity. Within the general ledger one account or more will be established (control accounts) to represent accounts receivable transactions – the sales by the entity for which invoices have been issued to customers. All customer invoices are recorded in accounts receivable and analysed into the various items of sale or revenue by allocating them to a specific general ledger control account. These entries are credited to the appropriate general ledger accounts from the analysis of customer invoices posted to accounts receivable. The totals of these entries are debited to the control account(s) representing accounts receivable in the general ledger.

The accounts receivable ledger is maintained to show the detail of all invoices issued to and cash received from customers. The totals of customer invoices are posted to the accounts receivable control account in the general ledger. The analyses of what the invoices represent are posted to the appropriate accounts in the general ledger. The sales ledger may also enable each invoice to be analysed and grouped by customer.