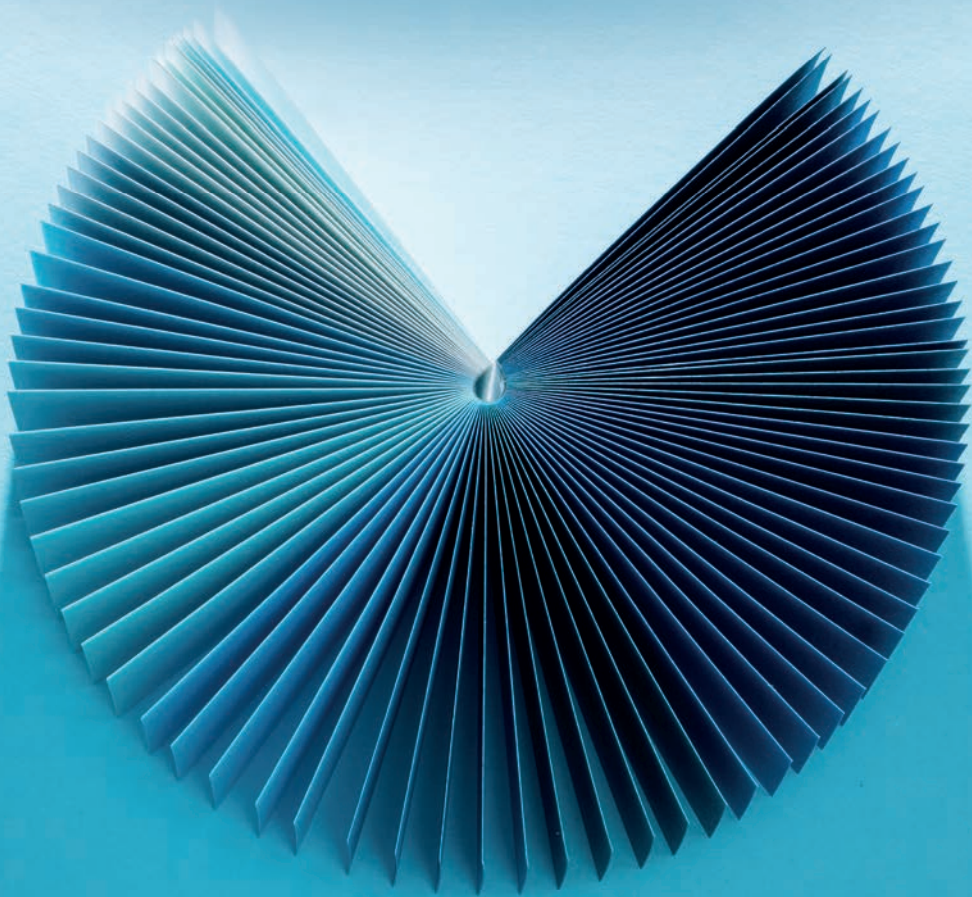


Financial and Management Accounting

An introduction

Pauline Weetman



 Pearson

Eighth Edition

EIGHTH EDITION

FINANCIAL AND MANAGEMENT ACCOUNTING

AN INTRODUCTION

PAULINE WEETMAN

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PREFACE TO THE EIGHTH EDITION

Introduction

This book uses the international *Conceptual Framework* (as revised in 2018) and International Financial Reporting Standards (IFRS) as its primary focus. It enables students in their early stages of study to understand and analyse the published annual reports and financial statements of our largest businesses and public sector institutions. IFRS are now applied in many aspects of government, local authority and other public sector accounting. Where relevant it also refers to the approach used in small and medium-sized businesses where the traditions of UK GAAP continue to be applied.

The book is written for the first level of undergraduate degree study in accounting and business studies, or equivalent introductory accounting courses for any professional training where an understanding of accounting is a basic requirement. While UK listed companies apply IFRS in their published financial statements, the remainder of the annual report is governed by UK-based regulations and codes. All UK companies operate under the Companies Act 2006. Their annual reports are influenced by the regulatory process applied to listed companies in the UK. This eighth edition is thoroughly revised to reflect these regulatory changes, particularly the restructuring of the Financial Reporting Council to take responsibility for the standards previously issued by the UK Accounting Standards Board, and the introduction of the strategic report.

All 'Real World' case studies at the start of each chapter have been updated to reflect current conditions. The underlying pedagogy of previous editions has been retained in response to encouraging comments from reviewers and from users of the book.

As academic institutions come under increasing scrutiny for the quality of the teaching and learning experience offered, a textbook must do more than present the knowledge and skills of the chosen subject. It must make explicit to the students what targets are to be achieved and it must help them to assess realistically their own achievements of those targets. It must help the class lecturer prepare, deliver, explain and assess the knowledge and skills expected for the relevant level of study. This is achieved by stating learning outcomes at the start of each chapter and by ensuring that the chapter headings and the end-of-chapter questions address the stated outcomes.

The management accounting chapters continue the approach of previous editions in taking some of the newer costing techniques into mainstream discussion, reflecting their increasing acceptance in management accounting practice. Business strategy and competitive position are recurring themes. A student who has completed this first-level study of management accounting will be aware of many of the day-to-day practices of management accounting in business and the relevance of those practices. It also provides a self-contained, broad introduction to management accounting for business students who do not need to develop specialist knowledge.

An accompanying website at www.pearsoned.co.uk/weetman provides the lecturer with a complete resource pack for each chapter. Student handouts containing a skeleton outline of each chapter, leaving slots for students to complete; powerpoints that match the lecture handouts; additional multiple-choice questions and further graded questions in application of knowledge and in problem solving; all are features for this eighth edition.

End-of-chapter questions are graded according to the skills being assessed. There are tests of retained knowledge, tests of application of knowledge in straightforward situations and tests of problem solving and evaluation using the acquired knowledge in less familiar situations.

Overall the aim of the eighth edition is to provide an introduction to financial accounting and management accounting which engages the interest of students and encourages a desire for further study. It also contributes to developing the generic skills of application, problem solving, evaluation and communication, all emphasised by employers.

The eighth edition has been updated throughout. It aims to provide a full understanding of the key aspects of the annual report, concentrating in particular on companies in the private sector but presenting principles of wider application which are relevant also to organisations operating in the public sector.

Distinctive approach

An international perspective reflects the convergence in accounting standards across the European Union for listed companies. *Features specific to the UK* are retained where these continue to be relevant to other enterprises.

Concepts of financial accounting are identified by applying the principles enunciated by the International Accounting Standards Board in its *Conceptual Framework*. The *Conceptual Framework* emphasises the desirability of meeting the needs of users of financial statements and it takes a balance-sheet-oriented approach. That approach is applied consistently throughout the book, with some indication of the problems which may arise when it is clear that the established emphasis on the matching of revenues and costs may give a more rational explanation of existing practice.

User needs are explained in every chapter and illustrated by including first-person commentary from a professional fund manager, holding a conversation with an audit manager. The conversations are based on the author's research in the area of communication through the annual report.

The *accounting equation* is used throughout the financial accounting section for analysis and processing of transactions. It is possible for students who do not seek a technical specialism to complete the text without any reference to debit and credit bookkeeping. It is, however, recognised that particular groups of students may wish to understand the basic aspects of debit and credit bookkeeping and for this purpose the end-of-chapter supplements revisit, on a debit-and-credit-recording basis, material already explored in the chapter. Debit and credit aspects of management accounting are not covered since these are regarded as best reserved for later specialist courses if the student so chooses.

Practical illustration is achieved by drawing on the financial information of a fictitious major listed company, taking an overview in early chapters and then developing the detailed disclosures as more specific matters are explored.

Interpretation of financial statements is a feature of all financial reporting chapters, formally brought together in Chapters 13 and 14. The importance of the wider range of corporate communication is reinforced in Chapter 14. This chapter also includes a discussion of some *current developments* that are under debate in the context of international convergence.

A *running case study example* of the fictitious company Safe and Sure plc provides illustration and interpretation throughout the chapters. Safe and Sure plc is in the service sector. The Instructor's Manual contains a parallel example, Craigielaw plc, in the

manufacturing sector. In the Instructor's Manual there are questions on Craigielaw to accompany most of the chapters.

Self-evaluation is encouraged by setting learning outcomes at the start of each chapter and reviewing these in the chapter summaries. Activity prompts are placed at the ends of the main sections of each chapter. The activities are designed to develop student learning by: recognising assumptions; evaluating arguments; and drawing conclusions through expressing an opinion. Self-testing questions at the end of each of the main sections of the chapter may be answered by referring again to the text. Further end-of-chapter questions provide a range of practical applications. Group activities are suggested at the end of each chapter with the particular aim of encouraging participation and interaction. Answers are available to all computational questions, either at the end of the book or in the Instructor's Manual.

A *sense of achievement* is engendered in the reader of the financial accounting section by providing a general understanding of the entire annual report by the end of Chapter 7. Thereafter specific aspects of the annual report are explored in Chapters 8–12. Lecturers who wish to truncate a first-level course or leave specific aspects to a later level will find Chapters 8–12 may be used on a selective basis.

A *spreadsheet* approach to financial accounting transactions is used in the body of the relevant chapters to show processing of transactions using the accounting equation. The author is firmly convinced, after years of trying every conceivable approach, that the spreadsheet encourages students to apply the accounting equation analytically, rather than trying to memorise T-account entries. Furthermore, students now use spreadsheets as a tool of analysis on a regular basis and will have little difficulty in applying suitable software in preparing spreadsheets. In the bookkeeping supplementary sections, the three-column ledger account has been adopted in the knowledge that school teaching is moving increasingly to adopt this approach which cuts out much of the bewilderment of balancing T-accounts. Computerised accounting systems also favour the three-column presentation with continuous updating of the balance.

Flexible course design

This text is written for one academic year comprising two semesters of 12 weeks each but may need selective guidance to students for a module of lesser duration.

In financial accounting, Chapters 1–4 provide an essential conceptual framework which sets the scene. For a general appreciation course, Chapters 5 and 6 are practical so that one or both could be omitted, leading directly to Chapter 7 as a guide to published accounts. Chapters 8–12 are structured so that the explanation of principles is contained early in each chapter, but the practical implementation is later in each chapter. For a general appreciation course, it would be particularly important to refer to the section of each chapter which analyses users' needs for information and discusses information provided in the financial statements. However, the practical sections of these chapters could be omitted or used on a selective basis rather than attempting full coverage. Chapters 13 and 14 are important to all readers for a sense of interpretation and awareness of the range of material within corporate reports. Chapter 15 takes the reader through a cash flow statement item-by-item with the emphasis on understanding and interpretation.

In teaching and learning management accounting various combinations are possible, depending on course design and aims. Chapters 16, 17 and 18 provide an essential set of basic tools of analysis but thereafter some flexibility is feasible. For applications in job costing, Chapter 19 provides further material. For concentrating on decision making and awareness of business strategy, Chapters 20, 24 and 25 are recommended. For

concentrating on planning and control, Chapters 21, 22 and 23 give students experience of the variety of techniques in use.

Approaches to teaching and learning

Learning outcomes

Targets for student achievement in relation to knowledge and understanding of the subject are specified in learning outcomes at the head of each chapter. The achievements represented by these learning outcomes are confirmed against graded questions at the end of each chapter. The achievement of some learning outcomes may be confirmed by Activities set out at the appropriate stage within the chapter. Activities encourage students to: recognise assumptions; evaluate arguments; and draw conclusions by expressing an opinion.

Skills outcomes

Questions test not only subject-specific knowledge and technical skills, but also the broader general skills that are transferable to subsequent employment or further training.

Graded questions

Questions are graded and each is matched to one or more learning outcomes. Where a solution is provided to a question this is shown by an [S] after the question number.

A series questions: self-test

The A series questions, placed at the end of the section to which they relate, confirm essential understanding and the application of technical skills. These are skills specific to the subject of accounting which add to the specialist expertise of the student. More generally they show the student's capacity to acquire and apply a technical skill of this type.

The answers to these questions can be found in the relevant sections of the chapter in which the questions are located.

B series questions: application

The B series questions apply the knowledge gained from reading and practising the material of the chapter. They resemble closely in style and content the technical material of the chapter. Confidence is gained in applying knowledge in a situation that is very similar to that illustrated. Answers are given in Appendix II and Appendix III or in the Instructor's Manual. These questions test skills of problem solving and evaluation that are relevant to many subjects and many activities in life, especially in subsequent employment. Some initiative is required in deciding how to apply relevant knowledge and in solving problems.

C series questions: problem solving and evaluation

The C series questions apply the knowledge gained from reading the chapter, but in a varied style of question. Problem-solving skills are required in selecting relevant data or in using knowledge to work out what further effort is needed to solve the problem. Evaluation means giving an opinion or explanation of the results of the problem-solving exercise. Some answers are given in Appendix II and Appendix III but others are in the Instructor's Manual so that they can be used in tutorial preparation or class work.

Group and individual cases

Cases apply knowledge gained from the chapter but they also test communication skills. Communication may involve writing or speaking, or both. It may require, for example, explanation of a technical matter to a non-technical person, or discussion with other students to explore and form an opinion on a controversial issue, or presentation of a report to a business audience.

S series questions in supplementary sections

The S series questions test knowledge of the accounting records system (bookkeeping entries) to confirm understanding by those who have chosen to study the supplementary bookkeeping sections.

Instructor's Manual

These resources are available at www.pearsoned.co.uk/weetman by password access to lecturers adopting this book. The Instructor's Manual contains additional problem questions for each chapter, with full solutions to these additional questions as well as any solutions not provided in the book. The Instructor's Manual also includes basic tutorial instructions and notes that can be used for class presentation to support each chapter.

Target readership

This book is targeted at a broad-ranging business studies type of first-level degree course. It is intended to support the equivalent of one semester of 12 teaching weeks. There is sufficient basic bookkeeping (ledger accounts) in the end-of-chapter supplements to make the book suitable for those intending to pursue a specialised study of accounting beyond the first level but the bookkeeping material is optional for those who do not have such special intentions. The book has been written with undergraduate students particularly in mind, but may also be suitable for professional and postgraduate business courses where financial reporting is taught at an introductory level.

Acknowledgements

I am grateful to academic colleagues and to reviewers of the text for helpful comments and suggestions. I am also grateful to undergraduate students of five universities who have taken my courses and thereby helped in developing an approach to teaching and learning the subject. Professor Graham Peirson and Mr Alan Ramsay of Monash University provided a first draft of their text based on the conceptual framework in Australia which gave valuable assistance in designing the structure of this book, which was also guided from the publishing side by Pat Bond and Ron Harper. Professor Ken Shackleton of the University of Glasgow helped plan the structure of the management accounting chapters. The Institute of Chartered Accountants of Scotland gave permission for use of some of the end-of-chapter questions.

Subsequently, I have received valuable support in successive editions from the editorial staff at Pearson Education. For this latest edition I am grateful to colleagues and students who have used the book in their teaching and learning. I have also been helped by constructive comments from reviewers and by guidance from Rebecca Pedley, formerly Acquisitions Editor, as well as Richard Townrow, Senior Portfolio Manager, and Anita Atkinson, Senior Content Producer.

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FINANCIAL ACCOUNTING

PART 1

A conceptual framework: setting the scene

- 1 Who needs accounting?
- 2 A systematic approach to financial reporting:
the accounting equation
- 3 Financial statements from the accounting equation
- 4 Ensuring the quality of financial statements

CHAPTER 1

Who needs accounting?

Real World Case

Oxfam: meeting users' needs

Extracts from Annual Report and Accounts

Purpose and charitable objects

Oxfam Great Britain's purpose is to help create lasting solutions to the injustice of poverty.

As stated in its Memorandum of Association, the objects for which Oxfam is established for the public benefit are:

- to prevent and relieve poverty and to protect vulnerable people, including through humanitarian intervention;
- to advance sustainable development;
- to promote human rights, equality and diversity, in particular where to do so contributes to the prevention and relief of poverty;
- in all cases working anywhere in the world.



Penny Tweedie/Alamy Stock Photo

Highlights (page 10)

11.6 million people reached directly in 51 countries

Nearly 9 million people supported in 31 humanitarian emergencies

1,168 grants to 737 partner organisations

450,000 people in the UK made a regular donation

How do we judge the impact of our work?

Oxfam is committed to ensuring that, in all that we do, we are accountable to those with whom we work, from our programme partners, communities and donors to other stakeholders such as our staff, volunteers, or those that we campaign through and with. We use several tools to monitor, evaluate, assess and learn from our stakeholders, including:

- reporting data on the numbers of people and communities reached by our programmes
- completing review exercises to understand – and speak about – our outcome achievements as well as our challenges, and how we deal with them

- undertaking evaluations to assess our overall strategies, test the core assumptions about how we contribute to social change, and assess our effectiveness in different contexts
- consulting with key stakeholders to gather their insights and assessments about our overall efforts.

Our success in achieving this commitment to accountability is measured annually through our membership of, and compliance with, the International NGO Accountability Charter and International Aid Transparency Initiative. More detail on our accountability objectives and achievements is set out on page 29.

Accounting conventions (page 38)

Oxfam is a public benefit entity. The financial statements are prepared in compliance with the Companies Act 2006, the Charities Act 2011, the Charities Statement of Recommended Practice (FRS 102), the Charities Accounts (Scotland) Regulations 2006 and Charities and Trustee Investment (Scotland) Act 2005, and FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland.

Source: Oxfam, Annual report and accounts, 2015/16, pp. 9, 10, 12, 38, 50. <http://www.oxfamannualreview.org.uk/>

Discussion points

- 1 Who might be included in the stakeholders to whom Oxfam is accountable?
- 2 To what extent do the 'Highlights' meet the information needs of users of the annual report?

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Learning outcomes

After studying this chapter you should be able to:

- Define, and explain the definition of, accounting.
- Explain what is meant by a *conceptual framework*.
- Explain the distinguishing features of a sole trader, a partnership and a limited company.
- List the main users of financial information and their particular needs.
- Discuss the usefulness of financial statements to the main users.

Additionally, for those who choose to study the supplement:

- Define the basic terminology of business transactions.

1.1 Introduction

There is no single ‘official’ definition of accounting, but for the purposes of this text the following wording will be used:

Definition

Accounting is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.¹

This definition may appear short, but it has been widely quoted over a number of years and is sufficient to specify the entire contents of this introductory textbook.

Taking the definition word by word, it leads to the following questions:

- 1 What is the process?
- 2 How is financial information identified?
- 3 How is financial information measured?
- 4 How is financial information communicated?
- 5 What is an entity?
- 6 Who are the users of financial information about an entity?
- 7 What types of judgements and decisions do these users make?

Writing the questions in this order is slightly dangerous because it starts by emphasising the process and waits until the final question to ask about the use of the information. The danger is that accountants may design the process first and then hope to show that it is suitable to allow judgements and decisions by users. This is what has often happened over many years of developing the process by accountants.

In order to learn about, and understand, **accounting** by taking a critical approach to the usefulness of the current processes and seeing its limitations and the potential for improvement, it is preferable to reverse the order of the questions and start by specifying the users of **financial information** and the judgements and decisions they make. Once the users and their needs have been identified, the most effective forms of communication may be determined and only then may the technical details of measurement and identification be dealt with in a satisfactory manner.

Reversing the order of the questions arising from the definition of accounting is the approach used in this book, because it is the one which has been taken by those seeking to develop a **conceptual framework** of accounting.

This chapter outlines in particular the *Conceptual Framework* of the International Accounting Standards Board which has been developed for international use in accounting practice. The chapter explains the nature of three common types of **business entity** and concludes by drawing on various views relating to the users of accounting information and their information needs.

Because the understanding of users' needs is essential throughout the entire text, the chapter introduces David Wilson, a **fund manager** working for a large insurance company. In order to balance the demands of users with the restrictions and constraints on preparers of financial information, the chapter also introduces Leona Rees who is a member of the **accountancy profession** and who works as an **audit manager** with an **accountancy firm**. Both of them will offer comments and explanations as you progress through the text.

Activity 1.1

The definition set out at the start of this section assumes that we are able to identify the users of accounting information. The Real World Case at the start of the chapter refers to 'stakeholders' rather than 'users'. Choose any three of those stakeholders and say what you could assume about the judgements and decisions each one might make.

Self test

A1.1 Define 'accounting'.

A1.2 Identify the separate questions raised by the definition.

A1.3 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- accountancy firm
- accountancy profession
- accounting
- audit manager
- business entity
- conceptual framework
- financial information
- fund manager.

1.2 The development of a conceptual framework

A **conceptual framework** for accounting is a statement of principles which provides generally accepted guidance for the development of new reporting practices and for challenging and evaluating the existing practices. Conceptual frameworks have been developed in several countries around the world. The structure of most conceptual frameworks is along the following lines:

- Who are the users of **financial statements**?
- What are the information needs of users?
- What types of financial statements will best satisfy their needs?
- What are the characteristics of financial statements which meet these needs?
- What are the principles for defining and recognising items in financial statements?
- What are the principles for measuring items in financial statements?

The most widely applicable conceptual framework originated as the *Framework for the Preparation and Presentation of Financial Statements* issued by the International

Accounting Standards Board (IASB) in 1989. In 2010 the *Framework* was partially updated. The new *Conceptual Framework* was completed in 2018, after some challenging accounting issues had been addressed. The thinking about concepts can be traced to two discussion papers of the 1970s in the UK and the USA. In the UK, *The Corporate Report*² was a slim but highly influential document setting out the needs of users and how these might be met. Two years earlier the *Trueblood Report*³ in the USA had taken a similar approach of identifying the needs of users, although perhaps coming out more strongly in support of the needs of shareholders and creditors than of other user groups. In the UK, various documents on the needs of users have been prepared by individuals invited to help the process⁴ or those who took it on themselves to propose radical new ideas.⁵

Since January 2005, all **listed companies** in member states of the European Union (EU) have been required by an accounting regulation called the IAS Regulation⁶ to use a system of international **financial reporting standards** set by the International Accounting Standards Board. The UK standard-setter was influential in the development of these international reporting standards and, over a period of years, has been moving UK accounting practice closely into line with the international standards. For **unlisted companies** and other organisations not covered by the IAS Regulation of the EU, the UK Financial Reporting Council (FRC) has a conceptual framework of its own, called the *Statement of Principles*.⁷ This document has many similarities to the IASB's *Conceptual Framework*.

Activity 1.2

Most conceptual frameworks start with the question: Who are the users of financial statements? The frameworks then assume that we know the information needs of those users. Assume you are the owner of five restaurants located in different parts of the same city. Write down three items of accounting information that you would want to know about your business in order to help you make judgements and decisions.

Self test

A1.4 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- business entity
- conceptual framework
- financial reporting standards
- financial statements
- listed companies
- unlisted companies.

1.3 The Conceptual Framework for Financial Reporting

The *Conceptual Framework* issued in 2018 has been in the process of gradual revision over several years, as a joint project of the IASB and the Financial Accounting Standards Board (FASB) of the USA. Progress was delayed by the financial crisis of 2007–08 and eventually the IASB decided to complete the project alone. The chapter topics are:

- 1 The objective of general purpose financial reporting.
- 2 Qualitative characteristics of useful financial information.
- 3 Financial statements and the reporting entity.
- 4 The elements of financial statements.
- 5 Recognition and derecognition.

- 6 Measurement.
- 7 Presentation and disclosure.
- 8 Concepts of capital and capital maintenance.

Chapters 1 and 2 of the *Conceptual Framework* are written at a general level and a reader would find no difficulty in reviewing these at an early stage of study, to gain a flavour of what is expected of financial statements. The remaining sections are a mixture of general principles, which are appropriate to first-level study of the subject, and some quite specific principles which deal with more advanced problems. Some of those problems need an understanding of accounting which is beyond a first level of study. This book will refer to aspects of the various sections of the *Conceptual Framework*, as appropriate, when particular issues are dealt with. You should be aware, however, that this book concentrates on the basic aspects of the *Conceptual Framework* and does not explore every complexity.

A conceptual framework is particularly important when practices are being developed for reporting to those who are not part of the day-to-day running of the business. This is called **external reporting** or **financial accounting** and is the focus of the *Financial Accounting* studied in this book. For those who are managing the business on a day-to-day basis, special techniques have been developed and are referred to generally as **internal reporting** or **management accounting**.

Before continuing with the theme of the conceptual framework, it is useful to pause and consider the types of business for which accounting information may be required.

Activity 1.3

“Accounting standards aim to portray economic reality, rather than shape it.” This statement appears in a document entitled ‘Working in the public interest’. The definition of accounting in section 1.1 refers to ‘informed judgements and decisions’. Is there an argument for saying that accounting standards should aim towards shaping economic reality?

<http://archive.ifrs.org/About-us/Documents/Working-in-the-Public-Interest.pdf>

Self test

A1.5 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- external reporting
- financial accounting
- internal reporting
- management accounting.

1.4 Types of business entity

The word **entity** means ‘something that exists independently’. A business entity is a business that exists independently of those who own the business. The owner provides an amount of finance to enable the business to acquire assets and sustain its operations. This is called the owner’s **capital**. There are three main categories of business which will be found in all countries, although with different titles in different ones. This chapter uses the terminology common to the UK. The three main categories are: **sole trader**, **partnership** and **limited liability company**. This list is by no means exhaustive but provides sufficient variety to allow explanation of the usefulness of most accounting practices and their application.

1.4.1 Sole trader

An individual may enter into business alone, either selling goods or providing a service. Such a person is described as a **sole trader**. The business may be started because the sole trader has a good idea which appears likely to make a profit, and has some cash to buy the equipment and other resources to start the business. If cash is not available, the sole trader may borrow from a bank to enable the business to start up. Although this is the form in which many businesses have started, it is one which is difficult to expand because the sole trader will find it difficult to arrange additional finance for expansion. If the business is not successful and the sole trader is unable to meet obligations to pay money to others, then those persons may ask a court of law to authorise the sale of the personal possessions, and even the family home, of the sole trader. Being a sole trader can be a risky matter and the cost of bank borrowing may be at a relatively unfavourable rate of interest because the bank fears losing its money.

From this description it will be seen that the sole trader's business is very much intertwined with the sole trader's personal life. However, for accounting purposes, the business is regarded as a separate economic entity, of which the sole trader is the owner who takes the risk of the bad times and the benefit of the good times. Take as an example the person who decides to start working as an electrician and advertises their services in a newspaper. The electrician travels to jobs from home and has no business premises. Tools are stored in the loft at home and the business records are in a cupboard in the kitchen. Telephone calls from customers are received on the domestic phone and there are no clearly defined working hours. The work is inextricably intertwined with family life.

For accounting purposes that person is seen as the owner of a business which provides electrical services and the business is seen as being separate from the person's other interests and private life. The owner may hardly feel any great need for accounting information because they know the business very closely, but accounting information will be needed by other persons or entities, mainly the government (in the form of **HM Revenue and Customs**) for tax collecting purposes. It may also be required by a bank for the purposes of lending money to the business or by another sole trader who is intending to buy the business when the existing owner retires.

1.4.2 Partnership

One method by which the business of a sole trader may expand is to enter into **partnership** with one or more people. This may permit a pooling of skills to allow more efficient working, or may allow one person with ideas to work with another who has the money to provide the resources needed to turn the ideas into a profit. There is thus more potential for being successful. If the business is unsuccessful, then the consequences are similar to those for the sole trader. Persons to whom money is owed by the business may ask a court of law to authorise the sale of the personal property of the partners in order to meet the obligation. Even more seriously, one partner may be required to meet all the obligations of the partnership if the other partner does not have sufficient personal property, possessions and cash. This is described in law as **joint and several liability** and the risks have to be considered very carefully by those entering into partnership.

Partnership may be established as a matter of fact by two persons starting to work together with the intention of making a profit and sharing it between them. More often there is a legal agreement, called a **partnership deed**, which sets out the rights and duties of each partner and specifies how they will share the profits. There is also **partnership law**, which governs the basic relationships between partners and which they may use to resolve their disputes in a court of law if there is no partnership deed, or if the partnership deed has not covered some aspect of the partnership.

For accounting purposes the partnership is seen as a separate economic entity, owned by the partners. The owners may have the same intimate knowledge of the business

as does the sole trader and may therefore feel that accounting information is not very important for them. On the other hand, each partner may wish to be sure that they are receiving a fair share of the partnership profits. There will also be other persons requesting accounting information, such as HM Revenue and Customs, banks who provide finance and individuals who may be invited to join the partnership so that it can expand even further.

1.4.3 Limited liability company

The main risk attached to either a sole trader or a partnership is that of losing personal property and possessions, including the family home, if the business fails. That risk would inhibit many persons from starting or expanding a business. Historically, as the UK changed from a predominantly agricultural to a predominantly industrial economy in the nineteenth century, it became apparent that owners needed the protection of **limited liability**. This meant that if the business failed, the owners might lose all the money they had put into the business but their personal wealth would be safe.

There are two forms of limited liability company. The **private limited company** has the word 'Limited' (abbreviated to 'Ltd') in its title. The **public limited company** has the abbreviation 'plc' in its title. The private limited company is prohibited by law from offering its **shares** to the public, so it is a form of limited liability appropriate to a family-controlled business. The public limited company is permitted to offer its shares to the public. In return it has to satisfy more onerous regulations. Where the shares of a public limited company are bought and sold on a **stock exchange**, the public limited company is called a **listed company** because the shares of the company are on a list of share prices.

In either type of company, the owners are called **shareholders** because they share the ownership and share the profits of the good times and the losses of the bad times (to the defined limit of liability). Once they have paid in full for their shares, the owners face no further risk of being asked to contribute to meeting any obligations of the business. Hopefully, the business will prosper and the owners may be able to receive a share of that prosperity in the form of a cash **dividend**. A cash dividend returns to the owners, on a regular basis and in the form of cash, a part of the profit created by the business.

If the company is very small, the owners may run the business themselves. If it is larger, then they may prefer to pay someone else to run the business. In either case, the persons running the business on a day-to-day basis are called the **directors**.

Because limited liability is a great privilege for the owners, the company must meet regulations set out by Parliament in the form of a **Companies Act**. At present the relevant law is the Companies Act 2006.

For accounting purposes the company is an entity with an existence separate from the owners. In the very smallest companies the owners may not feel a great need for accounting information, but in medium- or large-sized companies, accounting information will be very important for the shareholders as it forms a report on how well the directors have run the company. As with other forms of business accounting, information must be supplied to HM Revenue and Customs for tax-collecting purposes. The list of other users will expand considerably because there will be a greater variety of sources of finance, the company may be seeking to attract more **investors**, employees will be concerned about the well-being of the business and even the customers and suppliers may want to know more about the financial strength of the company.

Although the law provides the protection of limited liability, this has little practical meaning for many small family-controlled companies because a bank lending money to the business will ask for personal guarantees from the shareholder directors. Those personal guarantees could involve a mortgage over the family home, or an interest in life assurance policies. The potential consequences of such personal guarantees, when a company fails, are such that the owners may suffer as much as the sole trader whose business fails.

1.4.4 Limited liability partnership

A limited liability partnership (LLP) is a corporate body, which means it has a legal personality separate from that of its members. It is formed by being incorporated under the Limited Liability Partnerships Act 2000. Any new or existing partnership firm of two or more persons can incorporate as an LLP. There is no limit on the number of members. There must be at least two designated members who take responsibility for compliance with statutory requirements. The minimum capital requirement is only £2. An LLP structure may be used by any business seeking to make a profit. It has been used in particular by professional firms such as accountants, solicitors and architects.

The LLP may be managed like a normal partnership. All members may participate actively in the management of the business. However, the LLP is responsible for the debts of the business. The individual members do not have the unlimited liability that they would have in a normal partnership. Taxation procedures are those that apply to a partnership.

From an accounting perspective in the UK the disclosure requirements are similar to those of a company. LLPs are required to provide financial information equivalent to that of companies, including the filing of annual accounts with the Registrar of Companies.

1.4.5 Comparing partnership and limited liability company

Table 1.1 summarises the differences between a partnership and a limited liability company that are relevant for accounting purposes.

Table 1.1 Differences between a partnership and a limited liability company

| | Partnership | Limited liability company |
|---------------------------------------|---|---|
| <i>Formation</i> | Formed by two or more persons, usually with written agreement but not necessarily in writing. | Formed by a number of persons registering the company under the Companies Act, following legal formalities. In particular there must be a written memorandum and articles of association setting out the powers allowed to the company. |
| <i>Running the business</i> | All partners are entitled to share in the running of the business. | Shareholders must appoint directors to run the business (although shareholders may appoint themselves as directors). |
| <i>Accounting information</i> | Partnerships are not obliged to make accounting information available to the wider public. | Companies must make accounting information available to the public through the Registrar of Companies . |
| <i>Meeting obligations</i> | All members of a general partnership are jointly and severally liable for money owed by the firm. | The personal liability of the owners is limited to the amount they have agreed to pay for shares. |
| <i>Powers to carry out activities</i> | Partnerships may carry out any legal business activities agreed by the partners. | The company may only carry out the activities set out in its memorandum and articles of association . |
| <i>Status in law</i> | The partnership is not a separate legal entity (under English law), the partnership property being owned by the partners. (Under Scots law the partnership is a separate legal entity.) | The company is seen in law as a separate person, distinct from its members. This means that the company can own property, make contracts and take legal action or be the subject of legal action. |

Table 1.2 identifies the differences between the public limited company and the private limited company that are relevant for accounting purposes.

Table 1.2 Brief comparison of private and public companies

| | Public company | Private company |
|-------------------------------|--|---|
| <i>Running the business</i> | Minimum of two directors. | Minimum of one director. |
| | Must have a company secretary who holds a relevant qualification (responsible for ensuring the company complies with the requirements of company law). | The sole director may also act as the company secretary and is not required to have a formal qualification. |
| <i>Ownership</i> | Shares may be offered to the public, inviting subscription. | Shares must not be offered to the public. May only be sold by private arrangements. |
| | Minimum share capital £50,000. | No minimum share capital. |
| <i>Accounting information</i> | Extensive information required on transactions between directors and the company. | Less need for disclosure of transactions between directors and the company. |
| | Information must be made public through the Registrar of Companies. | |
| | Provision of financial information to the public is determined by size of company, more information being required of medium- and large-sized companies. | |
| | Accounting information must be sent to all shareholders. | |

Activity 1.4

Two brothers are planning to set up a computer repair business together. They need to decide whether to work in partnership or whether to form a limited liability company. From an accounting and legal perspective, give two arguments supporting formation of a partnership and two arguments supporting formation of a limited company.

Self test

A1.6 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- articles of association
- capital
- Companies Act
- directors
- dividend
- entity
- HM Revenue and Customs
- investors
- joint and several liability
- limited liability

- listed company
- memorandum
- partnership
- partnership deed
- partnership law
- private limited company
- public limited company
- Registrar of Companies
- share capital
- shareholders
- shares
- sole trader.

1.5 Users and their information needs

Who are the users of the information provided by these reporting entities? This section shows that there is one group, namely the **management** of an organisation, whose information needs are so specialised that a separate type of accounting has evolved called **management accounting**. However, there are other groups, each of which may believe it has a reasonable right to obtain information about an organisation, that do not enjoy unrestricted access to the business and so have to rely on management to supply suitable information. These groups include the owners, where the owners are not also the managers, but extend further to employees, lenders, suppliers, customers, government and its branches and the public interest. Those in the wider interest groups are sometimes referred to as **stakeholders**.

Definition

Stakeholder A general term to indicate all those who might have a legitimate interest in receiving financial information about a business because they have a 'stake' in it.

1.5.1 Management

Many would argue that the foremost users of accounting information about an organisation must be those who manage the business on a day-to-day basis. This group is referred to in broad terms as **management**, which is a collective term for all those persons who have responsibilities for making judgements and decisions within an organisation. Because they have close involvement with the business, they have access to a wide range of information (much of which may be confidential within the organisation) and will seek those aspects of the information which are most relevant to their particular judgements and decisions. Because this group of users is so broad, and because of the vast amount of information potentially available, a specialist branch of accounting has developed, called management accounting, to serve the particular needs of management.

It is management's responsibility to employ the resources of the business in an efficient way and to meet the objectives of the business. The information needed by management to carry out this responsibility ought to be of high quality and in an understandable form so far as the management is concerned. If that is the case, it would not be unreasonable to think that a similar quality (although not necessarily quantity)

of information should be made available more widely to those stakeholders who do not have the access available to management.⁸ Such an idea would be regarded as somewhat revolutionary in nature by some of those who manage companies, but more and more are beginning to realise that sharing information with investors and other stakeholders adds to the general atmosphere of confidence in the enterprise.

1.5.2 Owners as investors

Where the owners are the managers, as is the case for a sole trader or a partnership, they have no problem in gaining access to information and will select information appropriate to their own needs. They may be asked to provide information for other users, such as HM Revenue and Customs or a bank which has been approached to provide finance, but that information will be designed to meet the needs of those particular users rather than the owners.

Where the ownership is separate from the management of the business, as is the case with a limited liability company, the owners are more appropriately viewed as investors who entrust their money to the company and expect something in return, usually a **dividend** and a growth in the value of their investment as the company prospers. Providing money to fund a business is a risky act and investors are concerned with the **risk** inherent in, and **return** provided by, their investments. They need information to help them decide whether they should buy, hold or sell.⁹ They are also interested in information on the entity's financial performance and financial position that helps them to assess both its cash-generation abilities and how management discharges its responsibilities.¹⁰

Much of the investment in shares through the Stock Exchange in the UK is carried out by **institutional investors**, such as pension funds, insurance companies, unit trusts and investment trusts. A collection of investments is called a **portfolio**. The day-to-day business of buying and selling shares is carried out by a **fund manager** employed by the institutional investor. Private investors are in the minority as a group of investors in the UK. They will often take the advice of an **equities analyst** who investigates and reports on share investment. The fund managers and the equities analysts are also regarded as users of accounting information.

The kinds of judgements and decisions made by investors could include any or all of the following:

- (a) Evaluating the performance of the entity.
- (b) Assessing the effectiveness of the entity in achieving objectives (including compliance with **stewardship** obligations) established previously by its management, its members or owners.
- (c) Evaluating managerial performance, efficiency and objectives, including investment and dividend distribution plans.
- (d) Ascertaining the experience and background of company directors and officials including details of other directorships or official positions held.
- (e) Ascertaining the economic stability and vulnerability of the reporting entity.
- (f) Assessing the **liquidity** of the entity, its present or future requirements for additional **working capital**, and its ability to raise long-term and short-term finance.
- (g) Assessing the capacity of the entity to make future reallocations of its resources for economic purposes.
- (h) Estimating the future prospects of the entity, including its capacity to pay **dividends**, and predicting future levels of investment.
- (i) Making economic comparisons, either for the given entity over a period of time or with other entities at one point in time.
- (j) Estimating the value of present or prospective interests in or claims on the entity.
- (k) Ascertaining the ownership and control of the entity.¹¹

That list was prepared in 1975 and, while it is a valid representation of the needs of investors, carries an undertone which implies that the investors have to do quite a lot of the work themselves in making estimates of the prospects of the entity. Today there is a stronger view that the management of a business should share more of its thinking and planning with the investors. The list may therefore be expanded by suggesting that it would be helpful for investors (and all external users) to know:

- (a) the entity's actual performance for the most recent accounting period and how this compares with its previous plan for that period;
- (b) management's explanations of any significant variances between the two; and
- (c) management's financial plan for the current and forward accounting periods, and explanations of the major assumptions used in preparing it.¹²

In the **annual reports** of all but small companies you will find a section called the **strategic report**. This is where companies will include forward-looking statements which stop short of making a forecast but give help in understanding which of the trends observed in the past are likely to continue into the future.

1.5.3 Lenders

Lenders are interested in information that enables them to determine whether their loans, and the related interest, will be paid when due.¹³

Loan **creditors** provide finance on a longer-term basis. They will wish to assess the economic stability and vulnerability of the borrower. They are particularly concerned with the risk of **default** and its consequences. They may impose conditions (called **loan covenants**) which require the business to keep its overall borrowing within acceptable limits. The financial statements may provide evidence that the loan covenant conditions are being met.

Some lenders will ask for special reports as well as the general financial statements. Banks in particular will ask for **cash flow projections** showing how the business plans to repay, with interest, the money borrowed.

1.5.4 Suppliers and other trade creditors

Suppliers of goods and services (also called trade creditors) are interested in information that enables them to decide whether to sell to the entity and to determine whether amounts owing to them will be paid when due. The IASB mentions 'other creditors' as users of financial statements.¹⁴ Suppliers (trade creditors) are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer. The amount due to be paid to the supplier is called a trade payable or an account payable.

Trade creditors supply goods and services to an entity and have very little protection if the entity fails because there are insufficient assets to meet all **liabilities**. They are usually classed as **unsecured creditors**, which means they are a long way down the queue for payment. So they have to exercise caution in finding out whether the business is able to pay and how much risk of non-payment exists. This information need not necessarily come from accounting statements; it could be obtained by reading the local press and trade journals, joining the Chamber of Trade, and generally listening in to the stories and gossip circulating in the geographic area or the industry. However, the financial statements of an entity may confirm the stories gained from other sources.

In recent years there has been a move for companies to work more closely with their suppliers and to establish 'partnership' arrangements where the operational and financial plans of both may be dovetailed by specifying the amount and the timing of

goods and services required. Such arrangements depend heavily on confidence, which in turn may be derived partly from the strength of financial statements.

1.5.5 Employees

Employees and their representatives are interested in information about the stability and profitability of their employers. They are also interested in information that helps them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities. Employees continue to be interested in their employer after they have retired from work because in many cases the employer provides a pension fund.

The matters which are likely to be of interest to past, present and prospective employees include: the ability of the employer to meet wage agreements; management's intentions regarding employment levels, locations and working conditions; the pay, conditions and terms of employment of various groups of employees; job security; and the contribution made by employees in other divisions of the organisation. Much of this is quite specialised and detailed information. It may be preferable to supply this to employees by means of special purpose reports on a frequent basis rather than waiting for the annual report, which is slow to arrive and more general in nature. However, employees may look to financial statements to confirm information provided previously in other forms.

1.5.6 Customers

Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent upon, its prosperity. In particular, customers need information concerning the current and future supply of goods and services offered, price and other product details, and conditions of sale. Much of this information may be obtained from sales literature or from sales staff of the enterprise, or from trade and consumer journals.

The financial statements provide useful confirmation of the reliability of the enterprise itself as a continuing source of supply, especially when the customer is making payments in advance. They also confirm the capacity of the entity in terms of **non-current assets** (also called **fixed assets**) and **working capital** and give some indication of the strength of the entity to meet any obligations under guarantees or warranties.

1.5.7 Governments and their agencies

Governments and their agencies are interested in the allocation of resources and, therefore, in the activities of entities. They also require information in order to regulate the activities of entities, assess taxation and provide a basis for national income and economic statistics.

Acting on behalf of the UK government's Treasury Department, HM Revenue and Customs collects taxes from businesses based on profit calculated according to commercial accounting practices (although there are some specific rules in the taxation legislation which modify the normal accounting practices). HM Revenue and Customs has the power to demand more information than appears in published financial statements, but will take these as a starting point.

Other agencies include the regulators of the various utility companies. Examples are Ofcom¹⁵ (the Office of Communications) and Ofgem¹⁶ (the Office of Gas and Electricity Markets). They use accounting information as part of the package by which they monitor the prices charged by these organisations to consumers of their services. They also demand additional information designed especially to meet their needs.

1.5.8 Public interest

Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy by providing employment and using local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

A strong element of public interest has been aroused in recent years by environmental issues and the impact of companies on the environment. There are costs imposed on others when a company pollutes a river or discharges harmful gases into the air. It may be perceived that a company is cutting corners to prune its own reported costs at the expense of other people. Furthermore, there are activities of companies today which will impose costs in the future. Where an oil company has installed a drilling rig in the North Sea, it will be expected one day to remove and destroy the rig safely. There is a question as to whether the company will be able to meet that cost. These costs and future liabilities may be difficult to identify and quantify, but that does not mean that companies should not attempt to do so. More companies are now including descriptions of environmental policy in their annual reports, but regular accounting procedures for including environmental costs and obligations in the financial statements have not yet been developed.

Activity 1.5

Read again the Real World Case at the start of the chapter. In the extract on 'How do we judge the impact of our work', the report sets out the tools used to monitor, evaluate, assess and learn from stakeholders. What is the role of accounting in each of the tools set out in that extract?

Self test

A1.7 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- annual report
- cash flow projections
- creditors
- default
- dividend
- equities analyst
- fixed assets
- institutional investors
- fund manager
- liabilities
- liquidity
- loan covenants
- management
- management accounting
- non-current assets
- portfolio
- return
- risk
- stakeholder
- stewardship
- strategic report
- unsecured creditors
- working capital.

1.6 Financial statements

In this section we explore some of the controversial issues surrounding the need for, and usefulness of, financial statements. These issues continue to be debated, so you should think about the arguments on each side.

1.6.1 General purpose or specific purpose financial statements?

Some experts who have analysed the needs of users in the manner set out in the previous section have come to the conclusion that no single set of **general purpose financial statements** could meet all these needs. It has been explained in the previous section that some users already turn to special reports to meet specific needs. Other experts hold that there could be a form of general purpose financial statements which would meet all the needs of some user groups and some of the needs of others.

This book is written on the assumption that it *is* possible to prepare a set of general purpose financial statements which will have some interest for all users. The existence of such reports is particularly important for those who cannot prescribe the information they would like to receive from an organisation. That is perhaps because they have no bargaining power, or because they are many in number but not significant in economic influence.

Preparers of general purpose financial statements tend to regard the owners and long-term lenders as the primary users of the information provided. There is an expectation or hope that the interests of these groups will overlap to some extent with the interests of a wider user group and that any improvements in financial statements will be sufficient so that fewer needs will be left unmet.¹⁷

The primary focus of the *Conceptual Framework* is on general purpose financial statements. The IASB states that the objective of general purpose financial reporting is to provide information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.¹⁸ Some critics of the IASB's approach think this is a relatively narrow view of the potential coverage and usefulness of general purpose financial statements.

1.6.2 Stewards and agents

In an earlier section, the needs of investors as users were listed and the word 'stewardship' appeared. In the days before an industrial society existed, stewards were the people who looked after the manor house and lands while the lord of the manor enjoyed the profits earned. Traditionally, accounting has been regarded as having a particular role to play in confirming that those who manage a business on behalf of the owner take good care of the resources entrusted to them and earn a satisfactory profit for the owner by using those resources.

As the idea of a wider range of users emerged, this idea of the 'stewardship' objective of accounting was mentioned less often (although its influence remains strong in legislation governing accounting practice). In the academic literature it has been reborn under a new heading – that of **agency**. Theories have been developed about the relationship between the owner, as 'principal', and the manager, as 'agent'. A conscientious manager, acting as an agent, will carry out their duties in the best interest of the owners, and is required by the law of agency to do so. However, not all agents will be perfect in carrying out this role and some principals will not trust the agent entirely. The principal will incur costs in monitoring (enquiring into) the activities of the agent and may lose some wealth if the interests of the agent and the interests of the principal diverge. The view taken in **agency theory** is that there is an inherent conflict between the two parties and so they spend

time agreeing contracts which will minimise that conflict. The contracts will include arrangements for the agent to supply information on a regular basis to the principal.

In the *Conceptual Framework* the word ‘stewardship’ is used to describe how efficiently and effectively the entity’s management and governing board have discharged their responsibilities to use the entity’s economic resources.¹⁹

While the study of agency theory in all its aspects could occupy a book in itself, the idea of conflicts and the need for compromise in dealing with pressures of demand for, and supply of, accounting information may be helpful in later chapters in understanding why it takes so long to find answers to some accounting issues.

1.6.3 Who needs financial statements?

In order to keep the flavour of debate on accounting issues running through this text, two people will give their comments from time to time. The first of these is David Wilson, a fund manager of seven years’ experience working for an insurance company. He manages a UK equity portfolio (a collection of company shares) and part of his work requires him to be an equities analyst. At university he took a degree in history and has subsequently passed examinations to qualify as a chartered financial analyst (CFA).²⁰

The second is Leona Rees, an audit manager with a major accountancy firm. She has five years’ experience as a qualified accountant and had previously spent three years in training with the same firm. Her university degree is in accounting and economics and she has passed the examinations to qualify for membership of one of the major accountancy bodies.

David and Leona had been at school together but then went to different universities. More recently they have met again at workout sessions at a health club, relaxing afterwards at a nearby bar. David is very enthusiastic about his work, which demands long hours and a flexible attitude. He has absorbed a little of the general scepticism of audit which is expressed by some of his fund manager colleagues.

Leona’s main role at present is in company audit and she is now sufficiently experienced to be working on the audit of one listed company as well as several private companies of varying size. For two years she worked in the corporate recovery department of the accountancy firm, preparing information to help companies find sources of finance to overcome difficult times. She feels that a great deal of accounting work is carried out behind the scenes and the careful procedures are not always appreciated by those who concentrate only on the relatively few well-publicised problems.

We join them in the bar at the end of a hectic working week.

DAVID: *This week I’ve made three visits to companies, attended four presentations of preliminary announcements of results, received copies of the projector slides used for five others that I couldn’t attend, and collected around 20 annual reports. I have a small mound of brokers’ reports, all of which say much the same thing but in different ways. I’ve had to read all those while preparing my monthly report to the head of Equities Section on the performance of my fund and setting out my strategy for three months ahead consistent with in-house policy. I think I’m suffering from information overload and I have reservations about the reliability of any single item of information I receive about a company.*

LEONA: *If I had to give scores for reliability to the information crossing your desk, I would give top marks to the 20 annual reports. They have been through a very rigorous process and they have been audited by reputable audit firms using established standards of auditing practice.*

DAVID: *That's all very well, but it takes so long for annual reports to arrive after the financial year-end that they don't contain any new information. I need to get information at the first available opportunity if I'm to keep up the value of the share portfolio I manage. The meetings that present the preliminary announcements are held less than two months after the accounting year-end. It can take another six weeks before the printed annual report appears. If I don't manage to get to the meeting I take a careful look at what the company sends me in the way of copies of projector slides used.*

LEONA: *Where does accounting information fit in with the picture you want of a company?*

DAVID: *It has some importance, but accounting information is backward-looking and I invest in the future. We visit every company in the portfolio once a year and I'm looking for a confident management team, a cheerful-looking workforce and a general feeling that things are moving ahead. I'll also ask questions about prospects: how is the order book; which overseas markets are expanding; have prices been increased to match the increase in raw materials?*

LEONA: *Isn't that close to gaining insider information?*

DAVID: *No – I see it as clarification of information which is already published. Companies are very careful not to give an advantage to one investor over another – they would be in trouble with the Stock Exchange and perhaps with the Financial Services Authority if they did give price-sensitive information. There are times of the year (running up to the year-end and to the half-yearly results) when they declare a 'close season' and won't even speak to an investor.*

LEONA: *So are you telling me that I spend vast amounts of time auditing financial statements which no one bothers to read?*

DAVID: *Some people would say that, but I wouldn't. It's fairly clear that share prices are unmoved by the issue of the annual report, probably because investors already have that information from the preliminary announcement. Nevertheless, we like to know that there is a regulated document behind the information we receive – it allows us to check that we're not being led astray. Also, I find the annual report very useful when I want to find out about a company I don't know. For the companies I understand well, the annual report tells me little that I don't already know.*

LEONA: *I'll take that as a very small vote of confidence for now. If your offer to help me redecorate the flat still stands, I might try to persuade you over a few cans of emulsion that you rely on audited accounts more than you realise.*

Activity 1.6

In this conversation, David questions the usefulness and relevance of published financial statements because of the time taken to publish them. Leona defends the rigorous audit scrutiny. Would David have the same opinion if there were no audited financial statements available for investors in listed companies?

Self test

A1.8 The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- agency
- agency theory
- general purpose financial statements
- portfolio
- primary users.

1.7 Summary

This chapter has explained that accounting is intended to provide information that is useful to a wide range of interested parties (stakeholders).

Key points are:

- **Accounting** is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.
- A **conceptual framework** for accounting is a statement of principles which provides generally accepted guidance for the development of new reporting practices and for challenging and evaluating the existing practices.
- The *Conceptual Framework* of the IASB provides broad principles that guide accounting practice in many countries.
- Since January 2005, all **listed companies** in member states of the EU have been required by an accounting regulation to use a system of international financial reporting standards (IFRS) set by the IASB.
- Business **entities** in the UK are either **sole traders**, **partnerships** or **limited liability** companies.
- **Users** of accounting information include management, owners, employees, lenders, suppliers, customers, governments and their agencies and the public interest.
- **Stakeholders** are all those who might have a legitimate interest in receiving financial information about a business because they have a 'stake' in it.
- General purpose **financial statements** might ideally aim to meet the needs of a wide range of users. However the *Conceptual Framework* focuses on the information needs of investors and lenders.
- The relationship between the owner, as 'principal', and the manager, as 'agent', is described in the theory of **agency** relationships. Accounting information helps to reduce the potential conflicts of interest between principal and agent. 'Stewardship' indicates how management takes care in the use of the entity's resources.

Further reading

IASB (2018), *Conceptual Framework for Financial Reporting*, International Accounting Standards Board.

ICAEW (2009), *Developments in new reporting models*. Information for better markets initiative. The Institute of Chartered Accountants in England and Wales. www.icaew.co.uk.

Questions

Each chapter has three types of question. The 'A' series of 'Self-test' questions are placed at the end of each section to help you test your understanding and review your reading. You will find the answers to these questions by re-reading and thinking about the section. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

B Application

B1.1

Brian and Jane are planning to work in partnership as software consultants. Write a note (100–200 words) to explain their responsibilities for running the business and producing accounting information about the financial position and performance of the business.

B1.2

Jennifer has inherited some shares in a public company which has a share listing on the Stock Exchange. She has asked you to explain how she can find out more about the financial position and performance of the company. Write a note (100–200 words) answering her question.

B1.3

Martin is planning to buy shares in the company that employs him. He knows that the directors of the company are his employers but he wonders what relationship exists between the directors and the shareholders of the company. Write a note (100–200 words) answering his question.

C Problem solving and evaluation

C1.1

The following extracts are typical of the annual reports of large listed companies. Which of these extracts satisfy the definition of 'accounting'? What are the user needs that are most closely met by each extract?

- (a) Suggestions for improvements were made by many employees, alone or in teams. Annual savings which have been achieved total £15m. The best suggestion for improvement will save around £0.3m per year for the next five years.
- (b) As of 31 December, 3,000 young people were learning a trade or profession with the company. This represents a studentship rate of 3.9%. During the reporting period we hired 1,300 young people into training places. This is more than we need to satisfy our employment needs in the longer term and so we are contributing to improvement of the quality of labour supplied to the market generally.
- (c) During the year to 31 December our turnover (sales) grew to £4,000 million compared to £2,800 million last year. Our new subsidiary contributed £1,000 million to this increase.
- (d) It is our target to pay our suppliers within 30 days. During the year we achieved an average payment period of 33 days.

- (e) The treasury focus during the year was on further refinancing of the group's borrowings to minimise interest payments and reduce risk.
- (f) Our plants have emission rates that are 70% below the national average for sulphur dioxide and 20% below the average for oxides of nitrogen. We will tighten emissions significantly over the next ten years.

C1.2

Explain how you would class each of the following – as a sole trader, partnership or limited company. List any further questions you might ask for clarification about the nature of the business.

- (a) Miss Jones works as an interior decorating adviser under the business name 'U-decide'. She rents an office and employs an administrative assistant to answer the phone, keep files and make appointments.
- (b) George and Jim work together as painters and decorators under the business name 'Painting Partners Ltd'. They started the business ten years ago and work from a rented business unit on a trading estate.
- (c) Jenny and Chris own a hotel jointly. They operate under the business name 'Antler Hotel Company' and both participate in the running of the business. They have agreed to share profits equally.

Activities for study groups (4 or 5 per group)

Obtain the annual report of a listed company. Each member of the group should choose a different company. Most large companies will provide a copy of the annual report at no charge in response to a polite request – or you may know someone who is a shareholder and receives a copy automatically. Many companies have websites with a section for 'Investor Relations' where you will find a document file containing the annual report.

- 1 Look at the contents page. What information does the company provide?
- 2 Find the financial highlights page. What are the items of accounting information which the company wants you to note? Which users might be interested in this highlighted information, and why?
- 3 Is there any information in the annual report which would be of interest to employees?
- 4 Is there any information in the annual report which would be of interest to customers?
- 5 Is there any information in the annual report which would be of interest to suppliers?
- 6 Find the auditors' report. To whom is it addressed? What does that tell you about the intended readership of the annual report?
- 7 Note the pages to which the auditors' report refers. These are the pages which are regulated by company law, accounting standards and Stock Exchange rules. Compare these pages with the other pages (those which are not regulated). Which do you find more interesting? Why?
- 8 Each member of the group should now make a five-minute presentation evaluating the usefulness of the annual report examined. When the presentations are complete the group should decide on five criteria for judging the reports and produce a score for each. Does the final score match the initial impressions of the person reviewing it?
- 9 Finally, as a group, write a short note of guidance on what makes an annual report useful to the reader.

Notes and references

1. AAA (1966), *A Statement of Basic Accounting Theory*, American Accounting Association, p. 1.
2. ASSC (1975), *The Corporate Report*, Accounting Standards Steering Committee.
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4. Solomons, D. (1989), *Guidelines for Financial Reporting Standards*, Research Board of The Institute of Chartered Accountants in England and Wales.
5. ICAS (1988), *Making Corporate Reports Valuable*, Research Committee of The Institute of Chartered Accountants of Scotland.
6. The IAS Regulation (2002), see Chapter 4.
7. FRC (1999), *Statement of Principles for Financial Reporting*, Accounting Standards Board of the Financial Reporting Council.
8. ICAS (1988), para. 3.3.
9. IASB (2018) *Conceptual Framework*, para. 1.2.
10. IASB (2018) *Conceptual Framework*, para. 1.4.
11. ASSC (1975), para. 2.8.
12. ICAS (1988), para. 3.12.
13. IASB (2018) *Conceptual Framework*, para.1.3.
14. *Ibid.*, para. 1.3.
15. www.ofcom.org.uk
16. www.ofgem.gov.uk
17. ICAS (1988), para. 3.7.
18. IASB (2018) *Conceptual Framework*, para. 1.2.
19. IASB (2018) *Conceptual Framework*, para. 1.4.
20. www.cfainstitute.org

SUPPLEMENT TO CHAPTER 1

Introduction to the terminology of business transactions

The following description explains the business terminology which will be encountered frequently in describing transactions in this textbook. The relevant words are highlighted in bold lettering. These technical accounting terms are explained in the Financial accounting terms defined section at the end of the book.

Most businesses are established with the intention of earning a **profit**. Some do so by selling goods at a price greater than that paid to buy or manufacture the goods. Others make a profit by providing a service and charging a price greater than the cost to them of providing the service. By selling the goods or services the business is said to earn *sales revenue*.

Profit arising from transactions relating to the operation of the business is measured by deducting from sales revenue the expenses of earning that revenue.

Revenue from sales (often abbreviated to 'sales' and sometimes referred to as 'turn-over') means the value of all goods or services provided to customers, whether for *cash* or for *credit*. In a *cash sale* the customer pays immediately on receipt of goods or services. In a *credit sale* the customer takes the goods or service and agrees to pay at a future date. By agreeing to pay in the future the customer becomes a **debtor** of the business. The amount due to be collected from the debtor is called a **trade receivable** or an **account receivable**. The business will send a document called a **sales invoice** to the credit customer, stating the goods or services provided by the business, the price charged for these and the amount owing to the business.

Eventually the credit customer will pay cash to settle the amount shown on the invoice. If they pay promptly the business may allow a deduction of discount for prompt payment. This deduction is called *discount allowed* by the business. As an example, if the customer owes £100 but is allowed a 5% discount by the business, he will pay £95. The business will record cash received of £95 and discount allowed of £5.

The business itself must buy goods in order to manufacture a product or provide a service. When the business buys goods it *purchases* them and holds them as an **inventory** of goods (also described as a 'stock' of goods) until they are used or sold. The goods will be purchased from a supplier, either for **cash** or for **credit**. In a **credit purchase** the business takes the goods and agrees to pay at a future date. By allowing the business time to pay, the supplier becomes a **creditor** of the business. The name creditor is given to anyone who is owed money by the business. The amount due to be paid to a creditor is called a **trade payable** or an **account payable**. The business will receive a purchase invoice from the supplier describing the goods supplied, stating the price of the goods and showing the amount owed by the business.

Eventually the business will pay cash to settle the amount shown on the purchase invoice. If the business pays promptly the supplier may permit the business to deduct a discount for prompt payment. This is called **discount received** by the business. As an example, if the business owes an amount of £200 as a **trade payable** but is permitted a 10% discount by the supplier, the business will pay £180 and record the remaining £20 as **discount received** from the supplier.

The purchase price of goods sold is one of the **expenses** of the business, to be deducted from sales revenue in calculating profit. Other expenses might include wages, salaries, rent, rates, insurance and cleaning. In each case there will be a document providing evidence of the expense, such as a wages or salaries slip, a landlord's bill for rent, a local authority's demand for rates, an insurance renewal note or a cleaner's time sheet. There will also be a record of the cash paid in each case.

Sometimes an expense is incurred but is not paid for until some time later. For example, electricity is consumed during a quarter but the electricity bill does not arrive until after the end of the quarter. An employee may have worked for a week but not yet have received a cash payment for that work. The unpaid expense of the business is called an *accrued expense* and must be recorded as part of the accounting information relevant to the period of time in which the expense was incurred.

On other occasions an expense may be paid for in advance of being used by the business. For example, a fire insurance premium covering the business premises is paid annually in advance. Such expenditure of cash will benefit a future time period and must be excluded from any profit calculation until that time. In the meantime it is recorded as a **prepaid expense** or a **prepayment**.

Dissatisfaction may be expressed by a customer with the quantity or quality of goods or service provided. If the business accepts that the complaint is justified it may replace goods or give a cash refund. If the customer is a credit customer who has not yet paid, then a cash refund is clearly inappropriate. Instead the customer would be sent a **credit note** for sales returned, cancelling the customer's debt to the business for the amount in dispute. The credit note would record the quantity of goods or type of service and the amount of the cancelled debt.

In a similar way the business would expect to receive a credit note from a supplier for *purchases returned* where goods have been bought on credit terms and later returned to the supplier because of some defect.

S Test your understanding

S1.1 The following technical terms appear in this supplement. Check that you know the meaning of each.

- Profit
- Sales revenue
- Cash sale
- Credit sale
- Debtor
- Trade receivable
- Discount allowed
- Purchases
- Credit purchase
- Inventory
- Creditor
- Trade payable
- Discount received
- Expense
- Accrued expense
- Prepaid expense
- Credit note for sales returned
- Credit note for purchases returned
- Account receivable
- Sales invoice
- Account payable

CHAPTER 2

A systematic approach to financial reporting: the accounting equation

Real World Case

Micro-entities: statement of financial position

The Financial Reporting Council (FRC) in the UK has set out an accounting standard for micro-entities, which are the very smallest companies. Typically they have fewer than 10 employees. One permitted outline for a statement of financial position (balance sheet) is shown here.

| | |
|-------------------------------------|----------|
| Assets | |
| Fixed assets | X |
| Current assets | X |
| Prepayments and accrued income | <u>X</u> |
| | <u>X</u> |
| Capital, Reserves and Liabilities | |
| Capital and reserves | X |
| Provisions for liabilities | |
| Creditors | X |
| Amounts falling due within one year | X |
| Amounts falling due after one year | <u>X</u> |
| | X |
| Accruals and deferred income | <u>X</u> |
| | <u>X</u> |

Source: FRS 105: The Financial Reporting Standard applicable to the Micro-entities Regime (2015), paragraph 4.3., <https://www.frc.org.uk/accountants/accounting-and-reporting-policy/uk-accounting-standards/standards-in-issue/frs-105-the-financial-reporting-standard-applicabl>

Discussion points

- 1 How does the statement of financial position reflect the accounting equation?
- 2 What further questions would you ask about the statement of financial position?



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Learning outcomes

After studying this chapter you should be able to:

- Define and explain the accounting equation.
- Define assets.
- Apply the definition to examples of assets.
- Explain and apply the guidance for recognition of assets.
- Define liabilities.
- Apply the definition to examples of liabilities.
- Explain and apply the guidance for recognition of liabilities.
- Define ownership interest.
- Explain how the recognition of ownership interest depends on the recognition of assets and liabilities.
- Use the accounting equation to show the effect of changes in the ownership interest.
- Explain how users of financial statements can gain assurance about assets and liabilities.

Additionally, for those who choose to study the supplement:

- Explain how the rules of debit and credit recording are derived from the accounting equation.

2.1 Introduction

Chapter 1 considered the needs of a range of users of financial information and summarised by suggesting that they would all have an interest in the resources available to the business and the obligations of the business to those outside it. Many of these users will also want to be reassured that the business has an adequate flow of cash to support its continuation. The owners of the business have a claim to the resources of the business after all other obligations have been satisfied. This is called the **ownership interest** or the **equity interest**. They will be particularly interested in how that ownership interest grows from one year to the next and whether the resources of the business are being applied to the best advantage.

Accounting has traditionally applied the term **assets** to the resources available to the business and has applied the term **liabilities** to the obligations of the business to persons other than the owner. Assets and liabilities are reported in a financial statement called a **statement of financial position** (also called a **balance sheet**). The statement of the financial position of the entity represents a particular point in time. It may be described by a very simple equation.

Activity 2.1

This section contains several words in bold font that may be new to you. They will all be explained in the chapter. Look back to this page after you have read the chapter and check that you understand the new words.

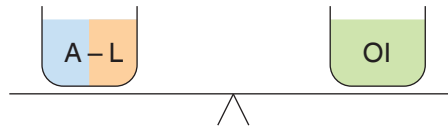
2.2 The accounting equation

The **accounting equation** as a statement of financial position may be expressed as:

| | | | | |
|--------|-------|-------------|--------|--------------------|
| Assets | minus | Liabilities | equals | Ownership interest |
|--------|-------|-------------|--------|--------------------|

The ownership interest is the residual claim after liabilities to third parties have been satisfied. The equation expressed in this form emphasises that residual aspect.

Another way of thinking about an equation is to imagine a balance with a bucket on each end. In one bucket are the assets (A) minus liabilities (L). In the other is the ownership interest (OI).



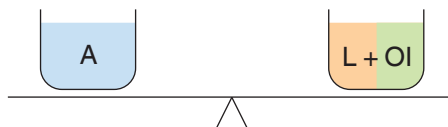
If anything happens to disturb the assets then the balance will tip unevenly unless some matching disturbance is applied to the ownership interest. If anything happens to disturb the liabilities then the balance will tip unevenly unless some matching disturbance is applied to the ownership interest. If a disturbance applied to an asset is applied equally to a liability, then the balance will remain level.

2.2.1 Form of the equation: international preferences

If you have studied simple equations in a maths course you will be aware that there are other ways of expressing this equation. Those other ways cannot change the magnitudes of each item in the equation but can reflect a different emphasis being placed on the various constituents. The form of the equation used in this chapter is the sequence which has, for many years, been applied in most statements of financial position (balance sheets) reported to external users of accounting information in the UK. The statements of financial position that have been reported to external users in some Continental European countries and in the USA are better represented by another form of the equation:

| | | | | |
|--------|--------|-------------|------|--------------------|
| Assets | equals | Liabilities | plus | Ownership interest |
|--------|--------|-------------|------|--------------------|

The ‘balance’ analogy remains applicable here, but the contents of the buckets have been rearranged.



A disturbance on one side of the balance will require a corresponding disturbance on the other side if the balance is to be maintained.

2.2.2 Flexibility

The International Accounting Standards Board (IASB) has developed a set of accounting standards which together create an accounting system which in this book is described as the **IASB system**. The IASB offers no indication as to which of the above forms of the accounting equation is preferred. That is because of the different traditions in different countries. Consequently, for companies reporting under the IASB system, the form of the equation used in any particular situation is a matter of preference related to the choice of presentation of the statement of financial position (balance sheet). That is a communication issue which will be discussed later. This chapter will concentrate on the nature of the various elements of the equation, namely assets, liabilities and ownership interest. You should be prepared to find different variations of the accounting equation in different companies' financial statements.

2.2.3 Measurement in the accounting equation

Measurements used in the accounting equation may use historical cost, or fair value, or a mixture of both.

Definition

Historical cost is the amount paid for an asset or agreed for a liability on the date that the transaction first occurred.

Traditionally accounting has been based on historical cost, with no regard for any effects of subsequent market prices or values. In historical cost accounting, assets have initially been measured at their cost on the date they were acquired. Liabilities have been measured at the amount agreed as owing on the date that the borrowing took place. Changes in historical cost caused by the passage of time, or use of resources, have been recognised through changes of the reported measurement of long-term assets and some long-term liabilities.

Definition

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

The measurement date for fair value is taken as the end date of the accounting period. This means that reported fair values of assets and liabilities change frequently. The market to be used in deciding on the fair value should be the principal market for the asset or liability. If there is no principal market then the fair value should be found in the most advantageous market for the asset or liability. Guidance on the use of fair value for specific assets and liabilities is found in accounting standards, explained in more detail in Chapter 4. The relationship to theories of value is explained in Chapter 14, section 14.9.

Activity 2.2

Make a simple balance from a ruler balanced on a pencil and put coins on each side. Satisfy yourself that the ruler only remains in balance if any action on one side of the balance is matched by an equivalent action on the other side of the balance. Note also that rearranging the coins on one side will not disturb the balance. Some aspects of accounting are concerned with taking actions on each side of the balance. Other aspects are concerned with rearranging one side of the balance.

Self test

- A2.1** Write out two versions of the basic form of the accounting equation.
- A2.2** Explain how historical cost measurement differs from fair value measurement.
- A2.3** Is there any point in time where historical cost and fair value measurement are the same?

2.3 Defining assets

An **asset** is defined as ‘a present economic resource controlled by the entity as a result of past events’. An **economic resource** is defined as ‘a right that has the potential to produce economic benefits’.¹

To understand this definition fully, each phrase must be considered separately.

2.3.1 Economic resource

Businesses use resources that have the potential to produce economic benefits. Eventually most resources generate an economic benefit in the form of cash. Some resources generate cash more quickly than others. If the business manufactures goods in order to sell them to customers, those goods have the potential to produce economic benefit through making a sale. That benefit comes to the entity relatively quickly. The business may own a warehouse in which it stores the goods before they are sold. The warehouse has the potential to produce economic benefits because it helps create the cash flow from sale of the goods (by keeping them safe from damage and theft) and also because at some time in the future the warehouse could itself be sold for cash.

The example of the warehouse is relatively easy to understand, but in other cases there may be some uncertainty about whether the resource has the potential to produce economic benefit. When goods are sold to a customer who is allowed time to pay, the customer becomes a **debtor** of the business (a person who owes money to the business) and the amount of the **trade receivable** is regarded as an asset. There may be some uncertainty as to whether the customer will eventually pay for the goods. That uncertainty does not prevent the trade receivable being regarded as an asset but may require some caution as to how the asset is measured in money terms.

The definition uses the word ‘right’ because sometimes the entity does not have legal ownership of the resource but does have the right to use the resource. Such a right could include an agreement to lease or rent a resource, and a licence allowing exclusive use of a resource.

2.3.2 Controlled by the entity

Control means the ability to obtain the economic benefits and to restrict the access of others. The items which everyone enjoys, such as the benefit of a good motorway giving access to the business or the presence of a highly skilled workforce in a nearby town, provide benefits to the business which are not reported in financial statements because there would be considerable problems in identifying the entity’s share of the benefits. If there is no control, the item is omitted.

The condition of control is also included to prevent businesses from leaving out of the statement of financial position (balance sheet) some items which ought to be in there. In past years, practices emerged of omitting an asset and a corresponding liability from a statement of financial position on the grounds that there was no effective obligation remaining in respect of the liability. At the same time, the business carefully retained effective control of the asset by suitable legal agreements. This practice of omitting items from the statement

of financial position was felt to be unhelpful to users because it was concealing some of the resources used by the business and concealing the related obligations.

The strongest form of control over an asset is the right of ownership. Section 2.3.1 explains that there are other forms of rights that give control, such as agreement to lease or rent a resource, and a licence allowing exclusive use of a resource.

2.3.3 Past events

Accounting depends on finding some reasonably objective way of confirming that the entity has gained control of the resource. The evidence provided by a past transaction is an objective starting point. A transaction is an agreement between two parties which usually involves exchanging goods or services for cash or a promise to pay cash. (The supplement to Chapter 1 explains basic business transactions in more detail.) Sometimes there is no transaction but there is an event which is sufficient to give this objective evidence. The event could be the performance of a service which, once completed, gives the right to demand payment.

Activity 2.3

Write down five items in your personal possession which you regard as assets. Use the definition given in this section to explain why each item is an asset from your point of view. Then read the next section and compare your list with the examples of business assets. If you are having difficulty in understanding why any item is, or is not, an asset you should consult your lecturer, tutor or other expert in the subject area for a discussion on how to apply the definition in identifying assets.

Self test

- A2.4** Define an asset.
A2.5 Explain each part of the definition.

2.4 Examples of assets

The following items are commonly found in the assets section of the statement of financial position (balance sheet) of a company:

- land and buildings (property) owned by the company
- buildings leased by the company on a 50-year lease
- plant and equipment owned by the company
- equipment leased (rented) by the company under a finance lease
- vehicles
- raw materials
- goods for resale
- finished goods
- work in progress
- trade receivables (amounts due from customers who have promised to pay for goods sold on credit)
- prepaid insurance and rentals
- investments in shares of other companies
- cash held in a bank account.

Table 2.1 Analysis of some frequently occurring non-current assets (fixed assets)

| | Economic benefits | Controlled by the entity by means of | Past event |
|--|--|---|---|
| <i>Land and buildings owned by the company</i> | Used in continuing operations of the business; potential for sale of the item. | Ownership. | Signing the contract as evidence of purchase of land and buildings. |
| <i>Buildings leased (rented) by the company on a 50-year lease</i> | Used in continuing operations of the business. | Contract for exclusive use as a tenant. | Signing a lease agreeing the rental terms. |
| <i>Plant and equipment owned by the company</i> | Used in continuing operations of the business. | Ownership. | Purchase of plant and equipment, evidenced by receiving the goods and a supplier's invoice. |
| <i>Equipment used under a finance lease</i> | Used in continuing operations of the business. | Contract for exclusive use. | Signing lease agreeing rental terms. |
| <i>Vehicles owned by the company</i> | Used in continuing operations of the business. | Ownership. | Purchase of vehicles, evidenced by taking delivery and receiving a supplier's invoice. |

Do all these items meet the definition of an asset? Tables 2.1 and 2.2 test each item against the aspects of the definition which have already been discussed. Two tables have been used because it is conventional practice to separate assets into current assets and non-current assets. **Current assets** are held with the intention of converting them into cash within the business cycle. **Non-current assets**, also called **fixed assets**, are held for continuing use in the business. The business cycle is the period (usually 12 months) during which the peaks and troughs of activity of a business form a pattern which is repeated on a regular basis. For a business selling swimwear, production will take place all winter in preparation for a rush of sales in the summer. Painters and decorators work indoors in the winter and carry out exterior work in the summer. Because many businesses are affected by the seasons of the year, the business cycle is normally 12 months. Some of the answers are fairly obvious but a few require a little further comment here.

First, there are the items of buildings and equipment which are rented under a lease agreement. The benefits of such leases are felt to be so similar to the benefits of ownership that the items are included in the statement of financial position (balance sheet) as assets. Suitable wording is used to describe the different nature of these items so that users, particularly **creditors**, are not misled into believing that the items belong to the business.

Second, it is useful to note at this stage that partly finished items of output may be recorded as assets. The term 'work in progress' is used to describe work of the business which is not yet completed. Examples of such work in progress might be: partly finished items in a manufacturing company; a partly completed motorway being built by a construction company; or a continuing legal case being undertaken by a firm of lawyers. Such items are included as assets because there has been an event in the partial completion of the work and it is capable of completion and eventual payment by a customer for the finished item.

Table 2.2 Analysis of some frequently occurring current assets

| | Economic benefits | Controlled by the entity by means of | Past event |
|---|--|---|---|
| <i>Raw materials</i> | Used to manufacture goods for sale. | Ownership. | Receiving raw materials into the company's store, evidenced by goods received note. |
| <i>Goods purchased from supplier for resale</i> | Expectation of sale. | Ownership. | Receiving goods from supplier into the company's store, evidenced by the goods received note. |
| <i>Finished goods (manufactured by the entity)</i> | Expectation of sale. | Ownership. | Transfer from production line to finished goods store, evidenced by internal transfer form. |
| <i>Work in progress (partly finished goods)</i> | Expectation of completion and sale. | Ownership. | Evaluation of the state of completion of the work, evidenced by work records. |
| <i>Trade receivables (amounts due from customers)</i> | Expectation that the customer will pay cash. | Contract for payment. | Delivery of goods to the customer, obliging customer to pay for goods at a future date. |
| <i>Prepaid insurance premiums</i> | Expectation of continuing insurance cover. | Contract for continuing benefit of insurance cover. | Paying insurance premiums in advance, evidenced by cheque payment. |
| <i>Investments in shares of other companies</i> | Expectation of dividend income and growth in value of investment, for future sale. | Ownership. | Buying the shares, evidenced by broker's contract note. |
| <i>Cash held in a bank account</i> | Expectation of using the cash to buy resources which will create further cash. | Ownership. | Depositing cash with the bank, evidenced by bank statement or certificate. |

Finally, it is clear that the economic benefits to be produced by these assets have a wide variation in potential risk. This risk is a matter of great interest to those who use accounting information, but there are generally no accounting techniques for reporting this risk directly in financial statements. Consequently, it is very important to have adequate descriptions of assets. Accounting information is concerned with the words used to describe items in financial statements, as well as the numbers attributed to them. (The narrative description of business risks is explained in Chapter 14, section 14.10.)

Definitions

An **asset** is 'a present economic resource controlled by the entity as a result of past events. An **economic resource** is a right that has the potential to produce economic benefits'.²

A **current asset** is an asset that satisfies any of the following criteria:

- (a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is expected to be realised within 12 months after the reporting period;
- (d) it is cash or a cash equivalent.³

A **non-current asset** is any asset that does not meet the definition of a current asset.⁴ Non-current assets include tangible, intangible and financial assets of a long-term nature. These are also described as **fixed assets**.⁵

Activity 2.4

Look back to the list at the start of section 2.4 and decide whether each item is a fixed asset or a current asset. Then check your understanding against Table 2.1 and Table 2.2.

Self test

A2.6 Give five examples of items which are assets.

A2.7 Use the definition to explain why each of the items in your answer to A2.6 is an asset.

2.5 Recognition of assets

When an economic resource has passed the tests of definition of an asset, it has still not acquired the right to a place in the statement of financial position (balance sheet). To do so it must meet further guidance on recognition. **Recognition** means depicting an item by means of words and amounts within the main financial statements in such a way that the item is included in the arithmetic totals. An item which is reported in the notes to the accounts is said to be **disclosed** but *not recognised*.

2.5.1 Recognition criteria

The recognition criteria are expressed as in the following definition.

Definition

An **asset** is **recognised** in the statement of financial position (balance sheet) when:

- it meets the definition of an asset; and
- the resulting information is relevant and provides a faithful representation; and
- the benefits of the information exceed the costs of providing it.⁶

Information might not be relevant if, for example, it is uncertain whether the asset exists, if it is unlikely that future flows of economic benefits will occur or if there is very significant measurement uncertainty associated with the item.

The *Conceptual Framework* sets out broad guidance that provides a narrative discussion of the thought process to go through in making recognition decisions. The IASB then applies this thought process in developing specific accounting standards.

The following are indicators that recognition might *not* provide relevant information about an asset:

- (a) The range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate.
- (b) An asset exists, but there is only a low probability that an inflow of economic benefits will result.
- (c) Identifying the resource is unusually difficult.
- (d) Measuring a resource requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.

2.5.2 Non-recognition

Consider some items which pass the definition test but do not appear in a statement of financial position (balance sheet):

- the workforce of a business (a human resource)
- the strength of the management team (another human resource)
- the reputation established for the quality of the product
- the quality of the regular customers
- a tax refund which will be claimable against profits in two years' time.

These items all meet the conditions of an economic resource, control and a past event. However, they all have associated with them a high level of uncertainty. The range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. This means that recognition would not meet the test of relevance.

The workforce as a whole may be reliable and predictable, but unexpected circumstances can come to all and the illness or death of a member of the management team in particular can have a serious impact on the perceived value of the business. A crucial member of the workforce might give notice and leave. In relation to the product, a reputation for quality may become well established and those who would like to include brand names in the statement of financial position (balance sheet) argue for the permanence of the reputation. Others illustrate the relative transience of such a reputation by bringing out a list of well-known biscuits or sweets of 30 years ago and asking who has heard of them today. Reliable customers of good quality are valuable to a business, but they are also fickle and may change their allegiance at a moment's notice. The tax refund may be measurable in amount, but will there be taxable profits in two years' time against which the refund may be claimed?

It could be argued that the assets which are not recognised in the financial statements should be reported by way of a general description in a note to the accounts. In practice, this rarely happens because accounting tries to avoid raising hopes which might subsequently be dashed. This cautious approach is part of what is referred to more generally as **prudence** in accounting practice.

Activity 2.5

Look at the items listed in section 2.5.2 as not being recognised in the balance sheet. Explain why you agree or disagree with each one.

Self test

- A2.8** Explain what 'recognition' means in accounting.
- A2.9** State the criteria for recognition of an asset.
- A2.10** Explain why an item may pass the definition test but fail the recognition conditions for an asset.
- A2.11** Give three examples of items which pass the definition test for an asset but fail the recognition criteria.
- A2.12** Some football clubs include the players in the statement of financial position (balance sheet) as an asset. Others do not. Give the arguments to support each approach.

2.6 Measurement of assets

Assets in the financial statements may be measured at **historical cost** or at **fair value**, depending on the nature of the asset and the requirements of accounting standards under which an entity is reporting.

2.6.1 Historical cost of assets

In historical cost accounting, assets have initially been measured at their cost on the date they were acquired. Liabilities have been measured at the amount agreed as owing on the date that the borrowing took place. In the historical cost system, the accounting treatment after the date of acquisition depends on the nature of the asset as described in Table 2.1.

- **Non-current assets** (usually those held for long-term use in the business) are valued at historical cost less **depreciation**. Depreciation is a measure of the use of the asset over its life. The calculation of depreciation is explained in more detail in Chapter 8.
- **Current assets**, such as inventories, accounts receivable and cash, usually remain recorded at historical cost until they are used in the operations of the business or are sold. The methods of recording current assets are explained in more detail in Chapter 9.

2.6.2 Fair value of assets

Fair value is the price that would be received to sell an asset in an orderly transaction between market participants at the measurement date.

- **Non-current assets** are held for use in the business and so their fair value cannot be measured directly through selling them. Instead the reporting entity must estimate the fair value of an asset of similar type and condition. Methods of making this estimate are described in more detail in Chapter 8.
- **Current assets** are used or sold within the reporting period. Their value in a market can usually be reported relatively easily. Methods of reporting the fair value of current assets are described in more detail in Chapter 9.

Activity 2.6

You will find more about the measurement of assets in later chapters. As a starting point, think about something you own, such as a mobile phone or a computer or some form of transport. What was the historical cost of the item? How would you decide on a fair value of the item today?

Self test

- A2.13** Explain what is meant by the 'fair value of an asset'.

2.7 Defining liabilities

A **liability** is defined as ‘a present obligation of the entity to transfer an economic resource as a *result of past events*’. An **economic resource** is defined as ‘a right that has the potential to produce economic benefits’.⁷

The most familiar types of liabilities arise in those situations where specific amounts of money are owed by an entity to specific persons called creditors. There is usually no doubt about the amount of money owed and the date on which payment is due. Such persons may be **trade creditors**, the general name for those suppliers who have provided goods or services in return for a promise of payment later. Amounts due to **trade creditors** are described as **trade payables**. Other types of creditors include bankers or other lenders who have lent money to the entity.

There are also situations where an obligation is known to exist but the amount due is uncertain. That might be the case where a court of law has found an entity negligent in failing to meet some duty of care to a customer. The company will have to pay compensation to the customer but the amount has yet to be determined.

Even more difficult is the case where an obligation might exist if some future event happens. Neither the existence nor the amount of the obligation is known with certainty at the date of the financial statements. An example would arise where one company has guaranteed the overdraft borrowing of another in the event of that other company defaulting on repayment. At the present time there is no reason to suppose a default will occur, but it remains a possibility for the future.

The definition of a liability tries to encompass all these degrees of variation and uncertainty. It has to be analysed for each separate word or phrase in order to understand the full implications.

2.7.1 Present obligation

An obligation is a duty or responsibility that an entity has no practical ability to avoid.⁸ A legal obligation is evidence that a liability exists because there is another person or entity having a legal claim to payment. Most liabilities arise because a legal obligation exists, either by contract or by statute law.

However, a legal obligation is not a necessary condition. There may be a commercial penalty faced by the business if it takes a certain action. For example, a decision to close a line of business will lead to the knowledge of likely redundancy costs long before the employees are actually made redundant and the legal obligation becomes due. There may be an obligation imposed by custom and practice, such as a condition of the trade that a penalty operates for those who pay bills late. There may be a future obligation caused by actions and events of the current period where, for example, a profit taken by a company now may lead to a taxation liability at a later date which does not arise at this time because of the wording of the tax laws.

The wording ‘present obligation’ is intended to indicate that the entity has no practical ability to avoid the transfer and the amount is determined by reference to past actions or benefits received. An entity would have no practical ability to avoid a transfer if, for example, avoiding the transfer would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself. Another case would be that the transfer could be avoided only by liquidating the entity or ceasing trading.

2.7.2 Transfer of economic resource

The resource of cash is the economic benefit transferable in respect of most obligations. The transfer of property in settlement of an obligation would also constitute a transfer

of economic benefits. More rarely, economic benefits could be transferred by offering a resource such as labour in settlement of an obligation.

2.7.3 Past events

A decision to buy supplies or to acquire a new non-current asset is not sufficient to create a liability. It could be argued that the decision is an event creating an obligation, but it is such a difficult type of event to verify that accounting prefers not to rely too much on the point at which a decision is made.

Most liabilities are related to a transaction. Normally the transaction involves receiving goods or services, receiving delivery of new non-current assets such as vehicles and equipment, or borrowing money from a lender. In all these cases there is documentary evidence that the transaction has taken place.

Where the existence of a liability is somewhat in doubt, subsequent events may help to confirm its existence at the date of the financial statements. For example, when a company offers to repair goods under a warranty arrangement, the liability exists from the moment the warranty is offered. It may, however, be unclear as to the extent of the liability until a pattern of customer complaints is established. Until that time there will have to be an estimate of the liability. In accounting this estimate is called a **provision**. Amounts referred to as **provisions** are included under the general heading of liabilities.

Activity 2.7

Write down five items in your personal experience which you regard as liabilities. Use the definition given in this section to explain why each item is a liability from your point of view. Then read the next section and compare your list with the examples of business liabilities. If you are having difficulty in understanding why any item is, or is not, a liability you should consult your lecturer, tutor or other expert in the subject area for a discussion on how to apply the definition in identifying liabilities.

Self test

- A2.14** Define a liability.
A2.15 Explain each part of the definition.

2.8 Examples of liabilities

Here is a list of items commonly found in the liabilities section of the statements of financial position (balance sheets) of companies:

- bank loans and overdrafts
- trade payables (amounts due to suppliers of goods and services on credit terms)
- taxation payable
- accruals (amounts owing, such as unpaid expenses)
- provision for deferred taxation
- long-term loans.

The first two items in this list would be classified as **current liabilities** because they will become due for payment within one year of the date of the financial statements. The last two items would be classified as **non-current liabilities** because they will remain due by the business for longer than one year.

An analysis of some common types of liability is given in Table 2.3.

Definitions

A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events. An **economic resource** is a right that has the potential to produce economic benefits.⁹

A **current liability** is a liability which satisfies any of the following criteria:

- (a) it is expected to be settled in the entity's normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is due to be settled within 12 months after the reporting period.¹⁰

A **non-current liability** is any liability that does not meet the definition of a current liability.¹¹ Non-current liabilities are also described as **long-term liabilities**.

Table 2.3 Analysis of some common types of liability

| Type of liability | Obligation | Transfer of economic resource | Past event |
|---|--|---|---|
| <i>Bank loans and overdrafts (repayable on demand or in the very short term)</i> | The entity must repay the loans on the due date or on demand. | Cash, potentially within a short space of time. | Receiving the borrowed funds. |
| <i>Trade payables (amounts due to suppliers of goods and services)</i> | Suppliers must be paid for the goods and services supplied, usually about one month after the supplier's invoice is received. | Cash within a short space of time. | Taking delivery of the goods or service and receiving the supplier's invoice. |
| <i>Taxation payable (tax due on company profits after the financial year-end date)</i> | Cash payable to HMRC. Penalties are charged if tax is not paid on the due date. | Cash. | Making profits in the accounting year and submitting an assessment of tax payable. |
| <i>Accruals (a term meaning 'other amounts owing', such as unpaid bills)</i> | Any expense incurred must be reported as an accrued liability (e.g. electricity used, gas used, unpaid wages), if it has not been paid at the financial year-end date. | Cash. | Consuming electricity or gas, using employees' services, receiving bills from suppliers (note that it is not necessary to receive a gas bill in order to know that you owe money for gas used). |
| <i>Provision for deferred taxation (tax due in respect of present profits but having a delayed payment date allowed by tax law)</i> | Legislation allows companies to defer payment of tax in some cases. The date of future payment may not be known as yet. | Cash eventually, but could be in the longer term. | Making profits or incurring expenditure now which meets conditions of legislation allowing deferral. |
| <i>Long-term loans (sometimes called debenture loans)</i> | Statement of financial position will show repayment dates of long-term loans and any repayment conditions attached. | Cash. | Received borrowed funds. |

Activity 2.8

Look at the items listed in Table 2.3 and explain which are current liabilities and which are non-current liabilities.

Self test

A2.16 Give five examples of items which are liabilities.

A2.17 Use the definition to explain why each of the items in your answer to A2.16 is a liability.

2.9 Recognition of liabilities

As with an asset, when an item has passed the tests of definition of a liability it may still fail the guidance on recognition. In practice, because of the concern for prudence, it is much more difficult for a liability to escape the statement of financial position (balance sheet).

The recognition criteria for a liability uses wording which mirrors those used for recognition of the asset. The only difference is that the economic benefits now flow *from* the enterprise. The conditions for recognition are expressed in the following way:

Definition

A **liability is recognised** in the statement of financial position (balance sheet) when:

- it meets the definition of a liability; and
- the resulting information is relevant and provides a faithful representation; and
- the benefits of the information exceed the costs of providing it.¹²

Information might not be relevant if, for example, it is uncertain whether the liability exists, or it is unlikely that future transfers of economic benefits will occur or there is very significant measurement uncertainty associated with the item.

The following are indicators that recognition might *not* provide relevant information about a liability:

- (a) The range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate.
- (b) A liability exists, but there is only a low probability that a transfer of economic benefits will result.
- (c) Identifying the resource to be transferred is unusually difficult.
- (d) Measuring the obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.

Examples of liabilities which are not recognised in the statement of financial position (balance sheet) are:

- a commitment to purchase new machinery next year (but not a firm contract);
- a remote, but potential, liability for a defective product, where no court action has yet commenced;
- a guarantee given to support the bank overdraft of another company, where there is very little likelihood of being called upon to meet the guarantee.

Because of the prudent nature of accounting, the liabilities which are not recognised in the statement of financial position (balance sheet) may well be reported in note form under the heading **contingent liabilities**. This is referred to as **disclosure** by way of a note to the accounts.

Looking more closely at the list of liabilities which are not recognised, we see that the commitment to purchase is not legally binding and therefore the outflow of resources may not occur. The claim based on a product defect appears to be uncertain as to occurrence and as to amount. If there has been a court case or a settlement out of court then there should be a provision for further claims of a similar nature. In the case of the guarantee the facts as presented make it appear that an outflow of resources is unlikely. However, such appearances have in the past been deceiving to all concerned and there is often interesting reading in the note to the financial statements which describes the contingent liabilities.

Activity 2.9

Look at the items listed in section 2.9 as not being recognised in the balance sheet. Explain why you agree or disagree with each one.

Self test

- A2.18** State the criteria for recognition of a liability.
A2.19 Explain why an item may pass the definition test but fail the recognition criteria for a liability.

2.10 Measurement of liabilities

Liabilities in the financial statements may be measured at **historical cost** or at **fair value**, depending on the nature of the liability and the requirements of accounting standards under which an entity is reporting.

2.10.1 Historical cost of liabilities

Under historical cost accounting, liabilities have been measured at the amount agreed as owing on the date that the borrowing took place. In the historical cost system the accounting treatment after the date of acquisition depends on the nature of the liability as described in Table 2.3.

- **Current liabilities**, such as accounts payable and accruals, usually remain recorded at historical cost until they are paid or settled. The methods of recording current liabilities are explained in more detail in Chapter 10.
- **Non-current liabilities**, extending over a period of years, are in some cases reported at historical cost throughout the period of their life. In other cases, the complexities of the interest charges and repayment conditions are used in calculating the spread of the historical cost obligation over the period of the loan. The methods of recording non-current liabilities are explained in more detail in Chapter 11.

2.10.2 Fair value

Fair value is the price that would be paid to transfer a liability in an orderly transaction between market participants at the measurement date. This idea is sometimes difficult intuitively because it can be hard to imagine why anyone would take on a liability. Let's suppose Chris owes Peter £100, due for payment in one year's time. Typical interest rates are 4% per annum. Chris says to Robin, 'I don't want to continue owing money to Peter. What can I pay you now to take on this liability?' The lowest payment Robin will accept is £96.15 because, if invested at 4%, that will grow to £100 in one year's time. Robin can then repay Peter. The fair value is the price at which Robin would be indifferent, which is £96.15.

Activity 2.10

Most people think about their personal liabilities in historical cost measures. What are the forms of personal or household liabilities commonly found?

Self test

A2.20 Explain what is meant by the 'fair value of a liability'.

2.11 The ownership interest

The ownership interest is described in the *Conceptual Framework* as equity. **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.¹³

The term **net assets** is used as a shorter way of saying 'total assets less total liabilities'. Because the ownership interest is the residual item, it will be the owners of the business who benefit from any increase in assets after liabilities have been met. Conversely it will be the owners who bear the loss of any decrease in assets after liabilities have been met. The ownership interest applies to the entire net assets. It is sometimes described as the owners' wealth, although economists would take a view that the owners' wealth extends beyond the items recorded in a statement of financial position (balance sheet).

If there is only one owner, as in the sole trader's business, then there is no problem as to how the ownership interest is shared. In a partnership, the partnership agreement will usually state the profit-sharing ratio, which may also be applied to the net assets shown in the statement of financial position (balance sheet). If nothing is said in the partnership agreement, the profit sharing must be based on equal shares for each partner.

In a company the arrangements for sharing the net assets depend on the type of ownership chosen. The owners may hold **ordinary shares** in the company, which entitle them to a share of any dividend declared and a share in net assets on closing down the business. The ownership interest is in direct proportion to the number of shares held.

Some investors like to hold **preference shares**, which give them a preference (although not an automatic right) to receive a dividend before any ordinary share dividend is declared. The rights of preference shareholders are set out in the articles of association of the company. Some will have the right to share in a surplus of net assets on winding up, but others will only be entitled to the amount of capital originally contributed.

Definitions

The **ownership interest** is called **equity** in the IASB *Conceptual Framework*.

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

Net assets means the difference between the total assets and the total liabilities of the business: it represents the amount of the ownership interest in the entity.

There can be no separate recognition criteria for the ownership interest because it is the result of recognising assets and recognising liabilities. Having made those decisions on assets and liabilities the enterprise has used up its freedom of choice.

2.11.1 Changes in the ownership interest

It has already been explained that the owner will become better off where the net assets are increasing. The owner will become worse off where the net assets are decreasing. To measure the increase or decrease in net assets, two accounting equations are needed:

| | | | |
|-----------------|--|--------|---|
| At time $t = 0$ | Assets _(t0) – Liabilities _(t0) | equals | Ownership interest _(t0) |
| At time $t = 1$ | Assets _(t1) – Liabilities _(t1) | equals | Ownership interest _(t1) |

Taking one equation away from the other may be expressed in words as:

| | | |
|---|--------|-------------------------------------|
| Change in (assets – liabilities) | equals | Change in ownership interest |
|---|--------|-------------------------------------|

or, using the term ‘net assets’ instead of ‘assets – liabilities’:

| | | |
|-----------------------------|--------|-------------------------------------|
| Change in net assets | equals | Change in ownership interest |
|-----------------------------|--------|-------------------------------------|

The change in the ownership interest between these two points in time is a measure of how much better or worse off the owner has become, through the activities of the business. The owner is better off when the ownership interest at time $t = 1$ is higher than that at time $t = 0$. To calculate the ownership interest at each point in time requires knowledge of all assets and all liabilities at each point in time. It is particularly interesting to know about the changes in assets and liabilities which have arisen from the day-to-day operations of the business.

2.11.2 Income and expenses

The word **income** is applied to any increase in the ownership interest caused by an increase in an asset which is greater than any decrease in another asset (or increase in a liability). The word **expense** is applied to any reduction in the ownership interest caused by a reduction in an asset to the extent that it is not replaced by a corresponding increase in another asset (or reduction in a liability). In both definitions it is assumed that the owner makes no new contributions or withdrawals.

Definitions

Income is defined as ‘increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.’¹⁴

Expenses are defined as ‘decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.’¹⁵

‘Contributions from holders of equity claims’ means new share capital contributed. ‘Distributions to holders of equity claims’ means dividends paid or share capital returned. These topics are dealt with in Chapter 12.

The owner or owners of the business may also change the amount of the ownership interest by deciding to contribute more cash or other resources in order to finance the business, or deciding to withdraw some of the cash and other resources previously contributed or accumulated. The amount contributed to the business by the owner is usually referred to as **capital**. Decisions about the level of capital to invest in the business are financing decisions. These financing decisions are normally distinguished separately from the results of operations.

Accordingly another equation may now be derived as a subdivision of the basic accounting equation, showing analysis of the changes in the ownership interest.

| | | |
|-------------------------------------|--------|--|
| Change in ownership interest | equals | Capital contributed/withdrawn by the ownership plus Income minus Expenses |
|-------------------------------------|--------|--|

2.11.3 Revenue and related expenses

The difference between revenue and expenses is more familiarly known as profit. A further subdivision of the basic equation is:

| | | |
|--------|--------|------------------------|
| Profit | equals | Revenue minus Expenses |
|--------|--------|------------------------|

Revenue is defined as income arising in the course of an entity's ordinary activities, which causes an increase in the ownership interest. It could be due to an increase in cash or trade receivables, received in exchange for goods or services. Depending on the nature of the business, revenue may be described as sales, turnover, fees, commission, royalties or rent.

An **expense** reported in the calculation of profit is caused by a transaction or event arising in the course of an entity's ordinary activities which causes a decrease in the ownership interest. It could be due to an outflow or depletion of assets such as cash, inventory (stock) or non-current assets (fixed assets). It could be due to a liability being incurred without a matching asset being acquired.

Definition

Revenue is income arising in the course of an entity's ordinary activities.¹⁶

2.11.4 Position after a change has occurred

At the end of the accounting period there will be a new level of assets and liabilities recorded. These assets and liabilities will have resulted from the activities of the business during the period, creating revenue, or other forms of income, and incurring expenses. The owner may also have made voluntary contributions or withdrawals of capital as a financing decision. The equation in the following form reflects that story:

| | | | | |
|------------------------------------|-------|-------------|--------|--|
| Assets at the end of the period | minus | Liabilities | equals | Ownership interest at the start of the period plus Capital contributed/ withdrawn in the period plus Income of the period minus Expenses of the period |
|------------------------------------|-------|-------------|--------|--|

Activity 2.11

How does the ownership interest in a business increase or decrease after the business has started operating?

Self test

- A2.21** Define the term 'equity'.
A2.22 Explain what is meant by 'net assets'.

2.12 Assurance for users of financial statements

The definitions of assets and liabilities refer to expected flows into or out of the business. The recognition criteria refer to the evidence that the expected flows in or out will occur. The directors of a company are responsible for ensuring that the financial statements presented by them are a faithful representation of the assets and liabilities of the business and of the transactions and events relating to those assets and liabilities. Shareholders need reassurance that the directors, as their agents, have carried out this responsibility with sufficient care. To give themselves this reassurance, the shareholders appoint a firm of auditors to examine the records of the business and give an opinion as to whether the financial statements correspond to the accounting records and present a true and

fair view. (Chapter 1 explained the position of directors as agents of the shareholders. Chapter 4 explains the regulations relating to company financial statements and the appointment of auditors.)

Meet David and Leona again as they continue their conversation on the work of the auditor and its value to the shareholder as a user of accounting information provided by a company.

DAVID: *I've now coated your ceiling with apple green emulsion. In return you promised to convince me that I rely on audited accounting information more than I realise. Here is your chance to do that. I was looking today at the annual report of a company which is a manufacturing business. There is a production centre in the UK but most of the production work is carried out in Spain where the operating costs are lower. The distribution operation is carried out from Swindon, selling to retail stores all over the UK. There is an export market, mainly in France, but the company has only scratched the surface of that market. Let's start with something easy – the inventories (stocks) of finished goods which are held at the factory in Spain and the distribution depot in Swindon.*

LEONA: *You've shown right away how limited your understanding is, by choosing the asset where you need the auditor's help the most. Everything can go wrong with inventories (stocks)! Think of the accounting equation:*

$$\text{Assets} - \text{Liabilities} = \text{Ownership interest}$$

If an asset is overstated, the ownership interest will be overstated. That means the profit for the period, as reported, is higher than it should be. But you won't know that because everything will appear to be in order from the accounts. You have told me repeatedly that you buy the future, not the past, but I know you look to the current profit and loss account as an indicator of future trends of profit. And so do all your friends.

DAVID: *How can the asset of finished goods inventories be overstated? It's quite a solid item.*

LEONA: *There are two types of potential error – the physical counting of the inventory and the valuation placed on it. There are two main causes of error, one being carelessness and the other an intention to deceive. I've seen situations where the stocktakers count the same stack of goods twice because they don't have a marker pen to put a cross on the items counted. I've also heard of situations where items are counted twice deliberately. We always attend the end-of-year counting of the inventory and observe the process carefully. I wish there weren't so many companies with December year-ends. Counting inventory on 2 January is never a good start to the new year.*

DAVID: *I suppose I can believe that people lose count but how does the valuation go wrong? All companies say that they value inventories at cost as the usual rule. How can the cost of an item be open to doubt?*

LEONA: *Answering that question needs a textbook in itself. The subject comes under the heading of 'management accounting'. Take the goods that you know are manufactured in Spain. There are costs of materials to make the goods, and labour to convert raw materials into finished goods. There are also the running costs of the production unit, which are called the overheads. There is an unbelievable variety of ways of bringing those costs together into one item of product. How much does the company tell you about all that? I know the answer – nothing.*

DAVID: Well, I could always ask them at a briefing meeting. I usually ask about the profit margin on the goods sold, rather than the value of the goods unsold. But I can see that if the inventories figure is wrong then so is the profit margin. Do you have a systematic procedure for checking each kind of asset?

LEONA: Our magic word is **CEAVOP**. That stands for:

- Completeness of information presented.
- Existence of the asset or liability at a given date.
- Amount of the transaction is correctly recorded.
- Valuation reported for assets and liabilities is appropriate.
- Occurrence of the transaction or event took place in the period.
- Presentation and disclosure is in accordance with regulations and accounting standards or other comparable regulations.

Every aspect of that list has to be checked for each of the assets and liabilities you see in the statement of financial position. We need good-quality evidence of each aspect before we sign off the audit report.

DAVID: I probably believe that you do a great deal of work with your CEAVOP. But next time I come round to paint your kitchen I'll bring a list of the situations where the auditors don't appear to have asked all the questions in that list.

Activity 2.12

What kinds of error, either deliberate or intentional, can lead to overstatement of assets? What is the effect on the accounting equation? How do auditors check for evidence of overstatement of assets?

2.13 Summary

This chapter has set out the accounting equation for a situation at any one point in time:

| | | | | |
|--------|-------|-------------|--------|--------------------|
| Assets | minus | Liabilities | equals | Ownership interest |
|--------|-------|-------------|--------|--------------------|

Key points are:

- An **asset** is a present economic resource controlled by the entity as a result of past events. An **economic resource** is a right that has the potential to produce economic benefits.
- A **current asset** is an asset that satisfies any of the following criteria:
 - (a) it is expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is expected to be realised within 12 months after the date of the financial year-end;
 - (d) it is cash or a cash equivalent.
- A **non-current asset** is any asset that does not meet the definition of a current asset. Non-current assets include tangible, intangible and financial assets of a long-term nature. These are also described as **fixed assets**.

- A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events. An **economic resource** is a right that has the potential to produce economic benefits.
- A **current liability** is a liability which satisfies any of the following criteria:
 - (a) it is expected to be settled in the entity's normal operating cycle;
 - (b) it is held primarily for the purpose of being traded;
 - (c) it is due to be settled within 12 months after the date of the financial year-end.
- A **non-current liability** is any liability that does not meet the definition of a current liability. Non-current liabilities are also described as **long-term liabilities**.
- The **ownership interest** is called **equity** in the *Conceptual Framework*.
- **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.
- **Net assets** means the difference between the total assets and the total liabilities of the business: it represents the amount of the ownership interest in the entity.
- **Recognition** means reporting an economic resource in the financial statements, in words and in amount, so that the amount is included in the arithmetic totals of the financial statements. Any other form of reporting by way of note is called disclosure. The criteria for recognition of assets and liabilities are similar in wording.
- At the end of an accounting period the assets and liabilities are reported in a statement of financial position (balance sheet). Changes in the assets and liabilities during the period have caused changes in the ownership interest through income-generating activities that include reporting profit from revenue minus expenses of operations. The owner may also have voluntarily added or withdrawn capital. The final position is explained on the left-hand side of the equation and the movement to that position is explained on the right-hand side:

| | | | | |
|--------------------------|-------|-------------|--------|--|
| Assets | minus | Liabilities | equals | Ownership interest at the start of the period plus Capital contributed/withdrawn in the period plus Income of the period minus Expenses of the period |
| at the end of the period | | | | |

- As with any equation, it is possible to make this version more complex by adding further details. That is not necessary for the purpose of explaining the basic processes, but the equation will be revisited later in the book when some of the problems of accounting are opened up. The helpful aspect of the accounting equation is that it can always be used as a basis for arguing a feasible answer. The limitation is that it cannot give an opinion on the most appropriate answer when more than one option is feasible.

In Chapter 3 there is an explanation of how the information represented by the accounting equation is displayed in a form which is useful to the user groups identified in Chapter 1.

Further reading

IASB (2018), *Conceptual Framework for Financial Reporting*, Chapter 4, 'The Elements of Financial Statements' and Chapter 5, 'Recognition and derecognition', International Accounting Standards Board.

Questions

Each chapter has three types of question. The ‘A’ series of ‘Self-test’ questions are placed at the end of each section to help you test your understanding and review your reading. You will find the answers to these questions by re-reading and thinking about the section. ‘Application’ questions to test your ability to apply technical skills are in the ‘B’ series of questions. Questions requiring you to show skills in problem solving and evaluation are in the ‘C’ series of questions.

B Application

B2.1 [S]

Classify each of the items in the following list as: asset; liability; neither an asset nor a liability.

- (a) cash at bank
- (b) loan from the bank
- (c) letter from the bank promising an overdraft facility at any time in the next three months
- (d) trade receivable (an amount due from a customer who has promised to pay later)
- (e) trade receivable (an amount due from a customer who has promised to pay later but has apparently disappeared without leaving a forwarding address)
- (f) trade payable (an amount due to a supplier of goods who has not yet received payment from the business)
- (g) inventory of finished goods (fashion clothing stored ahead of the spring sales)
- (h) inventory of finished goods (fashion clothing left over after the spring sales)
- (i) investment in shares of another company where the share price is rising
- (j) investment in shares of another company where the share price is falling
- (k) lender of five-year loan to the business
- (l) customer to whom the business has offered a 12-month warranty to repair goods free of charge
- (m) a motor vehicle owned by the business
- (n) a motor vehicle rented by the business for one year
- (o) an office building owned by the business
- (p) an office building rented by the business on a 99-year lease, with 60 years’ lease period remaining.

B2.2 [S]

Explain whether each of the items from question B2.1 above which you have identified as assets and liabilities would also meet the criteria for recognition of the item in the statement of financial position (balance sheet).

B2.3 [S]

Explain why each of the following items would not meet either the definition or the recognition criteria of an asset of the business:

- (a) a letter from the owner of the business, addressed to the bank manager, promising to guarantee the bank overdraft of the business
- (b) a list of the customers of the business
- (c) an order received from a customer
- (d) the benefit of employing a development engineer with a high level of ‘know-how’ specifically relevant to the business
- (e) money spent on an advertising campaign to boost sales
- (f) structural repairs to a building.

C Problem solving and evaluation

C2.1

The following information has been gathered from the accounting records of Pets Parlour:

Assets and liabilities at 31 December Year 4

| | £ |
|-------------------------------|--------|
| Cash at bank | 500 |
| Borrowings | 6,000 |
| Trade receivables (debtors) | 5,000 |
| Property, plant and equipment | 29,000 |

Revenue and expenses for the year ended 31 December Year 4

| | £ |
|-------------------------------|--------|
| Fees charged for work done | 20,000 |
| Interest paid on borrowings | 1,000 |
| Administration costs incurred | 1,500 |
| Salaries paid to employees | 14,000 |

Required

Using the accounting equation, calculate:

- (a) The amount of ownership interest at 31 December Year 4.
- (b) The amount of net profit for the year.
- (c) The amount of the ownership interest at 1 January Year 4.

Activities for study groups

Obtain the annual report of a listed company. From the statement of financial position (balance sheet) list the items shown as assets and liabilities. (This will require you to look in detail at the notes to the accounts using the references on the face of the statement of financial position (balance sheet). Share out the list of assets and liabilities so that each person has four or five assets and four or five liability items.

- 1 Separately, using the definitions and recognition criteria, prepare a short statement explaining why each item on your list passes the tests of definition and recognition. State the evidence you would expect to see, as auditor, to confirm the expected future inflow of economic benefit from any asset and the expected future outflow of benefit from any liability.
- 2 Present your explanations to the group and together prepare a list of assets and a separate list of liabilities in order of the uncertainty which attaches to the expected future benefit.
- 3 Read the 'contingent liability' note, if there is one, to find examples of liabilities which have not been recognised but have been disclosed. Why will you not find a 'contingent asset' note?

Notes and references

1. IASB (2018), *Conceptual Framework*, paras 4.3 and 11.4.
2. *Ibid.*
3. IAS 1 (2018), para. 66.
4. *Ibid.*
5. IAS 1 para. 67 permits the use of alternative descriptions for non-current assets provided the meaning is clear.
6. IASB (2018), *Conceptual Framework*, extracted from paras 5.6, 5.7 and 5.8.
7. IASB (2018), *Conceptual Framework*, para. 4.26.
8. IASB (2018), *Conceptual Framework*, para. 4.29.
9. IASB (2018), *Conceptual Framework*, para. 4.26.
10. IAS 1 (2018), para. 69.
11. *Ibid.*
12. IASB (2018), *Conceptual Framework*, extracted from paras 5.6, 5.7 and 5.8.
13. IASB (2018), *Conceptual Framework*, para. 4.63.
14. IASB (2018), *Conceptual Framework*, para. 4.68.
15. IASB (2018), *Conceptual Framework*, para. 4.69.
16. IASB (2018), IFRS 15, Revenue from contracts with customers, Appendix A.

SUPPLEMENT TO CHAPTER 2

Debit and credit bookkeeping

You do not have to read this supplement to be able to progress through the rest of the textbook. In the main body of each chapter the explanations are all given in terms of changes in elements of the accounting equation. However, for those who would like to know how debits and credits work, each chapter will have a supplement putting into debit and credit form the material contained in the chapter.

Recording in ledger accounts

The double-entry system of bookkeeping records business transactions in ledger accounts. It makes use of the fact that there are two aspects to every transaction when analysed in terms of the accounting equation.

A ledger account accumulates the increases and reductions either in a category of business activities such as sales or in dealings with individual customers and suppliers.

Ledger accounts may be subdivided. Sales could be subdivided into home sales and export sales. Separate ledger accounts might be kept for each type of non-current asset, e.g. buildings and machinery. The ledger account for machinery might be subdivided as office machinery and production machinery.

Ledger accounts for rent, business rates and property insurance might be kept separately or the business might instead choose to keep one ledger account to record transactions in all of these items, giving them the collective name administrative expenses. The decision would depend on the number of transactions in an accounting period and on whether it was useful to have separate records.

The managers of the business have discretion to combine or subdivide ledger accounts to suit the information requirements of the business concerned.

Using the accounting equation

Before entries are made in ledger accounts, the double entry system of bookkeeping assigns to each aspect of a business transaction a debit or a **credit** notation, based on the analysis of the transaction using the accounting equation.

In its simplest form the accounting equation is stated as:

| | | | | |
|--------|-------|-------------|--------|--------------------|
| Assets | minus | Liabilities | equals | Ownership interest |
|--------|-------|-------------|--------|--------------------|

To derive the debit and credit rules it is preferable to rearrange the equation so that there is no minus sign.

| | | | | |
|--------|--------|-------------|------|--------------------|
| Assets | equals | Liabilities | plus | Ownership interest |
|--------|--------|-------------|------|--------------------|

There are three elements to the equation and each one of these elements may either *increase* or *decrease* as a result of a transaction or event. The six possibilities are set out in Table 2.4.

Table 2.4 Combinations of increases and decreases of the main elements of transactions

Left-hand side of the equation

| | | |
|--------|----------|----------|
| Assets | Increase | Decrease |
|--------|----------|----------|

Right-hand side of the equation

| | | |
|--------------------|----------|----------|
| Liabilities | Decrease | Increase |
| Ownership interest | Decrease | Increase |

The double-entry bookkeeping system uses this classification (which preserves the symmetry of the equation) to distinguish debit and credit entries as shown in Table 2.5.

Table 2.5 Rules of debit and credit for ledger entries, basic accounting equation

| | <i>Debit entries in a ledger account</i> | <i>Credit entries in a ledger account</i> |
|--|--|---|
| <i>Left-hand side of the equation</i> | | |
| Asset | Increase | Decrease |
| <i>Right-hand side of the equation</i> | | |
| Liability | Decrease | Increase |
| Ownership interest | Decrease | Increase |

It was shown in the main body of the chapter that the ownership interest may be increased by:

- earning revenue; and
- new capital contributed by the owner;

and that the ownership interest may be decreased by:

- incurring expenses; and
- capital withdrawn by the owner.

So the ‘ownership interest’ section of Table 2.5 may be expanded as shown in Table 2.6.

That is all you ever have to know about the rules of bookkeeping. All the rest can be reasoned from this table. For any transaction there will be two aspects. (If you find there are more than two, the transaction needs breaking down into simpler steps.) For each aspect there will be a ledger account. Taking each aspect in turn you ask yourself: *Is this an asset, a liability, or an aspect of the ownership interest?* Then you ask yourself: *Is it an increase or a decrease?* From Table 2.6 you then know immediately whether to make a debit or a credit entry.

Examples of the application of the rules of debit and credit recording are given in the supplement to Chapter 5 for a service business and in the supplement to Chapter 6 for a manufacturing business. They will also be used in later chapters to explain how particular transactions are reported.

Table 2.6 Rules of debit and credit for ledger entries, distinguishing different aspects of ownership interest

| | <i>Debit entries in a ledger account</i> | <i>Credit entries in a ledger account</i> |
|--|--|---|
| <i>Left-hand side of the equation</i> | | |
| Asset | Increase | Decrease |
| <i>Right-hand side of the equation</i> | | |
| Liability | Decrease | Increase |
| Ownership interest | Expense | Revenue |
| | Capital withdrawn | Capital contributed |

S Test your understanding

(The answer to each of the following questions is either **debit** or **credit**)

- S2.1 What is the bookkeeping entry for an increase in an asset?
- S2.2 What is the bookkeeping entry for a decrease in a liability?
- S2.3 What is the bookkeeping entry for an increase in an expense?
- S2.4 What is the bookkeeping entry for a withdrawal of owner's capital?
- S2.5 What is the bookkeeping entry for an increase in revenue?

CHAPTER 3

Financial statements from the accounting equation

Real World Case

Whitbread plc: main points from financial statements

Extracts from the Annual Report

Whitbread is the UK's leading hospitality company

We have built two of the UK's most successful hospitality brands, Premier Inn and Costa, through consistent operational excellence and providing a great customer experience.

Good financial performance in line with expectations

Profit growth | Good sales growth and disciplined cost control underpins profit growth



Sorbis/Shutterstock

| | 2017/18 | 2016/17 | Change |
|-------------------------------------|--------------|--------------|-------------|
| Revenue | £3,295m | £3,106m | 6.1% |
| Profit from operations | £657m | £626m | 5.0% |
| Central costs | £(35)m | £(34)m | 4.5% |
| Underlying operating profit | £622m | £592m | 5.0% |
| Underlying net finance costs | £(31)m | £(27)m | (15.4)% |
| Underlying profit before tax | £591m | £565m | 4.5% |
| Non-underlying items | £(43)m | £(50)m | 15.1% |
| Profit before tax | £548m | £515m | 6.4% |
| Tax | £(112)m | £(99)m | (12.6)% |
| Net profit | £436m | £416m | 4.9% |

- Strong revenue growth of 6.1% and market share gains in both Premier Inn and Costa.
- Disciplined cost management enabling underlying profit growth of 4.5% to £591 million, and statutory profit before tax growth of 6.4% to £548 million.
- Premier Inn underlying operating profit grew to £498 million, Costa increased to £159 million.
- Good discretionary free cash flow conversion of 94%, delivering £585 million to reinvest.
- Strong balance sheet with net debt reduced to £833 million.
- Return on capital increased 20bps to 15.4%, despite scale of recent investment.

Source: Whitbread plc Annual Report and Accounts 2018 (p. 2); and Group Finance Director's Review, (p. 44). https://www.whitbread.co.uk/~/_media/Files/W/Whitbread/report-and%20presentations/2018/Whitbread%20Interactive%202018.pdf

Discussion points

- 1 How do the words of explanation add further information to the financial information provided in the table?
- 2 The information in the table is extracted from the income statement. How does the finance director provide information about the statement of financial position and the statement of cash flow?

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Learning outcomes

After studying this chapter you should be able to:

- Explain the benefits and problems of producing annual financial statements.
- Explain the purpose and structure of the statement of financial position (balance sheet).
- Explain the purpose and structure of the income statement (profit and loss account).
- Explain the purpose and structure of the statement of cash flows.
- Comment on the usefulness to users of the financial statements prepared.

Additionally for those who choose to study the supplement:

- Apply the debit and credit form of analysis to the transactions of a short period of time, summarising them in a list which may be used for preparation of simple financial statements.

3.1 Introduction

In the previous chapter the accounting equation was developed as a representation of the relationships among key items of accounting information: assets, liabilities and the ownership interest. An understanding of the accounting equation and the various elements of the equation provides a systematic approach to analysing transactions and events, but it gives no guidance as to how the results should be communicated in a manner which will be helpful and meaningful to users. The accounting equation is used in this chapter as a basis for explaining the structure of financial statements. Ideas beyond the accounting equation are required as to what qualities are expected of financial statements.

The various financial statements produced by enterprises for the owners and other external users are derived from the accounting equation. The *Conceptual Framework* identifies the purposes of financial reporting as producing information about the financial position, performance and financial adaptability of the enterprise. The three most familiar **primary financial statements**, and their respective purposes, are:

| | |
|---|-----------------------------|
| <i>Primary financial statement</i> | <i>Purpose is to report</i> |
| Statement of financial position (balance sheet) | Financial position |
| Income statement (profit and loss account) | Financial performance |
| Statement of cash flows | Financial adaptability |

This chapter explains the general shape and content of each of these financial statements.

Activity 3.1

Look back to Chapter 2 to check your understanding of the accounting equation as a statement of financial position.

3.2 Who is in charge of the accounting system?

Since 2005 two different accounting systems have existed for companies in the UK, depending on the type of company. When you look at the name of a company listed on the Stock Exchange, such as Vodafone, BskyB, Burberry and Marks and Spencer, you are really looking at a family group of companies all owned by one parent company.

One set of financial statements represents all the companies in the group. Under the law of the European Union (EU) and the law of the UK, these group financial statements for listed companies must apply the International Financial Reporting Standards (IFRS) accounting system set out by the International Accounting Standards Board (**IASB system**). Other companies in the UK may choose to follow the IASB system of standards but there is no requirement to do so. All companies in the UK that do not apply the IASB system must apply the accounting system set out by the UK Financial Reporting Council (FRC). Many public bodies in the UK, including central government and local authorities, now use the IASB system of IFRS.

Fortunately for those studying the subject, the FRC and the IASB have been working closely together for many years and there are relatively few differences between the two systems. However, there is a potential difference in the appearance and the wording of financial statements. Companies applying the UK FRC's accounting system must use specifications of the sequence and content of items (called **formats** of financial statements) set out in UK company law which is based on EU directives. Companies applying the IASB's system to their listed group reporting have a choice in how they present their financial statements. As a consequence we are now seeing variety in the content and sequence of financial statements published in the annual reports of groups listed on the Stock Exchange. This chapter gives you a flavour of the formats that you might see in financial statements. Where there are differences in words used, this chapter gives the wording of the IASB system first, followed by the wording of UK company law in brackets. As an example, the description:

income statement (profit and loss account)

means that the IASB system uses **income statement** in its illustrations of a profit statement, while UK company law uses **profit and loss account** in its specification of a profit statement.

Activity 3.2

Find the websites of the Financial Reporting Council, www.frc.org.uk, and the International Accounting Standards Board, www.ifrs.org. How does each of these bodies explain its overall responsibility in the accounting system?

3.3 The accounting period

In the far-away days of traders sailing out of Italian ports on three-year voyages, the **accounting period** was determined by the date of return of the ship, when the accounts could be prepared for the whole voyage. That rather leisurely view of the scale of time would not be tolerated in an industrial and commercial society where there is always someone demanding information. The convention is that businesses should prepare financial statements at least once in every calendar year. That convention is a requirement of law expressed in the Companies Act 2006 in the case of limited liability companies. Where companies have a Stock Exchange listing they are required to produce an interim report six months into the accounting year. Some companies voluntarily produce quarterly reports to shareholders, reflecting the practice of listed companies in the USA. For internal management accounting purposes, a business may produce reports more frequently (e.g. on a monthly or a weekly basis).

Businesses may choose their accounting date as a time convenient to their activities. Many companies choose 31 December for the year-end, but others (including many of

the utility companies which were formerly owned by the government) use 31 March. Some prefer a September or October date after the peak of the summer sales has passed. Whatever the choice, companies are expected to keep the same date from one year to the next unless there is a strong reason for changing.

The use of a 12-month accounting period should not be too much of a problem where the trading cycle fits neatly into a year. If the business is seasonal, there will be a peak of production to match the seasonal peak of sales and the pattern will be repeated every year. There could be a few technical problems of deciding exactly how to close the door on 31 December and whether transactions towards the end of the year are to be included in that year or carried to the next period. These problems can be dealt with by having systematic ‘cut-off’ rules. There is a bigger problem for those companies whose trading cycle is much longer. It could take two years to build a section of a motorway or three years to build a bridge over a wide river estuary. Such a company will have to subdivide the work on the main contract so that some can be reported each year.

The use of the 12-month accounting period also causes problems for recognition of assets and liabilities. Waiting for the ship to arrive was much safer evidence for the Venetian traders than hoping it was still afloat or relying on reported sightings. For today’s business the equivalent situation would be waiting for a property to be sold or for a large customer to pay the amount due as a debt. However, in practice the statement of financial position (balance sheet) cannot wait. Notes to the accounts give additional explanations to help users of financial statements evaluate the risk, but it is all quite tentative. Narrative descriptions of risk are explained further in Chapter 14, section 14.10.

Activity 3.3

Suggest an argument to support having businesses report quarterly (every three months) rather than once in each year.

Self-test

A3.1 Explain why an accounting period of 12 months is used as the basis for reporting to external users of financial statements.

3.4 The statement of financial position (balance sheet)

The **statement of financial position (balance sheet)** reflects the accounting equation. Both descriptions are used in this textbook because you will find both in use. The International Accounting Standards Board prefers the term ‘statement of financial position’ while company law in the UK uses the term ‘balance sheet’. You saw in Chapter 2 that there is more than one way to write the accounting equation. That means there is more than one way to present a statement of financial position (balance sheet). You will find throughout your study of accounting that there is often more than one approach to dealing with an activity or solving a problem. This is the first time but there will be more. It means that you need to be flexible in your approach to reading and using financial statements.

3.4.1 Focus on the ownership interest

One form of the accounting equation focuses on the ownership interest as the result of subtracting liabilities from assets. The equation is as follows:

| | | | | |
|--------|-------|-------------|--------|--------------------|
| Assets | minus | Liabilities | equals | Ownership interest |
|--------|-------|-------------|--------|--------------------|

UK companies who apply this form of the equation will present the statement of financial position (balance sheet) in a narrative form, reading down the page, as follows:

| |
|---------------------------|
| Assets |
| minus |
| Liabilities |
| equals |
| Ownership interest |

The assets are subdivided into current assets and non-current assets (defined in Chapter 2), while the liabilities are subdivided into current liabilities and non-current liabilities (also defined in Chapter 2). The ownership interest may also be subdivided to show separately the capital contributed or withdrawn and the profit of the period. Because current assets and current liabilities are closely intertwined in the day-to-day operations of the business, they are often grouped close to each other in the statement of financial position (balance sheet) (Table 3.1).

Table 3.1 represents a typical sequence used by UK public companies. Most companies will try to confine the statement of financial position (balance sheet) to a single side of

Table 3.1 Structure of a statement of financial position (balance sheet)

| |
|---|
| Non-current assets |
| plus |
| Current assets |
| minus |
| Current liabilities |
| minus |
| Non-current liabilities |
| equals |
| Capital at start of year |
| plus/minus |
| Capital contributed or withdrawn |
| plus |
| Profit of the period |

A4 paper but there is not much space on one sheet of A4 paper to fit in all the assets and liabilities of a company. Consequently a great deal of use is made of notes to the accounts which explain the detail. The statement of financial position (balance sheet) shows only the main categories of assets and liabilities.

3.4.2 Balancing assets and claims on assets

Another form of the accounting equation focuses on balancing the assets against the claims on assets. The claims on assets come from the ownership interest and from liabilities of all types. The equation is:

| | | | | |
|--------|--------|-------------|------|--------------------|
| Assets | equals | Liabilities | plus | Ownership interest |
|--------|--------|-------------|------|--------------------|

UK companies who apply this form of the equation will present the statement of financial position (balance sheet) vertically on one sheet of paper but the sequence will be different:

| |
|--------------------|
| Assets |
| equals |
| Liabilities |
| plus |
| Ownership interest |

In some countries there is a preference for lining up the statement of financial position (balance sheet) horizontally to match the accounting equation even more closely.

| | |
|--------|--------------------|
| Assets | Liabilities |
| | plus |
| | Ownership interest |

3.4.3 Example of presentation

The following list of assets and liabilities of P. Mason's legal practice was prepared from the accounting records of transactions summarised at 30 September Year 5:

| | £ |
|-----------------------------------|----------------|
| Land and buildings | 250,000 |
| Office furniture | 30,000 |
| Receivables (debtors) for fees | 1,200 |
| Prepayment of insurance premium | 540 |
| Cash at bank | 15,280 |
| Total assets (A) | 297,020 |
| Trade payables (creditors) | 2,800 |
| Long-term loan | 150,000 |
| Total liabilities (L) | 152,800 |
| Ownership interest (A - L) | 144,220 |

Table 3.2 shows how this would appear in a statement of financial position (balance sheet) based on the 'ownership interest' form of the equation. Table 3.3 shows how the same information would appear in a statement of financial position (balance sheet) based on the 'claims on assets' form of the equation.

The statement of financial position (balance sheet) in Table 3.2 is more informative than the list of assets and liabilities from which it was prepared because it has been arranged in a helpful format. The first helpful feature is the use of headings (shown in Table 3.2 in bold) for similar items grouped together, such as non-current assets, current assets, current liabilities and non-current liabilities. The second helpful feature is the use of **subtotals** (identified in Table 3.2 by descriptions in italics and shaded) for similar items grouped together. The subtotals used in this example are those for: total non-current assets; total current assets; total assets; and total liabilities. There are no standard rules on use of subtotals. They should be chosen in a manner most appropriate to the situation. Brackets round figures show the ‘minus’ in the accounting equation.

A person using this statement of financial position (balance sheet) can see at a glance that there is no problem for the business in meeting its current liabilities from its resources of current assets. The financing of the business is split almost equally between the non-current liabilities and the ownership interest, a split which would not be regarded as excessively risky by those who lend to businesses. The non-current assets used as a basis for generating profits from one year to the next are collected together as a group, although the statement of financial position (balance sheet) alone cannot show how effectively those assets are being used. For that, an income statement (profit and loss account) is needed.

Table 3.2 Statement of financial position (balance sheet): Assets minus liabilities equals ownership interest

| P. Mason's legal practice | |
|---|------------------|
| Statement of financial position (balance sheet) at 30 September Year 5 | |
| | £ |
| Non-current assets | |
| Land and buildings | 250,000 |
| Office furniture | <u>30,000</u> |
| <i>Total non-current assets</i> | <u>280,000</u> |
| Current assets | |
| Receivables (debtors) for fees | 1,200 |
| Prepayment of insurance premium | 540 |
| Cash at bank | <u>15,280</u> |
| <i>Total current assets</i> | <u>17,020</u> |
| Total assets | 297,020 |
| Current liabilities | |
| Trade payables (creditors) | (2,800) |
| Non-current liabilities | |
| Long-term loan | <u>(150,000)</u> |
| Total liabilities | (152,800) |
| Net assets | <u>144,220</u> |
| Ownership interest | <u>144,220</u> |

The statement of financial position (balance sheet) in Table 3.3 is again more informative than the list of assets and liabilities from which it was prepared because it has been arranged in a helpful format. It offers a helpful feature in the use of headings (in bold) for similar items grouped together. It is also helpful in providing subtotals (identified by descriptions in italics and shaded) for similar items grouped together. The subtotals used in this example are those for: total non-current assets and total current

Table 3.3 Statement of financial position (balance sheet): Assets equal liabilities plus ownership interest

| P. Mason's legal practice | |
|---|----------------|
| Statement of financial position (balance sheet) at 30 September Year 5 | |
| | £ |
| Non-current assets | |
| Land and buildings | 250,000 |
| Office furniture | <u>30,000</u> |
| <i>Total non-current assets</i> | <u>280,000</u> |
| Current assets | |
| Receivables for fees | 1,200 |
| Prepayment of insurance premium | 540 |
| Cash at bank | <u>15,280</u> |
| <i>Total current assets</i> | <u>17,020</u> |
| Total assets | <u>297,020</u> |
| Current liabilities | |
| Trade payables | 2,800 |
| Non-current liabilities | |
| Long-term loan | <u>150,000</u> |
| Total liabilities | <u>152,800</u> |
| Ownership interest | <u>144,220</u> |
| Total liabilities plus ownership interest | <u>297,020</u> |

assets. Some financial statements include a subtotal for the current assets less current liabilities (not current assets). There are no standard rules on use of subtotals. They should be chosen in a manner most appropriate to the situation.

A person using this statement of financial position (balance sheet) can again see at a glance that there is no problem for the business in meeting its current liabilities from its resources of current assets.

Activity 3.4

Before reading further, make sure that you can explain why each item in the accounting records is an asset or a liability, as shown in the foregoing list. If you have any doubts, read Chapter 2 again before proceeding with this chapter.

Self-test

A3.2 Explain how the structure of the statement of financial position (balance sheet) corresponds to the accounting equation.

A3.3 List three features of a statement of financial position (balance sheet) that are particularly useful in making the format helpful to readers.

3.5 The income statement (profit and loss account)

For many years in the UK, **profit and loss account** was the only title used for the financial statement reporting profit of the period. From 2005 many of those listed groups following the IASB's system have chosen to follow an example given by the IASB which uses the heading **income statement**, found more commonly in US company reports. It is not compulsory for listed group companies to use 'income statement' and some retain