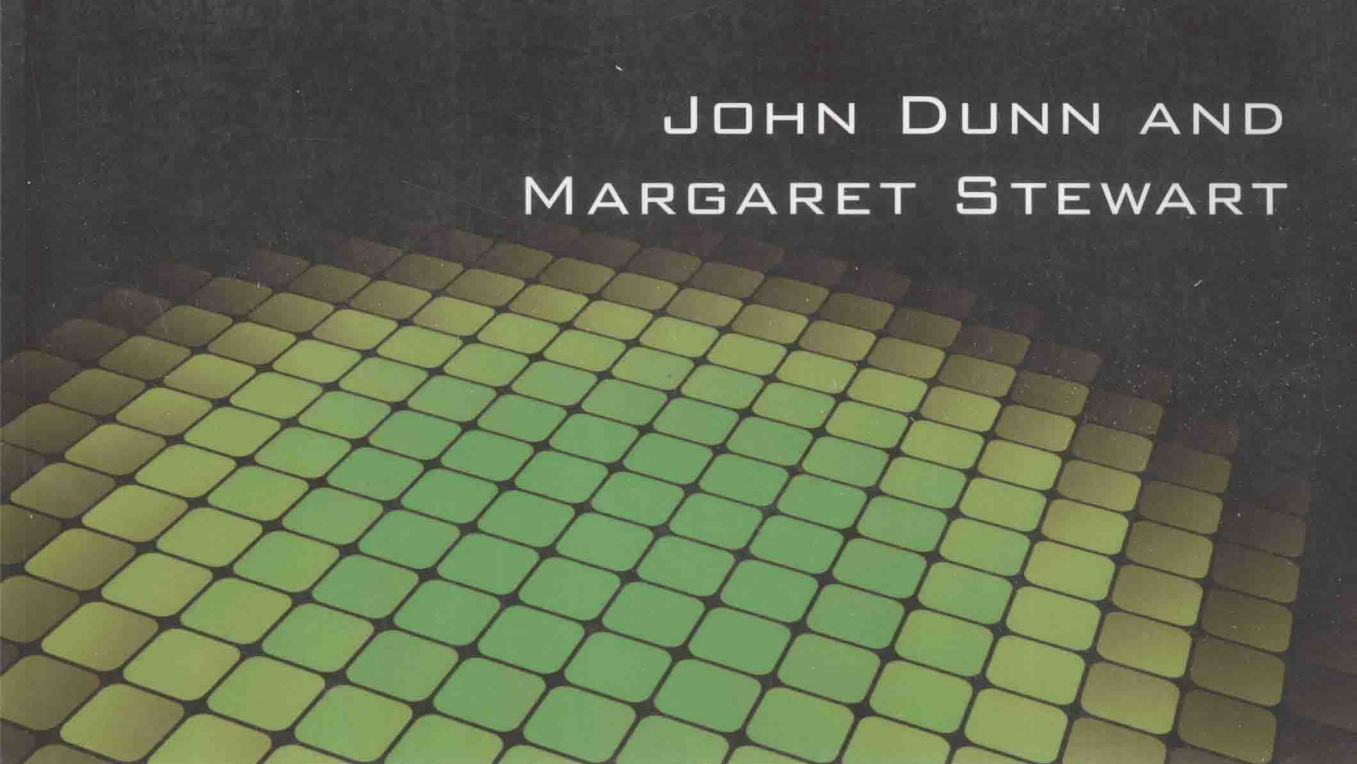
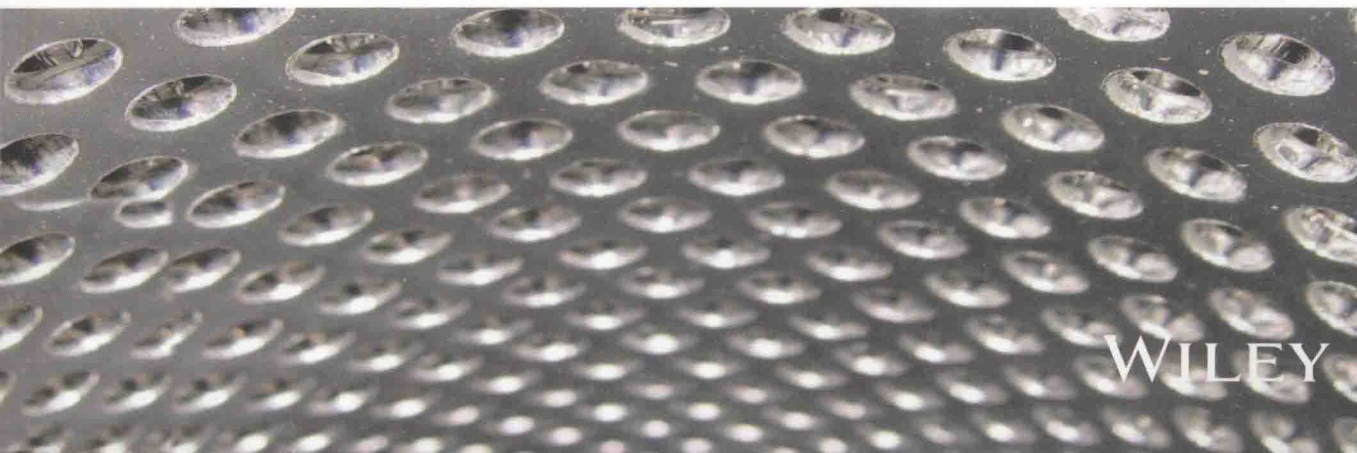




JOHN DUNN AND
MARGARET STEWART

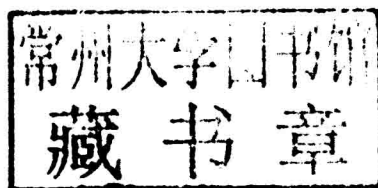
ADVANCED
FINANCIAL
REPORTING AND
ANALYSIS



WILEY

Advanced Financial Reporting and Analysis

John Dunn
Margaret Stewart



WILEY

Copyright © 2014 John Wiley & Sons Ltd

All effort has been made to trace and acknowledge ownership of copyright. The publisher would be glad to hear from any copyright holders whom it has not been possible to contact.

Registered office

John Wiley & Sons Ltd, The Atrium, Southern Gate, Chichester, West Sussex, PO19 8SQ, United Kingdom

For details of our global editorial offices, for customer services and for information about how to apply for permission to reuse the copyright material in this book please see our website at www.wiley.com.

The rights of John Dunn and Margaret Stewart to be identified as the authors of this work have been asserted in accordance with the UK Copyright, Designs and Patents Act 1988.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, except as permitted by the UK Copyright, Designs and Patents Act 1988, without the prior permission of the publisher.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at <http://booksupport.wiley.com>. For more information about Wiley products, visit www.wiley.com.

Designations used by companies to distinguish their products are often claimed as trademarks. All brand names and product names used in this book are trade names, service marks, trademarks or registered trademarks of their respective owners. The publisher is not associated with any product or vendor mentioned in this book. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold on the understanding that the publisher is not engaged in rendering professional services. If professional advice or other expert assistance is required, the services of a competent professional should be sought.

Library of Congress Cataloging-in-Publication Data

Dunn, John, 1959-

Advanced financial reporting and analysis / John Dunn, Margaret Stewart.

pages cm

Includes bibliographical references and index.

ISBN 978-0-470-97360-8 (pbk.) – ISBN 978-1-118-82404-7 (ebk) – ISBN 978-1-118-82394-1 (ebk)

1. Financial statements. 2. Accounting. I. Stewart, Margaret, 1956- II. Title.

HF5681.B2D7796 2014

657.3–dc23

2013042819

ISBN 978-0-470-97360-8 (pbk)

ISBN 978-1-118-82404-7 (ebk)

ISBN 978-1-118-82394-1 (ebk)

A catalogue record for this book is available from the British Library

Set in 11/13pt GoudyStd by Thomson Digital, India

Printed in Great Britain by Bell & Bain Ltd, Glasgow

Contents

Chapter 1	A Brief Introduction to the Text	1
Chapter 2	Professions and Professionalism	7
Chapter 3	Ethics	21
Chapter 4	An Overview of Accounting Problems	43
Chapter 5	Accounting and Corporate Governance	61
Chapter 6	Accounting for Post-Retirement Benefits	83
Chapter 7	Income, Value and Financial Reporting	103
Chapter 8	Financial Instruments	141
Chapter 9	Group Accounts	173
Chapter 10	The Mechanics of Consolidation	187
Chapter 11	More Complicated Group Structures	223
Chapter 12	Changes in Groups	253
Chapter 13	Foreign Currencies	275
Chapter 14	International Accounting	307
Chapter 15	Accounting for the Environment	327

Chapter 16	Writing a Dissertation	345
Appendix:	Answers to End-of-Chapter Questions	357
Index		391

A BRIEF INTRODUCTION TO THE TEXT

Contents

Introduction	1
The Basic Structure of This Text	2
A Concluding Thought	5

Introduction

This chapter provides a brief overview of the text and will, hopefully, provide an idea of the best approach to the study of financial reporting at the advanced level.

It is always dangerous to generalise, but our experience of teaching financial accounting suggests that there is a natural progression:

- First year classes focus on the mechanics of bookkeeping and the basics of preparing financial statements. That is a difficult set of skills to master, and the secret is to practise on as many questions as possible to develop the necessary number-crunching skills.
- Second year classes start to relate the material from first year to the preparation of financial statements in the real world. Accounting standards appear for the first time. The jump from first year to second is very pronounced and can often appear more daunting than the initial learning curve of dealing with first year material. Again, it is necessary to practise constantly in order to develop the mechanical skills that are required in order to prepare a set of financial statements.
- Third year classes mark a turning point. Firstly, the jump in complexity from second year to third is rarely as daunting as the jump from first year to second. Secondly, a typical third year class will focus on topics in financial reporting and

so it is unlikely that you will have to prepare a full set of financial statements in its entirety. A typical third year class will cover a range of specific topics, some related to practice and others related to obtaining a deeper understanding of the role of accounting in society. There is still scope to practise on numerical questions, but the secret to succeeding in a third year class is generally about being open to ideas and being ready and willing to develop and express opinions.

It is envisaged that most readers of this text will be in their third year of study, although that will vary from course to course.

The Basic Structure of This Text

The next two chapters deal with important matters to the members of the accountancy profession, although it is debatable whether they are directly related to accountancy.

Chapter 2 deals with the question of professional status, the manner in which accountants have worked to obtain recognition as professionals and the manner in which the accountant is portrayed in popular culture. Typically, students are attracted to a career in accountancy because of the opportunity to be respected as 'professionals', but the question of why some groups are regarded as professionals and others are not is often overlooked. It is no accident that accountants are regarded as professional people.

Chapter 3 deals with the question of ethics. We all have to make decisions and those decisions can have consequences for many different people. Accountants frequently have to offer advice or prepare reports that can require some consideration of different parties' interests. For example, the treatment of a particular transaction could affect reported earnings and so affect an entity's ability to raise finance. Accounting choices could threaten jobs if a pessimistic view is taken or lead to lenders accepting unacceptable and unreported risks in the event of optimism. Chapter 3 explores the ethical dimensions of accounting and discusses some of the findings of studies into the manner in which accountants address ethical dilemmas.

Chapters 4 to 8 deal with a range of technical matters that affect the preparation of financial statements. Each of these chapters deals with a particular area that will affect the reported profit and/or reported financial position.

Chapter 4 addresses some of the 'problem areas' in financial reporting. The chapter argues that many of these issues arise because of difficulties in defining the boundaries of the reporting entity and also in setting realistic figures for the 'fair value' that is frequently the basis for reported asset and liability figures. The role of

accounting is open to a degree of debate and the fact that certain hard decisions have not been taken has led to a lack of clarity in other areas.

Chapter 5 addresses governance issues and the manner in which they interact with accounting. The chapter commences by highlighting the economic causes for the conflict between the interests of shareholders and those of company directors. The role of accounting in resolving those conflicts is discussed. It is clear that accounting is only part of the solution, but it is nevertheless an important part. The chapter moves on to the accounting treatment of executive share options, which has been one of the more contentious areas in which accounting has been implicated in the problems associated with governance. The accounting treatment of options also raises questions about the need for consistency and the application of the principles underlying the International Accounting Standards Board's (IASB) *Conceptual Framework for Financial Reporting*.

Chapter 6 deals with accounting for post-retirement benefits, mainly pensions. This has been a contested area for accounting for many years. Very large amounts are involved, many of which are difficult to determine with any certainty. The accounting treatment of certain types of pension scheme is very complicated and standard setters have had to make some very difficult decisions. Furthermore, changes in the accounting rules have been blamed for the withdrawal of a type of pension arrangement that has been very popular with employees. Employers have used the changes to the accounting rules as a justification for doing so, even though the arguments that have been offered make no real economic sense.

Chapter 7 offers a diversion into the more esoteric question of the choice of a measurement basis for the preparation for financial statements. This is an important area because the choice of methods has implications for the usefulness of financial statements to different user groups. It has also been an interesting area in terms of the politics of setting and enforcing accounting standards. Different models for financial reporting have the capacity to increase or decrease reported profit figures when prices are rising (and it is a historical fact that prices do generally rise).

Chapter 8 concludes by addressing the question of accounting for financial instruments. Financial instruments that are issued in order to raise finance have been a controversial area in accounting for many years. There is a massive industry in 'financial engineering', with practitioners attempting to create instruments that make liabilities look like equity for reporting purposes. If successful, the overall effect is to reduce gearing ratios, thereby making the companies look less risky than they are. If anything, the accounting treatment of financial instruments held as assets has been even more controversial. There has been a boom in the creation of complex derivative instruments, many of which are sold in order to manage risk in a responsible manner. These instruments have also been purchased in order to create exposures to risks in order to speculate on market movements. The accounting

treatment of financial instruments has been blamed, at least in part, for the 2007 Credit Crunch.

Chapters 9 to 13 deal with aspects of the preparation of group accounts. Readers may or may not have studied this topic before and so chapters 9 and 10 offer an overview that assumes no prior knowledge. It is a good idea to read these chapters even if the material is familiar because the process of preparing consolidated financial statements is still worth practising.

Chapter 11 deals with some of the more complicated ways in which control can be obtained. For example, a parent company can control a subsidiary through indirect shareholdings, with different group members owning shares in the subsidiary. There are also other forms of relationship that are worth considering, including the associates and joint arrangements. These relationships create their own problems and have to be included in the group accounts in different ways.

Chapter 12 deals with the question of changes in the group, with additional investments in group members and disposals of investments requiring some further thought about the mechanics of preparing consolidated financial statements.

Chapter 13 deals with the problems associated with accounting for items that are expressed in foreign currencies. This is essentially a continuation of the discussion of consolidations because the primary issue is translating the financial statements of foreign subsidiaries whose figures are expressed in a different currency. Those figures have to be restated to make them compatible with the parent company's financial statements. The problem is that there are different approaches to the translation process and each provides different figures for profit and financial position. This has been a highly controversial area.

Chapter 14 provides an overview of the issues associated with comparative financial reporting. It might be assumed that the acceptance of International Financial Reporting Standards (IFRS) as the basis for financial reporting, at least for quoted companies, in many countries would mean that there is no need to consider international differences. That is not, however, the case. There are cultural differences between countries and those differences affect the attitudes and behaviour of accountants.

Chapter 15 provides an overview of the implications of sustainability for financial reporting. Attitudes have hardened towards irresponsible behaviour by businesses who overlook their impact on the environment or who abuse the interests of employees or other stakeholders. Accountants have claimed a role in the process of reporting on these matters. Whether by accident or design, this topic has been adopted as an accounting matter.

Chapter 16 brings the text to a conclusion by offering some thoughts on planning and conducting a student dissertation. Many readers will be involved in

dissertations at this stage in their studies. It is hoped that this final chapter will encourage some to write their dissertation on a topic that is related to financial reporting.

A Concluding Thought

The preceding overview has made repeated mention of problems and controversies. Accounting is not a straightforward mechanical process. Choices have to be made and those responsible for making the choices will be accountable to groups of stakeholders with different priorities. That can be frustrating to those students who would prefer to be told what the correct answer is, but it is hoped that this will be an encouragement to readers to explore the background to financial reporting. Accounting is interesting because it affects behaviour and relationships, both of which are endlessly fascinating subjects for study.

We hope that you enjoy working through this text.

Margaret and John

PROFESSIONS AND PROFESSIONALISM

Contents

Introduction	7
Why Do You Want to Be an Accountant?	8
The Professionalisation Project	11
Studies of Professionalisation	14
Educating Professional Accountants	15
Public Perceptions – Accountants at the Movies	17
Summary	18
Tutorial Questions	19
References	20

Learning Objectives

After studying this chapter, you should be able to:

- explain what it means for an occupation group to be classed as a profession;
- describe the professionalisation project and its implications for accountants;
- discuss the role of professional accountancy bodies;
- discuss the implications of the status granted to professional accountants.

Introduction

The reputation of accountants and the accountancy profession varies between countries and also over time. It is generally fair, however, to say that accountancy is regarded as a desirable occupation. Accountants usually enjoy a reasonable

standard of living in return for their labour and are respected by friends, neighbours and others as 'professional' people.

This chapter will argue that it is no accident that accountants enjoy a positive reputation. History suggests that occupation groups can and do capture professional status as a conscious and deliberate programme of working to capture the right to self-regulate and also to exclude potential rivals. Professional status imposes many obligations, but these are more than compensated for by the rights that are granted to professionals.

The discussion of this process should be of interest to most readers of this text because, it is hoped, most will wish to enter the accountancy profession. Hopefully the opportunity to study the profession's success in obtaining and retaining professional status will encourage that ambition.

Why Do You Want to Be an Accountant?

The question of professional status is one that is likely to be of interest to the target audience for this book. Asked why they chose to study accountancy, generally the first (and frequently the only) response from a lecture theatre full of accountancy students is that they expect to earn a large salary. If it is pointed out that there are other well-paid occupations, the two factors that emerge as secondary considerations are that accountants are generally unlikely to be unemployed and that it is regarded as prestigious to be an accountant.

The status granted to accountants (and other occupations) varies from country to country. In the UK, a career in accountancy is often regarded as more prestigious than a career in engineering. In Germany the opposite is likely to be the case. There is no point in debating whether such rankings are valid or whether they reflect the actual contributions to society made by various occupation groups. It is, however, worth considering the manner in which accountants seek to protect and further their interests.

In the interests of avoiding accusations of elitism, this chapter makes no specific claim that accountants are in any way 'better' or 'more deserving' than other occupation groups. One of Douglas Adams' *Hitchhiker's Guide* series of satirical novels describes a society that exiled its telephone hygienists, only to learn the true value of that occupation group when the entire population died from an epidemic of a disease that had originated from a single dirty telephone. That said, there is no denying that accountants are generally better paid than telephone hygienists and that they generally enjoy greater status. The place of the accountant in society is a phenomenon that is worthy of academic study regardless of whether such status is justified.

Badges of Professionalism

In the distant past, sociological studies identified a profession by the so-called 'badges' of professionalism. These could be presented as lists of benefits and obligations associated with professional status:

Obligations	Benefits
Focus on service to society	Restriction of trade
Achieving and maintaining competence	Self-regulation

To be recognised as a profession, an occupation group had to be willing to put the needs of society and the specific stakeholders who used the profession's services before self-interest. For example, a medical doctor would treat a sick patient outside of normal working hours and a lawyer would advise a client on the basis of the best overall outcome for the client rather than the greatest possible legal fee for the lawyer. Society would generally feel confident that a professional person would behave with integrity and would view personal interests as secondary to service.

There is also an expectation that professionals will offer services that are of very high quality. A professional person will be educated and will have sufficient practical experience to ensure that any work will be done to an appropriate and acceptable standard. That generally means that there will be stringent conditions imposed on the right to practice as a professional person.

The benefits granted to professionals were viewed as compensation for the restrictions imposed by the obligations. There would be very little incentive to enter into an extensive training programme that led to a career of service and sacrifice if there were no commensurate benefits.

Professionals are generally free to offer their services without the risk of competition from other parties. That is clearly an important safeguard because it prevents the public from being misled by unqualified practitioners. It is also a significant economic benefit because the professionals are only required to compete with the others who share their professional accreditation. The laws of supply and demand suggest that restricting the right to supply a product in this way will generally lead to it being sold at a higher price. Sometimes the law prevents those who are not accredited professionals from practising. For example, in many countries only a medical doctor can prescribe medicines classed as 'prescription only'. Sometimes the law restricts itself to limiting the right to use a particular title. There are alternative therapists, such as chiropractors, who can offer treatments that are complementary to traditional medicine and many lay people are trained to provide first aid in the event of an emergency. Those therapists and

first-aiders can treat patients but they cannot claim to be medical doctors in the process of doing so.

Self-regulation is also a significant benefit of professional status. Essentially, this means that the state leaves the regulation of the professions and their activities to the professionals themselves. Professionals are free to use their expertise to best advantage in serving society's needs. There is less risk of the professions being constrained by inflexible legislation and so professional rules and regulations can be far more responsive to changing circumstances. Clearly that also implies a great deal of trust in those professionals because they are effectively operating with relatively little oversight from the state.

Professions and Professional Bodies

From a practical point of view, all professions must be represented by one or more professional bodies. These bodies provide a focal point for their members and are an aid to the recruitment and training of new members. They also provide a means by which interested parties, primarily the government, can communicate and negotiate on areas of mutual interest.

Typically, anyone wishing to pursue a career in accountancy will join a professional body. In 2012, the magazine *Financial Director* published an analysis of the backgrounds of the finance directors of the UK FTSE 100 finance directors (Singh, 2012). Only 15 of them were not professionally qualified accountants and eight of those worked in mining or gas exploration, which is an industry with a history of appointing finance directors from non-traditional backgrounds.

Accountancy bodies generally require their members to pass a series of exams, often after first completing a degree. It would be unusual for an accountancy body to offer entry to anyone who has not passed, at the very least, the final level of professional exams. In addition, membership generally requires a period of professional experience, typically three years or more, working under the supervision of one or more qualified accountants. Thus, professionally qualified accountants can claim to have demonstrated that they have both the technical expertise required to pass professional exams and some practical experience.

The UK is typical of most countries in that there is more than one accountancy body to choose from. The most prominent of these are the six 'chartered' bodies:

- Chartered Association of Certified Accountants (ACCA)
- Chartered Accountants Ireland (CAI)
- Chartered Institute of Management Accountants (CIMA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants of Scotland (ICAS).

Each of these bodies can trace its origins back to one of 18 accountancy bodies that were created during the period from 1853 to 1919. A series of mergers has taken place since then to reduce the numbers to the six bodies listed above.

The original bodies were created by practitioners who wished to have a forum for the exchange of ideas and also in order to enhance their status. For example, the origins of ICAS lie in societies of accountants that were established in Glasgow and Edinburgh. These bodies merged to form a national society that has grown and prospered in the period since.

ACCA's earliest origins were in bodies that were created by professional accountants who did not meet the entry requirements for ICAEW's predecessors. Those somewhat negative beginnings have since been overtaken by the development of a global accountancy body that carries considerable influence in many countries.

The UK's accountancy bodies have had to learn to cooperate to the extent that they can offer a collective identity to government and to society at large. For example, an accountant who commits a serious offence may be subject to investigation and censure by a joint disciplinary board. Despite that, the bodies do compete with one another for members and for status. For example, ICAS offers training to large numbers of professional students in England who might otherwise have joined ICAEW.

There is a certain amount of specialisation in the services offered by members of different bodies. For example, the CIMA qualification focuses more on management accounting, whereas CAI, ICAEW and ICAS focus largely on financial reporting. However, most bodies would claim that their members are capable of fulfilling almost any role that is typically associated with accountancy.

There is an increasing tendency for accountancy bodies to operate internationally. For example, ACCA and CIMA recruit and train members from many countries and their examinations typically have more overseas candidates than UK.

The Professionalisation Project

Sociological studies of professions tend to start with the idea that professional status is desirable for virtually any occupation group. That status is essentially granted by society at large, but particularly by the state. Historical studies tend to present the process of obtaining this recognition as a deliberate project, acted out by the senior members of the bodies whose members constitute the profession.

Willmott's (1986) groundbreaking study of the development of professional bodies provides both a discussion of the theoretical approach that can be taken to the study of professions and an exploration of the development of the major accountancy bodies in the UK, from their creation through to the early 1980s.

Willmott argues that, 'professional [accountancy bodies] are *primarily*, but not exclusively, political bodies whose purpose is to define, organise, secure and advance the interests of their . . . members' (Willmott, 1986).

Willmott's exploration of three of the approaches that may be taken to the study of the history of the professional bodies finds value in all three (see Table 2.1).

Willmott acknowledges the merits of each approach. The most important issue for our purposes is that any study of the professions will be influenced by its theoretical perspective. There is no single or 'correct' reading of a set of events or of the historical development of a professional accountancy body.

Willmott prefaces his history of the professional accountancy associations by describing them as political bodies. He argues that they provide the means to advance the interests of their members. The bodies may promote the impression of competence and integrity on behalf of their members, but the intention will be to increase the market value of the services they offer. This can be achieved both by restricting the supply of accounting services by limiting the numbers of professionally qualified accountants and also by stimulating the demand for the services offered.

Willmott's history of the development of the accountancy bodies has been rather overtaken by the passage of time. However, his paper raises a number of important and enduring arguments:

- The emergence of an organised occupational group of accounting specialists coincided with the Industrial Revolution. The complexities of industrial (or capitalist) society created a demand for more sophisticated, standardised, specialised and complex accounting techniques.

- Market forces for labour can be complex and may not always operate freely. For example, trade unions may constrain the ability of employers to use the laws of supply and demand to reduce the wages on offer. Professional bodies can take this a stage further by creating a mystique concerning the services on offer and establishing a monopoly over the supply of those certified as competent in the provision of those services. Professional associations have sought to create monopolies of labour by restricting entry, by determining the type and duration of training and by regulating the mode and standards of practice.

- The interaction between the professions and the state is absolutely critical. Willmott argues that the relationship between professional associations and the state is best characterised as one of interdependence and tension in which each party enables as well as constrains the other. The state has the ultimate authority in terms of legal and physical compulsion. The professions require the endorsement and support of the state and the state will typically develop a dependence on the professions. Thus, the dynamic of the relationship between the state and the professions is one of mutual dependence.