

Financial Accounting

Raymond Brockington

The M & E Higher Business Education Series

Financial Accounting

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The M & E Higher Business Education Series

Financial Accounting

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Foreword

In recent years business practice has been undergoing major and fundamental changes for a variety of economic, social and technological reasons. In parallel with these changes the developments of education for business at all levels have also been extensive and far-reaching. In particular this is true at the advanced levels for courses leading to (a) the first degrees of the Council for National Academic Awards and of the universities, (b) the higher awards of the Business Education Council and its Scottish equivalent, and (c) examinations of the relevant professional bodies. Many such courses are now offered in educational institutions which include the polytechnics, the universities, the colleges and institutes of higher education, the further education colleges and the Scottish central institutions. In addition to these developments in curricular design there have also been important advances in educational and teaching methods.

Macdonald and Evans already has a large involvement in meeting needs of students and staff in Business Education through its BEC BOOK series and its HANDBOOK series. It has now decided to complement these series with its Higher Business Education series.

The series is intended to be one of major educational significance which will cover all important aspects of Higher Business Education. It will be designed for student and staff use with all of the advanced courses at all of the educational institutions mentioned above. Each book will have both a planned part in the series and be complete in itself and, in it, a thematic and problem-solving approach will be adopted, thus bringing a body of theory to bear on business problems—a major feature of the whole series.

The editorial team have chosen authors who are experienced people from technological institutions and from professional practice and will collaborate with them to ensure that the books are authoritative and are written in a style which will make them easy to use and will assist the students to learn effectively from such use.

The editorial team will welcome criticisms on each of the books so that improvements may be made at the reprint stages to ensure a closer achievement of the objectives of the books and the entire series.

Edwin Kerr
General Editor

Preface

A problem faced by any accounting educator, whether he be lecturer or author, is that of how to blend his course so that it contains the appropriate mix of theory and practice. What is appropriate depends on the nature and aspirations of his audience. If this consists of students with strictly vocational aims seeking a skill in financial processes of immediate use in their daily work, then the development of practical expertise is rightly to the fore. If it is made up of qualified accountants seeking further insight into the fundamentals of their subject, then a theoretical approach is likely to be correct.

The audience for this book is made up of first degree and higher diploma students of business studies (whether they are specialising in financial accounting or not) and the problem therefore takes on particular dimensions. These students are likely to be highly motivated by well-structured career aspirations although not necessarily predominantly in the financial area. At the same time they are studying within the context of a multi-disciplinary course having its own designed educational objectives to which financial accounting makes an important but not exclusive contribution.

The right blend of theory and practice is not here easy to find. It is necessary to provide a theoretical structure for the subject which will allow the proper intellectual development of the student and the integration of financial accounting with concurrent subjects of study, typically law, economics, behavioural sciences and quantitative methods. There is also a need to give sufficient technical content to satisfy career demands. A too-theoretical course will produce that despair of the professional accountant's office—an apparently relevant graduate, glib in ideas, but who cannot do any of the things which an accountant is supposed to do. A too-practical course will be sterile and ultimately boring to an enquiring student, making a fulfilment of the educational aims of the course impossible and imparting, at best, a few skills which may be of very short term usefulness in a rapidly changing world.

This book describes in adequate, though not exhaustive, detail what an accountant does and why he does it. It examines the implicit frame of reference within which accounting currently operates and thus constructs a theoretical underpinning to practice. It explores the possibilities and merits of adopting quite different frames of reference and investigates the consequences for

practice of so doing. It is thus hoped that conflicts between theory and practice are used as a gateway to understanding rather than as a barrier to progress.

Although this depends to an extent on the syllabus and general design of the course which the student is following, it is anticipated that this book will serve as a basic text for the whole of the first year of study of this subject and for a substantial part of the second. Thereafter it will fill the role of an introductory and supporting text which will need to be supplemented increasingly by specialist reading. Because this will be individual to each separate course, it is left to the teacher to recommend reading and no references to further reading are made here.

The format of the book is intended to give a logical progression to study although many chapters, particularly the later ones, may be taken out of order. Chapters 1 and 2 define the subject and establish its theoretical foundations. Chapters 3 and 4 then show how the two basic financial accounting statements, the balance sheet and the profit and loss account respectively, are derived. These chapters are followed by an important section, embracing Chapters 5 and 6, which develops double entry book-keeping, first in principle and then in considerably more practical detail. Chapters 8 to 10 show the important new accounting problems posed by those different but both important forms of organisation, the partnership and the limited company. Chapters 11 and 12 develop further accounting techniques of specific relevance to limited companies and Chapter 14 shows the importance of the interpretation of financial accounting figures and how this is supported by the calculation of ratios. Chapter 15 is a vital one discussing the detailed legal requirements imposed on companies' published accounts. The problem of the measurement of income and the associated problem of accounting within an inflationary environment are dealt with in Chapters 16 and 17. Chapter 18 is on Accounting Standards and Chapter 19 takes a speculative look at the future.

Each chapter is preceded by a statement of its contents and is followed by a summary of its important points. This should be helpful to the efficient planning of study and to revision. There is also a selection of test questions covering both theoretical and practical matters at the end of each chapter. At the end of the book there is an appendix containing essay topics which will provide ample material for course assignments. Another appendix consists of six substantial practical exercises. These will provide practice in the use of accounting techniques and could also be used as case studies for class consideration and discussion.

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Financial Accounting Defined

OBJECTIVES

In this chapter we shall deal with the following important topics:

- (a) a definition of the subject;
- (b) the contexts in which it is used;
- (c) the limitations of financial accounting;
- (d) the need to define the purposes for which accounts are being prepared;
- (e) the functions of financial accounting.

1. INTRODUCTION

To give an account of something is to describe and explain it. Thus financial accounting must be defined as that subject dealing with the description and explanation of financial matters. A very important part of all of human activity is concerned with the optimisation of our standard of life, given the resources we find about us. The way in which we do this is the area of study of the subject known as Economics. In a developed society it is an essential feature of such optimisation that it requires specialisation of function and an appropriate mechanism for the exchange of goods and services. Money is the medium by which such exchanges take place and has therefore become the unique measure of one person's indebtedness to another, of the quantity of resources devoted to a particular enterprise and of the success or otherwise of their use. Financial matters thus come to be equated with economic matters and financial accounting comes to be seen as a description and explanation of economic activities.

Every one of us is involved in economic activity in some way or another. This is true whether we be the chief executive of a multi-million pound enterprise or a pensioner seeking to make a small fixed income go as far as possible. Accounting thus affects every one of us. It helps us to organise and manage our own affairs in an appropriate fashion and it helps to assure that part of the quality of life which derives from the efficient operation of the businesses which supply us, the government which controls us and the social services with which we are provided.

Most of this book will be concerned with the financial accounting of business organisations, that is of organisations set up with the object that they should earn a profit on behalf of their proprietors. We might debate as an exercise in philosophy whether this profit is to be seen as a just reward for efforts made and for risks taken or whether it is the fruit of the exploitation of the weak or the ill-informed. This is not important to our present purpose which is to develop techniques whereby we can record what has happened and provide an analysis of its implications so that informed action can be taken in making progress towards a goal.

2. TYPES OF BUSINESS

Businesses are organised in many different ways and these differences may be important to the accounting process. One business might be established by a single individual providing his own capital, labour and management expertise. Such a person we would describe as a sole trader and businesses of this kind are very common. They tend to be small and to operate in fields where relatively little capital but much specialised skill is required. The small shop on the corner, the window cleaner and the landscape gardener are often operated by sole traders. They will usually be given the name of the proprietor, e.g. John Smith or, perhaps, to make them sound bigger, John Smith and Co., or they may adopt some appropriate business name like Toytown General Store.

Another business might operate as a partnership. The distinction between this and the sole trader is merely that, in a partnership, two or more people set up in business in common jointly providing the inputs which in the case of the sole trader come from one person. Partnerships are often formed in the case of businesses providing professional services such as accountants, doctors and solicitors. A partnership would have some such name as Smith, Brown and Jones or Roberts and Sons.

A third important form of business organisation is the limited company. Here the capital is provided jointly by a body of people, which may be very large, known as the shareholders or members of the company, while the management is provided by a small group of people employed for the purpose and known as directors. Companies frequently operate very large businesses and are most common where amounts of capital beyond the resources of an individual or small group of individuals are needed. A company will carry some such name as Arkville Manufacturing Company plc or McTavish Garden Centre plc.

3. BUSINESS ACCOUNTS

These forms of business organisation all have one thing in common. They assemble factors of production and organise them with a view to making a profit. They may be very successful in this endeavour or only moderately successful. They may even fail totally, ending up by making a loss. Although normally any profit is made for the exclusive benefit of the ultimate proprietor, it should not be overlooked that highly profitable businesses can afford to pay good wages and to offer good value for money to customers, i.e. that the benefits of successful operation may be widely spread. Similarly, although a loss falls apparently on the providers of capital, it may also lead to the loss of jobs by employees and to the cutting of the range of choice offered to customers.

The accounts which are prepared for each type of business will be similar in so far as they relate to the basic business activity but will have important differences when they deal with proprietorship matters. So far as the former is concerned the accounts will powerfully reflect the profit motive and the necessity to maintain an appropriate assembly of resources for continuance of the activity. So far as the latter is concerned the accounts will reflect the relative rights and entitlement of the proprietors. Thus we shall receive accounts from time to time which will tell us that during a particular period a business has made a certain profit and that it now stands in a certain position from which there is a potential for earning more profit in the future. They will also show who is to share in current profit and who has a stake in the current position and in what proportions these shares are held.

Important though business accounts are it should not be overlooked that financial accounting is important also to other forms of organisation. Nationalised industries, local authorities, charities and sports and social clubs are examples of different kinds of organisation where the conventional profit motive is absent. They do, however, have objectives and the use of scarce resources is involved in achieving those objectives. The objective of a nationalised industry is to provide efficiently some commodity or service on a commercial basis while breaking even, making neither profit nor loss, in the long run. A local authority has to spend its rates income in the way which optimises the benefit which rate-payers receive from the services which it provides. A charity will be concerned to do as much good as it can within its budget. We cannot judge the extent to which these objectives are met without information on which to base such a judgment. Such information will be provided by processes falling within the field of financial accounting.

4. PURPOSE OF ACCOUNTS

No one who gave more than a moment's thought to the matter could possibly suppose that all of the effects of economic activity, still less of the whole of human activity, could be quantified in terms of money. Financial accounting may tell us what value of our product a particular customer has bought in the past. It will not tell us what goodwill has thereby been generated and thus what we might anticipate that he will buy in the future, although this is crucial to our continuing success and survival. Again it will tell us what we have spent on the wages of our employees and on providing them with amenities such as a canteen and a sports field. It will not tell us the value of a contented, well-motivated workforce which again is as important to us as is cash in the bank. It will show us how much we pay our chief executive but will not directly reveal the benefit we receive from his personal enthusiasm and special flair for the job. We must be quite clear, therefore, that financial accounting explains money matters and only money matters. We shall be misled if we conclude that a complete explanation of a financial situation is the same thing as a complete explanation of an economic situation.

Accounting does not exist in a vacuum. It is essentially a conveyance of information from one person to another for a particular purpose and all of these components are important. The author of this book is explaining certain matters to his readers so that they can pass examinations in the subject and can then use what they know in their work. A naughty schoolboy will explain his conduct to the headmaster seeking to persuade the head not to punish him. A newspaper will explain events to its readers so that they may be informed for their own interest and for the creation of what is known as public opinion.

We do not have to look far for examples of how an account depends not merely on its underlying facts but on its originator, its intended recipient and on the context and purpose of the communication. Here is a novelist's description of a house: "It was a friendly house. Even as I approached it its windows seemed to twinkle with delight and its front door to open into a smile. Once I had entered it wrapped me in a warm embrace and seemed to tell me that I belonged and made it somehow complete". An estate agent might describe a house as follows: "Four bed det. res., 2 recep., 2 bath, hall, kitch., util., gas c.h., mature gdn." Each of these quotations describes a house and yet their form and content depends completely on the purpose for which they are given and they are in no way interchangeable.

The purposes of financial accounting may usefully be catego-

rised under three headings. These are (a) administrative, (b) regulatory and (c) decision-informing.

Administrative

Any organisation will require a considerable amount of financial information of a routine nature if it is to operate in an effective and businesslike fashion. The techniques for providing this kind of information are of a very simple nature but important because they must make it as accessible, clear and free from error as possible.

A few examples of administrative information and how it might be provided will immediately make its nature clear. Many businesses sell to some or all of their customers on credit terms. This means that goods are supplied as required on the understanding that they will be paid for at some future time, e.g. following a statement provided at the end of the month. It will be necessary to keep a record to show the value of the goods so supplied and any amounts paid so that we can ensure that all amounts due are eventually collected. An account such as the following would serve very well.

ACCOUNT WITH A CUSTOMER FOR JUNE

| <i>(Goods supplied)</i> | | | <i>(Amounts paid)</i> | | |
|-------------------------|-------------------|---------------|-----------------------|-----------------|---------------|
| 11th June | 144 notebooks | £12.00 | 30th June | Cash | £17.60 |
| 12th June | 50 pkts envelopes | 5.60 | | Balance (amount | |
| 15th June | 10 boxes paper | 22.80 | | still owed) | 22.80 |
| | | <u>£40.40</u> | | | <u>£40.40</u> |
| 1st July | Balance | £22.80 | | | |

From this it can readily be seen that at 1st July our customer still owed us for ten boxes of paper. It can also be seen that this amount has been outstanding for 15 days.

When we take delivery of goods on credit we shall need to keep a similar record of goods and cash to ensure that we pay what we owe at the agreed time. Another example of administrative information is where we keep an account of cash to show how much has been received or paid and what now remains in hand. Without such records debts would be uncollected, bills would be unpaid or paid twice and it would be impossible to check bank statements for accuracy or know how the business stood for cash.

Regulatory

Certain requirements for information are imposed on businesses by contract, by the law of the land or in some other regulatory way. Perhaps the best example is the statutory requirement imposed on

all limited companies under the Companies Acts to produce an annual balance sheet and profit and loss account. Copies of these must be sent to each shareholder and deposited with the Registrar of Companies where they are available for public consultation. The purpose of these accounts is to monitor the company to ensure that it is being operated honestly and in accordance with law and with the instruments (articles and memorandum of association) setting it up. The Stock Exchange requires the provision of accounting information over and above that which the law demands as a condition of offering companies a listing (i.e. the facility of having its shares dealt in on the Stock Exchange). Partnership accounts may be required under the agreement between the partners in order to enable profits to be calculated and correctly divided. The Inland Revenue has the legal power to compel financial disclosure as part of its duty to assess and collect tax. Nationalised undertakings are compelled under the individual Acts of Parliament establishing them to prepare and publish annual accounts. We must establish procedures whereby this sort of information can be correctly and promptly provided.

Decision-informing

Financial accounting has a third function and this is to provide information to those who need it for the purpose of making decisions. People who come into this category obviously include the providers of capital, actual and potential shareholders in the case of a limited company. It may also include lenders (such as banks) and those considering advancing credit to the business, e.g. the suppliers of goods. Some would argue that it includes employees who need to make decisions based on the ability of the business to meet wage demands and on the basic security of their employment. It may also include customers who may need information enabling them to decide whether they are being exploited (as evidenced by too high a profit) and members of the public at large who have an interest in the activities of any organisation with the power to change their environment.

The extent to which this decision-making requirement should be met will depend, in the absence of specific regulations, on the degree of responsibility which is accepted by the business in this connection. It has been argued that responsibility should go hand in hand with power and any centre of economic activity has power, although the degree of this will vary with size and other factors. The proprietor of a small corner shop has the power to inconvenience his customers by closing at awkward times or to serve them badly by selling low-quality goods at high prices. This power, however, is limited to a local area and can be avoided by most