Advanced Financial Accounting

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Preface

(with an Addendum including details of the Companies Act 1981 and other developments up to 31 March 1982)

This book is intended primarily for students preparing for the final professional examinations of the major accountancy bodies in the United Kingdom. It may also be helpful to members of those bodies who passed their examinations in simpler times and is likely to be of value to students following the more practically oriented advanced sections of degree courses in accountancy and business studies.

The book assumes a thorough knowledge of double-entry book keeping and readers are expected to be familiar with the basic principles and legal requirements underlying the preparation of accounts of sole traders, partnerships and limited companies. Chapter 2 provides a background to the sources of authority for accounting practice whilst chapter 14 deals with the additional statements, such as the statement of source and application of funds, which have become, or are becoming, an accepted part of a company's annual report.

Only a basic knowledge of consolidated accounts is required to study the problems of accounting for business combinations, associated companies and groups in chapters 11 and 12. The important subject of accounting for overseas subsidiaries is developed from first principles in chapter 13.

A large part of the book is devoted to current cost accounting and chapter 6 explains the provisions of SSAP 16 and provides a critical appraisal of those provisions. The authors see the proposals of SSAP 16 as merely one particular approach chosen from many possible accounting reforms. Chapters 3 to 5 therefore provide a wider perspective with which readers will be better able to appreciate SSAP 16 and future developments in this area.

While the introduction of current cost accounting is an extremely important stage in the development of the subject, it must be remembered that the only, or main, accounts of the vast majority of companies will continue to be based on historical cost principles. For this reason the problems introduced in the later chapters are mainly discussed in the context of historical cost accounts. Most of the issues are, however, equally relevant to current cost accounts and attention is given to the impact of current cost accounting on such topics as consolidated financial statements and the interpretation of accounts.

In order to achieve success in the final stages of the professional accountancy examinations, students must not only be familiar with Statements of Standard Accounting Practice but must also be aware of the problems which led to their publication as well as their respective strengths and weaknesses. Considerable attention is devoted to this subject and all U.K. Exposure Drafts and Statements of Standard Accounting Practice extant at June 30 (1980), as well as several topics on the agenda of the Accounting Standards Committee, are discussed.

Chapters 7 and 8 discuss the problems of valuing a business and securities. These are discussed from first principles although readers would find a knowledge of elementary discounting to be helpful.

We would like to take this opportunity of thanking all those who helped us complete the book. In particular we would like to thank Janice Dixon, Gillie McGowan and Jean Willis, who somehow made sense of our manuscripts, and Alfred Waller and Eric Dalton of Pitman Books for their advice and support. We would also like to thank our colleagues Ted French, Howard Mellett and Roydon Roberts for their helpful comments on early drafts of certain chapters. Finally, and not just because it is customary, we thank our wives Pamela, Louise and Marjorie for their tolerance and encouragement.

Addendum

Advanced financial accounting is a subject which is developing rapidly and, as a result, it is inevitable that a textbook can never be as up-to-date as both authors and publishers would like. Since June 1980, when writing was completed, there have been a considerable number of developments and we have taken advantage of the need for reprinting to extend this Preface in order to summarize the major changes since that date.

In Chapter 2 we have discussed the provisions of the EEC Fourth Directive on company accounts. The provisions of this Directive have now been included in the Companies Act 1981, which received the Royal assent on 30 October 1981. Although the primary purpose of that Act was to implement the provisions of the Fourth Directive, the Government used the opportunity to legislate on many other matters and we shall refer to one such matter, merger accounting, later in this Preface.

In addition to the new Companies Act, a number of Exposure Drafts and Statements of Standard Accounting Practice have been issued since 30 June 1980. Appendix I to Chapter 2 (pages 35/36), which lists British Exposure Drafts and Standards, would not include the following additions:

Appendix I: British Exposure Drafts and Standards Additions 30 June 1980 to 31 March 1982

Exposure drafts:

ED 26 'Accounting for investment properties' (September 1980)
ED 27 'Accounting for foreign currency translations' (October 1980)
ED 28 'Accounting for petroleum revenue tax' (March 1981)
ED 29 'Accounting for leases and hire purchase contracts' (October 1981)

Standards:

SSAP 17 'Accounting for post balance sheet events' (August 1980)
SSAP 18 'Accounting for contingencies' (August 1980)
SSAP 19 'Accounting for investment properties' (November 1981)

Appendix II to the same chapter (pages 36/37) lists the Exposure Drafts and Standards issued by the International Accounting Standards Committee. The following items should be added to the lists:

Appendix II: Exposure Drafts and Standards issued by IASC Additions 30 June 1980 to 31 March 1982

Exposure drafts:

IED 17 'Information reflecting the effects of changing prices' (August 1980)
IED 18 'Accounting for property, plant and equipment in the context of the historical cost system' (August 1980)
IED 19 'Accounting for leases' (October 1980)
IED 20 'Revenue recognition' (April 1981)
IED 21 'Accounting for government grants and disclosure of government assistance' (September 1981)
IED 22 'Accounting for business combinations' (September 1981)
IED 23 'Accounting for the effects of changes in foreign exchange rates' (March 1982)

Standards:

IAS 14 'Reporting financial information by segment (August 1981)
IAS 15 'Information reflecting the effects of changing prices' (November 1981)
IAS 16 'Accounting for property, plant and equipment' (March 1982)

As we explain in Chapter 2, the EEC Fourth Directive requires substantial changes to disclosure requirements in the UK. The most significant such change is that Schedule 1 to the Companies Act 1981, which replaces Schedule 8 to the Companies Act 1948, now contains not only an extended list of information to be disclosed in the accounts of limited companies but also prescribed formats for those accounts. In imposing these formats, the Government has granted the maximum flexibility permissible under the Fourth Directive and companies may choose one of two balance sheet formats and one of four profit and loss account formats. We discuss the formats on pages 32 and 33 and Appendices III and IV to Chapter 2 provide examples of the formats incorporated in UK statute law under the provisions of the Companies Act, 1981.

The Companies Act 1981 is to be implemented in stages on days appointed by the Secretary of State. It appears that companies will not have to comply with the new disclosure requirements until preparing accounts for years ended after a date yet to be specified in 1983. They will however be permitted to comply earlier and will, in any case, need to plan ahead to make sure that the necessary comparative figures are available.

Even when the Act comes into force, there are substantial exemptions for small and medium sized companies, although these are defined with reference to slightly higher monetary criteria than those included on pages 34 and 35. Although such companies must prepare full accounts for shareholders, they are permitted to file abridged accounts with the Registrar of Companies. Small companies, in particular will be permitted to publish much less information than they have had to publish in the past. Thus they may publish an abridged balance sheet and abridged notes to the accounts but need not publish a profit and loss account or a directors' report. As we anticipated in Chapter 2 (page 34) the accounts of small companies remain subject to audit.

In Chapter 11 we have discussed the merger method of accounting for certain business combinations and have explained why Exposure

Draft 3 'Accounting for acquisitions and mergers' never became a statement of standard accounting practice. One reason was the questionable legality of the method and, on page 329, we pointed out that the law could be changed if the Government so wished. In Part III of the Companies Act 1981, the Government has taken just this course of action to exempt companies from the need to create a share premium account, and hence to permit merger accounting, in certain circumstances. The legislation is retrospective and is applicable to certain share for share exchanges and group reconstructions.

As a result of this change in the law, the Accounting Standards Committee is again considering the subject of 'Accounting for acquisitions and mergers' with a view to producing a new exposure draft. In its deliberations the Committee will no doubt study International Exposure Draft 22 'Accounting for business combinations' which was issued by the International Accounting Standards Committee in September 1981. That Exposure Draft requires that, in accounting for mergers, that is business combinations involving a 'uniting of interests', we should use the purchase (or acquisition) method, the pooling of interests (or merger) method or the 'new entity' method. This new entity method, which owes much to Dutch thinking, seems to have considerable advantages over the merger method. Under this method both parties to a merger are required to restate their assets and liabilities at fair value at the date of the combination but no goodwill is created for either company. Thus the new entity method achieves a symmetry of accounting treatment with the benefit that the net assets of both companies are shown at current values, rather than at written down historical cost, at the date of the combination.

Another area in which there has been substantial developments since June 1980 is foreign currency translation which we discuss in Chapter 13. Exposure Draft 27 'Accounting for foreign currency translations' was published in October 1980. Unlike its predecessor, Exposure Draft 21, which permitted the use of either the Temporal method or the Closing Rate method, Exposure Draft 27 favours the Closing Rate method for most overseas interests. Only where the overseas entity is a direct extension of the trade of the UK company is the Temporal method to be used. This preference for the Closing rate method is also found in the US Statement of Financial Accounting Standard Number 52' Foreign Currency Translation' which was published in December 1981. The application of the Closing Rate method under Exposure Draft 27 differs from its application under Exposure Draft 21. Although assets and liabilities are translated at the closing rate, profit and loss account items are translated at the average rate for the period. The selection of average rate, rather than permitting a choice between average and closing rate as under Exposure Draft 21, appears to have been made in the interests of international harmonisation. The treatment of differences on exchange which is proposed in Exposure Draft 27 is somewhat simpler than the previous treatment illustrated in Chapter 13. All differences on exchange relating to the retranslation of the opening net assets and to the use of different exchange rates for profit and loss account and balance sheet items are to be taken direct to Reserves. This simplifies the accounting although, as discussed on pages 397 to 403, we must still have serious reservations about the meaning of the figures produced as a consequence of using the Closing Rate method.

Turning to the subject matter of Chapter 15 we have already noted the publication of SSAP 19 'Accounting for investment properties' and ED 29 'Accounting for leases and hire purchase contracts'.

SSAP 19 exempts companies from the need to depreciate investment properties, which are defined in the singular as 'a disposable investment interest in land and buildings, on which construction work has been completed, all or substantially all of which is held for the purpose of letting to produce a rental income which is negotiated at arm's length'. Such investment properties are to be valued at their open market value on each balance sheet date and any change in value from one date to the next is to be treated as a movement on an Investment Property Valuation Reserve. Only when a downward valuation occurs in excess of the credit balance on this Reserve account is a charge to profit and loss account required.

The long awaited Exposure Draft on 'Accounting for leases and hire purchase contracts' was published, together with a set of Guidance Notes, in October 1981. As expected it requires the capitalisation of finance leases and the Guidance Notes provide extensive guidance on the detailed accounting procedures to be adopted by both lessee and lessor. The section of the textbook on pages 466 to 476 provides a foundation for study of the more detailed provisions of the Exposure Draft and Guidance Notes.

On the subject matter covered in Chapter 16 there has been little change. Exposure Drafts 22 and 23 have now been issued as SSAP 17 'Accounting for post balance sheet events' and SSAP 18 'Accounting for contingencies' respectively. There have been some minor amendments here and SSAP 17, unlike its predecessor Exposure Draft, requires disclosure of the date on which financial statements are approved by directors.

We have left until last our comments on the major topic of Current Cost Accounting which is covered in Chapters 5 and 6. SSAP 16 and its accompanying Guidance Notes were published in March 1980, and as we explain on page 133, no major changes are envisaged during the three years following that date. However, there have naturally been some developments during the time since SSAP 16 was published.

On an official level, a panel set up by the Accounting Standards Committee has been wrestling with the problem of how to adjust comparative figures for price changes. In the publication 'Corresponding amounts and 10-year summaries in current cost accounting: a discussion paper', this panel comes to the not surprising conclusion that comparative amounts should be adjusted by reference to movements in a general index, the Retail Price Index. So we see yet another move towards the essential introduction of the general index, which was so strangely rejected by the Sandilands Committee back in 1975.

As the Accounting Standards Committee has been tackling the problem of comparative figures, thousands of accountants in all sorts of companies have been wrestling with the practical problems of preparing current cost accounts. Many difficulties have arisen and there seems to be growing opposition to the system of current cost accounting proposed in SSAP 16. The monetary adjustments, in particular, have attracted a great deal of criticism and, in the view of many people including the authors, the SSAP 16 gearing adjustment is conceptually indefensible. By requiring that the gearing adjustment be calculated by applying a current gearing proportion to holding gains which may have accrued over several decades, SSAP 16 requires us to produce a meaningless figure for the gearing adjustment and hence for profit attributable to shareholders. It is no wonder that accountants are having trouble explaining such figures to boards of directors and other users of financial accounts.

Many accountants now appear to be unhappy that the Accounting Standards Committee so firmly adopted one system of accounting. In such a fundamental reform of historical cost accounting, the approach of the US Financial Accounting Standards Board appears to be more fruitful. In Statement of Financial Standard number 33 'Financial Reporting and Changing Prices' issued in September 1979, the FASB requires large companies to publish supplementary information taking into account not only specific price movements but also both inflation and the combined effects of specific price movements and inflation.

As we have argued in Chapter 6, we consider that no attempt to reform accounting will be successful unless it takes into account both specific price change and general price change. We very much hope that the Accounting Standards Committee will move in this direction when the current period of experimentation with SSAP 16 comes to an end.

R.L.
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D.S.S.

31 March 1982

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