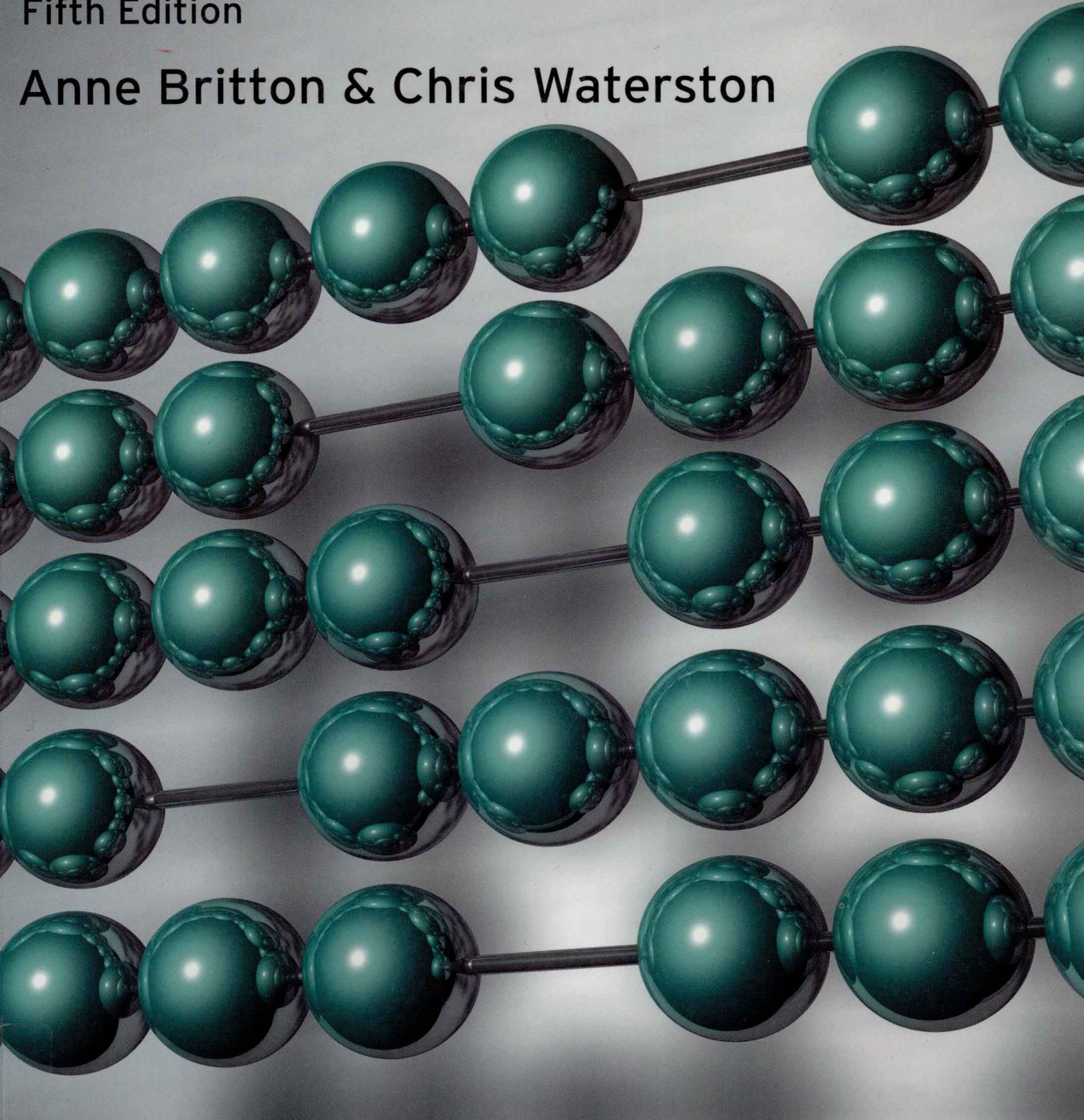
Financial Accounting

Fifth Edition

Anne Britton & Chris Waterston



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Preface

Welcome to your studies of financial accounting. Here we suggest how to use this book to gain the maximum benefit from your studies.

This fifth edition has been revised to introduce new topic areas, notably incomplete record accounting, accounting for partnerships and an introduction to group accounting, corporate governance and corporate social responsibility. All lists of key terms and self-assessment questions have been revised and updated. As before, the whole book is supported by a dedicated website, containing further questions, with answers available to tutors, and self-marking multiple-choice questions. The website also contains overhead transparency masters of key topics, for use by tutors, and an updated list of suggested web links for use by all users.

The book is divided into 16 chapters, each dealing with a separate area of financial accounting. The sequence of chapters is important, and you should normally work through the book following the chapter order. If you try to jump ahead, you may find that the material doesn't make much sense because you haven't yet picked up the necessary underpinning knowledge and skills.

Each chapter starts with a brief list of its objectives. This is a checklist of the things you should be able to do by the time you have worked through that chapter. Check back to this list when you finish each chapter to ensure that you have understood it all. If you are unsure about one or more aspects, don't leave the chapter, but have another look at the relevant part. You may also find it helpful to review the list of key terms towards the end of each chapter.

It is very tempting to forget this advice and to move on. However, we also know that the next topic will be much easier if you have thoroughly covered the previous one.

At a number of points in the book we suggest that you jot down your own ideas about a question raised, or that you calculate a figure, prepare an account, etc. You should therefore have pen, paper and a calculator at your side when you read this book.

Where an activity is designed to help you to learn the material, an answer is given in the text immediately following. It can be difficult to discipline yourself to make the effort to do the suggested activity instead of just reading ahead to the answer, but it is well worth the effort.

Notice that in each case we have provided *an* answer, not necessarily *the* answer. As you will see as you explore accountancy, it is not the exact science that many people suppose it to be. Almost all the answers in accountancy, at least in the UK, are contingent and dependent on ideas of what is to be achieved – which is why Chapter 1 is concerned with such fundamental issues. We must be clear about what we are trying to achieve before we start on the mechanics of doing it.

Self-assessment questions can be found at the end of each chapter and the relevant answers are at the end of the book. These are a selection of questions providing practice in the topics covered in the chapters. Don't forget that there is also a website to support this book at **www.pearson.co.uk/britton/**.

Remember, if you work through the issues for yourself, you will learn and retain them much more effectively than if you just read about them. Ultimately, it is your choice as to how much benefit you derive from studying this book.

A few words about current changes in accounting

The general public have tended to view accounting as a traditional, never-changing subject. This is not true; despite common appearances, accounting is a dynamic subject. The big change in recent years has been the gradual move in the UK from domestic accounting rules to international rules. Specifically, the rules that have been developed in the UK since 1970, known as Statements of Standard Accounting Practice (SSAPs) and Financial Reporting Standards (FRSs), are effectively being phased out. Coming in their place are International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs).

This change is being introduced gradually, with all companies across the European Union (EU), including the UK, that are listed on a stock exchange in the EU, using the international set of standards from 2005. Other companies, broadly the small and medium-sized ones, will continue to use the old UK standards for the time being. However, it seems likely that all companies will move to using the international standards in the medium term and the UK standards will then fade away. Indeed, the UK's standard setters are currently working on convergence of UK and international rules.

This means that UK accounting is currently in the middle of a major transition and this book reflects that. The book is based on the jargon and rules in the new international standards. However, we have also made reference to the older jargon and rules at the appropriate points. For example, what is now properly called the 'statement of comprehensive income' was previously known as the 'income statement' and before that was traditionally known as the 'profit and loss account' in the UK. This is a problem because everyday usage still commonly refers to the statement as the profit and loss account. Nevertheless, in this book, we have used the up to date terms. For reference, new and old terms for the main financial statements are set out below. We'll look at all these statements in more detail in the coming chapters.

Current name	Previous name	Pre-previous name, if any
Statement of comprehensive income/statement of income	Income statement	Profit and loss account
Statement of financial posititon	Balance sheet	
Statement of cash flows	Cash flow statement	
Statement of changes in equity	Same	

It's not just the names of the main statements which have changed. When we explore the format of the statement of cash flows in Chapter 10, we'll use the layout specified by the international standard rather than the layout required by the UK standard. Furthermore, the terms used for some individual items within the financial statements have also changed. In particular, people who owe us money have traditionally been called debtors, but the more correct, up-to-date name is 'trade receivables', and people we owe money to have traditionally been called creditors but we should now be calling them 'trade payables'. The original terms are likely to remain in wide use, of course, for the foreseeable future, but we should try to get used to the new terms.

We know this is confusing (it is for all accountants during the current transition!) but we believe that following the rules and jargon which will increasingly become the norm over the next few years will best prepare you for those years and beyond.

Brief Contents

Contents

1

What is accounting?

Objectives

By the end of this chapter you should be able to:

- **Discuss the need for, and purposes of, accounting.**
- **Outline the nature and types of accounting.**
- **Describe the major formats in which accounting information is presented.**
- **List the users of accounting and describe their particular informational needs.**

Introduction

This chapter aims to introduce the purposes and the types of accounting, and to consider who might be interested in a knowledge of accounting. Since you are reading this book, you presumably have some interest in accounting, or at least a need to study it. Nevertheless, you may not be aware of the range of activities that make up accounting, nor be quite sure about what, and who, accounting is for. In this chapter we look at these issues under three headings – the purposes, the types and the users.

If you have done some accounting before, you may be tempted to skip over this chapter. Don't. The last few years have seen a strong trend towards accounting for the spirit of transactions, rather than the letter. If you are to understand what the spirit of a transaction is, then you must be clear about the fundamental issues dealt with in this chapter.

Purposes of accounting

Before we look at the purposes of accounting, it is helpful to review briefly the contexts in which accounting occurs. In other words, we examine the different types of organisation that need accounting.

Activity 1.1 What types of organisation can you think of? Jot them down and then put a cross against any that you think have no need of accounting.

Answer

The following list of organisations covers the main types. You may have included others, or have expressed the same ones in different words.

- *Sole trader*. This means one person who runs a business on their own, or perhaps with a few employees. The main aim is to make a profit.
- *Partnership*. This is two or more people who carry on a business in common, intending to make a profit.
- *Limited company*. In the UK, a limited company is a legal organisation set up under the Companies Act 2006. The owners are called the shareholders, and it is run by directors, who are appointed by the shareholders. In small companies it is common for the shareholders to appoint themselves as directors. Larger companies are often public limited companies, or plcs. You will find out more about limited companies in Chapter 8.
- *Public sector bodies*, such as local councils or the National Health Service. Traditionally, these bodies have not existed to make a profit, but exist to provide a service.
- *Clubs and societies*, such as a local cricket club. Again the intention is not to make a profit but to provide services for members.

All of these organisations require some form of accounting, however simple. Our next task is to explore why this should be so.

Activity 1.2 Accounting is undertaken by organisations for a variety of reasons. What do you think they are? Jot down at least three reasons before you read on.

Answer

This is probably the most fundamental question in accountancy. Nevertheless, there are no agreed, clear answers to it. In principle, therefore, your answers are as valid as any others, but we would expect you to include some or all of the following:

1 To record what money has come into the organisation and what has gone out.

2 To help managers make decisions about how to run the organisation.

3 To tell other people about the activities and consequent profit or loss of the organisation during the past year, or other period.

4 To tell other people about the present financial state of the organisation.

5 To provide a basis for taxation.

6 To help assess whether the organisation is beneficial to society as a whole.

7 To control the organisation, by controlling the finances.

8 To provide a basis for planning future activities.

9 To support legal relationships, for example how much one business owes another.

This is not a comprehensive list: you may have listed other items, or expressed similar points in different ways. Points 2 and 8 in the list arguably overlap. However, if you look at our list and your own, you should see that the purposes are broadly of two types.

First, there are purposes that relate to the running of the business, that is, those that form a basis for **decision making**. In Chapter 11 you will see that part of the regulatory framework of financial accounting is a document called the 'Framework for the Preparation and Presentation of Financial Statements' (hereafter just called the Framework). This is a publication by the International Accounting Standards Board (IASB), which is itself an authoritative international group of accountants. The Framework is dealt with in more detail in Chapter 4; briefly, it states that the prime objective of financial statements is to aid decision making.

Second, there is a group of purposes that can be classified as '**stewardship**'. This term means that accounting is used to keep track of what has been done with the financial resources entrusted to its managers. Historically, this was the original purpose of financial accounting, whereby managers ('stewards') had to account to the owners for their stewardship of the owners' money. The Framework is clear that stewardship is secondary to decision making as a general aim of financial accounting. This means that accounting is now less a matter of keeping track of the money, and more a matter of using the resulting information to actively manage the organisation, and for outsiders to make decisions about the organisation.

A brief history

We've seen that the primary purpose of accounting is now seen as the provision of information to help those interested in the organisation (the 'stakeholders') make decisions about it. This is a more active use of accounting information than was originally the case.

Keeping track of economic data, i.e. stewardship, has been a main purpose of accounting for many years. Modern accounting is usually dated to 1494, when one Luca Pacioli codified the accounting that had developed during the Renaissance to keep track of the increased trading that was occurring. For a long time afterwards it was still about stewardship, but early in the twentieth century a more proactive use started to be made of accounting. As we've seen, this more modern view sees accounting as primarily a way of helping us make decisions about the future, rather than simply keeping track of what happened in the past.

If this is what accounting is for, what does that imply for the present nature of accounting? Well, for one thing, it means that accounting is not just a matter of recording data, or even of processing them in an organised way. It is both these things, but an increasingly large part of accounting is concerned with subsequently presenting the resultant information to those who are interested in the welfare of the organisation. The next section looks in more detail at the consequent nature of today's accounting.

Types of accounting

Accounting can be divided very roughly into two areas, financial accounting and management accounting. Bear in mind that the division is a rather arbitrary one, and many functions in the accountancy world spread across both areas. Nevertheless, it is a distinction that is often made, and which can help to make accountancy as a whole more manageable.

Financial accounting is concerned with the recording, processing and presentation of economic information after the event to those people outside the organisation who are interested in it. By contrast, management accounting deals with similar activities, but is geared to providing information about the organisation to its managers to help them run it. In other words, the heart of the distinction is the *purpose* of the accounting, rather than what is done. This may become clearer if we look at each of the three functions of recording, processing and presentation.

Recording

All accounting requires the prior collection of raw data and their organisation into some form of structured record. In principle, this could be as crude as writing down each transaction in a single book, as it occurs. It should be obvious, however, that it would not be easy to get information out of this book. You may be aware that, in fact, almost all accounting systems across the world rely on 'double entry' **recording** in some form. This method has been so successful over the past 500 years since it was codified precisely because it is relatively easy to get information out of it. In Chapter 5 you will start to learn about this system.

Before we can start on the practicalities of recording data, however, there remains one major question to be answered.

Activity 1.3 What sorts of transaction does an accountant record? Note down at least four.

Answer There are many kinds of transactions, and you may have noted others than those listed below, or expressed similar items in different ways.

1. Sales made.
2. Money received for the sales – remember that you don't always get paid as soon as you sell something.
3. Production materials bought.
4. Expenses incurred, for example electricity used.
5. Production materials and expenses paid for – again, we don't always pay for something as soon as we buy it.
6. Borrowing money from the bank.
7. Persuading other people to put money into our organisation.
8. Buying big items that we intend to keep, such as buildings or machinery.

Note that what accountants therefore record is almost always restricted to what can be valued reasonably objectively in money terms. In other words, if you can't attach a currency symbol, such as a £ sign, to it, accountants ignore it. Furthermore, accountants tend to focus on the organisation, rather than taking a broader societal view.

Activity 1.4 List three things about an organisation that accountants might not record, but which you would regard as useful things to be told about.

Answer As with most of the questions raised in this chapter, there is no single, correct answer. Some of the things we consider to be currently important are:

1. The value added to the economy by the activities of the organisation.
2. The measurement and inclusion of human resources. Some football clubs, for example, include a valuation of their players in their statement of financial position (balance sheet), that is, the summary of what the organisation owns and owes. Others claim that it is impossible to say objectively what a player is worth, and so omit them from the statement of financial position. Which approach do you think gives the best picture of what the organisation owns? We think this area of accounting is one of the more interesting ones, and it is dealt with more fully in the next chapter and in Chapter 13.
3. Environmental accounting, which tries to report the impact of the organisation on the environment, perhaps in terms of tonnes of pollutants emitted, compared with previous years, other similar organisations, or standards of some sort.
4. Social accounting, which provides information about the social impact of the organisation. This could include looking at, say, the employment of minority groups, or the effect of purchasing policies, especially where supplies come from the Third World. In the UK, The Body Shop plc is one of the more notable companies already moving down this road.

The above possibilities are not part of generally accepted accounting practice at the moment. However, there are signs that this is changing. Ethical investment is a growing force in the UK, with around £9 billion invested by investment funds which claim some ethical basis. An organisation trying to attract such investment could find that providing some of the information suggested above could help. Against this, there is a view that organisations in the UK, especially limited companies, already have to provide so much information that the costs of doing so prevent them from concentrating on their core business. All we can do here is note that accounting is constantly changing, and that there are signs that it is moving towards some of the issues indicated above. This is discussed in more detail under 'The future of financial accounting' later in this chapter.

Chapter 5 will start to explore exactly how organisations record data and turn them into useful financial statements of various sorts. For the moment all we need to consider is what data should be recorded and why. To consolidate your knowledge so far, try putting a tick in the correct box in the table shown in Activity 1.5.

Activity 1.5 In conventional accounting, which of the events listed in the table would usually be recorded and which would be ignored?

	Recorded	*Ignored*
1 Selling one of the organisation's cars		
2 Paying the wages		
3 Making the tea		
4 Moving staff between jobs in the office		
5 Incurring a fine for polluting a local river		
6 Paying the fine		

Answer You should have ticked the 'recorded' column for items 1, 2, 5 and 6, since all these result in objectively measurable resources coming into or leaving the organisation. On the other hand, items 3 and 4 do not change the economic relationship with the outside world, and would therefore not be recorded in a financial accounting system. You should therefore have ticked the 'ignored' column for these two.

You might expect the law to specify what records are required. In fact, in the UK the Companies Act is quite vague about exactly what records need be kept, and say only that they should be 'sufficient to show and explain' the transactions and consequent position of the company. This means that the records differ between companies, each organising the recording as it thinks best. It need not be like this. In France, for example, the *plan comptable*, that is, the government's accounting plan, specifies exactly which ledger accounts must be kept, and exactly what can and can't be recorded in each. Ledger accounts are explained in Chapter 5.

Activity 1.6 Which approach, the UK or the French, do you think is better? Why?

Answer As usual, the answer depends on what you think accounting is for. The UK system has the benefit of flexibility, in that it allows each organisation to set up an accounting system that best suits its own circumstances and needs. If we are aiming to present information for users to make decisions about that organisation, then gearing the system to the peculiarities of the organisation is most likely to result in relevant information.

On the other hand, allowing each organisation to design a different system is unlikely to result in information that is comparably prepared and presented between organisations. Despite rules set down by the Companies Acts and by the IASB in accounting standards, lack of comparability is a major problem in the UK. We leave it to you to judge whether state control of accounting would be politically and culturally acceptable in the UK. Nevertheless, as we've seen, it is becoming the case that UK accounting is increasingly subject to international accounting standards published by the International Accounting Standards Board. Ultimately, we get the accounting that reflects our society.