INTRODUCTION TO FINANCIAL ACCOUNTING

Andrew Thomas and Anne Marie Ward

Ninth Edition

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McGraw Hill Education

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Andrew Thomas & Anne Marie Ward

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For my husband Martin and our kids – Thomas, Anna, Mary, Séamus and Barry

Anne Marie Ward

Brief Table of Contents

THE FOLLOWING CHAPTERS ARE AVAILABLE ON THE ONLINE LEARNING CENTER WHICH CAN BE ACCESSED THROUGH OUR CONNECT PLATFORM.

Detailed Table of Contents

THE FOLLOWING CHAPTERS ARE AVAILABLE ON THE ONLINE LEARNING CENTER WHICH CAN BE ACCESSED THROUGH OUR CONNECT PLATFORM.

About the Authors

Andrew Thomas is a former Senior Lecturer in the Accounting and Finance Group at the University of Birmingham Business School, UK.

Dr Anne Marie Ward is a Professor of Accounting in the Department of Accounting, Finance and Economics at the Ulster University at Jordanstown, Northern Ireland. She is also a qualified Chartered Accountant.

Preface to Ninth Edition

What's new

New material and structural changes

- Overall, the structure of the book was reviewed with the chapter on accounting for inventory moving to Part 3 'Preparing Final Financial Statements for Sole Traders', the chapter on the manufacturing accounts updated and moved to the website and the chapters on the cash book and the petty cash book have been combined into one chapter after feedback from users.
- In Chapter 1 the discussion on the different forms of entity has been simplified and consolidated into a diagram, with explanation.
- Part 1 'The Framework of Accounting' has been updated to reflect the most recent guidance on standards and in particular the *Conceptual Framework for Financial Reporting* (2018). This highlights the importance of prudence for neutrality of information and also identifies the specific nature of the concept of materiality.
- Terminology has been aligned with the most recent terminology used by the IASB.

New pedagogical features

- Adopting lecturers and students stated that they found the real world examples beneficial. Therefore, many of the examples have been updated (replaced with more recent examples) and some new ones added. The real world examples highlight the link between the topic being covered academically and the real business world.
- Again in response to positive feedback obtained on the last edition, additional diagrams have been introduced to some chapters, particularly chapters that are quite narrative in nature. This pictorial presentation of information should help student learning by breaking up the text and providing another vehicle to highlight key points and connections between them.
- A simple example has been included in Chapter 25 to aid understanding.
- Several questions throughout the textbook have been rewritten and in particular, more difficult examples are included in Chapters 9, 10 and 13 after feedback from users.
- All references, key terms and learning objectives have also been updated as appropriate.

Aim of text

This book is primarily intended to be an introductory text for students taking a degree in accounting or business studies with a substantial element of accounting. Education in the UK and Europe has changed over the past two decades. Classrooms are no longer predominately filled with local students. The student body is international and will go on to seek employment internationally. Therefore to increase employability, most accounting departments teach accounting using international standards, called International Financial

Reporting Standards (IFRS). Therefore, this book is IFRS compliant, though also refers to UK terminology so that students are aware of the different accounting terms that are currently used in practice. Accounting regulation in the UK and Ireland is also outlined in Chapter 2.

The authors have tried to provide a textbook that deals with all the fundamental basic accounting techniques and practices required by the major accountancy bodies while at the same time going further to explain the reasons for accounting for transactions in a particular manner. The authors link the accounting techniques to the relevant International Financial Reporting Standard, the *Conceptual Framework* and real life examples where possible. In addition, in several of the chapters, the authors highlight how accounting can be used unethically, for example to smooth earnings. It is hoped that this deeper discussion will stimulate students to think strategically about the important influence that accounting can have on economic decision-making and hence society at large.

The book has been structured into six parts for ease of reference. The first part covers the conceptual framework of accounting as the authors feel that students should be exposed to the most important issues underlying accounting at the start. It is not expected that students who are only starting to learn accounting, or who have a low level of accounting knowledge, will understand every aspect of these chapters; however, reading the chapters will make students aware of the language of accounting, how accounting information is communicated by companies and the regulation of world accounting. Students are unlikely to comprehend in full the conceptual framework of accounting at the start of any accounting course, but understanding of the conceptual framework should start to become clearer as the student progresses through their accounting studies.

Knowledge of Part 2 ('Double-entry Bookkeeping') is required before Part 3 ('Preparing Final Financial Statements for Sole Traders') can be fully appreciated and this section needs to be studied before Part 4 on internal controls and incomplete records is taught. However, the parts from then on, 'Partnerships' (Part 5) and 'Companies' (Part 6) are stand-alone and can be approached in any order, so long as the first four parts have been studied.

The structure within each chapter also follows a deliberate pattern. These usually start by examining the purpose, theoretical foundation and practical relevance of the topic. This is followed by a description of the accounting methods and then a comprehensive example. A further unique feature of the book is that after most examples there is a series of notes. These are intended to explain the unfamiliar and more difficult aspects of the example in order that the reader is able to follow the example. The notes also provide guidance on further aspects of the topic that may be encountered in examination questions, such as alternative forms of wording.

Each chapter also contains a set of written review questions and numerical exercises designed by the authors to test whether the student has fulfilled the learning objectives set out in the chapter, as well as past questions from various examining bodies. The review questions and exercises are presented in a coherent progressive sequence designed to test understanding of terminology, legal requirements, theoretical foundations, etc. The exercises are categorized into three levels according to their level of difficulty. This is rather subjective for a book that focuses on the introductory level, but it is hoped that the following classification may be useful to students and lecturers:

- *Basic* questions are of a standard lower than those commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies' examinations and can usually be completed in a relatively short time (i.e. less than about 35 minutes).
- *Intermediate* questions are of a standard commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies' examinations and can usually be completed in about 35 minutes.
- *Advanced* questions are of a standard slightly higher than those commonly found in the first year of an undergraduate degree in accounting or the professional accountancy bodies' examinations, and/or more advanced in the depth of knowledge required to answer them, and can usually be completed in about 45 minutes.

All users, especially lecturers, should also be aware that some exercises are extensions of other exercises in previous chapters. This is intended to provide a more comprehensive understanding of the relationship between different topics in accounting, such as day books and cash books, and allowances for depreciation and irrecoverable receivables. Suggested solutions to some of the numerical exercises are included in Appendix 2 for student self-study. The answers to the rest of the numerical exercises are contained in a *Teachers' Solutions Manual* that is on the website for this book (page xxix).

Each chapter also includes learning objectives, learning activities, a summary, a list of key terms and concepts, and a real life example showing how a company is applying the topic or detailing a real life scenario. The learning objectives at the start of each chapter set out the abilities and skills that the student should be able to demonstrate after reading the chapter. Students should also refer back to these after reading each chapter. Similarly, students should satisfy themselves that they can explain the meaning of the key terms and concepts listed at the end of each chapter. The summaries provide a comprehensive but concise review of the contents of each chapter that students should find useful for revision purposes. The learning activities are mostly real-life activities of a project/case study type which require students to apply their knowledge to practical situations. They frequently necessitate students collecting publicly available data from actual companies, or their own financial affairs.

Anne Marie Ward and Andrew Thomas

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We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer bank have been prepared by us.

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I would like to thank a number of people who, directly or indirectly, helped or contributed to the text, including:

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The lecturers who adopt the text
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The Association of Chartered Certified Accountants (ACCA) and The Association of Accounting Technicians (AAT) for allowing us to reproduce copies of their questions in the text.

Guided Tour

Learning Objectives:

After reading this chapter you should be al

1. Describe the regulatory framework of
2. Describe the objectives and role of the
3. Explain the process adopted by the In preparing a new standard/revising an
4. Describe the UK regulatory framewor
5. Discuss the current activities of the In
6. Describe in brief the main elements of Standards that will be referred to in th

Learning Objectives

Each chapter opens with a set of learning objectives, summarizing what you should learn from each chapter.

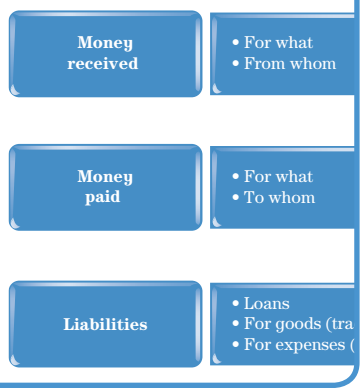
Key Terms and Concepts

These are highlighted throughout the chapter, with page number references at the end of each chapter so they can be found quickly and easily. A full glossary of definitions can be downloaded from the online learning centre.

Key terms and concepts

accounting policies	30
cash equivalents	30
comparative figures	30
Conceptual Framework for Financial Reporting	28
Contingent asset	31
contingent liability	31
depreciation	30
Discussion Paper (DP)	22
Exposure Draft (ED)	22
fair value	31

Figure 1.1



Figures and Tables

Figures and tables help you to visualize the various accounting documents, and to illustrate and summarize important concepts.

Learning Activities

These quick activities give opportunities to test your learning and practise accountancy methods throughout the book.

Learning Activity 6.3

Download and read the UK Corporate Govern
ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK
Then put the theoretical guidance into pract
information provides details of the board of di
company. This information is included in their f

Board of directors (20X9)	
Chairman and chief executive	R.A. Gilway
Finance director	Ms I.M. Smy
Production director	K.L. Mindfie
Other executive directors	S.R. Winery
	Lord Give
	G.H. Jazz

REAL WORLD EXAMPLE 2.1

Relationship between the FASB and the IASB

The Financial Accounting Standards Board an
have recently worked very closely together to h
recognition. However, though agreeing on som
meeting of minds on the recent standard that de
the standards in respect of accounting for credit

Though full convergence has not occurred, the
International Accounting Standards Board agree
consider that a common set of global standards
of financial statements across countries. Howev

Source: Accounting Today Website, https://www.acco
with-iasb-on-ifrs, accessed 9 December 2017. The full

Real World Examples

The chapters contain many and varied examples, including real-life accounting situations and mini case studies which bring accounting to life.

WORKED EXAMPLE 10.1

	E.
	Trial balance a
Name of account	
Bank	
Capital introduced	
Motor vehicles	
Motor expense	
Purchases	
A. Brown (trade payable)	
Sales revenue	
B. Green (trade receivable)	

Worked Examples

Examples of financial statements and worked problems will help you apply theory to practice.

Summary

Auditing is defined as an evaluation of an organi
by a competent, objective and independent p
The purpose of an audit of an entity's financial s
were completed according to approved and acc
An audit also usually evaluates the entity's con
continue to conform with these standards. Auditi
assertions. Auditing assertions are indications
prepared, applied in the correct period (cut-off
treated and disclosed in an understandable mar
applicable law.

According to ISA 200 (IFAC, 2018a), the objecti
auditors to give an opinion on whether the fi
respects, in accordance with an applicable fina
five main stages: client acceptance or retentio
risk and preparing a terms of engagement); aud

Summary

These briefly review and reinforce the main topics covered in each chapter to ensure you have acquired a solid understanding of the key topics.

Review Questions

These questions encourage you to review and apply the knowledge you have acquired from each chapter.

Review questions

International Framework

2.1* Describe the objectives of the Internatio

2.2 Discuss the current activities of the convergence/harmonization of account

2.3 Explain the role of the IFRS Interpretat

2.4 Explain the role and objectives of the IF

2.5 Describe the standard setting process f

Exercises

An asterisk after the question numbe

BASIC **10.3*** Close off the ledger accoun balances into the next perio *account* where appropriate.

BASIC **10.4*** Prepare a trial balance for W

BASIC **10.5*** Close off the T accounts and

BASIC **10.6*** Close off the T accounts and

BASIC **10.7** Close off the T accounts and

BASIC **10.8** Close off the T accounts and

BASIC **10.9** Close off the T accounts and

Exercises

This end-of-chapter feature is the perfect way to practise the techniques you have been taught and apply methodology to real-world situations. They are pitched at different levels to ensure all readers have questions appropriate to their stage of learning.

Case Studies Appendix

The Appendix contains case studies designed to test how well you can apply the main techniques learned.

Case study 1

The following case study shows how to track e
to the preparation of final financial statements
'Double-entry Bookkeeping', Part 3 'Preparing
Chapter 34, 'Value Added Tax, Columnar Books of

Trading details and supporting documenta

Mr O'Donnell, a sole trader, has owned and oper
He specializes in the purchase and sale of antiq
small number of reputable suppliers and reliable

You have been employed by Mr O'Donnell as a qu
his financial statements. Following discussions wi
you with all the necessary details, and after obt
established an opening trial balance at the start

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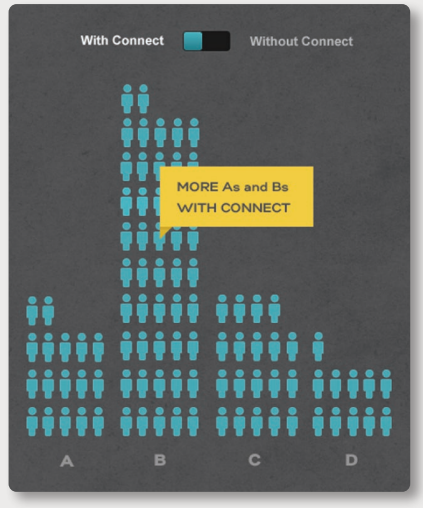

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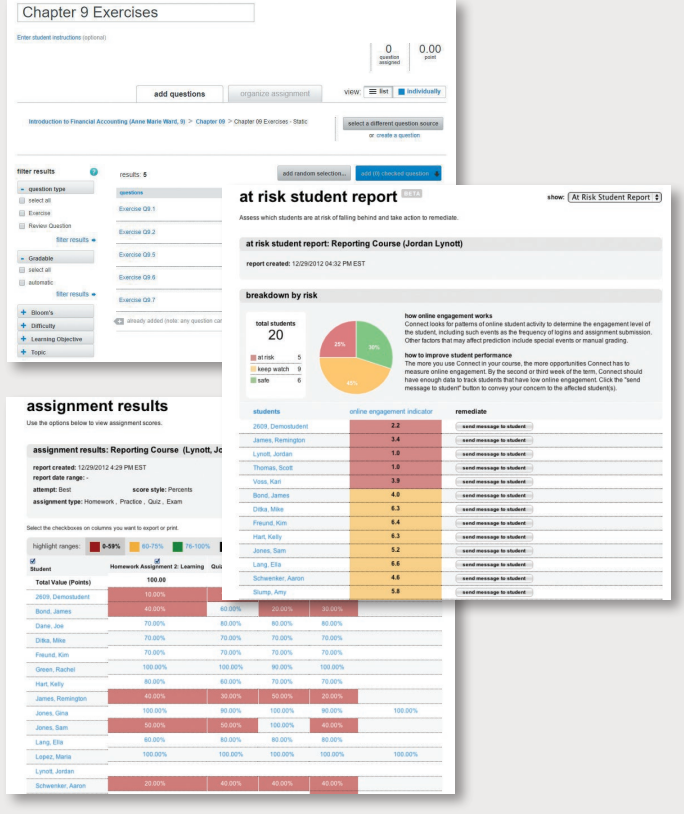

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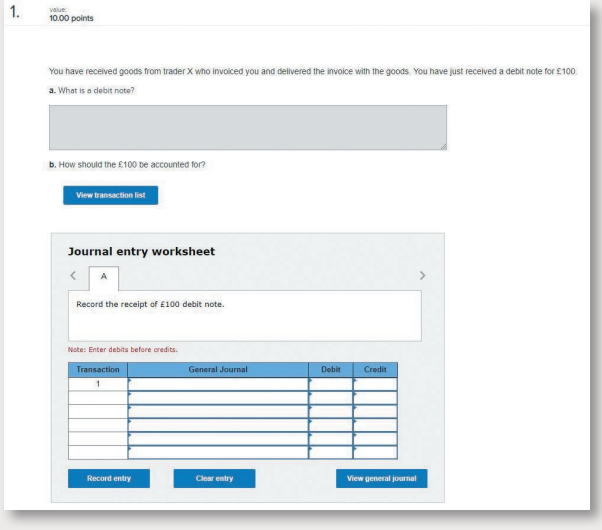

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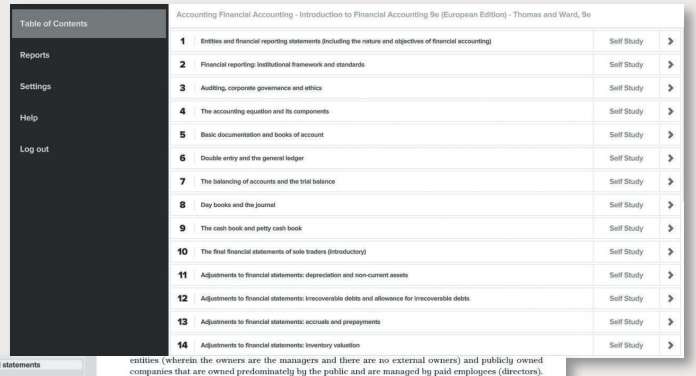

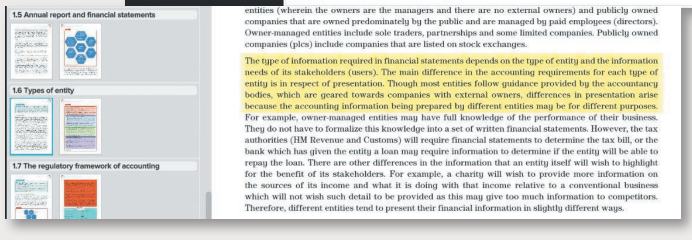

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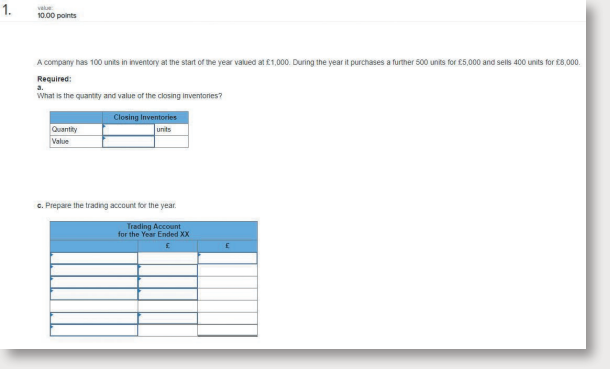
Is an online assignment and assessment solution that offers a number of powerful tools and features that make managing assignments easier, so faculty can spend more time teaching. With Connect Accounting, students can engage with their coursework anytime and anywhere, making the learning process more accessible and efficient.

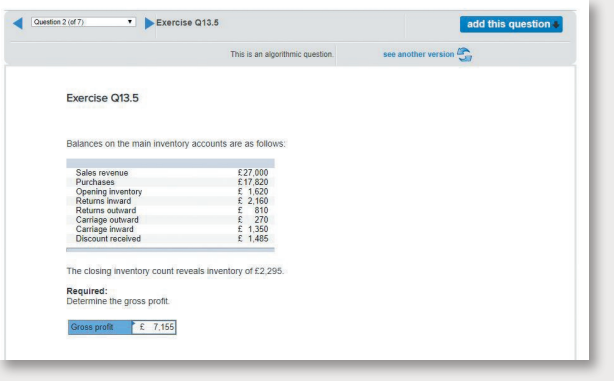
Calculation questions

Test students' mathematical understanding, allowing them additional practice and further opportunity to develop their problem solving skills. The questions are auto-graded so faculty can spend more time teaching. Exercises are presented in General Ledger format for the first time, challenging students to approach the problems as they would in a real accounting scenario.



Algorithmic problem sets

Provide repeated opportunities for students to practise and master concepts with multiple versions of each problem. Or use the algorithmic problems in class testing to provide each student with a different version than that seen by their peers.



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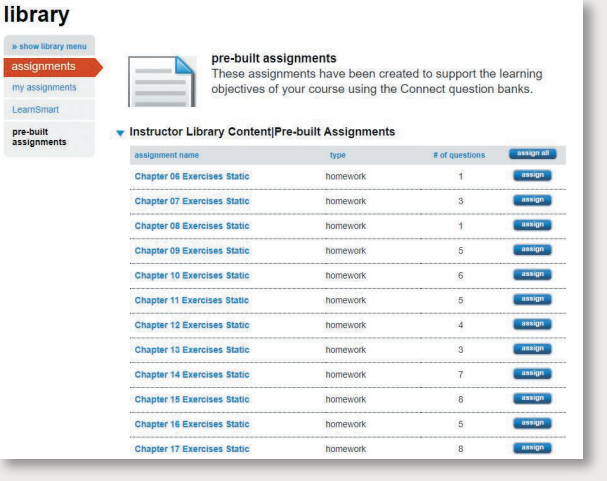
Assign all of the autogradable end of chapter material as a ready-made assignment with the simple click of a button.



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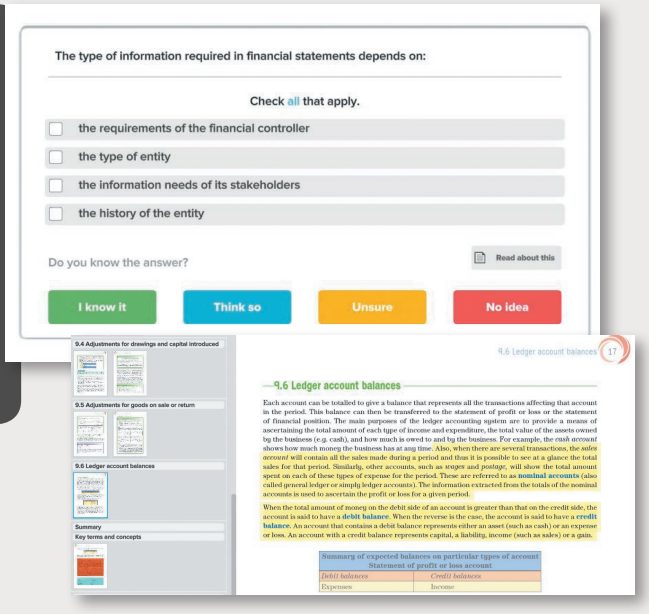

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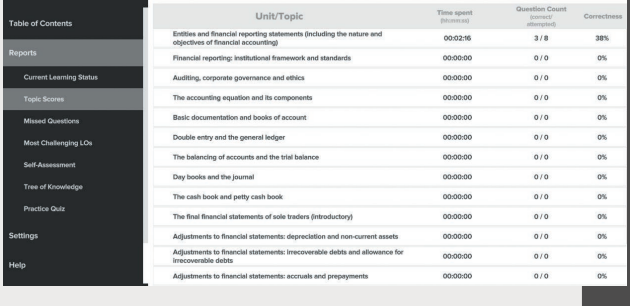

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PART ONE
The framework of accounting

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Chapter 1

Entities and financial reporting statements (including the nature and objectives of financial accounting)

Learning Objectives:

After reading this chapter you should be able to do the following:

1. Discuss the nature and functions of financial accounting.
2. Outline the differences between a company, a member-governed body, a sole trader and a partnership.
3. Describe the financial statements for sole traders, partnerships and companies.
4. List the typical contents of a company's published annual report.
5. Describe the main regulatory influences on financial reporting.

1.1 Introduction and history of accounting

Accounting is a necessity in every entity, regardless of type or size. It is so important that a full-time international body, the International Accounting Standards Board (IASB), representing accounting experts from several countries, exists to provide guidance on how to account for items and transactions and how to communicate (present) this information. This book is prepared using the most recent accounting guidance as produced by the IASB.

In its earliest form accounting involved keeping 'a count' of items. The first form of accounting was known as **stewardship accounting** as stewards were employed by wealthy individuals to keep 'a count' of items they owned (assets) and items they owed (liabilities). Evidence from archaeological digs would suggest that this form of accounting might be 7,000 years old. Stone tablets inscribed with hieroglyphic records of counts of assets were uncovered in Egypt and are considered to be evidence of stewardship accounting. The type of information collected under this ancient form of accounting is still important today and is captured in one of the key statements provided in an entity's **annual report** – the **statement of financial position**. This statement is referred to as the '**balance sheet**' under UK accounting. It provides information on what the entity owns (assets) and what the entity owes (liabilities). The difference represents 'equity capital' being the amount that the company owes the owners, or to consider it another way, it is the amount the owners have invested in the company either directly or indirectly.

The industrial revolution advanced the role and nature of accounting. For the first time the general public were able to purchase shares in companies. Before this time, most company managers were the company's owners. Accounting was more for internal control purposes. After the separation of ownership and control, accounting had to progress to provide information to people who were external to the company and who had little knowledge of what went on in the company. To help the external owners assess the performance of a company and the performance of management, legislation at this time required that companies provided their owners with statements of financial position and also required that they provide a statement detailing the performance of the company in the period. This statement is now called the **statement of profit or loss** or the **statement of comprehensive income**. In the UK this statement is also called the profit and loss account. This statement outlines the income for the period and the expenses incurred in the period. The difference between income and expenses is **profit or loss for the period**. The requirement to produce the two statements is generally regarded as the start of financial accounting as we now know it. When the two statements are published together with other related information, the combined document is called the annual report. In some instances a third statement is required, called the **statement of cash flows**. This statement shows an entity's **financial adaptability**. An entity's financial adaptability is its ability to take effective action to alter the amount and timing of its cash flows so that it can respond to unexpected needs or opportunities.

Accounting is typically categorized into either financial accounting or management accounting. **Financial accounting** is concerned with the preparation of reports for external stakeholders and **management accounting** is concerned with the preparation of reports for internal management purposes. The role of the accountant has extended beyond recording transactions – accountants today have to have strong business acumen, to be good communicators, to provide advice and guidance to companies and people, to have an awareness of influences on a business and to predict the consequences of external changes in the economic environment on a business. They need to be able to provide consultancy services and general business advice, not just prepare **financial statements**. For example, accountants are typically used as expert witnesses in court cases when divorce matters are being settled or where there is a fraud case.

1.2 The nature and functions of financial accounting

Financial accounting keeps a record of a company's financial transactions. Its first function is the design and operation of an information system for collecting, measuring and recording an enterprise's transactions. The second function is summarizing and communicating the results of these transactions to users to facilitate making financial/economic decisions.

The first function, the collection and recording of transactions, refers to the accounting system within an organization. This is typically called a **bookkeeping system**, which consists of maintaining a record of the nature and monetary value of the transactions of an organization usually in books of account. In many businesses these records are maintained on computer systems. The second function, relating to communicating the results, refers to preparing final financial statements from the books of account (or any other system of recording) showing the profit earned during a given period (statement of profit or loss) and the financial position at the end of that period (statement of financial position). The two functions of financial accounting may be broken down further as described below.

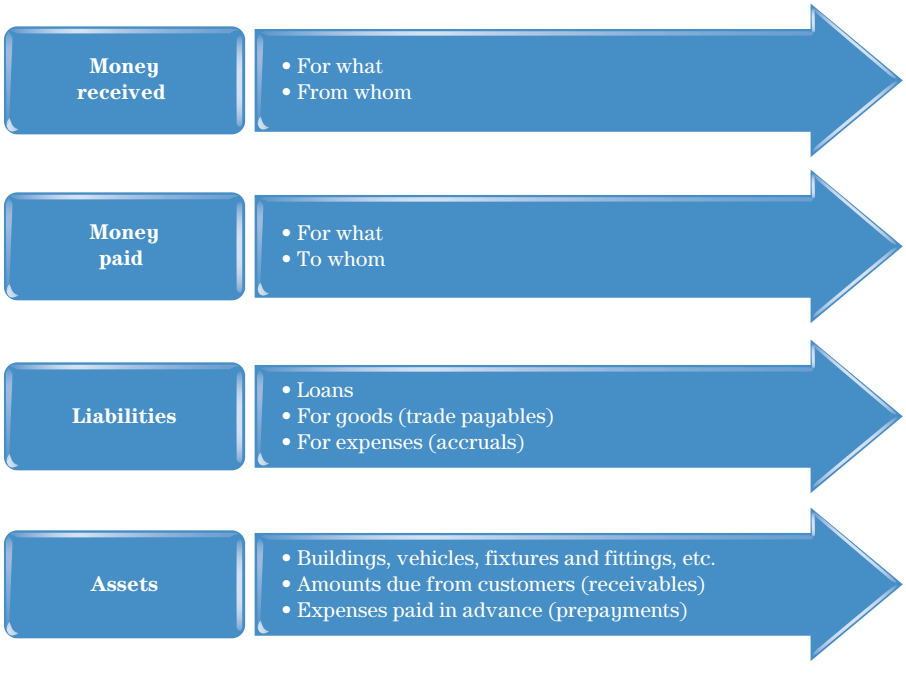
1.3 The objectives of an appropriate accounting system

The recording and control of business transactions

Accounting systems need to keep a record of the cash in and out of the business and the assets and liabilities of the business as detailed in Figure 1.1.

The owners of a business wish to safeguard their assets and to ensure that they are being utilized efficiently to produce wealth. An appropriate accounting system should have controls in place to protect business assets and to determine how the company is performing. The control aspect of an accounting system includes ensuring that the correct amounts are paid to those entitled to them at the appropriate time, to ensure that the business's debts are paid when due, and to ensure that assets are safeguarded against fraud and misappropriation. For example, an appropriate accounting system will have an up-to-date list of all non-current assets (buildings, etc.), including their location and state of condition. These will be inspected periodically to verify that they have not been misappropriated. The latter function is often referred to as **internal control**. Control is considered further in Chapter 6, 'Auditing, Corporate Governance and Ethics'.

Figure 1.1



Accounting systems should keep a record of the following:

To maintain accuracy in recording

Transactions are usually recorded using 'double entry'. **Double-entry bookkeeping** is generally regarded as the most accurate method of bookkeeping, primarily because each transaction is entered in the books twice. This duplication, considered to be a form of **internal check**, highlights any errors.

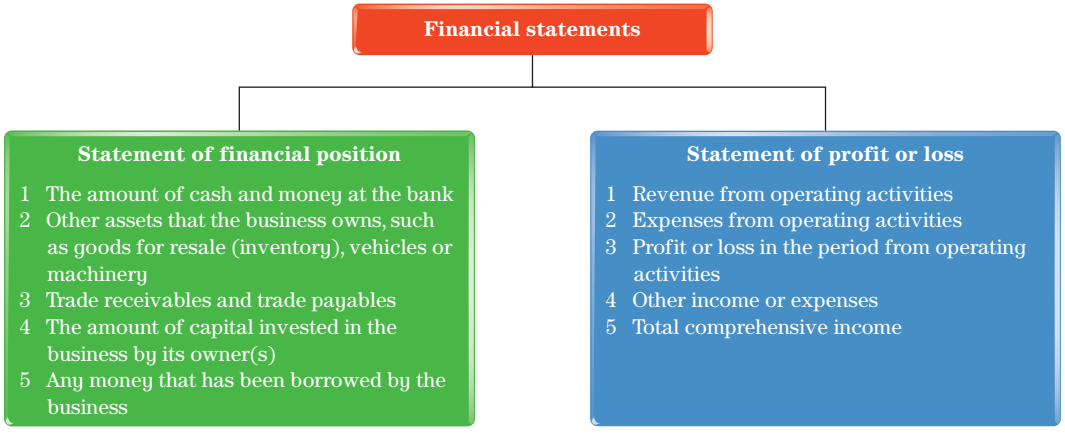
To meet the requirements of the law

The law, in the form of the Companies Act 2006, states that companies must keep a proper record of their transactions. There is no legislation that specifically requires sole traders or partnerships to keep records of their transactions. However, HM Revenue and Customs expects financial statements to be prepared and proper accounting records to be kept for the purpose of determining the proprietor's income tax liability. In addition, any trader who does not keep proper records and goes bankrupt will find it more difficult to obtain discharge from bankruptcy.

To present final financial statements to the owners of the business

In summary, the financial statements will include the items detailed in Figure 1.2.

Figure 1.2



Summary of information that is included in the financial statements

The **stewardship objective** is one of the objectives of current day financial statements. It states that financial statements should provide information that is useful for assessing management's stewardship function. Stewardship accounting is the accountability of an enterprise's management for the resources entrusted to them. **Accountability** refers to management's responsibility to provide an account/report on the way in which the resources entrusted to them have been used.

To present other financial reports and analyses

Financial statements are contained within an annual report. This includes other reports which provide a vehicle for the management team (directors) to communicate directly with stakeholders, for example, the operating and financial review, the directors' report, the chairman's statement, the remuneration report and the corporate social responsibility report. Summary analysis of the performance and financial

standing of the business are usually provided in these other reports. They typically include the use of ratio analysis. Ratio analysis is examined in detail in Chapter 29, 'The Appraisal of Company Financial Statements Using Ratio Analysis'.

To facilitate the efficient allocation of resources

Accounting also facilitates the efficient and effective allocation of resources (**economic decision-making**). The information in annual reports may assist investors in determining the companies that are efficient in the utilization of resources and which entities are not. More efficient firms will attract investment and hence will expand by more than less efficient firms. The result will be beneficial for the economy and the population as a whole.

Employees can also make informed judgements about company efficiency and sustainability from annual reports and are likely to seek employment from more efficient firms. The same interpretation could also be extended to other stakeholders such as bank lenders, payables/suppliers, the government and the public in general. Therefore, everyone will be more interested in more efficient entities.

This function of accounting can also be viewed at individual firm level. One of the main purposes of accounting is to enable an organization's management to operate the organization efficiently and effectively. This 'internal' function of accounting is more commonly attributed to management accounting, particularly in larger organizations. Management accounting can be defined as the provision of information to an organization's management for the purposes of planning, control and decision-making. The latter includes production, marketing, investment and financing decisions. For example, by viewing financial information about internal departments or products, management can direct resources to those that are more profitable and may even close down those that are not providing appropriate returns. This will improve the performance of the entity overall.

Learning Activity 1.1

Imagine that you are in business in a small general store or as a plumber. Prepare a list of the financial information about the business that you would expect to be able to obtain from your records. Compare this with the items noted in Figure 1.2 and consider any differences.

1.4 Accounting language

Accounting has its own language and differences arise in the terminology used at national and international level. The key terms used in financial reports are now outlined in brief.

Statement of profit or loss terminology

Profit or loss is the total income made by the entity in the period less the total expenses incurred by the entity in the period. **Income** is defined in the *Conceptual Framework* (IASB, 2018) as 'increases in assets or decreases in liabilities that result in increases in equity, other than those relating to contributions from holders of equity claims'. Revenue is income. **Revenue** is defined in *IFRS 18 Revenue* as the gross inflow of economic benefits arising from ordinary operating activities of an entity such as the sale of goods if a retailer, the sale of motor vehicles if a car dealership, or interest and fee income if a bank. When an entity has income from activities that are not its core business, such as a retailer receiving interest on its deposit account, then this is disclosed separately as '**other income**'. This is so the reader of the financial information can gauge management's performance in generating income from the business separately from income from investing activities. In simple terms, **expenses** are yearly running costs.

Expenses are defined by the *Conceptual Framework* (IASB, 2018) as 'decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims'. Examples include staff wages, electricity used to generate heat and light for the business and rent of the business premises for the period. Information on expenses can enable the reader of the statement of profit or loss to determine how well management are utilizing the entity's resources and how risky an entity's profits are.

Statement of financial position terminology

Assets

An **asset** is 'a present economic resource controlled by the entity as a result of past events' (IASB, 2018). An **economic resource** is 'a right that has the potential to produce economic benefits' (IASB, 2018). 'Control' is the ability to restrict the use of the asset. For example, cash can be locked in a safe or put into the entity's bank account, whereas a skilled employee, though able to generate future economic benefits, can leave at any time. Four categories of asset are detailed in Figure 1.3.

Figure 1.3

Tangible assets

- Referred to as **property, plant and equipment.**
- Can be seen and touched (they are tangible in nature); for example, a car, a house or a desk.

Intangible assets

- Cannot be seen or touched but have value.
- For example, new software that has just been developed or employee skill built up that means the tasks are completed more efficiently and new ideas generated.

Available-for-sale assets

- Investments that are denominated in money, or in paper.
- For example, shares and bonds that the entity holds for financial gain and which will be sold by the entity in the future.

Investments in associates

- Investments in paper shares.
- The intention is to retain this investment as part of the entity's normal activities.

The four types of asset commonly found in businesses

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Assets are typically presented in the financial statements according to the length of time an entity expects to hold on to the asset. Cash and cash equivalents that are expected to be turned into cash within 12 months, other assets that are expected to be turned into cash within 12 months and all assets that are intended for sale or consumption as part of the entity's normal operating (trading) activities of the business are called **current assets**. Other assets are called **non-current assets**. They typically are held for periods that extend beyond one year and include tangible, intangible and long-term financial assets.

Inventory (stock) is the name for goods that have been purchased as part of the operating activities for resale but are not yet sold. They are current assets. A **trade receivable** (debtor) is the term given to the money that is owed from a customer, where the goods were given to the customer in advance of the entity receiving money for the goods.

Liabilities

A **liability** is 'a present obligation of the entity to transfer an economic resource as a result of past events' (IASB, 2018). In simple terms it represents amounts owed by the entity. For example, a loan from a bank is a liability because at some point in the future the entity has to pay this back. A **trade payable** (creditor) is the term given to the money that is owed to a supplier who provides trade goods on credit (without up front payment). Liabilities that are due to be settled within 12 months or that are incurred as part of the firm's normal operating (trading) activities are called **current liabilities**. Other liabilities are called **non-current liabilities**. Non-current liabilities are typically due in periods that extend beyond one year, but not always.

Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities. **Equity shareholders** are usually used in reference to limited companies to refer to the shareholders who own ordinary shares.

1.5 Annual report and financial statements

As mentioned in the introduction, all entities have to produce a document periodically (usually yearly), which details what has been made in the period (profit or loss) and the entity's financial position. The most up-to-date guidance on how to present company financial statements is provided in International Accounting Standard 1 *Presentation of Financial Statements* (IAS 1). This accounting standard recommends that accounting information is provided in a number of short financial statements. These statements are included in an annual report with supporting notes. The typical contents of an annual report are detailed in Figure 1.4.

The first financial statement provides details on the profits/losses made by the entity in the period. The information can either be presented in a single statement called the statement of profit or loss and other comprehensive income, which shows the profits or losses for the period from realized activities in the first section followed by a section providing information on **other comprehensive income** (typically unrealized gains/losses). The final line on this statement shows the total comprehensive income for the period. The second alternative splits the information into two consecutive statements the first of which is called the statement of profit or loss and the second the **statement of other comprehensive income**. An example format is provided in Figure 27.1 in Chapter 27 'The Final Financial Statements of Limited Companies'. The second financial statement provides an aggregated list of the entity's assets, liabilities and equity at the reporting date. This statement is called the statement of financial position. A **statement of changes in equity** is also required to show the changes in equity, such as dividends paid to owners,

Figure 1.4

Typical contents of an annual report

or new share issues. The fourth financial statement, the **statement of cash flows**, shows the source and use of cash in the period. As all the financial information about an entity is summarized in the four statements, which usually do not extend beyond one page each, more detail is provided in the **notes to the financial statements**. In practice, prior year figures called **comparatives** are provided for each financial statement. The annual report also contains reports from management telling the owners what they are doing and what they plan to do. Some of the reports included are listed in Figure 1.4. These reports typically highlight key information about the company and outline the principal risks that the company faces. A public limited company's annual report typically extends to over 100 pages.

Learning Activity 1.2

Visit the Ryanair plc website and view a copy of their most recent annual report. Familiarize yourself with the reports provided by the directors at the front of the annual report. Note how long this part of the annual report is. The latter part of the annual report contains the income statement, a separate statement of comprehensive income, the balance sheet (as mentioned, IAS 1 prefers to label this the statement of financial position but many UK and Irish companies elect to maintain the national terminology for this statement), the statement of cash flows and the notes to the financial statements for the Group and separately for the company.

1.6 Types of entity

Changes in accounting practices and disclosures usually arise from the need to provide quality financial information that is regarded as useful for the external stakeholders of an entity. The stakeholders are discussed in detail in Chapter 3, 'The Conceptual Framework 1: Objective of Financial Statements, Stakeholders and Other Reports'. They include the owners of the company, investors, creditors, employees, customers, the government and the public. There are several types of entity, for example owner-managed entities (wherein the owners are the managers and there are no external owners) and publicly owned companies that are owned predominately by the public and are managed by paid employees (directors). Owner-managed entities include sole traders, partnerships and some limited companies. Publicly owned companies (plcs) include companies that are listed on stock exchanges.

The type of information required in financial statements depends on the type of entity and the information needs of its stakeholders (users). The main difference in the accounting requirements for each type of entity is in respect of presentation. Though most entities follow guidance provided by the accountancy bodies, which are geared towards companies with external owners, differences in presentation arise because the accounting information being prepared by different entities may be for different purposes. For example, owner-managed entities may have full knowledge of the performance of their business. They do not have to formalize this knowledge into a set of written financial statements. However, the tax authorities (HM Revenue and Customs) will require financial statements to determine the tax bill, or the bank which has given the entity a loan may require information to determine if the entity will be able to repay the loan. There are other differences in the information that an entity itself will wish to highlight for the benefit of its stakeholders. For example, a charity will wish to provide more information on the sources of its income and what it is doing with that income relative to a conventional business which will not wish such detail to be provided as this may give too much information to competitors. Therefore, different entities tend to present their financial information in slightly different ways.

The characteristics of four different types of business entity (sole traders, partnerships, member-governed bodies and companies) are outlined briefly in Figure 1.5.

As shown in Figure 1.5 each type of business entity has a different ownership structure ranging from a single owner in sole trader businesses to multiple owners in companies. There are differences in legal status also across the entity types – when incorporated, the business entity is considered to be a separate legal person responsible for its own debts and taxation. When unincorporated, the law regards the business entity and the owners as the same legal person, hence the owner is responsible for the debts (and tax). Though there are many similarities in the information that has to be provided by all business entities, the different ownership structure, legal status and tax positions means that some differences do arise. For example, only companies pay dividends – these are distributions of profits to shareholders. In addition, there are some differences in the way accounting information is presented, with presentation dictated by law in the case of companies but being less prescriptive in sole traders or partnerships. The differences in accounting across the business entities are covered in this textbook.

Figure 1.5

Sole trader business

- When one individual owns and operates a business.
- The business is **unincorporated**, which means the business is not seen as legally separate from the individual. Therefore, the individual is responsible for the debts of the business.
- Creditors have a claim over the individual's personal assets if the business cannot pay.
- Business profits are deemed to be the individual's and are subject to **income tax**.
- The tax expense is the individual's not the business's.
- Financial statements are required for taxation purposes, therefore, quite a bit of detail is provided on expenses as this information is required to complete the **self-assessment tax return**.
- When the individual invests in the business it is called 'capital introduced' and when the individual removes cash/assets from the business they are called drawings.

Partnership business

- When the business is run and owned by two or more individuals.
- Can be unincorporated or incorporated as separate legal entities.
  - If unincorporated then the partners are jointly responsible for the debts of the business and creditors have claim over their personal assets if the business cannot pay.
  - If incorporated the partnership is considered to be a separate legal entity and is called a company. In this instance the partners have limited liability. This means creditors can only get access to the funds the partner has invested in the business, not their personal assets.
- Financial statements are prepared for taxation purposes and also to determine the amount of profit that can be withdrawn by each partner from the business.
- The financial statements include a statement, the **appropriation account**, dealing with the equitable distribution of profits between the partners.
- The profits are split between the partners who are taxed individually on their portion of the profits. The business does not incur taxation, the partners do.

Member-governed bodies

- Businesses that are run by the members for the benefit of the members.
- Some are **unincorporated**, therefore are not separate legal entities. In these instances the members are responsible for the debts of the business.
- Others are incorporated as companies to protect the members. Their liability can be limited to the amount invested by the member to obtain their owner's share or liability can be limited by guarantee.
- When limited by guarantee, the company has no shares or shareholders but the members agree to pay a fixed sum towards the debts of the company in the event of the company being unable to do so. The sums are usually small.
- The tax treatment of these businesses is unique, many are tax exempt and others are partially exempt.
- Some member-governed bodies are large and subject to their own legislation, for example mutual building societies, sports clubs and life assurance companies.

Companies

- Are incorporated by law as separate legal entities.
- Own their own assets and can take action on their own behalf.
- Are responsible for the tax on any profits made. The tax is called **corporation tax**.
- Are either **public limited companies** (PLCs) or **private limited companies** (Ltds).
- Under law companies have to use the abbreviation plc or ltd in their name so **stakeholders** (interested parties) are aware of their status.
- Ownership is assigned by allocating shares.
- In plc companies the shares are sold on public stock exchanges such as the London Stock Exchange. These are called **listed companies**.
- In ltd companies the shares are privately held, they are called private companies. Their shares are not publicly sold on stock exchanges.
- The owners of shares are called shareholders, or equity shareholders.
- Equity shareholders have **limited liability** for the company's debts, the shareholders will only lose the value of their shares. Hence their liability is limited to the amount invested in the company when buying the shares.

Types of entity

Learning Activity 1.3

This activity has three tasks.

1. List the type of financial information that you should include in a set of financial statements for each of the different types of business entity.
2. Prepare a list of stakeholders (interested parties) that would be interested in finding out financial information about the business entity.
3. Will the financial information that you identified in 1 satisfy the information needs of the stakeholders you listed in 2? If not, what other financial information should be included?

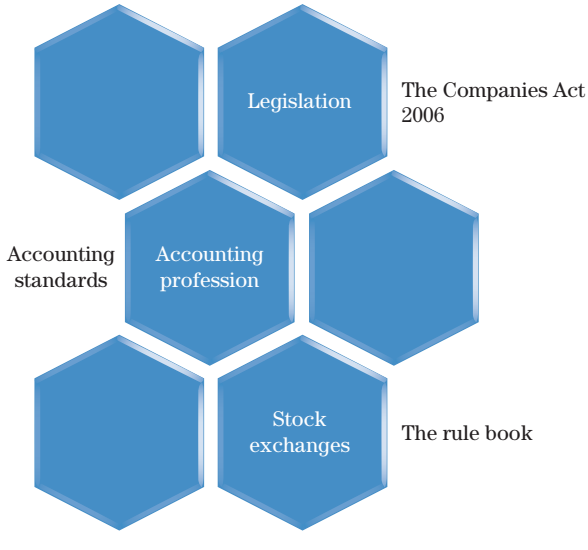
Stakeholders are considered in Chapter 3 and typical financial information to be included in a set of financial statements is included in Chapter 13.

1.7 The regulatory framework of accounting

The **regulatory framework of accounting** is a general term used to describe the legislation and other rules that govern the content and format of company financial statements. There is no legislation covering the financial statements of sole traders and partnerships. However, it is generally accepted that their financial statements should closely follow the rules and regulations relating to companies since these are regarded as 'best practice'. The main sources of regulation are presented in Figure 1.6.

Companies prepare financial statements under either International Financial Reporting Standards (IFRSs) or UK Financial Reporting Standards (FRSs). The regulatory framework for setting IFRS is described in Chapter 2, 'Financial Reporting: Institutional Framework and Standards'. IFRSs are compulsory for all publicly listed companies though can be adopted by all other types of entity also. UK FRSs cannot be applied by publicly listed companies though can be used for all other entities. In practice, the financial statements of unincorporated entities (e.g. sole traders and partnerships) are prepared using FRSs.

Figure 1.6



Sources of company regulation

Summary

Financial accounting is the process of designing and operating an information system for collecting, measuring and recording business transactions, and summarizing and communicating the results of these transactions to users to facilitate the making of financial/economic decisions. The first part of this definition, relating to collecting and recording business transactions, is called double-entry bookkeeping. The purposes of financial accounting systems are to record and control business transactions, maintain accuracy in recording, meet the requirements of the law, present final financial statements and other financial reports to the owners of the enterprise, and facilitate the efficient allocation of resources.

Financial accounting emerged from demand for quality financial information about an entity's financial performance and financial position by stakeholders who are external to the entity. To provide information on performance, a statement of comprehensive income has evolved showing profit or loss from normal activities, other types of gains and the total comprehensive income (the sum of both these figures) for the period. To provide information on the state of a company's affairs, the statement of financial position has evolved. It shows the total assets of the entity split into non-current and current categories. The bottom half of the statement of financial position shows how the entity is financed. The amount of the owner's equity invested and the liabilities (split into non-current and current) are disclosed. The sum of the equity and liabilities should equal the total assets (it should balance).

In this chapter, outline information on the ownership structure, legal status and responsibility for debt and taxation is provided for sole traders, partnerships, member-governed bodies and companies. More detailed information on the accounting requirements of each of these types of business entity is provided in separate chapters of this book and its accompanying website.

Finally, the contents of company financial statements are governed by a regulatory framework. In the UK this comprises the Companies Act 2006, London Stock Exchange regulations, and accounting standards as issued by the national and international accountancy bodies.

Key terms and concepts

An asterisk after the question number indicates that there is a suggested answer in Appendix 2.

Review questions

connect

1.1* Explain the nature and functions of financial accounting.

1.2 List the typical contents of an annual report for a public limited company.

1.3 Outline the differences between sole traders and partnerships.

1.4 Outline the differences between sole traders and companies.

1.5* **a.** Describe the recording and control function of financial accounting.

b. Explain the role of financial accounting with regard to the presentation of final financial statements.

Exercises

connect

1.6* In which statement will the following appear, and under which heading will it be included? BASIC

a. Furniture and fixtures;

b. Rent;

c. Wages;

d. Amounts owing to a supplier;

e. Amounts due from a customer.

BASIC **1.7** Why are financial statements prepared by companies?

BASIC **1.8** What do you think is the objective of financial statements?

BASIC **1.9** Who do you think the stakeholders (users) of financial statement might be?

BASIC **1.10*** Explain briefly each of the following: internal control; internal check; stewardship accounting; and accountability.

References

International Accounting Standards Board (2014) *International Accounting Standard 1 – Presentation of Financial Statements* (IASB).

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

Chapter 2

Financial reporting: institutional framework and standards

Learning Objectives:

After reading this chapter you should be able to do the following:

1. Describe the regulatory framework of international accounting.
2. Describe the objectives and role of the International Accounting Standards Board.
3. Explain the process adopted by the International Accounting Standards Board when preparing a new standard/revising an existing standard.
4. Describe the UK regulatory framework of accounting.
5. Discuss the current activities of the International Accounting Standards Board.
6. Describe in brief the main elements of each of the International Financial Reporting Standards that will be referred to in this book.

2.1 Introduction

Accounting is not meant to be creative. It is meant to portray the economic substance of a transaction. This is not always as easy as it may seem. For example, in some instances it may be difficult to determine whether a transaction actually results in an asset. In other instances it is difficult to determine whether a liability should be created or not. Not all transactions are straightforward and there are incentives to account in a manner which best serves management (who are in charge of accounting). Guidance on how to account is required to protect stakeholders (users of accounting information) and to provide information that is useful for their economic decision-making.

Most countries have professional bodies or government departments that either provide national guidance on how to account for transactions or have adopted global accounting standards. The advantages and disadvantages of global accounting standards are summarized in Figure 2.1.

Global financial reporting standards are prepared by the **International Accounting Standards Board (IASB)** The IASB is a worldwide umbrella accounting standards board which aims to issue one set of accounting standards which are agreed upon and adopted in every country in the world. By 2018,

Figure 2.1

Advantages	Disadvantages
• Having global financial reporting standards improves comparability of financial statements across countries • Global financial reporting standards provide a global business language which should lead to improvements in business communication • Businesses can more easily raise funds in other countries as their financial statements will be recognized by stock markets in the respective countries • Preparation of group accounts is simpler and less costly • Global financial reporting standards should lead to improved global decision-making that may lead to improved global growth • Global financial reporting standards should lead to increased levels of global investment as investors will be familiar with the financial statements • Having global financial reporting standards reduces the cost of an entity starting a business in another country • When a country does not have the resources to create their own national framework, global financial reporting standards provide a high quality 'off-the-shelf' alternative • The use of global financial reporting standards provides legitimacy to businesses in countries that do not have their own financial reporting frameworks	• Using global financial reporting standards is argued to be a threat to national identity • The treatments recommended within global financial reporting standards may not reflect national culture • Global financial reporting standards may not be flexible enough to deal with unique transactions that are country specific • It is costly for entities to change from national financial reporting standards to global financial reporting standards • Global financial reporting standards are deemed to be inappropriate for small and medium-sized entities (this is one of the reasons that the UK did not fully converge with global standards)

The advantages and disadvantages of global financial reporting standards

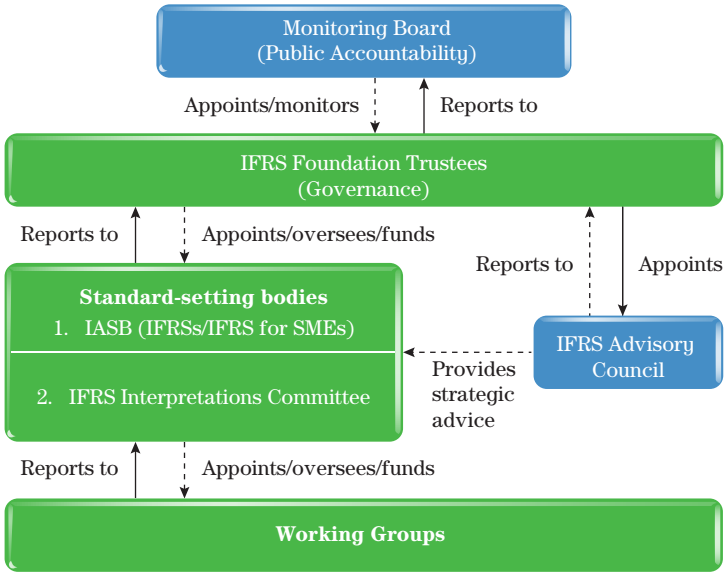
126 jurisdictions have required or permitted the use of IFRS. This chapter examines the role of the IASB and describes in brief the 11 main **International Financial Reporting Standards** (IFRSs) that are referred to in this book. **International Accounting Standards** (IASs) is the name given to the standards that were issued by the International Accounting Standards Committee (IASC), the predecessor of the IASB. The IASB has adopted a number of the IASC's standards and the name (IAS) has not been changed, though new standards are called IFRSs.

2.2 The institutional framework for setting IFRSs

The institutional framework for setting IFRSs is shown in Figure 2.2.

There are three tiers to the framework, the first tier is the **Monitoring Board**. It is responsible for public accountability. The second tier is the **IFRS Foundation Trustees**. They are responsible for governance and report to the Monitoring Board. The third tier is the independent accounting standard setters, the IASB and the **IFRS Interpretations Committee**. They are accountable to the IFRS Foundation Trustees. The IFRS Advisory Council provides advice to the IFRS Foundation and the IASB. Finally, the IASB sets up working groups when needed to investigate key topics on their agenda. Some brief detail is now provided on each of the main bodies involved.

Figure 2.2



The institutional framework for setting IFRSs

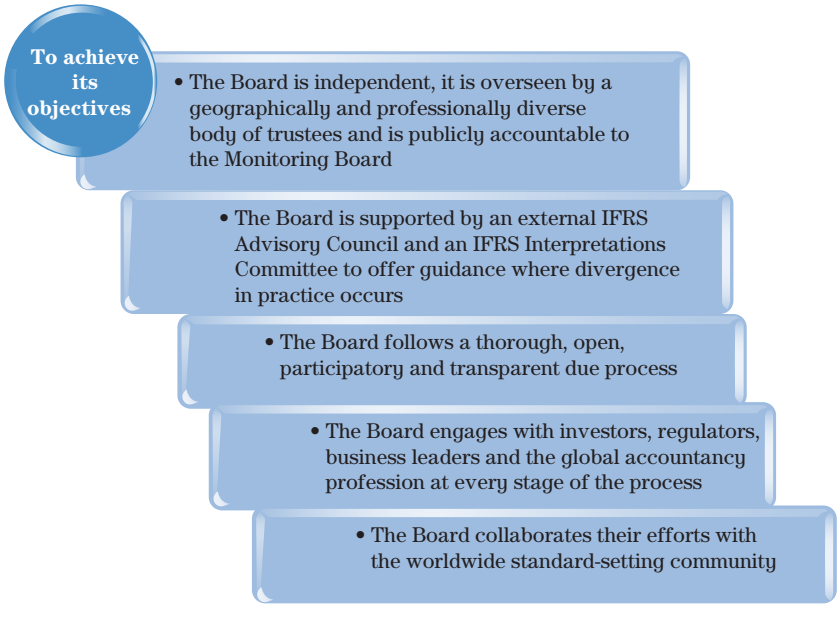
2.3 The International Accounting Standards Board (IASB)

The predecessor to the IASB, the **International Accounting Standards Committee (IASC)** was formed in 1973. Up until 2000 the IASC was governed by representatives from some of its member countries. In 2001 the IASC was renamed the IASB (hereafter called the 'Board') when it became governed by an independent board whose members are appointed by trustees. The members are drawn from the world's financial community, who represent the public interest. The Board has 14 full-time members.

These members have a variety of functional backgrounds – from academics, to former chief executives of financial institutions, to former partners in professional accounting firms. Each member has one vote. As mentioned previously, standards that are issued by the Board are known as IFRSs. The IASC issued 41 IASs and a conceptual framework called *The Framework for the Preparation and Presentation of Financial Statements* (IASC, 1989). Currently, 28 IASs are still in existence and are promulgated by the Board. Seventeen IFRSs have been produced by the Board.

The mission of the IASB Foundation and the Board is '*to develop IFRS Standards that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy*' (IASB and the IFRS Foundation, 2018). Certain aspects of the regulatory framework help the Board to achieve its mission. These are outlined in Figure 2.3.

Figure 2.3



How the regulatory framework helps the Board achieve its mission

2.4 SME Implementation Group

The **SME Implementation Group (SMEIG)** was established on 1 January 2010. Its aim is to support the international adoption of the IFRS for Small and Medium-sized Entities (IFRS for SMEs) and to monitor its implementation. The **IFRS for SMEs** is a separate IFRS that was issued by the Board in July 2009 to cater for the needs of smaller entities that deemed full IFRSs to be too onerous and inappropriate for their needs. It is based on the same principles as full IFRSs but contains certain omissions, simplifications, and reduced disclosures, and has been written for clarity.

2.5 The IFRS Foundation Trustees

The IFRS Foundation Trustees was formed on 1 March 2012. The aim of the trustees is to promote the work of the Board and the rigorous application of IFRSs. However, they are not involved in any technical matters relating to the standards. The trustees are accountable to an external body, the Monitoring Board.

The Monitoring Board appoints the trustees. Ultimately the trustees are responsible for the governance of all the bodies that are directly involved in the development of international accounting standards. The responsibilities of the Foundation trustees include:

> "1. *appointing members of the Board, the IFRS Interpretations Committee and the IFRS Advisory Council;*
>
> 2. *establishing and amending the operating procedures, consultative arrangements and due process for the IASB, the Interpretations Committee and the Advisory Council;*
>
> 3. *reviewing annually the strategy of the Board and assessing its effectiveness; and*
>
> 4. *ensuring the financing of the IFRS Foundation and approving annually its budget.*"

(IFRS website, 2018)

2.6 The Monitoring Board

In 2009 the trustees of the IFRS Foundation established the Monitoring Board to enhance the public accountability of the IFRS Foundation whilst not impairing the independence of the standard-setting process. The Monitoring Board serves as a formal link and a forum for interaction between representatives of the main capital market authorities worldwide (nominated and appointed to the Board) and the IFRS Foundation. The aim of the Monitoring Board is to appoint members of the IFRS Foundation and to hold them accountable in their role.

2.7 The IFRS Interpretations Committee

The IFRS Interpretations Committee is the interpretive body of the IFRS Foundation. It supports the application of IFRS by responding to questions about the application of the standards. It also does other work at the request of the board. The IFRS Interpretations Committee is like a filter committee, considering issues and deciding if they need to be considered by the Board. They may publish an interpretation of a standard. This does not change the standard but adds to the requirements of the standard. In some instances they can recommend narrow scope changes to a standard. The public can attend IFRS Interpretations Committee meetings or they can be viewed, as they are recorded using a webcam. This is for transparency reasons.

2.8 The IFRS Advisory Council

The **IFRS Advisory Council** is the formal advisory body to the Board and the IFRS Foundation. The Advisory Council is made up of representatives from groups that are interested in the work of the Board. The groups include '*investors, financial analysts and other users of financial statements, as well as preparers, academics, auditors, regulators, professional accounting bodies and standard-setters*' (IFRS, 2018).

The primary objective of the Advisory Council is to give the Board advice on issues including:

> "1. *technical agenda;*
>
> 2. *project priorities;*
>
> 3. *project issues related to application and implementation of IFRS Standards; and*
>
> 4. *possible benefits and costs of particular proposals.*"

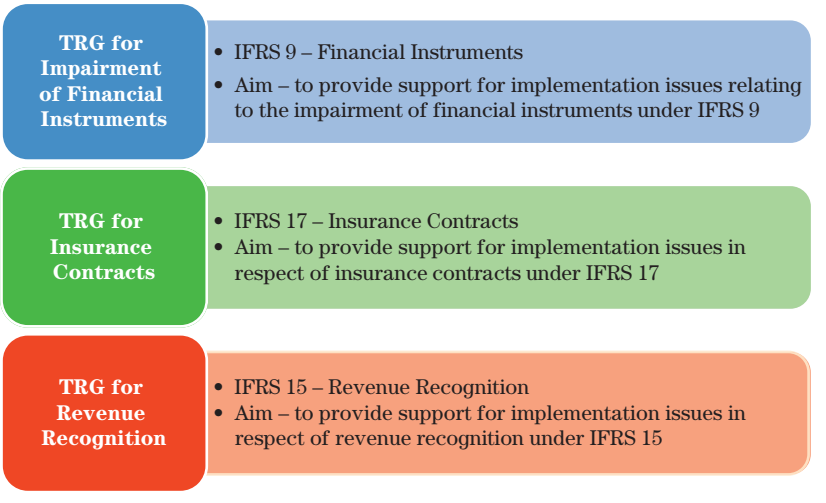
(IFRS website, 2018)

The IFRS Advisory Council also provides advice to the Board on forthcoming projects and existing standards that it believes should be passed to the IFRS Interpretations Committee for consideration. Finally, the Board can use the Advisory Council as a sounding board to gather opinion on its standards during the consultative process.

2.9 Working Groups: Transition Resource Groups

The Board establishes **Transition Resource Groups** (TRGs) to assist with the smooth implementation of an IFRS or certain aspects of an IFRS that are deemed to require guidance. The TRGs in existence at the start of 2018 are outlined in Figure 2.4.

Figure 2.4



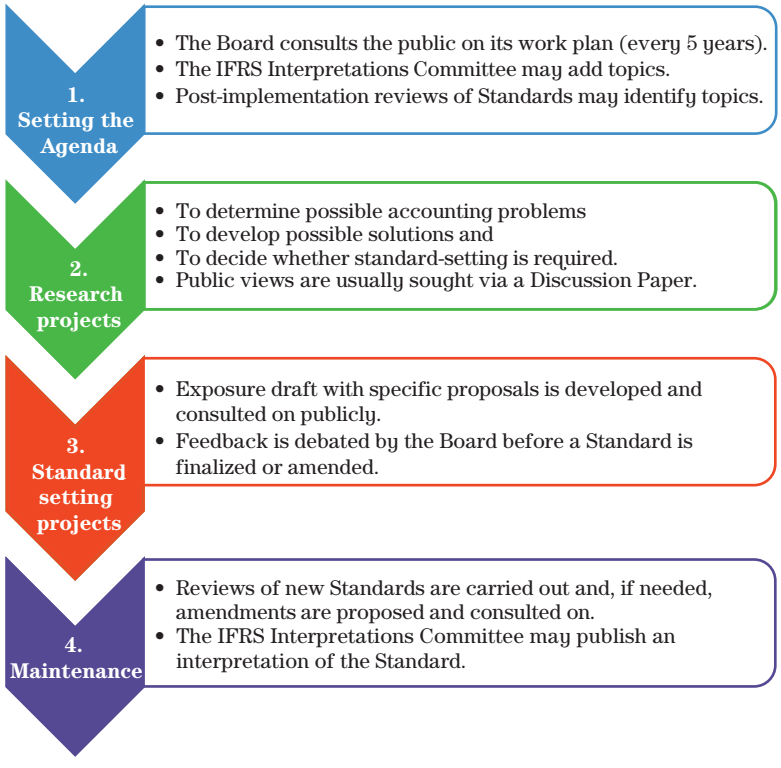
Transition Resource Groups (TRGs)

2.10 The standard-setting process

The standard-setting process involves four stages as outlined in Figure 2.5.

The first stage is 'setting the agenda'. This provides a timetable that highlights the various topic areas that the Board are either working on or are planning to work on. When setting the agenda the Board consults with the public, the IFRS Interpretations Committee and considers any issues arising from other standards. The second stage is 'researching the project'. The Board may set up a working group at this stage to undertake research into the topic being considered. Research considers accounting treatments, issues encountered and provides a range of possible solutions. The standard-setting process formally starts with the publication of a **Discussion Paper (DP)** which is prepared by the Board and distributed for public consultation to various interested parties. The third phase starts when the feedback received from the public consultation on the DP is received. This is called the 'standard setting phase'. During this phase an **Exposure Draft (ED)** is drafted taking into account the feedback from the DP. The ED is a draft standard. It is reissued to interested parties and the general public for comment. The Board then reviews and debates the comments/feedback received and may decide to revise and publish the ED again. Finally, when all outstanding issues are resolved and the Board members vote in favour of the standard, a new IFRS is issued and is adopted by the various accounting bodies around the world who have signed up to IFRS. The final phase is called 'maintenance'. This involves reviewing the IFRS and discussing

Figure 2.5



The IASB standard setting process

any communications/feedback received from interested parties. At this stage the IFRS Interpretations Committee may publish an interpretation of the standard or may request an amendment.

The Board goes to great lengths to ensure that each stage of the process for developing Standards is transparent. The public are invited to get involved at every stage of the process. They can access all Board papers and observe all Board meetings via the Board's website or by attending the meetings.

Learning Activity 2.1

Why do you think the IASB is keen to get the public involved in its standard setting process?

2.11 UK Accounting Regulation (and the ROI)

Introduction

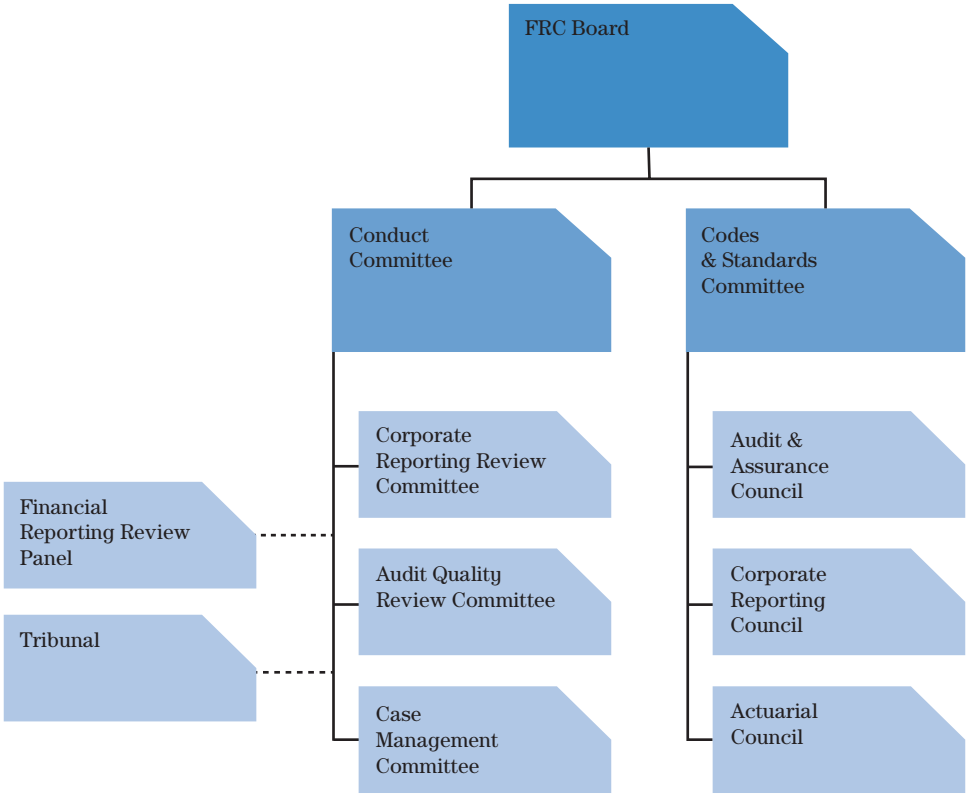
This book focuses on accounting using international financial reporting standards. However, it would be remiss not to make students aware of the fact that the UK (and the ROI) has its own regulatory framework, with its own standards, which are still being used by most small, medium and some large-sized entities in the UK. One of the historic aims of the body responsible for UK accounting standard setting, the Financial Reporting Council (FRC), was to converge UK accounting standards with those of the IASB; however, convergence has been popular with UK accountants and a new UK framework that allows choice was implemented on 1 January 2015 after a period of consultation.

The UK institutional framework

The first UK accounting standard setter was the Accounting Standards Committee (ASC). It was formed in 1975 and issued 25 accounting standards known as **Statements of Standard Accounting Practice (SSAPs)**. In 1990 the ASC was replaced by the Accounting Standards Board (ASB). The ASB issued **Financial Reporting Standards (FRSs)** The ASB issued 30 FRSs. On 2 July 2012, responsibility for UK financial reporting standard setting was taken over by the **Financial Reporting Council (FRC)**. The structure of the FRC Board is detailed in Figure 2.6.

On the operational side there is the Conduct Committee and the Codes and Standards Committee. The Conduct Committee is supported by three sub-committees as detailed in Figure 2.6 and there are two further bodies, the Financial Reporting Review Panel and the Tribunal that deal with conduct issues. Finally, the Codes and Standards Committee has three Councils and one of these, the Corporate Reporting Council, provides assistance to the FRC Board when issuing UK accounting standards.

Figure 2.6



Institutional framework for setting financial reporting standards and regulating financial statement preparation in the UK

Source: FRC website, https://www.frc.org.uk/about-the-frc/structure-of-the-frc, accessed 9 December 2017.

Though not included in Figure 2.6, the FRC Board is supported by three governance committees:

1. Audit committee
2. Remuneration committee
3. Nominations committee

Learning Activity 2.2

Using the internet and FRC website, prepare notes to describe the objective of all the departments/councils/committees etc. detailed in Figure 2.6.

The role of the Corporate Reporting Council in supporting the FRC Board is outlined in Figure 2.7.

Figure 2.7

Role of the Corporate Reporting Council

Major changes to UK accounting standards occurred on 1 January 2015. All prior standards were withdrawn and new standards issued. At the time of writing the FRC has issued six standards. Details of the standards are provided in Figure 2.8.

Figure 2.8

FRS 100 Application of Financial Reporting Requirements

Sets out the applicable financial reporting framework for entities preparing financial statements in accordance with legislation, regulations or accounting standards applicable in the United Kingdom and Republic of Ireland

FRS 101 Reduced Disclosure Framework

Sets out the disclosure exemptions (a reduced disclosure framework) for the individual financial statements of qualifying entities that would otherwise apply the recognition, measurement and disclosure requirements of EU-adopted IFRS

FRS 102 The Financial Reporting Standard Applicable in the UK and in the Republic of Ireland

This standard describes the **objective of financial statements** and the qualities that make the information in the **financial statements** useful. It also sets out the concepts and basic principles underlying the financial statements. The latter part of the standard provides detail on the specific accounting requirements for a variety of items that are to be disclosed in financial statements

FRS 103 Insurance Contracts

Provides guidance on how to account for insurance contracts issued and reinsurance contracts that the entity holds

FRS 104 Interim Financial Reporting

Provides guidance on interim financial reporting for entities that apply FRS 101 or FRS 102 when preparing their final financial statements

FRS 105 The Financial Reporting Standard Applicable to the Micro-entities Regime

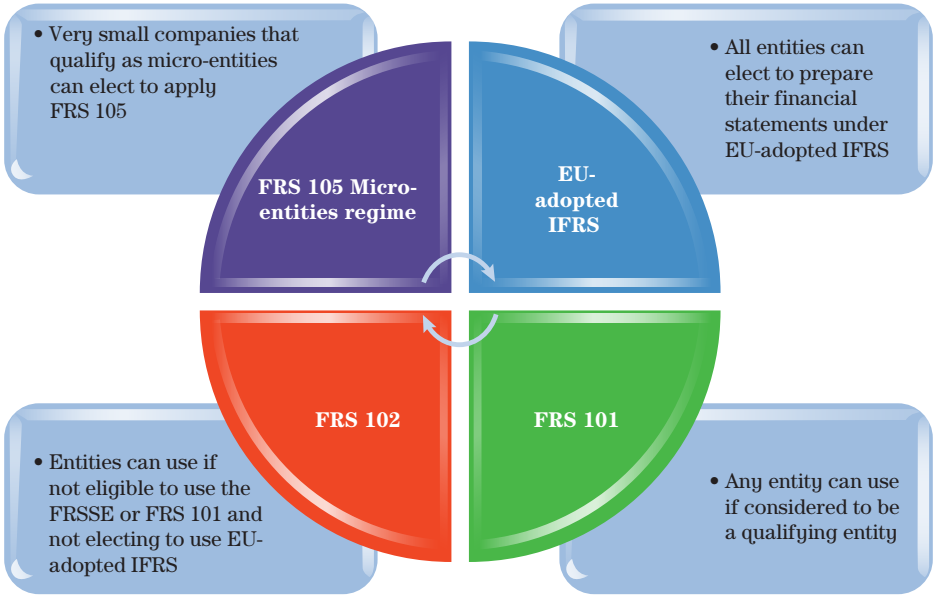
This standard can be applied by entities who qualify as micro-entities. The standard reflects the simpler nature and smaller size of these organizations

UK Financial Reporting Standards in force (2018)

Figure 2.8 refers to qualifying entities. **Qualifying entities** under UK GAAP, are entities that are included within published consolidated financial statements that have been prepared under EU-adopted IFRS.

The overriding objective of the FRC when setting accounting standards is to *'enable users of accounts to receive high-quality, understandable financial reporting proportionate to the size and complexity of the entity and users' information needs'* (FRS 100, paragraph 1). To this end they have shifted the choice of complexity in accounting treatment and disclosure to entities. All listed entities must prepare their financial statements under EU-adopted IFRS. Other entities, such as sole traders, partnerships, limited companies and charities have a choice under FRS 100. The possibilities are detailed in Figure 2.9.

Figure 2.9



Accounting framework adoption possibilities for UK and ROI entities.

Note: FRS 103 and FRS 104 only apply to companies that have insurance contracts or that produce interim accounts

Learning Activity 2.3

Using the internet, research the current qualifying criteria for micro-entities and small companies. Tip: there are size limits in terms of assets, turnover and employees.

2.12 Harmonization

Many accountancy and standard-setting bodies throughout the world are involved in the work of the IASB, as are various government agencies and stock market regulators. For example, all the countries of the EU, Russia, the USA, Australia, China and many of the African countries require or permit the use of IFRSs. Indeed, 126 countries have required or permitted the use of IFRSs and in 2013 the G20 called for global adoption of a single set of high-quality financial reporting standards. The UK and the USA have a long tradition of standard setting and as a result these two countries have probably had the greatest influence on the development of IFRSs, especially given that the working language of the IASB is English.

From 2005 all EU listed companies have had to prepare their financial statements in accordance with EU-adopted IFRSs (Pope and McLeay, 2011). The IASB (International), FASB (USA) and the FRC (UK) also engaged in what is known as a 'convergence project' to harmonize international, US and UK accounting standards. However, stiff opposition from preparers in the UK resulted in the FRC continuing to issue national standards and in the US the Securities and Exchange Commission (SEC) has not yet backed full conversion. Nonetheless, the FASB is committed to working with the IASB on standard setting projects. They recently worked together to create IFRS 15 Revenue Recognition. A reflection of the stance of the FASB to harmonization is provided in Real World Example 2.1.

REAL WORLD EXAMPLE 2.1

Relationship between the FASB and the IASB

The Financial Accounting Standards Board and the International Accounting Standards Board have recently worked very closely together to harmonize the treatment and standard on revenue recognition. However, though agreeing on some aspects of accounting, they did not come to a meeting of minds on the recent standard that deals with accounting for leases and the changes to the standards in respect of accounting for credit losses.

Though full convergence has not occurred, the Financial Accounting Standards Board and the International Accounting Standards Board agreed in 2017 to continue to work together. They both consider that a common set of global standards reduces complexity and improves comparability of financial statements across countries. However, the process will not be easy.

Source: Accounting Today Website, https://www.accountingtoday.com/news/fasb-continues-engagement-with-iasb-on-ifrs, accessed 9 December 2017. The full article can be accessed using this link.

The IASB has enormous status and authority stemming from the impact of IFRSs worldwide. However, unlike, for example, the FRC in the UK, the IASB has no power to enforce IFRSs. Compliance depends on adoption and enforcement by nation states and respective stock market regulatory bodies such as the SEC and the London Stock Exchange (LSE).

2.13 International Financial Reporting Standards (IFRSs)

Figure 2.10 details the main IFRSs/IASs referred to in this book.

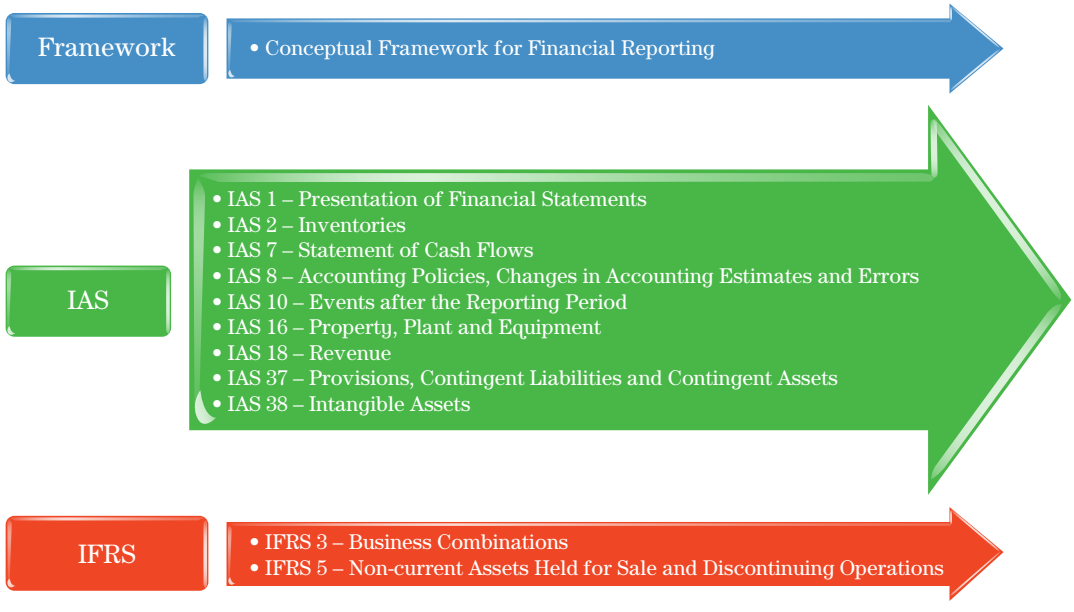
The remainder of this chapter outlines a brief summary of the international conceptual framework for accounting and each of the above IASs/IFRSs. At this stage these brief summaries are only intended to provide you with a sense of the type of information that is provided in IFRSs. You will have to return to study these summaries when you complete the book. They will be more understandable to you then.

Conceptual Framework for Financial Reporting

The **Conceptual Framework for Financial Reporting** (IASB, 2018) sets out the concepts that underlie the preparation and presentation of financial statements for external users. It provides guidance on the fundamentals of accounting. The key issues considered by the conceptual framework are outlined in Figure 2.11.

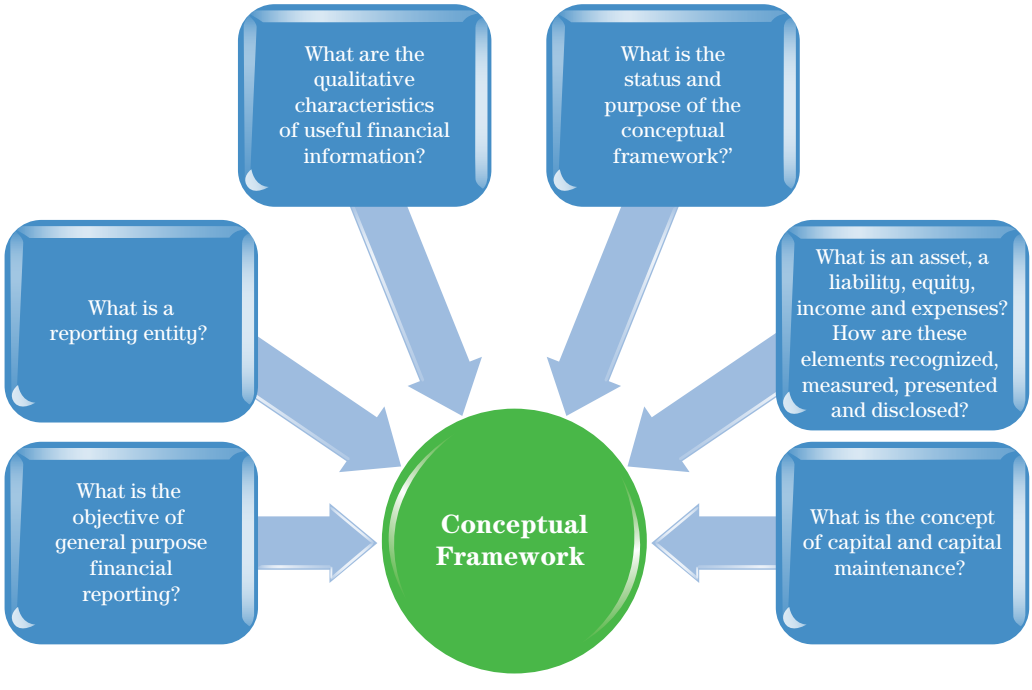
The questions outlined in Figure 2.11 are examined in depth in Chapters 3, 4, 5 and 7.

Figure 2.10



Accounting standards referred to in this book

Figure 2.11



Issues dealt with by the 'Conceptual Framework'

2.14 IAS 1 – Presentation of Financial Statements

IAS 1 (IASB, 2018a) was discussed in Chapter 1, 'Entities and Financial Reporting Statements'. It provides guidance on how to present financial information in the financial statements. It tries to promote standardization of accounting formats and terminology.

2.15 IAS 2 – Inventories

IAS 2 (IASB, 2018b) requires that inventories should be measured at the lower of cost and net realizable value. Cost includes all expenditures required to transform inventories into a saleable condition. Where specific cost is not appropriate, the benchmark treatment is to use either the first-in-first-out (FIFO) or the weighted average cost (AVCO) methods for determining inventory value. Inventory valuation is covered in depth in Chapter 17.

2.16 IAS 7 – Statement of Cash Flows

In IAS 7 (IASB, 2018c) cash flows are classified under the headings of **operating activities**, **investing activities** and **financing activities**. Within the operating activities section of the statement of cash flows, a reconciliation of operation profit before tax from the statement of profit or loss to net cash inflows from operating activities is provided. Separate disclosure is required of the movement in cash and **cash equivalents** and details are provided for any significant non-cash transactions.

2.17 IAS 8 – Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 (IASB, 2018d) covers changes in **accounting policies** and the correction of errors. Changes in accounting policies and the correction of errors should be treated as prior year adjustments. This involves restating the **comparative figures** (previous year's figures) to take account of the adjustment. IAS 1 requires that entities that have a change in accounting policy provide two years of comparatives in respect of the statement of financial position (assets, liabilities and owners' capital) and one year of comparatives for most other disclosures.

Changes in accounting policy are only allowed in restricted circumstances. The spirit seems to be that a change is allowable if it produces better quality financial information. This usually occurs when a new standard is introduced, or updated with new measurement or recognition guidance. In contrast to changes in accounting policies, changes in accounting estimates should only be included in the financial statements of the current and future accounting periods, and their classification will be unchanged (e.g. depreciation arising from a change in the estimated useful life of a non-current asset).

2.18 IAS 10 – Events after the Reporting Period

IAS 10 (IASB, 2018e) states that events occurring after the reporting date that provide additional information on conditions existing at the reporting date should lead to adjustment of the financial statements. In addition, disclosure should be made for other non-adjusting events, if necessary, for a proper evaluation.

2.19 IAS 16 – Property, Plant and Equipment

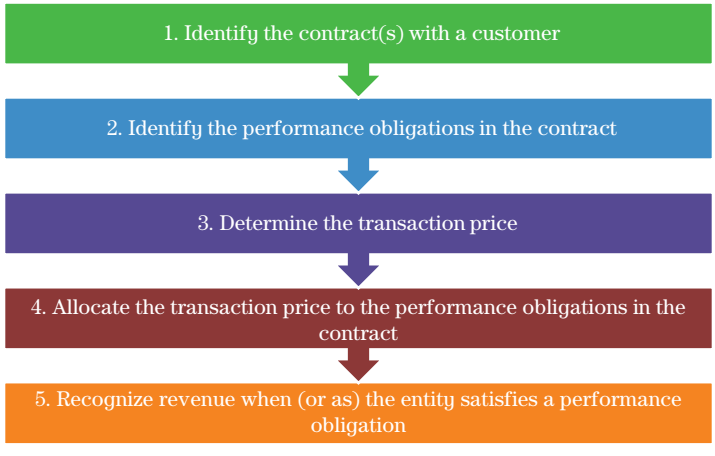
Under IAS 16 (IASB, 2018f) all tangible non-current assets are recognized at **historic cost** and depreciated over the asset's **useful economic life**. The value to appear in the statement of financial position should equal the tangible assets' cost less accumulated (built-up) **depreciation**. An alternative treatment

is allowed, wherein the tangible non-current assets can be revalued to **fair value** and depreciated. Under IAS 16, fair value is the amount that an entity would expect to receive for the asset in an arm's length transaction between two unconnected parties. This usually equates to market price, replacement cost or economic value. When an asset is revalued, the whole class of asset has to be revalued and the valuations have to be kept up to date.

2.20 IFRS 15 – Revenue from Contracts with Customers

The objective of IFRS 15 is to ensure that entities report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer (IASB 2018k). Revenue recognition is a controversial accounting topic and as a result the IASB setout a five-step model that entities can use when determining the recognition of revenue on the transfer of promised goods or services. The five-steps are outlined in Figure 2.12.

Figure 2.12



The five-steps to revenue recognition under IFRS 15

2.21 IAS 37 – Provisions, Contingent Liabilities and Contingent Assets

Under IAS 37 (IASB, 2018h) a provision has to be recognized when the enterprise has a present obligation to transfer economic benefits as a result of past events and it is probable (more likely than not) that such a transfer will be required and a reliable estimate of the obligation can be made. A present obligation exists when an entity has little or no discretion to avoid incurring the economic outflow. This means that the item comes into the statement of financial position as a liability and as an expense in the statement of profit or loss.

Contingent liabilities are liabilities whose outcome will be confirmed on the occurrence or non-occurrence of uncertain future events that are outside the entity's control. They are recognized in the financial statements (as a liability and an expense) if it is more likely than not (probable) that a transfer of economic benefits will result from past events and a reliable estimate of the amount can be made. When this condition cannot be fulfilled, disclosures of the nature and amount (if possible) should be provided in the notes to the financial statements.

Contingent assets should not be recognized unless they are reasonably certain, then they are treated as assets. If they are not reasonably certain they should be disclosed in the notes to the financial statements.

2.22 IAS 38 – Intangible Assets

Under IAS 38 (IASB, 2018i) intangible assets can only be recognized if they meet the definition of an asset (i.e. if it is probable that future economic benefits attributable to the asset will flow to the enterprise and that cost of the asset can be measured reliably). Like IAS 16 an intangible asset can be carried at cost or at fair value. Fair value can only be determined in this instance with reference to an active market for the asset. Internally generated assets cannot be recognized unless they meet the recognition criteria for capitalizing development expenditure. The criteria are that the expenditure should be on a clearly defined product or process, capable of reliable measurement, technically feasible, there should be evidence of an intention to sell the product being developed for a profit (i.e. there should be evidence of the existence of a market in which to sell the product, or the product being developed should be demonstrated to be useful internally) and the entity should have the technical expertise and resources to complete the project. Intangible assets have to be amortized over their useful economic lives.

2.23 IFRS 3 – Business Combinations

Under IFRS 3 (IASB, 2018j) any **goodwill** arising on a business combination (i.e. the excess amount given for a business over and above the value of its separately identifiable assets, liabilities and contingent liabilities) should be capitalized as an intangible non-current asset and impaired. This is covered in the section on partnerships and companies.

2.24 IFRS 5 – Non-current Assets Held for Sale and Discontinuing Operations

Under IFRS 5 (IASB, 2018g) discontinuing operations includes operations that actually discontinued in the reporting period and operations that are likely to be discontinued in the next reporting period. The assets, liabilities, revenue and expenses from those operations/assets should be presented separately from the assets, liabilities, revenues and expenses from continuing activities. All required disclosures in respect of these items should also be provided separately. In the statement of financial position, the assets and liabilities are disclosed separately for each main category (e.g. non-current assets). In the statement of profit or loss the approach is different, the revenue and expenses from the discontinuing activity are shown in a note to the financial statements, with the profit or loss for the period being added to the profit for the period from continuing operations.

Learning Activity 2.4

Go to the UK FRC's website and read the relevant parts of FRS 101 and FRS 102. Note the similarities between these and the summaries provided in this chapter for the international equivalent.

2.25 Current issues

In response to criticism received after the financial crises, the IASB have been and are actively discussing current standards, or introducing new standards to deal with:

1. *Goodwill and impairment:* The Board is currently exploring whether the existing impairment test for goodwill under IAS 36 Impairment of Assets can be improved or simplified. Their research has focused on whether goodwill should be amortized or not and on specifying which intangible assets should be separated from goodwill. Finally, they are also considering whether additional disclosures about goodwill impairment are required to improve the quality of information disclosed to users.

2. *Primary financial statements:* The Board is currently exploring presentation of income and expenses from investing activities in the statement(s) of financial performance. In November 2017 the Board agreed to change the description of this type of transaction from 'investing' to 'income/expenses from investments' and they also agreed not to label the subtotal before the 'income/expenses from investments' category as 'operating profit'. Discussions are ongoing about the presentation of the share of the profit or loss of associates and joint ventures accounted for using the equity method; however, there is no agreement yet. In addition, the Board agreed to use the term 'cash and cash equivalents' in the definition of 'finance income/expenses' as a proxy for cash and temporary investments of excess cash in the Statement of Cash Flows. The presentation of other comprehensive income is also being discussed.
3. *Principles of disclosure:* The Board is currently consulting a variety of stakeholders about possible principles of disclosure that could help the Board develop better disclosure requirements and help companies communicate information more effectively to users of financial statements.
4. *Conceptual Framework:* The IASB is also currently revising the conceptual framework. In particular, it revised the definitions of the different elements making up the financial statements and is hoping to publish a revised Framework in 2018 with an updated definition of 'liability'.
5. *Globalization:* The IASB continues to pursue globalization of its accounting standards.

Source: IASB Work Plan – projected targets as at 9 December 2017, http://www.ifrs.org/projects/current-areas-of-focus/, accessed 9 December 2017.

Summary

The international framework of accounting is made up of several bodies. The Monitoring Board is an independent board that aims to make the IFRS Foundation Trustees accountable in their role to the public. Though reporting to the IFRS Foundation Trustees, the IASB has independent control over issuing IFRS and revising IAS. They are supported by the IFRS Interpretations Committee (publishes authoritative guidance on new issues, issues that are unclear or are omitted from an IFRS). The IFRS Advisory Council represents the major stakeholders of accounting information and provides strategic advice to the IASB. Finally, working groups are set up by the IASB to investigate topics when required.

The mission of the IASB and the IFRS Foundation is *'to develop IFRS Standards that bring transparency, accountability and efficiency to financial markets around the world. Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy'*. At the time of writing 126 countries have either adopted IFRSs in their entirety, have converged national accounting standards with IFRSs, or allow IFRSs to be used. The G20 have voiced support for the global adoption of a single set of high-quality financial reporting standards as has the SEC. It is therefore likely that convergence will continue, though cultural differences and cost will affect the rate of globalization.

In the UK the FRC is responsible for accounting standards. After a period of consultation, complete harmonization was rejected, with UK accounting stakeholders (preparers, auditors) electing to keep UK GAAP in 2015. All UK-listed PLCs must prepare their financial statements using EU-adopted IFRS. However, the current framework offers choice to other entities. They can elect to prepare their financial statements under EU-adopted IFRS instead of using UK standards. At this point six standards have been issued. However, most companies will use one of three accounting standards: FRS 101 The Reduced Disclosure Framework; FRS 102 The Financial Reporting Standard Applicable in the UK and in the ROI and FRS 105 The Financial Reporting Standard Applicable to the Micro-entities Regime. A further standard FRS 100 Application of Financial Reporting Requirements provides guidance on the choices open to entities when preparing financial statements. The other two standards deal with insurance contracts and interim reports.

Key terms and concepts

An asterisk after the question number indicates that there is a suggested answer in Appendix 2.

Review questions

connect

International Framework

2.1* Describe the objectives of the International Accounting Standards Board (IASB).

2.2 Discuss the current activities of the International Accounting Standards Board (IASB) in the convergence/harmonization of accounting standards.

2.3 Explain the role of the IFRS Interpretations Committee.

2.4 Explain the role and objectives of the IFRS Advisory Council.

2.5 Describe the standard setting process for International Financial Reporting Standards (IFRSs).

2.6 Describe the accounting treatment for measuring the value of inventories under *IAS 2 – Inventories*.

2.7 Describe the rules relating to the recognition of revenue set out in *IFRS 15 – Revenue from Contracts with Customers*.

2.8 State the two measurement methods recommended by *IAS 16 – Property, Plant and Equipment* for recording the value of tangible non-current assets.

UK Framework

2.9* Describe the sources of the rules and regulations that govern the content and format of company final financial statements in the UK.

2.10* Describe the structure of the current institutional framework concerned with the setting and enforcement of accounting standards in the UK.

2.11* Explain the accounting framework options open to the following types of UK entity:

a. A subsidiary of a company that has prepared consolidated financial statements using EU-adopted IFRS

b. An entity qualifying as a micro-entity under the micro-entity regime

c. A small limited company

d. A public limited company

e. A large limited company that is not listed on any exchange

Websites

For more information on topics covered in this chapter visit:

http://www.frc.org.uk/ Provides details on the UK framework and standards.

www.ifrs.org/ Provides guidance on the institutional framework underlying the production of IFRSs and new issues.

www.iasplus.com/ Provides a summary of IFRSs, the institutional framework and the objectives of all the bodies that are party to the framework.

References

International Accounting Standards Board (2018a) *International Accounting Standard 1 – Presentation of Financial Statements* (IASB).

International Accounting Standards Board (2018b) *International Accounting Standard 2 – Inventories* (IASB).

International Accounting Standards Board (2018c) *International Accounting Standard 7 – Statement of Cash Flows* (IASB).

International Accounting Standards Board (2018d) *International Accounting Standard 8 – Accounting Policies, Changes in Accounting Estimates and Errors* (IASB).

International Accounting Standards Board (2018e) *International Accounting Standard 10 – Events after the Reporting Period* (IASB).

International Accounting Standards Board (2018f) *International Accounting Standard 16 – Property, Plant and Equipment* (IASB).

International Accounting Standards Board (2018g) *International Financial Reporting Standard 5 – Non-current Assets Held for Sale and Discontinuing Operations* (IASB).

International Accounting Standards Board (2018h) *International Accounting Standard 37 – Provisions, Contingent Liabilities and Contingent Assets* (IASB).

International Accounting Standards Board (2018i) *International Accounting Standard 38 – Intangible Assets* (IASB).

International Accounting Standards Board (2018j) *International Financial Reporting Standard 3 – Business Combinations* (IASB).

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International Accounting Standards Committee (1989) Adopted by the International Accounting Standards Board 2001, *Framework for the Preparation and Presentation of Financial Statements* (IASC).

International Accounting Standards Board and the IFRS Foundation (January 2018) *Who We Are and What We Do* (IFRS Foundation, 2017).

Pope, P. and McLeay, S. (2011) 'The European IFRS Experiment: Objectives, Research Challenges and Some Early Evidence', *Accounting and Business Research*, 41(3), 42–56.

Note: All the recommended UK accounting practices covered in this book will be contained in three standards: FRS 101 *The Reduced Disclosure Framework* (for qualifying entities); FRS 102 *The Financial Reporting Standard Applicable in the UK and in the Republic of Ireland* (all other entities); and FRS 105 *The Financial Reporting Standard Applicable to the Micro-entities Regime.*

Chapter 3

The Conceptual Framework 1: objective of financial statements, stakeholders and other reports

Learning Objectives:

After reading this chapter you should be able to do the following:

1. Explain the nature, purpose and scope of the conceptual framework of accounting, including the main contents of the International Accounting Standards Board's *Conceptual Framework for Financial Reporting* (IASB, 2018).
2. Discuss the objectives of general purpose financial statements.
3. Outline the limitations of general purpose financial statements.
4. Explain the relevance of the accounting entity concept in financial accounting.
5. Identify the users of annual reports and describe their information needs.
6. Explain corporate social responsibility and discuss the type of information included in a corporate social responsibility report.
7. Discuss the type of information a company includes under environmental reporting.
8. Describe the conceptual framework and standardization debates and discuss related issues.
9. Describe the main types of accounting theory and their implications for a conceptual framework of accounting.

3.1 Introduction

The nature of a conceptual framework – an analogy

At some point in your studies you may feel rather confused and frustrated by accounting theory. It is a hurdle that has to be overcome. On the one hand, accounting seems definitive because much of it is based on the law and you will learn a simplified set of rules about double-entry bookkeeping that is very systematic. On the other hand, there is some flexibility in the rules and some accountants have been known to use this flexibility to manipulate the reported results of a company. This is referred to as 'cooking the books', or **creative accounting**. As you progress through the chapters in this book you will see that some transactions can be treated in different ways, thus giving possible alternative figures of profit.

It is important to appreciate the difference between 'cooking the books' and the professional judgement involved in decisions between alternative methods (bases) of accounting. An analogy may prove useful. Imagine you went to a private consultant because you had backache. In order to maximize his or her fee, the consultant might decide to operate on you. If this was the sole consideration, it would be unethical of the surgeon. Similarly, an accountant who chose a particular form of accounting treatment with the sole intention of reducing net profit would be acting unethically. However, an ethical physician or accountant is still faced with a number of possible forms of treatment. The physician might prescribe a number of different drugs, but needs to ascertain which is likely to be most appropriate for you. Similarly, the accountant has to choose which accounting treatment for, say, development costs is the most appropriate in the circumstances.

This analogy can be extended further to illustrate another very important relevant idea. The physician's judgement about your treatment for backache is guided by a body of expert knowledge and research, loosely known as 'medical science'. This includes such disciplines as anatomy and chemistry, which are based on generally accepted theories and concepts similar, in principle, to those discussed in this chapter relating to accounting. Similarly, the accountant's judgement about the most appropriate treatment of certain types of transaction is guided by a body of expert knowledge and research, which is loosely referred to as the theoretical or **conceptual framework for financial reporting**.

However, it is unlikely that a conceptual framework of accounting could be as definitive as, say, medical science in the foreseeable future since accounting theory, like other social sciences, is fundamentally different from natural sciences, such as medical science.

This tension between the need for a set of concepts/principles to guide the practice of accounting, and the awareness that these are unlikely to be conclusive/definitive, has given rise to an extensive debate over the past three decades about the development of a conceptual framework of accounting or what are sometimes called **generally accepted accounting principles (GAAP)**.

(*Note:* The abbreviation GAAP is commonly taken as referring to generally accepted accounting practice; that is, accounting standards.)

3.2 The conceptual framework of accounting

Definition and purpose

The definition and purpose of a conceptual framework of accounting is provided on the IFRS website (2018). It is presented diagrammatically in Figure 3.1.

Learning Activity 3.1

Visit the Financial Reporting Council (FRC) website (UK standard setters) and read about the purpose of the conceptual framework of accounting.

Figure 3.1

Definition
• Describes the objective of, and concepts for, general purpose financial statements.
Purpose
• Practical tool to assist the IASB when developing IFRSs that are based on consistent concepts. • To help preparers to develop consistent accounting policies for areas that are not covered by a Standard or when there is choice in accounting policy • To assist all parties to understand and interpret the Standards.

Definition and purpose of the *Conceptual Framework*

***Source*:** IFRS website 2018, accessed 15 April 2018.

The definition highlights one of the main purposes of a conceptual framework; that is, to provide standard-setting bodies with a set of internally consistent definitions of accounting concepts that can be used as a basis for setting accounting standards that are not contradictory nor in conflict with each other. The other main purpose of a conceptual framework, explained earlier using the analogy with medicine, is to provide guidance to accountants in their day-to-day work of choosing appropriate forms of accounting treatments for various transactions and items. In addition, the *Conceptual Framework* provides a guide to resolving accounting issues that are not addressed directly in a Standard. When this happens judgement is required to develop and apply an accounting policy that results in information that is relevant, reliable and is a fair representation of the transaction. The conceptual framework does not override any specific IFRS.

The global financial crisis fuelled debate on whether an international accounting framework is appropriate, as highlighted in Real World Example 3.1.

REAL WORLD EXAMPLE 3.1

'Accounting standard to blame for the financial crisis'

In the period before the financial crisis the IASB downplayed the importance of prudence as it was believed that some companies used this concept to manage their earnings, for example, by providing for potential losses when profits were high (this has the effect of reducing profits), and releasing the provisions when profits were low (this has the effect of increasing profits). The result is that the company would seem to have steady profits, which investors could interpret as an indicator of low risk. Investors typically pay a premium for lower risk and hence share price is higher than it would be if the company had fluctuating profits.

To counteract this type of behaviour, the IASB made changes to IFRS to limit a company's ability to create provisions. One such change affected financial institutions and the consequence of this change was that financial institutions did not have to provide for potential bad debts in their books. So they were carrying many loans that were risky as assets (because the monies are owed to the bank) but did not have a provision for potential losses set off against these assets,

even though the bank knew that they contained sub-prime mortgages. The result is that the financial institutions' assets were overstated and their financial statements looked very strong. In addition, banks seemed to have plenty of cash, but when the financial crisis took hold, they ran out of cash very quickly and several needed bank bailouts. The financial statements did not identify any of these risks.

Since this time the IASB has undertaken a revision of several of the standards that were deemed to mislead stakeholders and they have also revised the conceptual framework.

One approach to determining the nature and scope of a conceptual framework of accounting is to answer questions in respect of information required from accounting (financial statements). Questions put forward in this respect include:

"
- *For whom are financial statements to be prepared?*
- *For what purposes do they want to use them?*
- *What kind of accounting reports do they want?*
- *How far are present financial statements suitable for these purposes? and*
- *How could we improve accounting practice to make them more suitable?*"

(ASC, 1978)

The scope of the international conceptual framework, as detailed in the *Conceptual Framework*, is to provide guidance in eight areas represented by eight chapters as outlined in Figure 3.2. These chapters are considered to represent different accounting principles.

Figure 3.2

Conceptual Framework
• Chapter 1: the objective of general purpose financial reporting
• Chapter 2: qualitative characteristics of useful financial information
• Chapter 3: financial statements and the reporting entity
• Chapter 4: the elements of financial statements
• Chapter 5: recognition and derecognition
• Chapter 6: measurement
• Chapter 7: presentation and disclosure
• Chapter 8 concepts of capital and capital maintenance

Areas addressed by the IASB *Conceptual Framework*

The international framework: scope restrictions

The guidance provided in the *Conceptual Framework* is restricted to accounting in general purpose financial statements only. **General purpose financial statements** are 'a particular form of general purpose financial reports that provide information about the reporting entity's assets, liabilities, equity, income and expenses' (IASB, 2018). In simple terms they are financial statements that comply with the conceptual framework requirements and accounting standards and meet the information needs of the primary users. The information needs are in respect of the decision of whether to provide resources to the entity, or not.

The *Conceptual Framework* identifies three primary users:

- existing and potential investors
- lenders
- other creditors

There is much controversy about this restriction as a variety of other stakeholders are argued to have a legitimate claim to information from companies. Other users include: employees, suppliers and other trade creditors, customers, governments and their agencies and the public.

3.3 The objectives of general purpose financial reporting

As explained above, one of the main functions of financial accounting is **financial reporting**, which involves the preparation of final financial statements, also referred to as **financial accounts**. These consist of a statement of comprehensive income, statement of changes in equity, a statement of financial position, a statement of cash flows and notes to the financial statements. In the case of companies, the final financial statements are often referred to as **published financial statements**. These are sent to equity shareholders in the form of a pamphlet known as the **annual or corporate report**. It is therefore usual to discuss the objectives of company final financial statements in terms of the functions of annual reports.

Chapter 1 of the *Conceptual Framework* states that

> "*the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.*"
>
> (IASB, 2018)

This means that the financial statements should provide information on the economic resources of the entity (its assets) and the claims against the entity (its liabilities). The reporting entity is explained in Section 3.5. This information is contained in the statement of financial position. In addition the financial statements should provide information on transactions or events that change the entity's economic resources and claims against the entity. Changes to these elements is the entity's financial performance and information on the entity's financial performance is summarized in the statement of comprehensive income. Primary users need to assess an entity's financial performance and their financial position to assess management's stewardship of the entity. Financial performance enables an assessment of management's effectiveness in their use of the financial resources. The financial statements should also enable the primary users to assess the variability of the entity's financial performance and the key components contributing to financial performance.

The *Conceptual Framework* highlights that before making an economic decision, users will need to consider pertinent information from other sources as well.

3.4 The limitations of financial statements

This section provides a summary of the debate relating to whether financial statements achieve the objective of financial statements given in the *Conceptual Framework*. Four main themes are discussed here:

- The first is often referred to as the adequacy of financial statements in meeting users' information needs, and includes a debate about general-purpose versus specific-purpose financial reports (tailor-made financial reports).
- The second relates to problems of classification, aggregation and allocation.
- The third involves the lack of non-financial information in financial statements.
- The fourth theme in the debate concerns the use of largely historical information. This includes the use of historical cost accounting, which refers to recording transactions at cost price on the date the item is recognized in the financial statements – where the price reflects the price that has been agreed in an arm's-length transaction.

There is a fundamental presumption underlying most of the authoritative pronouncements on financial reporting that financial statements should be general purpose documents. This is based on the premise that the main information needs of users other than investors are similar to those of investors. That is, they all need information about the financial performance and financial position of the reporting entity in order to assess its ability to provide rewards (dividends, wages, etc.) and the likelihood of its continued existence, respectively. This is explained by the IASB as follows:

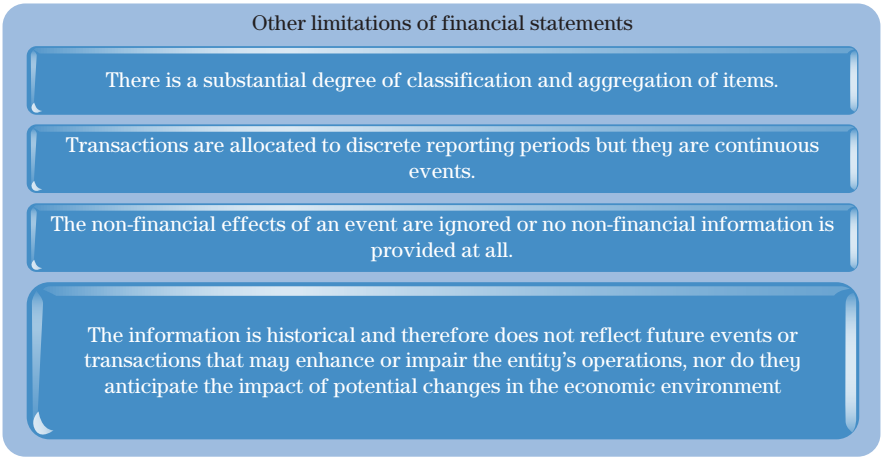
> *"While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy."*

It is up to companies to decide if they want to voluntarily publish specific-purpose financial reports that are aimed at another class or classes of users of financial statements. Examples of commonly prepared reports include a statement of value added, an employee report, an environmental report and simplified financial statements. These may be included in the annual report with the financial statements or published as separate documents.

Problems with classification, aggregation and allocation embrace a wide range of issues discussed throughout the book. For example, a classification problem might be the treatment of overdrafts. In most financial statements these are classified as current liabilities because they are repayable on demand. In practice the entity may be using an overdraft as a long-term source of funds and in practice the bank is not likely to ask for the overdraft to be repaid. In these circumstances the company might look as though it is having liquidity problems (problems paying its short-term commitments), when it does not. An example of how aggregation limits the quality of information is the disclosure on the face of the statement of financial position in company financial statements of trade receivables. One figure is provided, yet it represents two accounts: one shows the money owing to the company from trade customers (a positive account) and the other shows the amount of these trade customers who are not likely to pay (a negative account). Only the net amount is disclosed, yet information on potential irrecoverable debts is vital for highlighting the efficiency of the credit control policies of the entity. Finally, an example of the limitations associated with allocation can be found in the treatment of non-current tangible assets. The cost of these assets is allocated to the statement of profit or loss in the years that the assets help to generate revenue. This is a process called 'depreciation'. The concept is simple, yet in practice there are a variety of methods used to allocate this cost, all ending up with different profit or loss figures.

Financial statements have several other limitations (see Figure 3.3) that suggest they do not reflect the full impact of transactions or events on an entity's financial position or performance.

Figure 3.3



Limitations of financial statements prepared under IFRS

Learning Activity 3.2

Download Ryanair plc's annual report and financial statements.

Read through the financial statements (statement of profit or loss, balance sheet [statement of financial position], statement of cash flows and the related notes) and make a list of whatever information you find that is likely to be useful to a potential investor. Draw up a different list of any other information that is missing and that you think would be useful to a potential investor. Then read the narrative reports at the start of the annual report.

Do these reports provide the information you listed as being useful for investors, but not present in the financial statements?

3.5 The reporting entity

A **reporting entity** is defined in the *Conceptual Framework* (IASB, 2018) as '*an entity that is required, or chooses, to prepare financial statements*'. Accounting for a reporting entity focuses on setting up a means of recording all accounting information in relation to that entity, as distinct from information that does not relate to the entity. The reporting entity can be a single entity, for example, a particular company, club or business partnership. It can also be a portion of an entity, for example a subsidiary, or a combination of entities, for example a group. We are used to hearing that a financial report relates to a specific organization. 'Entity' is just another name for organization. The use of the word 'entity' emphasizes the properties of being separate and discrete. Greater precision is demanded by accounting in deciding what is, and is not, part of the entity. Boundaries are created to separate out the **accounting entity** (the entity concept). Realizing that these boundaries are necessary, even though they may be artificial, is the key to the entity concept. It becomes possible to accept that a business may be separate from its sole proprietor. Worked Example 3.1 provides examples of the entity concept operating in practice, wherein only business expenses are included in the business accounting records.

WORKED EXAMPLE 3.1

A trainee accountant is starting to prepare the financial statements for a sole proprietor who has a retail shop as his business. The following items appear in the list of payments made by the businessman. The trainee accountant has been asked to state whether or not the items of expenditure below should be included in the financial statements of the retail shop.

1. Direct debit paying the shop's rates.
2. Direct debit paying the sole proprietor's house rates.
3. Cheque paying for a new cash till.
4. Debit card payment for a new washing machine for the proprietor's wife's birthday.
5. Cash payment for stationery (90 per cent is for the shop, 10 per cent is for his kids).
6. Credit card payment for overalls for himself for cleaning the shop.
7. Credit card payments for a new outfit, which he can wear to work.

Required

Complete a table detailing whether the items should enter the accounting system of the reporting entity or not.

Solution

	Yes	No
1. Shop rates	✓	
2. House rates		✓
3. Till	✓	
4. Washing machine		✓
5. Stationery	✓ (90%)	✓ (10%)
6. Overalls	✓	
7. New outfit		✓

By defining the boundaries of the organizational unit, the accounting entity concept determines the transactions that will be recorded in the financial statements. For example, when a local plumber buys tools to carry out his work, that action can be regarded as a purchase by the business, while when the same man buys a cinema ticket this would be seen as a personal purchase. In the same way, the salary paid to a company director is treated not as some internal transfer within a company but as a payment to an officer as a separate individual. In general, accounting sets up 'the business', 'the company' or 'the club' as entities that are artificial constructs, separate from their owners and employees as individuals.

In some instances the boundary between business and private expenditure is difficult to determine, particularly where an expense is incurred for both business and private purposes. The taxation authorities have identified that treating private expenses as business expenses is 'tax evasion' and hence a crime, as explained in Real World Example 3.2.

REAL WORLD EXAMPLE 3.2

Tax avoidance versus tax evasion

Tax evasion is illegal. It arises when tax owing to the tax authorities is reduced by illegal means, such as not declaring income. Tax evasion is deemed to be fraudulent and is regarded as a criminal offence. Money laundering is a form of tax evasion and accountants have a responsibility to inform the authorities if they uncover or suspect money laundering.

On the other hand **tax avoidance** is when a transaction is structured to reduce the tax owing to the local authorities. Tax avoidance is legal. Companies and individuals pay accountants to find ways to reduce their tax bills. Hence accountants are always looking for loopholes in the tax legislation, that enable them to reduce their clients' tax bills within the limits of the law.

One area that requires care is claiming personal expenses as business expenses. This is normal practice when preparing a sole trader's financial statements. The accountant typically has to estimate the portion that is business and to allocate that portion to the business entity. This adjustment provides the potential for manipulating an entity's reported performance. Where private expenses are treated as business expenditure, a lower profit results, which can have detrimental consequences for users, for example the tax authorities. In recent years the tax authorities have emphasized that over-claiming personal expenses is a form of tax evasion. Therefore, accountants and sole traders have to be very careful to make sure that they do not overstate the business element of a private expense and that they keep proper records to substantiate their claim of the extent of the business element.

The consequence of not respecting the entity concept when accounting for private transactions can be great as highlighted in Real World Example 3.3. In this example six individuals set up a company and swindled funds from wealthy individuals who claimed tax breaks from investing in the company. The invested funds were used to pay their personal expenses.

REAL WORLD EXAMPLE 3.3

Fraud

After a ten-year investigation by the tax authorities, Michael Richards, aged 55 from East Sussex and five others were jailed for a total of 45 years for fraud. The six men set up a fake company that undertook fake environmental projects. They lured wealthy individuals to invest in the environmental projects by highlighting the tax break available for investing in environmental companies. Wealthy individuals invested about £108 million in these projects. The six directors used the money to fund lavish lifestyles.

Source: See https://international-adviser.com/hmrc-reveals-top-10-tax-fraud-cases-2017/?gallery-image=2 for more examples of frauds in the UK in 2017. Accessed April 2018.

As will be seen in later chapters, one accounting entity can be a part of another accounting entity. For example, a branch of a retail chain store (such as Marks & Spencer plc) may be treated as a separate accounting entity for internal reporting purposes. However, the branch will also be a part of the business as a whole, which would be treated as another accounting entity for external reporting purposes. Similarly, one company may be a subsidiary of (i.e. owned by) another (holding) company. In this case the subsidiary will be one accounting entity, and its final financial statements must also be consolidated with those of the holding (owner) company into group final financial statements, representing another accounting entity.

In summary, an accounting entity can be a legal entity, part of a legal entity, a combination of several legal entities, part of another accounting entity, or a combination of accounting entities.

3.6 Key users of annual reports and their information needs

The users of annual reports identified in the *Conceptual Framework* are described below.

Investors

Investors are providers of risk capital. They are concerned with evaluating the 'risk in, and return provided by their investment'. A basic premise in the *Conceptual Framework* is that '*investors require information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends and to vote, or otherwise influence, management's actions that affect the use of the entity's economic resources*'. More explicit information needs are set out in *The Corporate Report* (ASSC, 1975, p. 20) – investors require information for five purposes:

1. To evaluate the performance of the entity and its management, and assess the effectiveness of the entity in achieving its objectives.
2. To assess the economic stability and vulnerability of the reporting entity including its liquidity (i.e. whether it will have enough money to pay its debts), its present or future requirements for additional capital, and its ability to raise long- and short-term finance.
3. To estimate the value of users' own or other users' present or prospective interests in, or claims on, the entity.
4. To ascertain the ownership and control of the entity.
5. To estimate the future prospects of the entity, including its capacity to pay dividends and to predict future levels of investment.

Accountants have traditionally regarded published financial statements as fulfilling two main functions: (1) stewardship, and (2) facilitating share trading and lending decisions. The concept of stewardship roughly corresponds with everyday usage of the word and refers to the directors' responsibility to account for the uses to which they have put the equity shareholders' investment. This is the one function of published financial statements on which most accountants agree. When it comes to providing information to facilitate share trading and lending decisions there is some disagreement. In particular, it is debatable whether past data is likely to be useful in predicting future profits, dividends or share prices. The literature on efficient market theory suggests that the content of annual reports has little, if any, predictive value. Published financial statements may therefore only perform a stewardship and feedback function.

Lenders

According to the *Conceptual Framework,* lenders are interested in information that enables them to determine whether their loans, and the interest attached to them, will be paid when due. Lenders encapsulate entities like the bank and investors in debt capital (bonds). Holders of debt capital that is traded on a recognized stock exchange will have similar information requirements to equity investors as they will also have to decide whether to hold, buy or sell their bonds. Certain information will be of particular relevance, such as that relating to:

1. The present and likely future cash position, since this will determine whether the company will be able to pay the annual interest on loans and repay the money borrowed as and when it becomes due (liquidity and solvency).
2. The economic stability and vulnerability of the company in so far as this reflects the risk of possible default in repayment of money borrowed by the company (risk).
3. Prior claims on the company's assets in the event of its going into liquidation (security).

Other creditors

Other creditors include suppliers. They have similar interests to lenders. When a supplier provides goods in advance of receiving payment, this is like giving a loan. Therefore, they are interested to determine at the outset whether to trade with the entity or not, and will want to make judgements on the length of credit period to give and the amount of credit to allow. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Credit suppliers are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer. Therefore, they are most interested in liquidity and changes in liquidity. A supplier may be interested in determining whether the company is growing as they may have to decide whether to increase their production capacity in order to meet the reporting entity's future demands.

How financial reporting is meeting the needs of the primary users

Information about the nature and amounts of a reporting entity's economic resources and claims is provided in the statement of financial position. The objective of this statement is to assist users when assessing an entity's financial strengths and weaknesses; when assessing the entity's liquidity and solvency; and the entity's need and ability to obtain financing. Information about the claims and payment requirements assists users to predict how future cash flows will be distributed among those with a claim on the reporting entity.

Changes in a reporting entity's economic resources and claims that result from that entity's performance are included in the statement of comprehensive income; and changes in a reporting entity's economic resources from other events or transactions, such as issuing debt or equity instruments, are disclosed in the statement of changes in equity. The separation of these changes in economic resources and claims into two different accounting reports helps users to distinguish between both types of change.

Information about a reporting entity's cash flows during the reporting period is disclosed in the statement of cash flows. The aim of the statement of cash flows is to assist users when assessing an entity's ability to generate future net cash inflows from different sources. This information indicates how the entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends to shareholders, and so on.

An underlying assumption of the *Conceptual Framework* is that to meet the objective of financial reporting the financial statements should be prepared using the accruals and going concern concept (discussed in Chapter 4).

3.7 Public accountability

The *Conceptual Framework* focuses on a narrow set of users who provide financial resources to the entity. However, there has long since been debate about this with many arguing that entities have a responsibility to account to a wide range of stakeholders including the public. It is argued that they need to be accountable to the public. **Public accountability** is where:

> *"there is an implicit responsibility to report publicly . . . incumbent on every entity whose size or format renders it significant; . . . we consider the responsibility to report publicly (referred to . . . as public accountability) is separate from and broader than the legal obligation to report and arises from the custodial role played in the community by economic entities; . . . they are involved in the maintenance of standards of life and the creation of wealth for and on behalf of the community."*
>
> (ASSC, 1975)

The 'custodial role' of business enterprises refers to their responsibility to use the assets with which they have been entrusted to create wealth and maintain the standard of living, and other considerations such as the quality of the environment. It follows from this notion of public accountability that the objective or function of annual reports is: '*to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information*'. 'Reasonable rights' is defined as follows: '*A reasonable right to information exists where the activities of an organisation impinge or may impinge on the interest of a user group.*'

There is widespread support for the notion that companies have responsibility for and are accountable to a wider range of stakeholders than the three user types referred to in the *Conceptual Framework*. Indeed, a cursory search through company annual reports and websites will highlight the fact that companies recognize their duty to other stakeholders. Real World Example 3.4 is an extract from Tesco Plc's annual report showing the importance of customer and suppliers to Tesco. These stakeholders form a key element of their business model.

REAL WORLD EXAMPLE 3.4

Key stakeholders central to Tesco's business model

Customers

Tesco exists to serve customers – listening to them and acting on what is most important to deliver the best possible shopping trip.

Our focus is always on making Tesco the best it can be for our customers. The better a job we do for customers, the more we will improve sales; the more our sales improve, the more we can reinvest in further improving the shopping trip.

Suppliers

We build close and mutually-beneficial relationships with our supplier partners, to source the best-possible products that meet and anticipate customers' needs.

***Source*:** Extract from Tesco's business model (2017) 'Annual Report and Financial Statements 2017', https://www.tescoplc.com/media/392373/68336_tesco_ar_digital_interactive_250417.pdf, accessed April 2018.

3.8 Other users of annual reports and their information needs

Employees

Employees and their representative groups are typically interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities. It is considered that entities have a responsibility for the future livelihood and prospects of their employees (*Corporate Report*, p. 21). Employee representatives (trade unions) will be interested in information for the purpose of wage bargaining. According to *The Corporate Report* such information may relate to

> *"the ability of the employer to meet wage demands, management's intentions regarding employment levels, locations and working conditions, the pay, conditions and terms of employment of various groups of employees and the contributions made by employees in different divisions. In addition, employees are likely to be interested in indications of the position, progress and prospects of the employing enterprise as a whole and about individual establishments and bargaining units."*

Some companies produce employee reports or set out their employment policies. Tesco have included a statement in their Corporate Responsibility Commitments on their approach to their employees, referred to as colleagues. This sets out the benefits from working in Tesco and the potential for employees if they remain with the company. An extract from the section on 'Creating Opportunities for Colleagues' is included in Real World Example 3.5.

REAL WORLD EXAMPLE 3.5

Colleagues

The improvements we are making to our business are driven by our colleagues, as they serve our shoppers a little better every day.

This year, we announced a 10.5% increase in hourly pay for our UK store colleagues over the next two years, and our Colleague Bonus Plan continues to reward colleagues in the UK for their contribution to our turnaround.

Some of the changes we have made to simplify our business have had a significant impact on colleagues, including the closure of our Customer Engagement Centre in Cardiff, and changes to our operational structures in stores, and I am grateful for the professionalism and integrity of our colleagues at these difficult times.

Over the summer, we also began to move to a new service model in our offices in the UK, followed by similar changes in Central Europe, in order to simplify the way we organise ourselves, reduce duplication and cost, and invest in serving shoppers better.

In a simpler business, it's particularly important that we still do everything we can to help colleagues develop their careers as they wish, and this year we have continued our apprenticeship programme in the UK, as well as running a Career Academy in our Thai business, for around 150 students.

We're also committed to building a team which is diverse, and reflects the communities we serve. We continue to develop an inclusive culture at every level of our organisation, helping our colleagues with the flexibility, skills and reward they need to get on.

***Source*:** Tesco plc (2018) 'Annual Report 2018', https://www.tescoplc.com/media/474793/tesco_ar_2018.pdf, accessed July 2018.

Customers

Customers have an interest in information about the continuance of an entity. Therefore, going concern will be of particular interest, especially when the customer has a long-term involvement with, or is dependent on, the entity. For example, if the reporting entity is engaged in construction work, customers will wish to assess the likelihood of its being able to complete long-term contracts. In the case of manufactured goods, such as computers and vehicles, customers will be concerned about the reporting entity's continued existence because of its warranty obligations and the need for spare parts. Annual reports may thus be useful to customers in assessing the likelihood of a reporting entity's continued existence.

Governments and their agencies

Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities and determine taxation policies, and as the basis for national income and similar statistics. For example, HM Revenue and Customs have a statutory right to information about the reporting entity for the purpose of assessing its liability to taxation. The Department of Trade and Industry require industry sector statistics to determine how sectors are performing. The government can utilize this information to provide assistance to particular sectors (e.g. grants and subsidies are awarded to the farming sector) and to penalize other sectors (e.g. a windfall tax was charged on utility companies in 1997). The government also needs to estimate economic trends, including balance of payments figures (imports versus exports), employment figures and inflation levels. In the UK most of this information is collected through special government returns. However, in some other countries corporate reports perform this function.

The public

Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to a local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and its range of activities. The public has a right to information about a local entity as most entities use community-owned assets such as roads and car parks. Their employment requirements may bring an influx of people to the area. More people means more places required in schools, longer waits for the doctor, and so on.

Some members of the public may be concerned about the employment policies of the reporting entity and therefore want information relating to local employment levels or discrimination in employment, for example. Other members of the public may be interested in any plans that the reporting entity has that affect the environment, including issues relating to conservation, pollution and congestion. Other matters

of a political or ethical nature may also be of particular concern to some sections of the community, such as contributions to political organizations, pressure groups or charities, and whether the reporting entity is trading with countries having repressive political regimes. Some of this information must be disclosed under the Companies Act 2006 (e.g. donations to political parties and charities). Most companies provide information that is relevant for the public and the local community in their CSR report, others provide it in the directors' report. Wm Morrison Supermarket plc provided information on what they do for local communities in a variety of places. Some are referred to in Real World Example 3.6).

REAL WORLD EXAMPLE 3.6

Wm Morrison Supermarket plc providing information for the local community

Morrisons have several initiatives to help the community and to provide information to the community about the activities that they undertake in support of the community.

Morrisons have set up the Morrisons Foundation. This foundation serves to provide grants and match funding to charities located in communities in England, Scotland and Wales. Staff can get involved in this and have a say in where the funds are to be invested. (see https://www.morrisonsfoundation.com/ for more details).

Morrisons host a blog, wherein they report what they are doing for communities acoss the UK. The blog is interactive and they solicit feedback from users. (See https://my.morrisons.com/blog/community/ for more detail.)

Finally, Morrisons provide information on what they are doing for their community in their CSR report.

***Source*:** Author, 2018.

Other users

Three further categories of user are also considered important – the analyst–adviser group, competitor and takeover bidders, and management. These are described next.

The analyst–adviser group

This group's information needs are satisfied by financial statements that have been prepared for the three key user groups identified in the *Conceptual Framework*. This grouping is explicitly referred to in *The Corporate Report*, which states that '*the information needs of the analyst–adviser group are likely to be similar to the needs of the users who are being advised. For example, the information needs of stockbrokers are likely to be similar to the needs of investors and those of trade unions are likely to be similar to the needs of employees*'. *The Corporate Report* makes the point that this group, because of their expertise, will tend to demand more elaborate information than other groups.

Competitors and takeover bidders

This grouping comes under 'the business contact group' in *The Corporate Report*. The rationale for competitors having a right to information is a little vague but seems to rest on the premise that inter-firm

comparisons of performance and costs can facilitate improvements in efficiency. Similarly, given that mergers and takeovers of less efficient firms are in the public interest, a case can be made for the disclosure of information to potential bidders.

Management

One of the duties required of management is to prepare financial statements that give a true and fair view of the state of the company's affairs for the period and its financial position at the end of the period. This involves ensuring that they comply with the *Conceptual Framework*, the accounting standards and legislation. The IASB recognizes that management are users of financial statements. However, it takes the view that financial statements should not be prepared with management's information needs in mind. Management have access to information which can be, and is, tailored to their information needs. As their needs are varied and bespoke given the decision being made, it is considered that the *Conceptual Framework* and the information included in financial statements should ignore their needs. Regardless, management usually find the information useful as they use it to assess their performance in the past and to determine if their projections of what will happen in the future are realistic or not.

Though there is no formal legislative rule or accounting standard requiring companies to provide information to a wider range of stakeholder, it is clear that companies have accepted that they are accountable to a number of different groups (employees, the public, etc.) and that the function of annual reports is also to provide each of them with information. Two topical reports that are typically disclosed in annual reports are corporate social responsibility reports and environmental reports.

3.9 Corporate social responsibility (CSR)

Over the past twenty years there has been an increase in the level of disclosures provided by companies on how they interact with society, stakeholders and the environment. The increased focus on a wide range of users has been supplemented by some regulatory requirements, for example, EU Directives on company law and other matters (e.g. employee participation) require greater disclosure of information that is primarily for the benefit of employees, potential employees and trade unions in the annual report. Furthermore, the privatization of government-owned enterprises and greater environmental awareness has resulted in more demand from members of the public, such as small investors and environmental activist groups, for tailored annual reports. To cater for these wider interests directors in publicly listed companies prepare a *corporate social responsibility report* which can be issued as a document in its own right or as part of the company's annual report.

Corporate social responsibility (CSR) describes how entities adopt policies of their own free will which benefit stakeholders. Figure 3.4 outlines some of the different types of stakeholder and potential action taken by companies that may be reported in a CSR report.

The function of the CSR report is to communicate social and environmental effects of a company's actions to interested parties within society and to society at large (Gray et al., 1987). CSR activities are mooted to bring benefits to an organization. Bhattacharya et al. (2008) argue that CSR can help with the recruitment and retention of employees, as they have a better perception of the company if they have policies such as payroll giving, active fundraising or releasing staff to do community volunteering (on full pay). It is also argued that CSR is good risk management. Promoting a culture of doing good means that, when deviant behaviour does occur, the markets and public will react less negatively as the behaviour will be seen as being out of character. CSR activities also lead to brand enhancement and a stronger brand reputation; this can lead to investor loyalty and customer loyalty, which is beneficial for the organization. A real life example detailing some of the socially responsible activities undertaken by Tesco is provided in Real World Example 3.7.

Figure 3.4

Local communities	• Purchasing produce from the locality, volunteering in local schools, providing money donations to local charities, sponsoring prizes for educational programmes, etc.
Employees	• Health and safety, fair wages, pensions, training, promotion, share options, etc.
Customers	• Warranties, customer support, guarantees, etc.
The environment	• Pollution, recycling, energy saving
In general	• Conducting business in an ethical manner (ethical code of practice)

Examples of CSR activities that benefit different stakeholders

REAL WORLD EXAMPLE 3.7

Tesco CSR: Ireland

Tesco focus on five main areas: food waste, community funds, charity partnerships, sustainability and packaging. At the time of writing, September 2018, Tesco were working with 275 different charitable groups to provide over four million meals to people in need. They estimate this to be worth €5.8 million to the charity sector. They also have a policy of giving to the community locality around each store, with large stores donating up to €1,000 every eight weeks to up to three charities and small stores donating up to €500. Tesco also forms a partnership with a local charity and in October 2014 Tesco Ireland partnered with Temple Street University Hospital and from this time Tesco colleagues, staff and communities have raised €3 million for the hospital.

Tesco also strive to promote sustainability in several areas including the Irish food and agriculture sectors, by supporting Irish suppliers. In 2018 Tesco were sourcing produce from over 480 Irish suppliers. These in turn were purchasing produce from 13,000 Irish farming families. Finally, in terms of packaging Tesco is improving the amount of its packaging that can be recycled and have made a pledge to be fully recyclable by 2025.

***Source*:** Tesco website (2018) https://www.tesco.ie/, accessed September 2018.

On the downside, some environmentalists argue that UK companies 'greenwash' their annual reports, highlighting what they do for the environment and the community; however, they do not identify the environmental risks that their entity creates for the community/environment, nor the steps taken to hedge against these risks. BP is one example of a company that champions CSR, even changing its brand name to 'BP – beyond petroleum' to emphasize its environmental objectives. However, the environmental catastrophe that occurred in 2010 in the Gulf of Mexico (the Deepwater oil leak) was caused by reckless practice that had not been identified as a potential environmental risk (Thornton, 2010).

3.10 Environmental accounting (social accounting)

Sometimes referred to as 'green accounting' or 'social accounting', environmental accounting has many aims. At government level it tries to highlight the contribution that the natural environment makes to the economy both in terms of the economic contribution earned from the environment's resources and the impact that a clean economy has on social well-being. In addition, it tries to determine the expenditure that is incurred in ensuring that the environment is protected (for example, expenditure on controlling pollution or controlling resource depletion such as the destruction of the Amazon forest).

At company level environmental reporting is used to raise public/stakeholder awareness about the steps that an entity is taking to protect the environment. It typically identifies the costs incurred in, for example, reducing pollution, protecting wildlife and wildlife habitats. The impact that a company's actions have on society and the environment is difficult to ascertain as many of the benefits and costs are intangible, are difficult to identify, and when identified are difficult to quantify as the values may be very subjective. Nonetheless, many companies make reference to environment management in their annual report and prepare a separate report providing details of all their activities that impact on society and the environment. In many instances the items reported are not converted to a monetary value but are instead reported on in terms of quantity, for example, green house gas emissions are commonly reported on in millions of tonnes (Mte) of CO_2. When you attempt Learning Activity 3.3, you will realize the difficulties faced by companies when reporting on environmental issues.

Learning Activity 3.3

Search the internet for BP's most recent report on sustainability performance. Note the range of different performance indicators reported on. A consideration of the different types of environmental issues being considered should help you to realize the difficulties companies face, both trying to manage and measure their impact on the environment. Could you convert this to a monetary report?

3.11 The conceptual framework debate, standardization and choice

Much controversy has surrounded the idea of developing a conceptual framework of accounting, particularly in the UK where the self-regulatory standard-setting institutions have limited resources. There are two main related issues. The first is whether the cost of preparing a conceptual framework is justified in terms of its benefits, including the questions of whether it is possible to develop a set of consistent fundamentals and whether these will lead to improvements in accounting standard setting. The second issue concerns whether accounting standards just make published financial statements more consistent rather than comparable, or alternatively whether more meaningful comparisons would result from allowing companies to choose those accounting policies that are appropriate to their individual circumstances. This has always been an issue in standard setting, but the development of a conceptual framework accentuates the debate because it will presumably lead to greater standardization.

There is a wide variety of schools of thought on the conceptual framework debate, but for the sake of structuring and simplifying the discussion, these can be grouped into two extremes comprising the normative/deductive approach and the positive/empiricist approach.

The normative/deductive approach regards a conceptual framework as absolutely essential. **Normative theories** view accounting as a technical process that is capable of measuring the 'true income' of a business given a set of theories that specify how this should be done (e.g. Hicks, 1946). They often use the analogy that financial statements are like maps, which have the potential to provide a **faithful representation** of reality given a set of underlying consistent rules (i.e. a conceptual framework). Similarly, **deductive theories** view accounting as a technical process but advocates a user needs' approach based on identifying the objectives of financial statements similar to that taken in all the conceptual framework projects to date.

In contrast, the positive/empiricist approach regards a conceptual framework as at best unnecessary, and at worst positively dysfunctional. **Empirical theories** view accounting as an economic process, and the objective of financial statements as being to facilitate predictions (of profits, insolvency, etc.). Thus, accounting methods should be selected on the basis of which give the best predictions – that is, not according to some conceptual framework. Many **positive theories** view accounting, and particularly standard setting, as a political process that may be used to provide information for some stakeholders (equity shareholders) to the detriment of other stakeholders (employees, creditors). They maintain that standard setting should be as a result of consensus and not dictatorial pronouncements based on a conceptual framework which, itself, is the product of a particular set of class interests (e.g. equity shareholders' interests).

At present the international accounting standard setters seem to have taken a deductive view – emphasizing the need for accounting information to satisfy user information needs. However, standards are created after an extensive consultation period wherein all stakeholders are encouraged to contribute their view.

It is difficult to determine if the monetary cost of preparing a conceptual framework is justified in terms of the benefits (in the form of improvements in standard setting). In recent years some of the standards have been considered to have been poor (for example, the standard on accounting for derivative transactions). Furthermore, the development of a conceptual framework is unlikely to quieten those who argue that accounting standards may promote more consistency of accounting policies between companies but this does not necessarily result in greater comparability. There are said to be 'circumstantial variables' or 'differences in circumstances' between companies that necessitate the exercise of managerial discretion in the choice of accounting methods. It is argued that standardization forces companies to use the same accounting policies, but it does not necessarily mean that they are the most appropriate accounting policies for each company and thus comparisons may be misleading. The existence of a conceptual framework is likely to lead to greater standardization and, it is said, more rigidity, a lack of flexibility, and thus less innovation. It is easy to be cynical about innovation when it takes the form of creative accounting, but it must be recognized that standardization taken to the extreme (as uniformity) would probably reduce innovation, which is said to be the case in some countries with uniform national accounting systems specified solely by law.

Summary

All professions need a body of theological, empirical and/or theoretical knowledge to guide the actions of their practitioners. In accounting this guidance is provided in the conceptual framework. The standard setters have recently reviewed the conceptual framework with the new version

published in 2018. The tension between the need for a set of rules to guide practice, and the awareness that these are unlikely to be definitive, has given rise to extensive debate about the current development of a conceptual framework of accounting, also known as generally accepted accounting principles (GAAP).

The FASB, IASC/IASB and ASC/ASB have all published conceptual frameworks of accounting. The main purposes of a conceptual framework of accounting are to provide a basis for the development and review of accounting standards, to assist preparers when deciding on accounting policy or when accounting for a transaction that is not covered by a standard and to assist users and auditors of financial statements. This typically takes the form of an internally consistent set of interrelated objectives and fundamentals that prescribe the nature, function and limits of financial statements.

The IASB conceptual framework is contained in its *Conceptual Framework for Financial Reporting* (2018). This sets out the objective of general purpose financial reporting, the qualitative characteristics of useful financial information, the financial statements and the reporting entity, the elements that make up financial statements, recognition and derecognition of the elements, measurement of the elements, presentation and disclosure of transactions and concepts of capital and capital maintenance.

The accounting entity concept defines the boundaries of the organizational unit that is the focus of the accounting process, and thus the transactions that will be recorded. An accounting entity may also be viewed as a set of assets and liabilities, the difference between the money values of these being capital. This is referred to as the accounting equation, and can be presented in the form of a statement of financial position in which the assets and liabilities are valued at their historical cost (or fair value if a listed entity).

The IASB's *Conceptual Framework* views the role of accounting as providing information to potential and existing investors, loan providers and other creditors to assist their economic decision-making. This accountability is discharged through financial reports (the statement of financial performance, the statement of financial position and other statements and notes). However, in practice, it is recognized that businesses have accountability responsibilities that go beyond providing information for investors, loan and other creditors. They have a responsibility to a wider range of users including employees, suppliers, customers, governments and their agencies, and the public. Each of these will have particular information needs and the *Conceptual Framework* does not specifically set out to satisfy their needs.

Therefore, most plc companies provide information for employees and on their activities towards the local community and the environment within a CSR report. The CSR report can form part of the annual report or can be a separate report.

Key terms and concepts