FINANCIAL ACCOUNTING FOR DECISION MAKERS

NINTH EDITION

Peter Atrill
Eddie McLaney

Pearson

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Preface

This text provides a comprehensive introduction to financial accounting. It is aimed at students who are not majoring in accounting as well as those who are. Those studying introductory-level financial accounting as part of their course in business, economics, hospitality management, tourism, engineering, or some other area, should find that the text provides complete coverage of the material at the level required. Students who are majoring in accounting should find the text a useful introduction to the main principles, which can serve as a foundation for further study.

The main focus of the text is on the ways in which financial statements and financial information can improve the quality of decision making. To ensure that readers understand the practical implications of the subject, there are, throughout the text, numerous illustrative extracts using commentary from company reports, survey data and other sources. Although some technical issues are dealt with in the text, the main emphasis throughout is on basic principles and underlying concepts.

In this ninth edition, we have taken the opportunity to make improvements, including those suggested by students and lecturers who used the previous edition. We have rewritten some material to make it more understandable to readers. We have updated and expanded the number of examples from real life. We have also incorporated developments to International Financial Reporting Standards, including the recently-published version of the Conceptual Framework for Financial Reporting. Recent developments in the area of corporate governance are discussed and explained. Finally, the discussion of the role of the auditor has been expanded.

The text is written in an 'open-learning' style. This means that there are numerous integrated activities, worked examples and questions throughout the text to help you to understand the subject fully. In framing these questions and tasks, we have tried to encourage critical thinking by requiring analysis and evaluation of various concepts and techniques. You are encouraged to interact with the material and to check your progress continually. Irrespective of whether you are using the text as part of a taught course or for personal study, we have found that this approach is more 'user-friendly' and makes it easier for you to learn.

We recognise that most of you will not have studied financial accounting before and, therefore, we have tried to write in a concise and accessible style, minimising the use of technical jargon. We have also tried to introduce topics gradually, explaining everything as we go. Where technical terminology is unavoidable we try to provide clear explanations. You will find all of the key terms highlighted in the text, and then listed at the end of each chapter with a page reference. All of these key terms are also listed alphabetically, with a concise definition, in the glossary given in Appendix B. This should provide a convenient point of reference from which to revise.

A further important consideration in helping you to understand and absorb the topics covered is the design of the text itself. The page layout and colour scheme have been carefully considered to allow for the easy navigation and digestion of material. The layout features a large page format, an open design, and clear signposting of the various features and assessment material.

We hope that you will find the text both readable and helpful.

Peter Atrill
Eddie McLaney

How to use this book

We have organised the chapters to reflect what we consider to be a logical sequence and, for this reason, we suggest that you work through the text in the order in which it is presented. We have tried to ensure that earlier chapters do not refer to concepts or terms that are not explained until a later chapter. If you work through the chapters in the 'wrong' order, you will probably encounter concepts and terms that were explained previously.

Irrespective of whether you are using the book as part of a lecture/tutorial-based course or as the basis for a more independent mode of study, we advocate following broadly the same approach.

Integrated assessment material

Interspersed throughout each chapter are numerous **activities.** You are strongly advised to attempt all of these questions. They are designed to simulate the sort of quick-fire questions that your lecturer might throw at you during a lecture or tutorial. Activities serve two purposes:

- to give you the opportunity to check that you understand what has been covered so far;
- to encourage you to think about the topic just covered, either to see a link between that topic and others with which you are already familiar, or to link the topic just covered to the next.

The answer to each activity is provided immediately after the question. This answer should be covered up until you have deduced your solution, which can then be compared with the one given.

Towards the end of Chapters 2–12 there is a **self-assessment question.** This is more comprehensive and demanding than most of the activities, and is designed to give you an opportunity to check and apply your understanding of the core coverage of the chapter. The solution to each of these questions is provided in Appendix C. As with the activities, it is important that you attempt each question thoroughly before referring to the solution. If you have difficulty with a self-assessment question, you should go over the relevant chapter again.

End-of-chapter assessment material

At the end of each chapter there are four **critical review questions.** These are short questions requiring a narrative answer or discussion within a tutorial group. They are intended to help you assess how well you can recall and critically evaluate the core terms and concepts covered in each chapter. Answers to these questions are provided in Appendix D at the end of the book.

At the end of each chapter, except for Chapter 1, there is a set of **exercises.** These are mostly computational and are designed to reinforce your knowledge and understanding. Exercises are graded as 'basic', 'intermediate' or 'advanced' according to their level of difficulty.

The basic-level questions are fairly straightforward; the more advanced ones can be quite demanding but can be successfully completed if you have worked conscientiously through the chapter and have attempted the basic exercises. Solutions to some of the exercises in each chapter are provided in Appendix E. A coloured exercise number identifies these questions. Here, too, a thorough attempt should be made to answer each exercise before referring to the solution.

Solutions to the other exercises are provided in a separate Instructors' Manual.

Content and structure

The text comprises twelve main chapters. The market research for this text revealed a divergence of opinions, given the target market, on whether or not to include material on double-entry bookkeeping techniques. So as to not interrupt the flow and approach of the main chapters, Appendix A on recording financial transactions (including activities and three exercise questions) has been placed after Chapter 12.

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Chapter 1

INTRODUCTION TO ACCOUNTING

INTRODUCTION

We begin this opening chapter of the book by considering the role of accounting. We shall see how accounting can be a valuable tool for decision making. We shall also identify the main users of accounting information and the qualities, or characteristics, needed for accounting information to be useful for decision-making purposes. We shall then go on to consider the two main strands of accounting: financial accounting and management accounting. We shall discuss the differences between them and why these differences arise.

Since this book is mainly concerned with accounting and financial decision making for private-sector businesses, we shall devote some time to examining the business environment. We shall consider the purpose of a private-sector business, the main forms of business enterprise that exist and the ways in which businesses may be structured. We also consider what the key financial objective of a business is likely to be. These are all important factors that help to shape the accounting and financial information produced.

Learning outcomes

When you have completed this chapter, you should be able to:

- explain the nature and role of accounting;
- identify the main users of financial information and discuss their needs;
- identify and discuss the qualities that make accounting information useful; and
- explain the purpose of a business and describe how businesses are organised and structured.

WHAT IS ACCOUNTING?

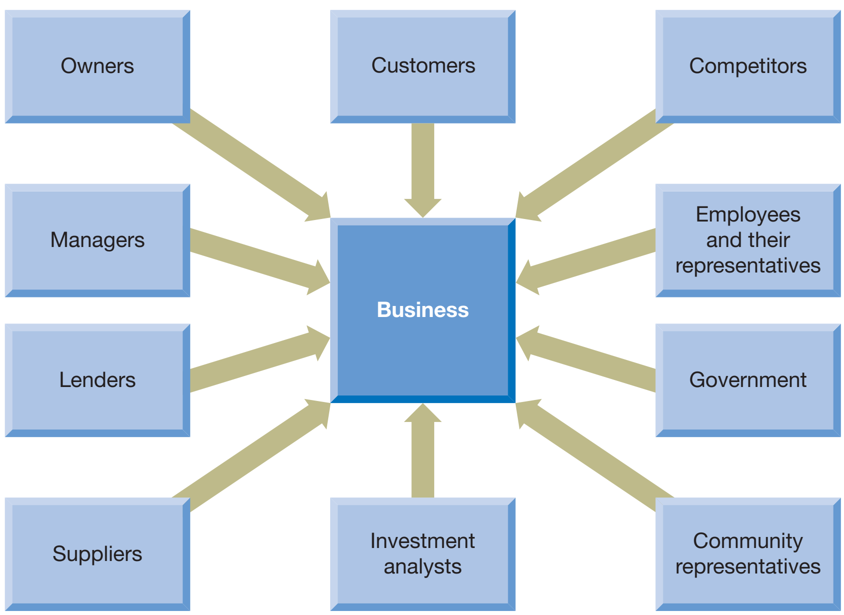
Accounting is concerned with *collecting*, *analysing* and *communicating* financial information. The ultimate aim is to help those using this information to make more informed decisions. Unless the financial information being communicated can improve the quality of decisions that users make, there is really no point in producing it.

Sometimes the impression is given that the purpose of accounting is simply to prepare financial (accounting) reports on a regular basis. While it is true that accountants undertake this kind of work, it does not represent an end in itself. As already mentioned, the ultimate aim of the accountant's work is to give users better financial information on which to base their decisions. This decision-making perspective of accounting fits in with the theme of the book and shapes the way in which we deal with each topic.

A useful starting point in exploring the subject is to ask who uses financial information and for what kind of decisions it is useful. It is to these issues that we now turn.

WHO ARE THE USERS OF ACCOUNTING INFORMATION?

For accounting information to be useful, the accountant must be clear *for whom* the information is being prepared and *for what purpose* the information will be used. There are likely to be various groups of people (known as 'user groups') with an interest in a particular organisation, in the sense of needing to make decisions about it. For a typical private-sector business, the more important of these groups are shown in Figure 1.1. Take a look at this figure and then try Activity 1.1.



Several user groups have an interest in accounting information relating to a business. The majority of these are outside the business but, nevertheless, have a stake in it. This is not meant to be an exhaustive list of potential users; however, the groups identified are normally the most important.

Figure 1.1 Main users of financial information relating to a business

Activity 1.1

Ptarmigan Insurance plc (PI) is a large motor insurance business. Taking the user groups identified in Figure 1.1, suggest, for each group, the sorts of decisions likely to be made about PI and the factors to be taken into account when making these decisions.

Your answer may be along the following lines:

User group	*Decisions likely to be made*
Customers	Whether to take further motor policies with PI. This might involve an assessment of PI's ability to continue in business and to meet customers' needs, particularly concerning any insurance claims made.
Competitors	How best to compete against PI or, perhaps, whether to leave the market on the grounds that it is not possible to compete profitably with PI. This might involve competitors using PI's performance in various respects as a 'benchmark' when evaluating their own performance. They might also try to assess PI's financial strength and to identify significant changes that may signal PI's future intentions (for example, raising funds as a prelude to market expansion).
Employees	Whether to continue working for PI and, if so, whether to demand higher rewards for doing so. The future plans, profits and financial strength of the business are likely to be of particular interest when making these decisions.
Government	Whether PI should pay tax and, if so, how much, whether it complies with agreed pricing policies, whether financial support is needed and so on. In making these decisions, an assessment of PI's profits, sales revenues and financial strength would be made.
Community representatives	Whether to allow PI to expand its premises and/or whether to provide economic support for the business. When making such decisions, PI's ability to continue to provide employment for the community, its use of community resources and its willingness to fund environmental improvements are likely to be important considerations.
Investment analysts	Whether to advise clients to invest in PI. This would involve an assessment of the likely risks and future returns associated with PI.
Suppliers	Whether to continue to supply PI with goods or services and, if so, whether to supply these on credit. This would require an assessment of PI's ability to pay for any goods or services supplied at the due dates.
Lenders	Whether to lend money to PI and/or whether to require repayment of any existing loans. PI's ability to pay the interest and to repay the principal sum on time would be important factors in such decisions.
Managers	Whether the performance of the business needs to be improved. Performance to date may be compared with earlier plans or some other 'benchmark' to decide whether action needs to be taken. Managers may also wish to consider a change in PI's future direction. This may involve determining whether the business has the financial flexibility and resources to take on new challenges
Owners	Whether to invest more in PI or to sell all, or part, of the investment currently held. This would involve an assessment of the likely risks and returns associated with PI. Owners may also be involved with decisions on the rewards offered to senior managers. When doing so, the financial performance and position of the business would normally be taken into account.

Although this answer covers many of the key points, you may have identified other decisions and/or other factors to be taken into account by each group.

THE CONFLICTING INTERESTS OF USERS

We have just seen that each user group will have its own particular interests. There is always a risk, however, that the interests of the various user groups will collide. The distribution of business wealth provides the most likely area for collisions to take place. Take, for example, the position of owners and managers. Although managers are appointed to act in the best interests of the owners, they may not always do so. Instead, they may use the wealth of the business to award themselves large pay rises, to furnish large offices or to buy expensive cars for their own use. Accounting can play an important role in monitoring and reporting how various groups benefit from the business. Owners may, therefore, rely on accounting information to see whether pay and benefits received by managers are appropriate and are in line with agreed policies.

There is also a potential collision of interest between lenders and owners. Funds loaned to a business, for example, may not be used for their intended purpose. They may be withdrawn by the owners for their own use rather than used to expand the business as agreed. Thus, lenders may rely on accounting information to see whether the owners have kept to the terms of the loan agreement.

Activity 1.2

Can you think of *two* other examples where accounting information may be relied upon by a user group to check whether the distribution of business wealth is appropriate and/or in accordance with particular agreements?

Two possible examples that spring to mind are:

- employees wishing to check that they are receiving a 'fair share' of the wealth created by the business and that managers are complying with agreed profit-sharing schemes;
- governments wishing to check that the owners of a monopoly do not benefit from excessive profits and that any pricing rules relating to the monopoly's goods or services have not been broken.

You may have thought of other examples.

HOW USEFUL IS ACCOUNTING INFORMATION?

No one would seriously claim that accounting information fully meets all of the needs of each of the various user groups. Accounting is a developing subject and we still have much to learn about user needs and the ways in which these needs should be met. Nevertheless, the information contained in accounting reports should help users make decisions relating to the business. The information should reduce uncertainty about the financial position and performance of the business. It should help to answer questions concerning the availability of funds to pay owners a return, to repay loans, to reward employees and so on.

Typically, there is no close substitute for the information provided by the financial statements. Thus, if users cannot glean the required information from the financial statements, it is often unavailable to them. Other sources of information concerning the financial health of a business are normally much less useful.

Activity 1.3

What other sources of information might, say, an investment analyst use in an attempt to gain an impression of the financial position and performance of a business? (Try to think of at least four.) What kind of information might be gleaned from these sources?

Other sources of information available include:

- meetings with managers of the business;
- public announcements made by the business;
- newspaper and magazine articles;
- websites, including the website of the business;
- radio and TV reports;
- information-gathering agencies (for example, agencies that assess the creditworthiness or credit ratings of the business);
- industry reports; and
- economy-wide reports.

These sources can provide information on various aspects of the business, such as new products or services being offered, management changes, new contracts offered or awarded, the competitive environment within which the business operates, the impact of new technology, changes in legislation, changes in interest rates and future levels of inflation.

The kind of information identified above is not really a substitute for accounting information. Rather, it is best used in conjunction with accounting information to provide a clearer picture of the financial health of a business.

Evidence on the usefulness of accounting

There are arguments, and convincing evidence, that accounting information is at least *perceived* as being useful to users. Numerous research surveys have asked users to rank the importance of accounting information, in relation to other sources of information, for decision-making purposes. Generally, these studies have found that users rank accounting information very highly. There is also considerable evidence that businesses choose to produce accounting information that exceeds the minimum requirements imposed by accounting regulations. For example, businesses often produce a considerable amount of accounting information for managers that is not required by any regulations. Presumably, the cost of producing this additional accounting information is justified on the grounds that users find it useful. Such arguments and evidence, however, leave unanswered the question of whether the information produced is actually used for decision-making purposes, that is: does it affect behaviour?

It is normally very difficult to assess the impact of accounting on decision-making behaviour. One situation arises, however, where the impact of accounting information can be observed and measured. This is where the **shares** (portions of ownership of a business) are traded on a stock exchange. The evidence shows that, when a business makes an announcement concerning its accounting profits, the prices at which shares are traded and the volume of shares traded often change significantly. This suggests that investors are changing their views about the future prospects of the business as a result of this new information becoming available to them. This, in turn, leads them to make a decision either to buy or to sell shares in the business.

While there is evidence that accounting reports are seen as useful and are used for decision-making purposes, it is impossible to measure just how useful they really are to users.

Activity 1.4

Can you figure out why it is impossible to measure this?

Accounting reports will usually represent only one input to a particular decision. The weight attached to them by the decision maker, and the resulting benefits, cannot normally be accurately assessed.

We cannot say with certainty, therefore, whether the cost of producing these reports represents value for money.

It is possible, however, to identify the kinds of qualities which accounting information must possess in order to be useful. Where these qualities are lacking, the usefulness of the information will be diminished. This point is now considered in some detail.

PROVIDING A SERVICE

One way of viewing accounting is as a form of service. The user groups identified in Figure 1.1 can be seen as the 'clients' and the accounting (financial) information produced can be seen as the service provided. The value of this service to the various 'clients' can be judged according to whether the accounting information meets their needs.

To be useful to users, particularly investors and lenders, the information provided should possess certain qualities, or characteristics. In particular, it must be relevant and it must faithfully represent what it is meant to represent. These two qualities, **relevance** and **faithful representation**, are regarded as fundamental qualities and require further explanation.

- *Relevance.* Accounting information should make a difference. That is, it should be capable of influencing user decisions. To do this, it should help to *predict future events* (such as predicting next year's profit), or help to *confirm past events* (such as establishing last year's profit), or do both. By confirming past events, users can check on the accuracy of their earlier predictions. This can, in turn, help them to improve the ways in which they make predictions in the future.

  To be relevant, accounting information must cross a threshold of **materiality**. An item of information is considered material, or significant, only if its omission or misstatement would change the decisions that users make.

Activity 1.5

Do you think that what is material for one business will also be material for all other businesses?

No, it will normally vary from one business to the next. What is material will depend on factors such as the size of the business, the nature of the information and the amounts involved.

Ultimately, what is considered material is a matter of judgement. When making this kind of judgement, managers should consider how this information is likely to be used by users. If a piece of information is not considered material, it should not be included within the accounting reports. It will merely clutter them up and, perhaps, interfere with the users' ability to interpret them.

- *Faithful representation.* Accounting information should represent what it is meant to represent. To do so, the information provided must reflect the *substance* of what has occurred rather than simply its *legal form*. Take for example a manufacturer that provides goods to a retailer on a sale-or-return basis. The manufacturer may wish to treat this arrangement as two separate transactions. Thus, a contract may be agreed for the sale of the goods and a separate contract agreed for the return of the goods if unsold by the retailer. This may result in a sale being reported when the goods are delivered to the retailer even though they are returned at a later date. The economic substance, however, is that the manufacturer made no sale as the goods were subsequently returned. They were simply moved from the manufacturer's business to the retailer's business and then back again. Accounting reports should reflect this economic substance. To do otherwise would be misleading.

  To provide a perfectly faithful representation, the information should be *complete.* In other words, it should incorporate everything needed to understand what is being portrayed. Thus, information relating to a particular item would normally contain a description of its nature, some suitable numerical measurement and, where necessary, explanations of important facts. Information should also be *neutral,* which means that it should be presented and selected without bias. No attempt should be made to manipulate the information in such a way as to influence user attitudes and behaviour. Finally, it should be *free from error.* This is not the same as saying that it must be perfectly accurate. Accounting information often contains estimates, such as future sales or costs, which may turn out to be inaccurate. Nevertheless, estimates may still be faithfully represented providing they are accurately described and properly prepared.

Activity 1.6

In practice, do you think that each piece of accounting information produced will be perfectly complete, neutral and free from error?

Probably not – however, each piece of information should be produced with these aims in mind.

Accounting information should contain *both* of these fundamental qualities - relevance and faithful representation – if it is to be useful. There is usually little point in producing information that is relevant, but which lacks faithful representation, or producing information that is irrelevant, even if it is faithfully represented. Nevertheless, a trade-off between relevance and faithful representation may sometimes have to be made. Where, for example, an estimate of some future financial commitment is highly uncertain, it may not reflect a totally faithful portrayal of the item. This estimate may, however, be the most relevant information available. In such a situation, it may be better for users to receive the estimate, along with a description of the uncertainties that surround it, rather than receive no estimate at all.

Further qualities

Where accounting information is both relevant and faithfully represented, there are other qualities that, if present, can enhance its usefulness. These are **comparability**, **verifiability**, **timeliness** and **understandability**. Each of these qualities is now considered.

- *Comparability.* When choosing between alternatives, users of accounting information seek to make comparisons. They may want to compare performance of the business over time (for example, the profit for this year compared to that for last year). They may also want to compare certain aspects of business performance (such as the level of sales achieved during the year) to those of similar businesses. To help users make comparisons, items that are alike should be treated in the same way – both over time and between businesses. Items that are not alike, on the other hand, should not be treated as though they are. Users must be able to detect both similarities and differences in items being compared.
- *Verifiability.* This quality provides assurance to users that the accounting information provided faithfully portrays what it is supposed to portray. Accounting information is verifiable where different, independent experts can reach broad agreement, that it provides a faithful portrayal. Verification can be direct, such as checking a bank account balance, or indirect, such as checking the underlying assumptions and methods used to derive an estimate of a future cost.
- *Timeliness.* Accounting information should be made available in time for users to make their decisions. A lack of timeliness undermines the usefulness of the information. Broadly speaking, the later accounting information is produced, the less useful it becomes.
- *Understandability.* Accounting information should be presented in as clear and as concise a form as possible. Nevertheless, some accounting information may be too complex to be presented in an easily digestible form. This does not mean, however, that it should be ignored. To do so would result in reporting only a partial view of financial matters. (See Reference 1 at the end of the chapter.)

Activity 1.7

Accounting reports are aimed at users with a reasonable knowledge of accounting and business and who are prepared to invest time in studying them. Do you think, however, that accounting reports should be understandable to users without any knowledge of accounting or business?

It would be very helpful if everyone could understand accounting reports. This, however, is unrealistic as complex financial events and transactions cannot normally be expressed in simple terms. Any attempts to do so are likely to produce a very distorted picture of reality.

It is probably best that we regard accounting reports in the same way that we regard a report written in a foreign language. To understand either of these, we need to have had some preparation. When producing accounting reports, it is normally assumed that the user not only has a reasonable knowledge of business and accounting but is also prepared to invest some time in studying the reports. Nevertheless, the onus is clearly on accountants to provide information in a way that makes it as understandable as possible to non-accountants.

It is worth emphasising that the four additional qualities just discussed cannot make accounting information useful. They can only enhance the usefulness of information that is already relevant and faithfully represented.

WEIGHING UP THE COSTS AND BENEFITS

Even when an item of accounting information may have all the qualities described, this does not automatically mean that it should be collected and reported to users. There is still one more hurdle to jump. Consider Activity 1.8.

Activity 1.8

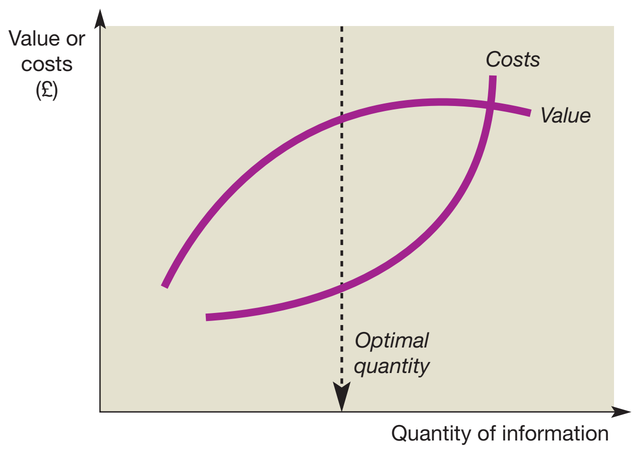
Suppose an item of information is capable of being provided. It is relevant to a particular decision and can be faithfully represented. It is also comparable, verifiable and timely, and can be understood by the decision maker.

Can you think of the reason why, in practice, you might choose not to produce the information?

The reason is that you judge the cost of doing so to be greater than the potential benefit of having the information. This cost–benefit issue will limit the amount of accounting information provided.

In theory, a particular item of accounting information should only be produced if the costs of providing it are less than the benefits, or value, to be derived from its use. Figure 1.2 shows the relationship between the costs and value of providing additional accounting information.

The figure shows how the value of information received by the decision maker eventually begins to decline. This is, perhaps, because additional information becomes less relevant, or because of the problems that a decision maker may have in processing the sheer quantity of



The benefits of accounting information eventually decline. The cost of providing information, however, will rise with each additional piece of information. The optimal level of information provision is where the gap between the value of the information and the cost of providing it is at its greatest.

Figure 1.2 Relationship between costs and the value of providing additional accounting information

information provided. The costs of providing the information, however, will increase with each additional piece of information. The broken line indicates the point at which the gap between the value of information and the cost of providing that information is at its greatest. This represents the optimal amount of information that can be provided. This theoretical model, however, poses a number of problems in practice.

To illustrate the practical problems of establishing the value of information, let us assume that we accidentally reversed our car into a wall in a car park. This resulted in a dented boot and scraped paintwork. We want to have the dent taken out and the paintwork re-sprayed at a local garage. We know that the nearest garage would charge £450 but we believe that other local garages may offer to do the job for a lower price. The only way of finding out the prices at other garages is to visit them, so that they can see the extent of the damage. Visiting the garages will involve using some fuel and will take up some of our time. Is it worth the cost of finding out the price for the job at the various local garages? The answer, as we have seen, is that if the cost of discovering the price is less than the potential benefit, it is worth having that information.

To identify the various prices for the job, there are several points to be considered, including:

- How many garages shall we visit?
- What is the cost of fuel to visit each garage?
- How long will it take to make all the garage visits?
- At what price do we value our time?

The economic benefit of having the information on the price of the job is probably even harder to assess. The following points need to be considered:

- What is the cheapest price that we might be quoted for the job?
- How likely is it that we shall be quoted a price cheaper than £450?

As we can imagine, the answers to these questions may be far from clear – remember that we have only contacted the local garage so far. When assessing the value of accounting information, we are confronted with similar problems.

Producing accounting information can incur significant costs. Furthermore, these costs can be difficult to identify. Although direct, out-of-pocket costs, such as salaries of accounting staff, can usually be identified without too much problem, these are only part of the total costs involved. There are other costs such as the cost of users' time spent on analysing and interpreting the information provided. These costs are much more difficult to identify and may vary between users.

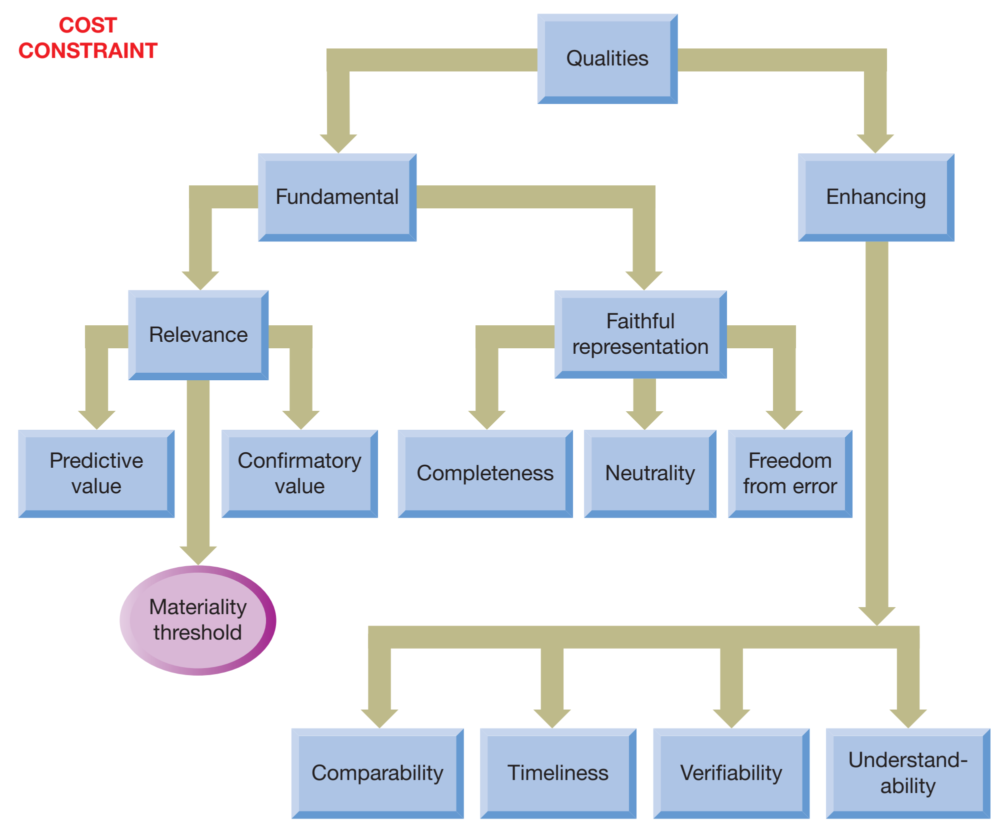
Activity 1.9

What about the economic benefits of producing accounting information? Do you think it is easier, or harder, to identify the economic benefits of accounting information than the associated costs?

It is normally even harder to identify the benefits. We saw earlier that, even if we could accurately measure the economic benefits arising from a particular decision, accounting information will be only one factor influencing that decision. Furthermore, the benefits of accounting information, like the associated costs, can vary between users.

There are no easy answers to the problem of weighing costs and benefits. Although it is possible to apply some 'science' to the problem, a lot of subjective judgement is normally involved.

The qualities, or characteristics, influencing the usefulness of accounting information, which have been discussed above, are summarised in Figure 1.3.



There are two fundamental qualities that determine the usefulness of accounting information. In addition, there are four qualities that enhance the usefulness of accounting information. **The benefits of providing the information, however, should outweigh the costs.**

Figure 1.3 The qualities that influence the usefulness of accounting information

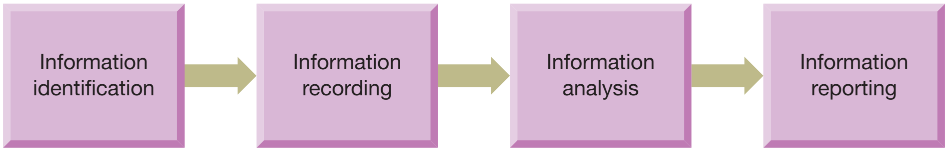
ACCOUNTING AS AN INFORMATION SYSTEM

We have already seen that accounting can be seen as the provision of a service to 'clients'. Another way of viewing accounting is as a part of the business's total information system. Users, both inside and outside the business, have to make decisions concerning the allocation of scarce resources. To ensure that these resources are efficiently allocated, users often need financial information on which to base decisions. It is the role of the accounting system to provide this information.

The **accounting information system** should have certain features that are common to all information systems within a business. These are:

- identifying and capturing relevant information (in this case, financial information);
- recording, in a systematic way, the information collected;
- analysing and interpreting the information collected; and
- reporting the information in a manner that suits the needs of users.

The relationship between these features is set out in Figure 1.4.



There are four sequential stages of an accounting information system. The first two stages are concerned with preparation, whereas the last two stages are concerned with using the information collected.

Figure 1.4 The accounting information system

Given the decision-making emphasis of this book, we shall be concerned primarily with the final two elements of the process: the analysis and reporting of financial information. We shall consider the way in which information is used by, and is useful to, users rather than the way in which it is identified and recorded.

Efficient accounting information systems are an essential ingredient of an efficient business. Where they contain errors, it can be both costly and disruptive. **Real World 1.1** describes how spreadsheets, which are widely used to prepare accounting and financial information, may introduce errors. This, in turn, can lead to poor financial decisions.

Real World 1.1

Systems error!

Almost one in five large businesses have suffered financial losses as a result of errors in spreadsheets, according to F1F9, which provides financial modelling and business forecasting to large businesses. It warns of looming financial disasters as 71 per cent of large British businesses always use spreadsheets for key financial decisions.

The company's new white paper entitled *Capitalism's Dirty Secret* showed that the abuse of the humble spreadsheet could have far-reaching consequences. Spreadsheets are used in the preparation of British company accounts worth up to £1.9 trillion and the UK manufacturing sector uses spreadsheets to make pricing decisions for up to £170 billion worth of business.

In total, spreadsheet calculations represent up to £38 billion of British private sector investment decisions per year, data harvested through YouGov found. Yet 16 per cent of large companies have admitted finding inaccurate information in spreadsheets more than 10 times in 2014.

Grenville Croll, a spreadsheet risk expert, said of the findings: 'Spreadsheets have been shown to be fallible yet they underpin the operation of the financial system. If the uncontrolled use of spreadsheets continues to occur in highly leveraged markets and companies, it is only a matter of time before another “Black Swan” event (an event that is highly unusual and difficult to predict) occurs causing catastrophic loss.’

The report warns that while 33 per cent of large businesses report poor decision-making as a result of spreadsheet problems, a third of the financial decision-makers using spreadsheets in large UK businesses are still given zero training.

Source: Adapted extract from: Burn-Callander, R. (2015) Stupid errors in spreadsheets could lead to Britain’s next corporate disaster, *Daily Telegraph*, 7 April, www.telegraph.co.uk.

MANAGEMENT ACCOUNTING AND FINANCIAL ACCOUNTING

Accounting is usually seen as having two distinct strands. These are:

- **management accounting**, which seeks to meet the accounting needs of managers; and
- **financial accounting**, which seeks to meet the needs of owners and lenders. It should also, however, be useful to other users, identified earlier in the chapter , excluding the managers (see Figure 1.1).

The difference in their targeted user groups has led to each strand of accounting developing along different lines. The main areas of difference are as follows:

- *Nature of the reports produced.* Financial accounting reports tend to be general-purpose. As mentioned above, they are aimed primarily at providers of finance (owners and lenders) but contain financial information that should also be useful for a broad range of external users. Management accounting reports, on the other hand, are often specific-purpose reports. They are designed with a particular decision in mind and/or for a particular manager.
- *Level of detail.* Financial accounting reports provide users with a broad overview of the performance and position of the business for a period. As a result, information is aggregated (that is, added together) and detail is often lost. Management accounting reports, however, often provide managers with considerable detail to help them with a particular operational decision.
- *Regulations.* Financial accounting reports, for many businesses, are subject to accounting regulations imposed by the law and accounting rule makers. These regulations often require a standard content and, perhaps, a standard format to be adopted. Management accounting reports, on the other hand, are not subject to regulation and can be designed to meet the needs of particular managers.

Activity 1.10

Why do you think financial accounting reports are subject to regulation, whereas management accounting reports are not?

Financial accounting reports are for external publication. To protect external users, who depend on the quality of information provided by managers, they are subject to regulation. Management accounting reports, on the other hand, are produced exclusively for managers and so are for internal use only.

- *Reporting interval.* For most businesses, financial accounting reports are produced on an annual basis, although some large businesses produce half-yearly reports and a few produce quarterly ones. Management accounting reports will be produced as frequently as needed by managers. A sales manager, for example, may require routine sales reports on a daily, weekly or monthly basis, so as to monitor performance closely. Special-purpose reports can also be prepared when the occasion demands: for example, where an evaluation is required of a proposed investment in new equipment.
- *Time orientation.* Financial accounting reports reflect the performance and position of the business for the past period. In essence, they are backward looking. Management accounting reports, on the other hand, often provide information concerning future performance as well as past performance. It is an oversimplification, however, to suggest that financial accounting reports never incorporate expectations concerning the future. Occasionally, businesses will release projected information to other users in an attempt to raise funds or to fight off unwanted takeover bids. Even preparation of the routine financial accounting reports typically requires making some judgements about the future, as we shall see in Chapter 3.
- *Range and quality of information.* Two key points are worth mentioning. First, financial accounting reports concentrate on information that can be quantified in monetary terms. Management accounting also produces such reports, but is also more likely to produce reports that contain information of a non-financial nature, such as physical volume of inventories, number of sales orders received, number of new products launched, physical output per employee and so on. Second, financial accounting places greater emphasis on the use of objective, verifiable evidence when preparing reports. Management accounting reports may use information that is less objective and verifiable, but nevertheless provides managers with the information they need.

We can see from this that management accounting is less constrained than financial accounting. It may draw from a variety of sources and use information that has varying degrees of reliability. The only real test to be applied when assessing the value of the information produced for managers is whether or not it improves the quality of the decisions made.

The main differences between financial accounting and management accounting are summarised in Figure 1.5.

The differences between management accounting and financial accounting suggest that there are differences in the information needs of managers and those of other users. While differences undoubtedly exist, there is also a good deal of overlap between the needs of both.

Activity 1.11

Can you think of *two* areas of overlap between the information needs of managers and those of other users? (*Hint*: Think about the time orientation and the level of detail of accounting information.)

Two areas that spring to mind are:

- Managers will, at times, be interested in receiving a historical overview of business operations of the sort provided to other users.
- Other users would be interested in receiving detailed information relating to the future, such as the planned level of profits, and non-financial information, such as the state of the sales order book and the extent of product innovations.

	Management accounting	Financial accounting
Nature of the reports produced	Tend to be specific-purpose	Tend to be general-purpose
Level of detail	Often very detailed	Usually broad overview
Regulations	Unregulated	Usually subject to accounting regulation
Reporting interval	As short as required by managers	Usually annual or bi-annual
Time orientation	Often based on projected future information as well as past information	Almost always historical
Range and quality of information	Tend to contain financial and non-financial information; often use non-verifiable information	Focus on financial information; great emphasis on objective, verifiable evidence

Though management and financial accounting are closely linked and have broadly common objectives, they differ in emphasis in various aspects.

Figure 1.5 Management and financial accounting compared

To some extent, differences between the two strands of accounting reflect differences in access to financial information. Managers have much more control over the form and content of the information that they receive. Other users have to rely on what managers are prepared to provide or what financial reporting regulations insist must be provided. Although the scope of financial accounting reports has increased over time, fears concerning loss of competitive advantage and user ignorance about the reliability of forecast data have resulted in other users not receiving the same detailed and wide-ranging information as that available to managers.

In the past, accounting systems tended to be primarily concerned with providing information for external users. Financial accounting requirements were the main priority and management accounting suffered as a result. Survey evidence suggests, however, that this is no longer the case. Modern management accounting systems usually provide managers with information that is relevant to their needs rather than that determined by external reporting requirements. External reporting cycles, however, retain some influence over management accounting. Managers tend to be aware of external users' expectations (see Reference 2 at the end of the chapter).

SCOPE OF THIS BOOK

This book is concerned with financial accounting rather than management accounting. In Chapter 2 we begin by introducing the three main financial statements:

- the statement of financial position;
- the income statement; and
- the statement of cash flows.

These statements are briefly reviewed before we go on to consider the statement of financial position in more detail. We shall see that the statement of financial position provides information concerning the wealth held by a business at a particular point in time and the claims against this wealth. Included in our consideration of the statement of financial position will be an introduction to the **conventions of accounting**. These are generally accepted rules that are followed when preparing financial statements.

Chapter 3 concentrates on the second of the major financial statements, the income statement. This statement provides information concerning the wealth (profit) created by a business during a period. We shall, therefore, be looking at such issues as how profit is measured, the point at which profit is recognised and the accounting conventions applied when preparing the income statement.

In the UK, and throughout much of the world, the limited company is the major form of business unit. In Chapter 4 we consider the accounting aspects of limited companies. Although these are, in essence, the same as for other types of business, some points of detail need to be considered. We shall continue our examination of limited companies in Chapter 5 and, in particular, consider the framework of rules governing the presentation of accounting reports to owners and external users.

Chapter 6 deals with the last of the three major financial statements, the statement of cash flows. This financial statement is important in identifying the financing and investing activities of the business over a period. It sets out how cash was generated and how cash was used during a period.

How financial reporting rules have developed to try to provide clear definitions and recognition criteria for key items appearing in the financial statements is developed in Chapter 7. The ultimate purpose of these rules is to enhance the comparability of financial statements between businesses. In an increasingly complex world, there is a need for rules to help both preparers and users of financial statements.

Chapters 8 and 9 consider the various techniques for analysing financial statements. To gain a deeper understanding about the financial health of a business, financial statements may be analysed using financial ratios and other techniques. Expressing two figures in the financial statements in the form of a ratio and then comparing it with a similar ratio for, say, another business, can often tell us much more than just reading the figures alone.

The typical large business in the UK operates as a group of companies rather than a single company. A group of companies exists where one company controls one or more other companies. In Chapter 10 we consider the reasons why groups exist and explore the accounting issues raised by combining companies into groups.

In Chapter 11 we shall see how the focus of financial reporting has changed over time to become more decision-oriented. We shall also look at possible ways in which the scope of financial reporting may be increased in order to meet the needs of users.

Finally, in Chapter 12, we consider the way in which larger businesses are managed. We examine the reasons why conflicts of interests may arise between owners and managers and how the behaviour of managers may be monitored and controlled.

THE CHANGING FACE OF ACCOUNTING

Over the past fifty years or so, the environment within which businesses operate has become increasingly turbulent and competitive. Various reasons have been identified to explain these changes, including:

- the increasing sophistication of customers;
- greatly improved speed and sophistication of communication (particularly with the Internet);
- the development of a global economy where national frontiers become less important;
- rapid changes in technology;
- the deregulation of domestic markets (for example, electricity, water and gas);
- increasing pressure from owners (shareholders) for competitive economic returns; and
- greater volatility of financial markets.

This new, more complex, environment has brought new challenges for managers and other users of accounting information. Their needs have changed and both financial accounting and management accounting have had to respond. To meet the changing needs of users, there has been a radical review of the kind of information to be reported.

The changed environment has given added impetus to the search for a clear conceptual framework, or framework of principles, upon which to base financial accounting reports. Various attempts have been made to clarify their purpose and to provide a more solid foundation for the development of accounting rules. Work on developing a conceptual framework tries to address fundamental questions such as:

- Who are the users of financial accounting information?
- What kinds of financial accounting reports should be prepared and what should they contain?
- How should items such as profit and assets be identified and measured?

The internationalisation of businesses has created a need for accounting rules to have an international reach. It can no longer be assumed that users of accounting information relating to a business are based in the country in which the business operates. Neither can it be assumed that the users are familiar with the accounting rules of that country. Thus, there has been increasing harmonisation of accounting rules across national frontiers.

Activity 1.12

How should the harmonisation of accounting rules benefit:

(a) an international investor?
(b) an international business?

(a) An international investor should benefit because the accounting definitions and policies used in preparing financial accounting reports will not vary across countries. This should make the comparison of performance between businesses operating in different countries much easier.

(b) An international business should benefit because the cost of producing accounting reports in order to comply with the rules of different countries can be expensive. Harmonisation can, therefore, lead to significant cost savings. It may also broaden the appeal of the business among international investors. Where there are common accounting rules, they may have greater confidence to invest.

In response to criticisms that the financial reports of some businesses are opaque and difficult for users to interpret, great efforts have been made to improve reporting rules. Accounting rule makers have tried to ensure that the accounting policies of businesses are more comparable and transparent and that the financial reports provide a more faithful portrayal of economic reality.

Management accounting has also changed by becoming more outward looking in its focus. In the past, information provided to managers has been largely restricted to that collected within the business. However, the attitude and behaviour of customers and rival businesses have now become the object of much information gathering. Increasingly, successful businesses are those that are able to secure and maintain competitive advantage over their rivals.

To obtain this advantage, businesses have become more ‘customer driven’ (that is, concerned with satisfying customer needs). This has led to the production of management accounting information that provides details of customers and the market, such as customer evaluation of services provided and market share. In addition, information about the costs and profits of rival businesses, which can be used as ‘benchmarks’ by which to gauge competitiveness, is gathered and reported.

To compete successfully, businesses must also find ways of managing costs. The cost base of modern businesses is under continual review and this, in turn, has led to the development of more sophisticated methods of measuring and controlling costs.

ACCOUNTING FOR BUSINESS

We have seen that the needs of the various user groups will determine the kind of accounting information to be provided. Those needs, however, will partly be shaped by the forms of business ownership and the ways in which a business is organised and structured. In the sections that follow, we shall consider the business environment within which accounting information is produced. This should help our understanding of points that crop up in later chapters.

WHAT IS THE PURPOSE OF A BUSINESS?

Peter Drucker, an eminent management thinker, has argued that ‘the purpose of business is to create and keep a customer’ (see Reference 3 at the end of the chapter). Drucker defined the purpose of a business in this way in 1967, at a time when most businesses did not adopt this strong customer focus. His view, therefore, represented a radical challenge to the accepted view of what businesses should do. More than fifty years on, however, his approach has become part of the conventional wisdom. It is now widely recognised that, in order to succeed, businesses must focus on satisfying the needs of the customer.

Although the customer has always provided the main source of revenue for a business, this has often been taken for granted. In the past, too many businesses have assumed that the customer would readily accept whatever services or products were on offer. When competition was weak and customers were passive, businesses could operate under this assumption and still make a profit. However, the era of weak competition has passed. Now, customers have much greater choice and are much more assertive concerning their needs. They now demand higher quality services and goods at cheaper prices. They also require that services and goods be delivered faster with an increasing emphasis on the product being tailored to their individual needs. If a business cannot meet these needs, a competitor often can. Thus, the business mantra for the current era is '*the customer is king*'. Most businesses recognise this fact and organise themselves accordingly.

Real World 1.2 describes how the Internet and social media have given added weight to this mantra. It points out that dissatisfied customers now have a powerful medium for broadcasting their complaints.

Real World 1.2

The customer is king

The mantra that the 'customer is king' has gained even greater significance among businesses in recent years because of the rise of the Internet and social media. In the past, a dissatisfied customer might tell only a few friends about a bad buying experience. As a result, the damage to the reputation of the business concerned would normally be fairly limited. However, nowadays, through the magic of the Internet, several hundred people, or more, can be very speedily informed of a bad buying experience.

Businesses are understandably concerned about the potential of the Internet to damage reputations, but are their concerns justified? Do customer complaints, which wing their way through cyberspace, have any real effect on the businesses concerned? A Harris Poll survey of 2,000 adults in the UK and US suggests they do and so businesses should be concerned. It seems that social media can exert a big influence on customer buying decisions.

The Harris Poll survey, which was conducted online, found that around 20 per cent of those surveyed use social media when making buying decisions. For those in the 18 to 34 age range, the figure rises to almost 40 per cent. Furthermore, 60 per cent of those surveyed indicated that they would avoid buying from a business that receives poor customer reviews for its products or services.

The moral of this tale appears to be that, in this Internet age, businesses must work even harder to keep their customers happy if they are to survive and prosper.

Source: Based on information in Miesbach, A. (2015) Yes, the customer is still king, 30 October, www.icmi.com.

WHAT KINDS OF BUSINESS OWNERSHIP EXIST?

The particular form of business ownership has certain implications for financial accounting and so it is useful to be clear about the main forms of ownership that can arise. There are basically three arrangements for private-sector businesses:

- sole proprietorship;
- partnership; and
- limited company.

We shall now consider these.

Sole proprietorship

Sole proprietorship, as the name suggests, is where an individual is the sole owner of a business. This type of business is often quite small in terms of size (as measured, for example, by sales revenue generated or number of staff employed); however, the number of such businesses is very large indeed. Examples of sole-proprietor businesses can be found in most industrial sectors but particularly within the service sector. Hence, services such as electrical repairs, picture framing, photography, driving instruction, retail shops and hotels have a large proportion of sole-proprietor businesses.

The sole-proprietor business is easy to set up. No formal procedures are required and operations can often commence immediately (unless special permission is required because of the nature of the trade or service, such as running licensed premises (a pub)). The owner can decide the way in which the business is to be conducted and has the flexibility to restructure or dissolve the business whenever it suits. The law does not recognise the sole-proprietor business as being separate from the owner, so the business will cease on the death of the owner.

Although the owner must produce accounting information about the business to satisfy the taxation authorities, there is no legal requirement to provide it to other user groups. Some user groups, however, may demand accounting information about the business and may be in a position to enforce their demands (for example, a bank requiring accounting information on a regular basis as a condition of a loan). A sole proprietor has unlimited liability which means that no distinction is made between the proprietor's personal wealth and that of the business if there are business debts to be paid.

Partnership

A **partnership** exists where two or more individuals carry on a business together with the intention of making a profit. Partnerships have much in common with sole-proprietor businesses. They are usually quite small in size (although some, such as partnerships of accountants and solicitors, can be large). They are also easy to set up, as no formal procedures are required (and it is not even necessary to have a written agreement between the partners). The partners can agree whatever arrangements suit them concerning the financial and management aspects of the business. Similarly, the partnership can be restructured or dissolved by agreement between the partners.

Partnerships are not recognised in law as separate entities and so contracts with third parties must be entered into in the name of individual partners. The partners of a business usually have unlimited liability.

Activity 1.13

What do you think are the main advantages and disadvantages of a partnership compared to a sole-proprietor business?

The main advantages of a partnership over a sole-proprietor business are:

- sharing the burden of ownership;
- the opportunity to specialise rather than cover the whole range of services (for example, in a solicitors' practice each partner may specialise in a different aspect of the law); and
- the ability to raise capital where this is beyond the capacity of a single individual.

The main disadvantages of a partnership compared with a sole proprietorship are:

- the risks of sharing ownership of a business with unsuitable individuals; and
- the limits placed on individual decision making that a partnership will impose.

Limited company

A **limited company** can range in size from quite small to very large. There is no limit on the number of individuals who can subscribe capital and become the owners, which provides the opportunity to create a very large-scale business. The liability of owners, however, is limited (hence 'limited' company), which means that those individuals subscribing capital to the company are liable only for debts incurred by the company up to the amount that they have invested, or agreed to invest. This cap on the liability of the owners is designed to limit risk and to produce greater confidence to invest. Without such limits on owner liability, it is difficult to see how a modern capitalist economy could operate. In many cases, the owners of a limited company are not involved in the day-to-day running of the business and will, therefore, invest in a business only if there is a clear limit set on the level of investment risk.

Note that this 'limited liability' does not apply to sole proprietors and partners. These individuals have a legal obligation to meet all of their business debts, if necessary using, what they may have thought of as, private assets (for example, their private houses). The ability of the owners of limited companies to limit their liability can often make this type of type of business more attractive than either sole proprietorships or partnerships.

The benefit of limited liability, however, imposes certain obligations on such companies. To start up a limited company, documents of incorporation must be prepared that set out, among other things, the objectives of the business. Furthermore, a framework of regulations exists that places obligations on limited companies concerning the way in which they conduct their affairs. Part of this regulatory framework requires annual financial reports to be made available to owners and lenders and, usually, an annual general meeting of the owners has to be held to approve the reports. In addition, a copy of the annual financial reports must be lodged with the Registrar of Companies for public inspection. In this way, the financial affairs of a limited company enter the public domain.

With the exception of small companies, there is also a requirement for the annual financial reports to be subject to an audit. This involves an independent firm of accountants examining the annual reports and underlying records to see whether the reports provide a true and fair view of the financial health of the company and whether they comply with the relevant accounting rules established by law and by accounting rule makers. Limited companies are considered in more detail in Chapters 4 and 5.

All of the large household-name UK businesses (Marks and Spencer, Tesco, Shell, Sky, Rolls-Royce, BT, easyJet and so on) are limited companies.

Activity 1.14

What are the main advantages of forming a partnership business rather than a limited liability company? Try to think of at least three.

The main advantages are:

- the ease of setting up the business;
- the degree of flexibility concerning the way in which the business is conducted;
- the degree of flexibility concerning restructuring and dissolution of the business; and
- freedom from administrative burdens imposed by law (for example, the annual general meeting and the need for an independent audit).

As we saw earlier, the main disadvantage of a partnership compared with a limited company is that it is not normally possible to limit the liability of all of the partners. There is, however, a hybrid form of business ownership that is referred to as a Limited Liability Partnership (LLP). This has many of the attributes of a normal partnership but is different insofar that the LLP, rather than the individual partners, is responsible for any debts incurred. Accountants and solicitors often use this type of partnership.

This book concentrates on the accounting aspects of limited liability companies because they are, by far, the most important in economic terms. The early chapters will introduce accounting concepts through examples that do not draw a distinction between the different types of business. Once we have dealt with the basic accounting principles, which are precisely the same for all three types of business, we go on to see how they are applied to limited companies.

HOW ARE BUSINESSES ORGANISED?

Most businesses involving more than a few owners and/or employees are set up as limited companies. Finance will come from the owners (shareholders) both in the form of a direct cash investment to buy shares (in the ownership of the business) and through the shareholders allowing past profits, which belong to them, to be reinvested in the business. Finance will also come from lenders (banks, for example), who earn interest on their loans. Further finance will be provided through suppliers of goods and services being prepared to supply on credit.

In larger limited companies, the owners (shareholders) tend not to be involved in the daily running of the business; instead they appoint a board of directors to manage the business on their behalf. The board is charged with three major tasks:

1 setting the overall direction and strategy for the business;
2 monitoring and controlling the activities of the business; and
3 communicating with shareholders and others connected with the business.

Each board has a chairman, elected by the directors, who is responsible for running the board in an efficient manner. In addition, each board has a chief executive officer (CEO) who is responsible for running the business on a day-to-day basis. Occasionally, the roles of chairman and CEO are combined, although it is usually considered to be a good idea to separate them to prevent a single individual having excessive power. We shall consider the relationship between directors and shareholders in more detail in Chapters 4 and 12.

The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager being given responsibility for a particular part of the business's operations.

THE QUEST FOR WEALTH CREATION

A business is normally created to enhance the wealth of its owners. This may come as a surprise, as there are other objectives that a business may pursue that would fulfil the needs of others with a stake in the business.

Activity 1.15

What other objectives might a business pursue? Try to think of at least two.

A business may seek:

- to provide well-paid jobs and good working conditions for its employees;
- to conserve the environment for the local community;
- to produce products or services that will benefit its customers; and/or
- to support local suppliers.

You may have thought of others.

Although a business may pursue other such objectives, it is normally set up primarily with a view to increasing the wealth of its owners. In practice, the behaviour of businesses over time appears to be consistent with this objective.

Within a market economy, there are strong competitive forces at work that ensure that failure to enhance owners' wealth will not be tolerated for long. Competition for the funds provided by the owners and competition for managers' jobs will normally mean that the owners' interests will prevail. If the managers do not provide the required increase in ownership wealth, the owners have the power to replace the existing management team with a new team that is more responsive to their needs.

MEETING THE NEEDS OF OTHER STAKEHOLDERS

The points made above do not mean that the needs of other groups with a stake in the business, such as employees, customers, suppliers, the community, are unimportant. In fact, the opposite is true, if the business wishes to survive and prosper over the longer term. For example, a business with disaffected customers may well find that they turn to another supplier, resulting in a loss of shareholder wealth. **Real World 1.3** provides examples of businesses that acknowledge the vital link between satisfying customers' needs and creating wealth (value) for their owners (shareholders).

Real World 1.3

Expressing its position

National Express plc, a leading transport provider, states its approach as follows:

> At National Express we believe our business model should start with our customers. By serving our customers with operational excellence, we are able to create profit and cash, thereby generating shareholder value.

Source: www.nationalexpress.com [accessed 2 January 2019].

Adopting a customer focus

John Menzies plc, a distribution and aviation logistics business, states:

> **We believe that the passion of our people, and their commitment to delivering great customer experiences, are crucial to delivering shareholder value – and this belief informs our entire approach to doing business.**

Source: www.johnmenziesplc.com [accessed 2 January 2019].

Other stakeholders that contribute towards the wealth-creation process must also be considered. A dissatisfied workforce can result in low productivity and strikes while dissatisfied suppliers can withhold vital supplies or give lower priority to orders received. A discontented local community can withdraw access to community resources. In each case, the owners' wealth will suffer.

Real World 1.4 describes how one well-known business came to recognise that future success depended on the support of key stakeholder groups.

Real World 1.4

The price of clothes

Nike is a highly successful business with a globally-recognised brand. However, it was not so long ago that the business was mired in controversy. It had become a focal point for protesters who regarded the business as a byword for 'sweatshop' labour practices. In 1992, an article was published that exposed the low wages and poor working conditions of those producing Nike products in Indonesia. Subsequent protests and further revelations resulted in unwanted media attention to which the business was, at first, slow to properly respond. However, by 1998, weakening demand for its products meant that the issue could no longer be lightly dismissed. Nike publicly acknowledged the reputation it had gained for 'sweatshop' labour practices and the adverse effect this was having on customer attitudes.

Its management realised that, if nothing else, it was good business to improve the working lives of those producing Nike products in third world countries. This resulted in a commitment to better working conditions, higher wages and a minimum working age. A code of conduct for Nike suppliers concerning the treatment of their workforce was established and independent audits were implemented to monitor adherence to the code. The business also committed to greater transparency: it now publishes reports on its responsibilities and the ways in which these have been fulfilled.

Although Nike was not the only large business engaged in sweatshop practices, it took a lead in trying to eradicate them and, by doing so, removed the stain from its reputation. This has been rewarded by a continuing demand for its products.

Source: Based on information in Nisen, M. (2013) *How Nike Solved it Sweatshop Problem* Business Insider 9 May and Allarey, R. (2015) *This Is How Nike Managed to Clean Up Its Sweatshop Reputation* 8 June http://www.complex.com.

It is clear from the above that creating wealth for the owners is not the same as seeking to maximise the current year's profit. Wealth creation is concerned with the longer term. It relates not only to this year's profit but to that of future years as well. In the short term, corners can be cut and risks taken that improve current profit at the expense of future profit. **Real World 1.5** provides some examples of how emphasis on short-term profit can be very damaging.

Real World 1.5

Short-term gains, long-term problems

For many years, under the guise of defending capitalism, we have been allowing ourselves to degrade it. We have been poisoning the well from which we have drawn wealth. We have misunderstood the importance of values to capitalism. We have surrendered to the idea that success is pursued by making as much money as the law allowed without regard to how it was made.

Thirty years ago, retailers would be quite content to source the shoes they wanted to sell as cheaply as possible. The working conditions of those who produced them was not their concern. Then headlines and protests developed. Society started to hold them responsible for previously invisible working conditions. Companies like Nike went through a transformation. They realised they were polluting their brand. Global sourcing became visible. It was no longer viable to define success simply in terms of buying at the lowest price and selling at the highest.

Financial services and investment are today where footwear was thirty years ago. Public anger at the crisis will make visible what was previously hidden. Take the building up of huge portfolios of loans to poor people on US trailer parks. These loans were authorised without proper scrutiny of the circumstances of the borrowers. Somebody else then deemed them fit to be securitised and so on through credit default swaps and the rest without anyone seeing the transaction in terms of its ultimate human origin.

Each of the decision makers thought it okay to act like the thoughtless footwear buyer of the 1970s. The price was attractive. There was money to make on the deal. Was it responsible? Irrelevant. It was legal, and others were making money that way. And the consequences for the banking system if everybody did it? Not our problem.

The consumer has had a profound shock. Surely we could have expected the clever and wise people who invested our money to be better at risk management than they have shown themselves to be in the present crisis? How could they have been so gullible in not challenging the bankers whose lending proved so flaky? How could they have believed that the levels of bonuses that were, at least in part, coming out of their savings could have been justified in 'incentivising' a better performance? How could they have believed that a 'better' performance would be one that is achieved for one bank without regard to its effect on the whole banking system? Where was the stewardship from those exercising investment on their behalf?

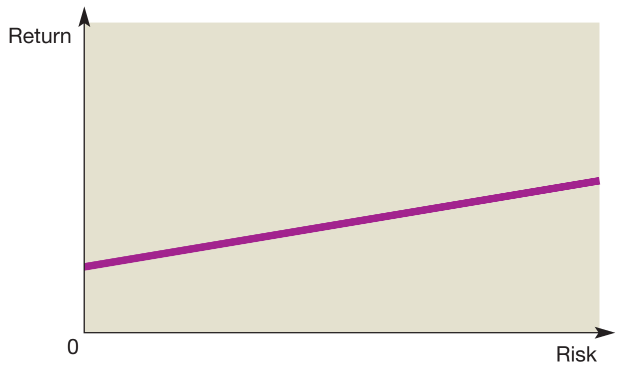
The answer has been that very few of them do exercise that stewardship. Most have stood back and said it doesn't really pay them to do so. The failure of stewardship comes from the same mindset that created the irresponsible lending in the first place. We are back to the mindset that has allowed us to poison the well: never mind the health of the system as a whole, I'm making money out of it at the moment. Responsibility means awareness for the system consequences of our actions. It is not a luxury. It is the cornerstone of prudence.

FT *Source*: Goyder, M. (2009) How we've poisoned the well of wealth, *Financial Times*, ft.com, 15 February.

BALANCING RISK AND RETURN

All decision making concerns the future and financial decision making is no exception. The only thing certain about the future, however, is that we cannot be sure what will happen. Things may not turn out as planned and this risk should be taken into account when making financial decisions.

As in other aspects of life, risk and return tend to be related. Evidence shows that returns relate to risk in something like the way shown in Figure 1.6.



Even at zero risk a certain level of return will be required. This will increase as the level of risk increases.

Figure 1.6 Relationship between risk and return

Activity 1.16

Look at Figure 1.6 and state, in broad terms, where an investment in:

(a) UK government savings account; and
(b) shares in an oil business

should be placed on the risk–return line.

A UK government savings account is normally a very safe investment. Even if the government were in financial difficulties, it may well be able to print more money to repay investors. Returns from this form of investment, however, are normally very low.

Investing in shares in a commercial business runs a risk of losing part or, possibly, the entire amount invested. On the other hand, such an investment can produce very high positive returns. Thus, the government savings account should be placed towards the far left of the risk–return line and the oil business shares towards the far right.

This relationship between risk and return has important implications for setting financial objectives for a business. The owners will require a minimum return to induce them to invest at all, but will require an additional return to compensate for taking risks; the higher the risk, the higher the required return. Managers must be aware of this and must strike the appropriate balance between risk and return when setting objectives and pursuing particular courses of action.

The turmoil in the banking sector, earlier this century, has shown, however, that the right balance is not always struck. Some banks took on excessive risks in pursuit of higher returns and, as a consequence, incurred massive losses. They are now being kept afloat with taxpayers' money. **Real World 1.6** discusses the collapse of one leading bank, in which the UK government took a majority stake, and argues that the risk appetite of banks must now change.

Real World 1.6

Banking on change

The taxpayer has become the majority shareholder in the Royal Bank of Scotland (RBS). This change in ownership, resulting from the huge losses sustained by the bank, will shape the future decisions made by its managers. This does not simply mean that it will affect the amount that the bank lends to homeowners and businesses. Rather it is about the amount of risk that it will be prepared to take in pursuit of higher returns.

In the past, those managing banks such as RBS saw themselves as producers of financial products that enabled banks to grow faster than the economy as a whole. They did not want to be seen as simply part of the infrastructure of the economy. It was too dull. It was far more exciting to be seen as creators of financial products that created huge profits and, at the same time, benefited us all through unlimited credit at low rates of interest. These financial products, with exotic names such as 'collateralised debt obligations' and 'credit default swaps', ultimately led to huge losses that taxpayers had to absorb in order to prevent the banks from collapse.

Now that many banks throughout the world are in taxpayers' hands, they are destined to lead a much quieter life. They will have to focus more on the basics such as taking deposits, transferring funds and making simple loans to customers. Is that such a bad thing?

The history of banking has reflected a tension between carrying out their core functions and the quest for high returns through high risk strategies. It seems, however, that for some time to come they will have to concentrate on the former and will be unable to speculate with depositors' cash.

Source: Based on information in Peston, R. (2008) We own Royal Bank, BBC News, 28 November, www.bbc.co.uk.

REASONS TO BE ETHICAL

The way in which individual businesses operate in terms of the honesty, fairness and transparency with which they treat their stakeholders (customers, employees, suppliers, the community, the shareholders and so on) has become a key issue. There have been many examples of businesses, some of them very well known, acting in ways that most people would regard as unethical and unacceptable. Examples of such actions include:

- paying bribes to encourage employees of other businesses to reveal information about the employee's business that could be useful;
- oppressive treatment of suppliers, for example, making suppliers wait excessive periods before payment; and
- manipulating the financial statements to mislead users of them, for example, to overstate profit so that senior managers become eligible for performance bonuses (known as 'creative accounting').

Despite the many examples of unethical acts that have attracted publicity over recent years, it would be very unfair to conclude that most businesses are involved in unethical activities. Nevertheless, revelations of unethical practice can be damaging to the entire business community. Lying, stealing and fraudulent behaviour can lead to a loss of confidence in business and the imposition of tighter regulatory burdens. In response to this threat, businesses often seek to demonstrate their commitment to acting in an honest and ethical way. One way of doing this is to develop, and adhere to, a code of ethics concerning business behaviour.

Accountants are likely to find themselves at the forefront with issues relating to business ethics. In the three examples of unethical business activity listed above, an accountant would probably have to be involved either in helping to commit the unethical act or in covering it up. Accountants are, therefore, particularly vulnerable to being put under pressure to engage in unethical acts. Some businesses acknowledge this risk and produce an ethical code for their accounting staff. **Real World 1.7** provides an example of one such code.

Real World 1.7

The only way is ethics

Vodafone plc, the telecommunications business, has a code of ethics for its chief executive and senior finance and accounting staff. The code states that they to have a duty to:

. . . act with integrity. Integrity requires, among other things, being honest and candid. Deceit, dishonesty and subordination of principle are inconsistent with integrity. Service to the Company should never be subordinated to personal gain and advantage.

The code specifically states that they must:

- act with integrity, including being honest and candid while still maintaining the confidentiality of Company information where required or in the Company's interests;
- observe, fully, applicable governmental laws, rules and regulations;
- comply with the requirements of applicable accounting and auditing standards and Company policies in the maintenance of a high standard of accuracy and completeness in the Company's financial records;
- adhere to a high standard of business ethics and not seek competitive advantage through unlawful or unethical business practices; and
- avoid conflicts of interest wherever possible. Anything that would be a conflict for a Relevant Officer will also be a conflict if it is related to a member of his or her family or a close relative.

Source: Code of Ethics Vodafone plc Accessed 13 February 2019 www.vodafone.com.

NOT-FOR-PROFIT ORGANISATIONS

Although the focus of this book is accounting as it relates to private-sector businesses, there are many organisations that do not exist mainly for the pursuit of profit.

All of these organisations need to produce accounting information for decision-making purposes. Once again, various user groups need this information to help them to make decisions. These user groups are often the same as, or similar to, those identified for private-sector businesses. They often have a stake in the future viability of the organisation and may use accounting information to check that the wealth of the organisation is being properly controlled and is used in a way that conforms to its objectives.

Activity 1.17

Can you think of at least four types of organisation that are not primarily concerned with making profits?

We thought of the following:

- charities
- clubs and associations
- universities
- local government authorities
- national government departments
- churches
- trade unions.

Nevertheless, certain types of not-for-profit organisation, such as charities, often suffer from inadequate accounting systems and a lack of financial skills among its managers. This can have disastrous consequences. **Real World 1.8** describes how one high-profile UK charity collapsed amid claims of weak accounting controls and financial mismanagement.

Real World 1.8

No kidding?

Senior directors at the charity Kids Company repeatedly warned trustees of the need to build up financial reserves or face going to the wall, the *Guardian* can reveal, as an analysis of the accounts show that its funding increased by more than 75% in five years.

Two finance directors at Kids Company left in less than three years because of their frustrations that no one – from the board of trustees, led by the BBC's Alan Yentob, to the chief executive, Camila Batmanghelidjh – heeded warnings of the need to build a financial cushion to protect the charity from catastrophe, the *Guardian* understands.

'If you keep building an organisation without building reserves, then it's a house of cards and it will fall down,' said one source who worked in a senior role at the charity for several years.

A *Guardian* analysis of five years of accounts show how the charity got itself into dire financial straits. Despite receiving millions of pounds in government funding, it lived hand to mouth, never built up any reserves, and spent almost all its income each year.

Analysis of the charity's accounts from 2009 to 2013 shows the organisation was receiving huge injections of funding, which included millions of pounds in government grants. Between 2009 and 2013, its income increased by 77% from £13m to £23m, but the charity was spending almost every penny it brought in. In the same period, its outgoings increased by 72%.

Despite repeated warnings on the accounts seen by trustees and presented to the Charity Commission, no consistent reserve was built up.

In March 2014, an audit of the charity was commissioned by the Cabinet Office and carried out by accountancy firm PKF Littlejohn. It noted that the charity was facing a 'serious cashflow' issue.

Historical note: The charity collapsed in August 2015.

Source: Laville S., Barr C. and Slawson, N. (2015) *Kids Company trustees accused of ignoring finance warnings*, www.theguardian.com, 6 August.

SUMMARY

The main points of this chapter may be summarised as follows:

What is accounting?

- Accounting provides financial information to help various user groups make better judgements and decisions.

Accounting and user needs

- For accounting to be useful, it must be clear *for whom* and *for what purpose* the information will be used.
- Owners, managers and lenders are important user groups, but there are several others.
- Conflicts of interest between users may arise over the ways in which business wealth is generated or distributed.
- The evidence suggests that accounting is both used and useful for decision-making purposes.

Providing a service

- Accounting can be viewed as a form of service as it involves providing financial information to various users.
- To provide a useful service, accounting information must possess certain qualities, or characteristics. The fundamental qualities are relevance and faithful representation. Other qualities that enhance the usefulness of accounting information are comparability, verifiability, timeliness and understandability.
- Providing a service to users can be costly and financial information should be produced only if the cost of providing the information is less than the benefits gained.

Accounting information

- Accounting is part of the total information system within a business. It shares the features that are common to all information systems within a business, which are the identification, recording, analysis and reporting of information.

Management accounting and financial accounting

- Accounting has two main strands – management accounting and financial accounting.
- Management accounting seeks to meet the needs of the business's managers, and financial accounting seeks to meet the needs of owners and lenders, but should also be of use to other user groups.
- These two strands differ in terms of the types of reports produced, the level of reporting detail, the time orientation, the degree of regulation and the range and quality of information provided.

The changing face of accounting

- Changes in the economic environment have led to changes in the nature and scope of accounting.

- Financial accounting has improved its framework of rules and there has been greater international harmonisation of accounting rules.
- Management accounting has become more outward looking, and new methods for managing costs have been developed to help a business gain competitive advantage.

What is the purpose of a business?

- The purpose of a business is to create and keep customers.

What kinds of business ownership exist?

There are three main forms of business unit:

- sole proprietorship – easy to set up and flexible to operate, but the owner has unlimited liability;
- partnership – easy to set up and spreads the burdens of ownership, but partners usually have unlimited liability and there are ownership risks if the partners are unsuitable;
- limited company – limited liability for owners, but obligations are imposed on how a company conducts its affairs.

How are businesses organised and managed?

- Most businesses of any size are set up as limited companies.
- A board of directors is appointed by owners (shareholders) to oversee the running of the business.

The quest for wealth creation

- The key financial objective of a business is to enhance the wealth of the owners.
- To achieve this objective, the needs of other groups connected with the business, such as employees, suppliers and the local community, cannot be ignored.
- When setting financial objectives, the right balance must be struck between risk and return.

Ethical behaviour

- Accounting staff may be put under pressure to commit unethical acts.
- Many businesses produce a code of ethical conduct to help protect accounting staff from this risk.

Not-for-profit organisations

- These organisations also produce accounting information for decision-making purposes.
- They have user groups that are similar to, or the same as, those of private-sector businesses.

KEY TERMS

For definitions of these terms, see at the back of the book, starting on page 514.

accounting p. 2
shares p. 5
relevance p. 6
faithful representation p. 6
materiality p. 6
comparability p. 8
verifiability p. 8
timeliness p. 8
understandability p. 8
accounting information system p. 12
management accounting p. 13
financial accounting p. 13
conventions of accounting p. 16
sole proprietorship p. 19
partnership p. 20
limited company p. 21

REFERENCES

1. International Accounting Standards Board (2018) *Conceptual Framework for Financial Reporting*, pp. 14–20.
2. Dugdale, D., Jones, C. and Green, S. (2006) *Contemporary Management Accounting Practices in UK Manufacturing*, CIMA/Elsevier.
3. Drucker, P. (1967) *The Effective Executive*, Heinemann.

FURTHER READING

If you would like to explore the topics covered in this chapter in more depth, we recommend the following:

Alexander, D. and Nobes, C. (2016) *Financial Accounting: An International Introduction*, 6th edn, Pearson, Chapters 1 and 3.

Drury, C. (2018) *Management and Cost Accounting*, 10th edn, Cengage Learning EMEA, Chapter 1.

Elliott, B. and Elliott, J. (2017) *Financial Accounting and Reporting*, 18th edn, Pearson, Chapters 6 and 7.

Scott W. (2014) *Financial Accounting Theory*, 7th edn, Pearson, Chapters 1 and 3.

CRITICAL REVIEW QUESTIONS

Solutions to these questions can be found at the back of the book, starting on page 536.

1.1 Accounting is sometimes described as 'the language of business'. Why do you think this is the case? Is this an apt description of accounting?

1.2 Identify the main users of accounting information for a university. For what purposes would different user groups need information? Is there a major difference in the ways in which accounting information for a university would be used compared with that of a private-sector business?

1.3 'Not-for-profit organisations are not interested in making a profit.' Is this statement true? Does accounting and finance have a less important role to play in not-for-profit organisations than for businesses?

1.4 Financial accounting statements tend to reflect past events. In view of this, how can they be of any assistance to a user in making a decision when decisions, by their very nature, can only be made about future actions?

Chapter 2

MEASURING AND REPORTING FINANCIAL POSITION

INTRODUCTION

We saw in Chapter 1 that accounting has two distinct strands: financial accounting and management accounting. This chapter, along with Chapters 3 to 6, examines the three major financial statements that form the core of financial accounting. We start by taking an overview of these statements to see how each contributes towards an assessment of the overall financial position and performance of a business.

Following this overview, we begin a more detailed examination by turning our attention towards one of these financial statements: the statement of financial position. We identify the key elements of this statement and consider the interrelationships between them. We also consider the main accounting conventions, or rules, to be followed when preparing the statement of financial position.

Learning outcomes

When you have completed this chapter, you should be able to:

- explain the nature and purpose of the three major financial statements;
- prepare a simple statement of financial position and interpret the information that it contains;
- discuss the accounting conventions underpinning the statement of financial position; and
- discuss the uses and limitations of the statement of financial position for decision-making purposes.

THE MAJOR FINANCIAL STATEMENTS – AN OVERVIEW

The major financial accounting statements aim to provide a picture of the financial position and performance of a business. To achieve this, a business's accounting system will normally produce three financial statements on a regular, recurring basis. These three statements are concerned with answering the following questions relating to a particular period:

- What cash movements took place?
- How much wealth was generated?
- What is the accumulated wealth of the business at the end of the period and what form does it take?

To address each of these questions, there is a separate financial statement. The financial statements are:

- the **statement of cash flows**;
- the **income statement** (also known as the profit and loss account); and
- the **statement of financial position** (also known as the balance sheet).

Together they provide an overall picture of the financial health of the business.

Perhaps the best way to introduce these financial statements is to look at an example of a very simple business. From this we shall be able to see the sort of information that each of the statements can usefully provide. It is, however, worth pointing out that, while a simple business is our starting point, the principles for preparing the financial statements apply equally to the largest and most complex businesses. This means that we shall continually encounter these principles again in later chapters.

Example 2.1

Paul was unemployed and unable to find a job. He therefore decided to embark on a business venture. With Christmas approaching, he decided to buy gift wrapping paper from a local supplier and to sell it on the corner of his local high street. He felt that the price of wrapping paper in the high street shops was unreasonably high. This provided him with a useful business opportunity.

He began the venture with £40 of his own money, in cash. On Monday, Paul's first day of trading, he bought wrapping paper for £40 and sold three-quarters of it for £45 cash.

What cash movements took place in Paul's business during Monday?

For Monday, a *statement of cash flows* showing the cash movements (that is, cash in and cash out) for the day can be prepared as follows:

Statement of cash flows for Monday

	£
Cash introduced (by Paul)	40
Cash from sales of wrapping paper	45
Cash paid to buy wrapping paper	(40)
Closing balance of cash	45

The statement shows that Paul placed £40 cash into the business. The business received £45 cash from customers, but paid £40 cash to buy the wrapping paper. This left £45 of cash by Monday evening. Note that we are taking the standard approach found in financial statements of showing figures to be deducted (in this case the £40 paid out) in brackets. We shall take this approach consistently throughout the chapters dealing with financial statements.

How much wealth (that is, profit) was generated by the business during Monday?

An *income statement* can be prepared to show the wealth generated (profit) on Monday. The wealth generated arises from trading and will be the difference between the value of the sales made and the cost of the goods (that is, wrapping paper) sold.

Income statement for Monday

	£
Sales revenue	45
Cost of goods sold ($^3/_4$ of £40)	(30)
Profit	15

Note that it is only the cost of the wrapping paper *sold* that is matched against (and deducted from) the sales revenue in order to find the profit, not the whole of the cost of wrapping paper acquired. Any unsold inventories (also known as *stock)* will be charged against any future sales revenue that it generates. In this case the cost of the unsold inventories is $^1/_4$ of £40 = £10.

What is the accumulated wealth on Monday evening and what form does it take?

To establish the accumulated wealth at the end of Monday's trading, we can draw up a *statement of financial position* for Paul's business. This statement will also list the forms of wealth held at the end of that day.

Statement of financial position as at Monday evening

	£
Cash (closing balance)	45
Inventories of goods for resale ($^1/_4$ of 40)	10
Total assets	55
Equity	55

Note the terms 'assets' and 'equity' that appear in this statement. 'Assets' are business resources (things of value to the business) and include cash and inventories. 'Equity' is the word used in accounting to describe the investment, or stake, of the owner(s) – in this case Paul – in the business. Both of these terms will be discussed in some detail a little later in this chapter. Note that the equity on Monday evening was £55. This represented the £40 that Paul put in to start the business, plus Monday's profit (£15) – profits belong to the owner(s).

Let us now continue by looking at what happens on the following day.

On Tuesday, Paul bought more wrapping paper for £20 cash. He managed to sell all of the new inventories and all of the earlier inventories, for a total of £48.

→

The statement of cash flows for Tuesday will be as follows:

Statement of cash flows for Tuesday

	£
Opening balance (from Monday evening)	45
Cash from sales of wrapping paper	48
Cash paid to buy wrapping paper	(20)
Closing balance	73

The income statement for Tuesday will be as follows:

Income statement for Tuesday

	£
Sales revenue	48
Cost of goods sold (£20 + £10)	(30)
Profit	18

The statement of financial position as at Tuesday evening will be:

Statement of financial position as at Tuesday evening

	£
Cash (closing balance)	73
Inventories	–
Total assets	73
Equity	73

We can see that the total business wealth had increased to £73 by Tuesday evening. This represents an increase of £18 (that is, £73 − £55) over Monday's figure – which, of course, is the amount of profit made during Tuesday as shown on the income statement.

We can see from the financial statements in Example 2.1 that each statement provides part of a picture of the financial performance and position of the business. We begin by showing the cash movements. Cash is a vital resource that is needed for any business to function effectively. It is used to meet debts that become due and to acquire other resources (such as inventories). Cash has been described as the 'lifeblood' of a business.

Reporting cash movements alone, however, is not enough to portray the financial health of the business. To find out how much profit was generated, we need an income statement. It is important to recognise that cash and profits rarely move in unison. During Monday, for example, the cash balance increased by £5, but the profit generated, as shown in the income statement, was £15. The cash balance did not increase in line with profit because part of the wealth (£10) was held in the form of inventories.

The statement of financial position that was drawn up as at the end of Monday's trading provides an insight into the total wealth of the business. This wealth can be held in various forms. For Paul's business, wealth is held in the form of cash and inventories. This means that, when drawing up the statement of financial position, both forms will be listed. For a large business, many other forms of wealth may be held, such as property, equipment, motor vehicles and so on.

Activity 2.1

On Wednesday, Paul bought more wrapping paper for £46 cash. However, it was raining hard for much of the day and sales were slow. After Paul had sold half of his total inventories for £32, he decided to stop trading until Thursday morning.

Have a go at drawing up the three financial statements for Paul's business for Wednesday.

Statement of cash flows for Wednesday

	£
Opening balance (from Tuesday evening)	73
Cash from sales of wrapping paper	32
Cash paid to buy wrapping paper	(46)
Closing balance	59

Income statement for Wednesday

	£
Sales revenue	32
Cost of goods sold ($^1/_2$ of £46)	(23)
Profit	9

Statement of financial position as at Wednesday evening

	£
Cash (closing balance)	59
Inventories ($^1/_2$ of £46)	23
Total assets	82
Equity	82

Note that the total business wealth has increased by £9 (that is, the amount of Wednesday's profit) even though the cash balance has declined. This is because the business is holding more of its wealth in the form of inventories rather than cash, compared with the position on Tuesday evening.

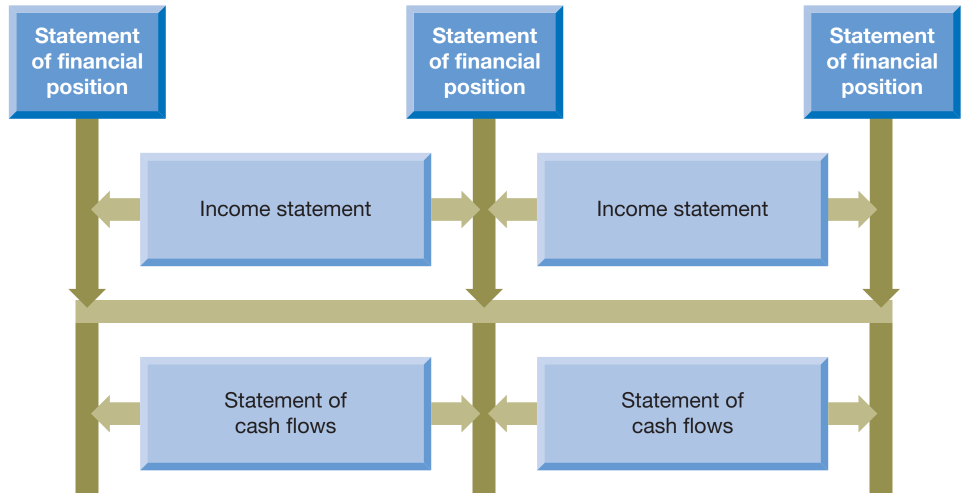
By Wednesday evening, the equity stood at £82. This arose from Paul's initial investment of £40, plus his profits for Monday (£15), Tuesday (£18) and Wednesday (£9). This represents Paul's total investment in his business at that time. The equity of most businesses will similarly be made up of injections of funds by the owner(s) plus any accumulated profits.

We can see that the income statement and statement of cash flows are both concerned with measuring flows (of wealth and cash respectively) during a particular period. The statement of financial position, however, is concerned with the financial position at a particular moment in time. Figure 2.1 illustrates this point.

The three financial statements discussed are often referred to as the **final accounts** of the business.

For external users (that is, virtually all users except the managers of the business concerned), these statements are normally backward-looking because they are based on information concerning past events and transactions. This can be useful in providing feedback on past performance and in identifying trends that provide clues to future performance. However, the statements can also be prepared using projected data to help assess likely future profits, cash flows and so on. Normally, this is done only for management decision-making purposes.

Now that we have an overview of the financial statements, we shall consider each one in detail. The remainder of this chapter is devoted to the statement of financial position.



The income statement and statement of cash flows are concerned with measuring flows of wealth and cash (respectively) over time. The statement of financial position, however, is concerned with measuring the amount of wealth at a particular moment in time.

Figure 2.1 The relationship between the major financial statements

THE STATEMENT OF FINANCIAL POSITION

We saw a little earlier that this statement shows the forms in which the wealth of a business is held and how much wealth is held in each form. We can, however, be more specific about the nature of this statement by saying that it sets out the **assets** of a business, on the one hand, and the **claims** against the business, on the other. Before looking at the statement of financial position in more detail, we need to be clear about what these terms mean.

Assets

An asset is essentially a resource held by a business. To qualify as an asset for inclusion in the statement of financial position, however, a resource must possess the following characteristics:

- *It must be an economic resource*. This type of resource provides a right to potential economic benefits. These benefits must not, however, be equally available to others. Take, for example, what economists refer to as *public goods.* These include resources such as the road system, GPS satellites or official statistics. Although these may provide economic benefits to a business, others can receive the same benefits at no great cost. A public good cannot, therefore, be regarded as an asset of a business. Economic benefits flowing from a resource can take various forms depending on how it is used by a business. Note that an economic resource need only have the *potential* to generate benefits. They need not be certain or even probable.

Activity 2.2

What forms might economic benefits take? Try to think of at least two.

These may include:

- cash generated from producing goods or services;
- cash received from the proceeds on selling the resource;
- the value received when exchanged for another economic resource;
- the value received when used to satisfy debts incurred by the business; and
- cash generated from renting or leasing it.

You may have thought of others.

- *The economic resource must be under the control of the business*. This gives a business the exclusive right to decide how the resource is used as well as the right to any benefits that flow. Control is usually acquired by a business through legal ownership or through a contractual agreement (for example, leasing equipment). The event, or transaction, leading to control of the resource must have occurred in the past. In other words, the business must already exercise control over it. (See Reference 1 at the end of the chapter.)

Activity 2.3

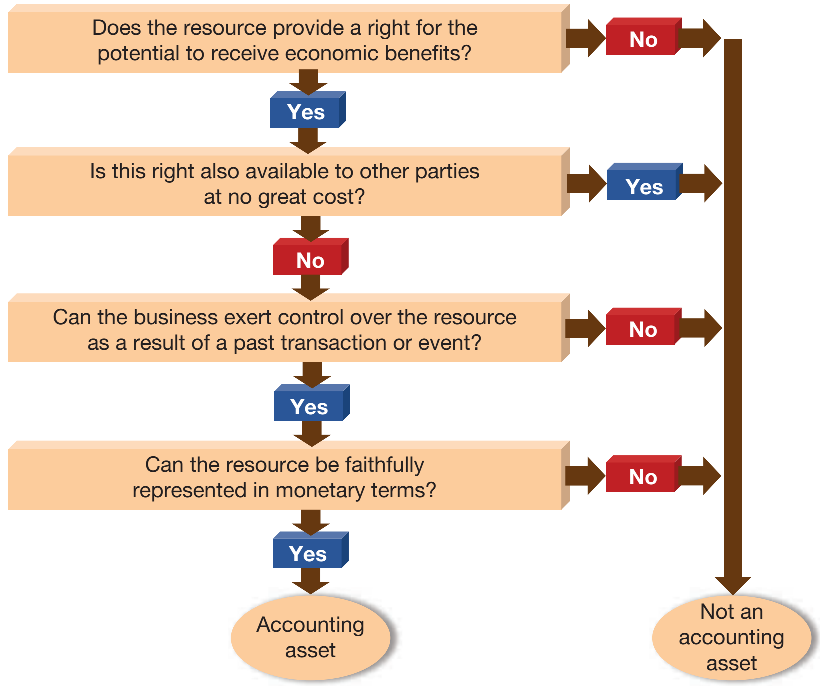
Assume a business owns a 40 per cent stake in a gold mine. As this ownership stake will not give control over the whole of the gold mine, can this resource be regarded as an asset of the business?

In this case, the asset of the business will be the 40 per cent share of the mine that is under its control, rather than the whole of the gold mine.

- *The economic resource must be capable of measurement in monetary terms*. Often, an economic resource cannot be measured with a great deal of certainty. Estimates may be used that ultimately prove to be inaccurate. Nevertheless, it can still be reported as an asset for inclusion in the statement of financial position as long as a sufficiently faithful representation of its measurement can be produced. There are cases, however, where uncertainty regarding measurement is so great that this cannot be done. Take for example, the title of a magazine (such as *Hello!* or *Vogue*) that has been created by its publisher. While it may be extremely valuable to the publishing business, any attempt to measure this resource would be extremely difficult: it would have to rely on arbitrary assumptions. As a result, any measurement produced is unlikely to be useful. The publishing title will not, therefore, appear as an asset in the statement of financial position.

Note that *all* the characteristics identified must exist if a resource is to qualify for recognition. This will strictly limit the resources that are regarded as an asset for inclusion in the statement of financial position. Once included, an asset will continue to be recognised until the economic benefits are exhausted, or the business disposes of it.

Figure 2.2 summarises the above discussion in the form of a decision chart.



The characteristics identified are discussed in the chapter.

Figure 2.2 Identifying an asset for inclusion in the statement of financial position

Activity 2.4

Indicate which of the following items could appear as an asset on the statement of financial position of a business. Explain your reasoning in each case.

1. **£1,000 owed to the business by a credit customer who is unable to pay.**
2. **A patent, bought from an inventor, that gives the business the right to produce a new product. Production of the new product is expected to increase profits over the period during which the patent is held.**
3. **A recently hired new marketing director who is confidently expected to increase profits by over 30 per cent during the next three years.**
4. **A recently purchased machine that will save the business £10,000 each year. It is already being used by the business but it has been acquired on credit and is not yet paid for.**

Your answer should be along the following lines:

1. Under normal circumstances, a business would expect a customer to pay the amount owed. Such an amount is therefore typically shown as an asset under the heading '**trade receivables**' (or 'debtors'). However, in this particular case, the customer is unable to pay. As a result, the item is not an economic resource and the £1,000 owing would not be regarded as an asset. Debts that are not paid are referred to as *bad debts*.
2. The patent would have all the characteristics identified and would, therefore, be regarded as an asset.

3 The new marketing director would not be considered as an asset. One argument in support of this position is that the business does not have rights of control over the director. Nevertheless, it may have control over the services that the director provides. Even if these services become the focus of attention, however, it is usually impossible to measure them in monetary terms with any degree of certainty.

4 The machine has the characteristics identified and so would be considered an asset even though it is not yet paid for. Once the business has contracted to buy the machine, and has accepted it, ownership will pass even though payment is still outstanding. (The amount outstanding would be shown as a claim, as we shall see shortly.)

The sorts of items that often appear as assets in the statement of financial position of a business include:

- property;
- plant and equipment;
- fixtures and fittings;
- patents and trademarks;
- trade receivables (debtors); and
- investments outside the business.

Activity 2.5

Can you think of two additional items that might appear as assets in the statement of financial position of a typical business?

You may be able to think of a number of other items. Two that we have met so far, because they were held by Paul's wrapping paper business (in Example 2.1), are inventories and cash.

Note that an asset does not have to be a physical item – it may be a non-physical one that gives a right to potential benefits. Assets that have a physical substance and can be touched (such as inventories) are referred to as **tangible assets**. Assets that have no physical substance but which, nevertheless, may provide future benefits (such as patents) are referred to as **intangible assets**.

Claims

A claim is an obligation of the business to provide cash, or some other form of benefit, to an outside party. It will normally arise as a result of the outside party providing assets for use by the business. There are essentially two types of claim against a business:

- **Equity**. This represents the claim of the owner(s) against the business. This claim is sometimes referred to as the *owner's capital.* Some find it hard to understand how the owner can have a claim against the business, particularly when we consider the example of a sole-proprietor-type business, like Paul's, where the owner *is,* in effect, the business. For accounting purposes, however, a clear distinction is made between the business and the owner(s). The business is viewed as being quite separate from the owner. It is seen as a separate entity with its own separate existence. This means that, when financial statements are prepared, they relate to the business rather than to the owner(s). Viewed from this perspective, any funds contributed by the owner will be seen as coming from outside the business and will appear as a claim against the business in its statement of financial position.

- **Liabilities**. Liabilities represent the claims of other parties, apart from the owner (s). They involve an obligation to transfer economic resources (usually cash) as a result of past transactions or events. A liability incurred by a business cannot be avoided and so will remain a liability until it is settled.

  Most liabilities arise for legal or contractual reasons, such as from acquiring goods or services or from borrowing funds. They can, however, arise from the policies and practices adopted by the business, such as 'no quibble' refunds.

Now that the meanings of the terms *assets*, *equity* and *liabilities* have been established, we can consider the relationship between them. This relationship is quite straightforward. If a business wishes to acquire assets, it must raise the necessary funds from somewhere. It may raise these funds from the owner(s), or from other outside parties, or from both. Example 2.2 illustrates this relationship.

Example 2.2

Jerry and Company is a new business that was created by depositing £20,000 in a bank account on 1 March. This amount was raised partly from the owner (£6,000) and partly from borrowing (£14,000). Raising funds in this way will give rise to a claim on the business by both the owner (equity) and the lender (liability). If a statement of financial position of Jerry and Company is prepared following these transactions, it will appear as follows:

Jerry and Company
Statement of financial position as at 1 March

	£
ASSETS	
Cash at bank	20,000
Total assets	20,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing	14,000
Total equity and liabilities	20,000

We can see from the statement of financial position that the total claims (equity and liabilities) are the same as the total assets. Thus:

Assets = Equity + Liabilities

This equation – which we shall refer to as the *accounting equation* – will always hold true. Whatever changes may occur to the assets of the business or the claims against it, there will be compensating changes elsewhere that will ensure that the statement of financial position always 'balances'. By way of illustration, consider the following transactions for Jerry and Company:

2 March	Bought a motor van for £5,000, paying by cheque.
3 March	Bought inventories (that is, goods to be sold) on one month's credit for £3,000. (This means that the inventories were bought on 3 March, but payment to the supplier will not be due until 3 April.)
4 March	Repaid £2,000 of the amount borrowed, to the lender, by cheque.
6 March	Owner introduced another £4,000 into the business bank account.

A statement of financial position may be drawn up after each day in which transactions have taken place. In this way, we can see the effect of each transaction on the assets and claims of the business. The statement of financial position as at 2 March will be:

Jerry and Company
Statement of financial position as at 2 March

	£
ASSETS	
Cash at bank (20,000 − 5,000)	15,000
Motor van	5,000
Total assets	20,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing	14,000
Total equity and liabilities	20,000

As we can see, the effect of buying the motor van is to decrease the balance at the bank by £5,000 and to introduce a new asset – a motor van – to the statement of financial position. The total assets remain unchanged. It is only the 'mix' of assets that has changed.

The claims against the business remain the same because there has been no change in the way in which the business has been funded.

The statement of financial position as at 3 March, following the purchase of inventories, will be:

Jerry and Company
Statement of financial position as at 3 March

	£
ASSETS	
Cash at bank	15,000
Motor van	5,000
Inventories	3,000
Total assets	23,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing	14,000
Liabilities – trade payable	3,000
Total equity and liabilities	23,000

The effect of buying inventories has been to introduce another new asset (inventories) to the statement of financial position. Furthermore, the fact that the goods have not yet been paid for means that the claims against the business will be increased by the £3,000 owed to the supplier, who is referred to as a **trade payable** (or trade creditor) on the statement of financial position.

Activity 2.6

Try drawing up a statement of financial position as at 4 March for Jerry and Company.

The statement of financial position as at 4 March, following the repayment of part of the borrowing, will be:

Jerry and Company
Statement of financial position as at 4 March

	£
ASSETS	
Cash at bank (15,000 − 2,000)	13,000
Motor van	5,000
Inventories	3,000
Total assets	21,000
EQUITY AND LIABILITIES	
Equity	6,000
Liabilities – borrowing (14,000 − 2,000)	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	21,000

The repayment of £2,000 of the borrowing will result in a decrease in the balance at the bank of £2,000 and a decrease in the lender's claim against the business by the same amount.

Activity 2.7

Try drawing up a statement of financial position as at 6 March for Jerry and Company.

The statement of financial position as at 6 March, following the introduction of more funds, will be:

Jerry and Company
Statement of financial position as at 6 March

	£
ASSETS	
Cash at bank (13,000 + 4,000)	17,000
Motor van	5,000
Inventories	3,000
Total assets	25,000
EQUITY AND LIABILITIES	
Equity (6,000 + 4,000)	10,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	25,000

The introduction of more funds by the owner will result in an increase in the equity of £4,000 and an increase in the cash at bank by the same amount.

The example of Jerry and Company illustrates the point that the accounting equation (assets equals equity plus liabilities) will always hold true. It reflects the fact that, if a business wishes to acquire more assets, it must raise funds equal to the cost of those assets. The funds raised must be provided by the owners (equity), or by others (liabilities), or by a combination of the two. This means that the total cost of assets acquired should always equal the total equity plus liabilities. Similarly, if the business raises the funds by selling an existing asset, one asset replaces another, leaving the accounting equation holding true.

It is worth pointing out that businesses do not normally draw up a statement of financial position after each day, as shown in the example. We have done this to illustrate the effect on the statement of financial position of each transaction. In practice, a statement of financial position for a business is usually prepared at the end of a defined period. The period over which businesses measure their financial results is usually known as the **reporting period**, but it is sometimes called the 'accounting period' or 'financial period'.

Determining the length of the reporting period will involve weighing up the costs of producing the information against the perceived benefits of having that information for decision-making purposes. In practice, the reporting period will vary between businesses; it could be monthly, quarterly, half-yearly or annually. For external reporting purposes, an annual reporting period is the norm (although certain businesses, typically larger ones, report more frequently than this). For internal reporting purposes to managers, however, more frequent (perhaps monthly) financial statements are likely to be prepared.

THE EFFECT OF TRADING TRANSACTIONS

In the example (Jerry and Company), we showed how various types of transactions affected the statement of financial position. However, one very important type of transaction – trading transactions – has yet to be considered. To show how this type of transaction affects the statement of financial position, let us return to Jerry and Company.

Example 2.2 (continued)

The statement of financial position that we drew up for Jerry and Company as at 6 March was as follows:

Jerry and Company
Statement of financial position as at 6 March

	£
ASSETS	
Cash at bank	17,000
Motor van	5,000
Inventories	3,000
Total assets	25,000
EQUITY AND LIABILITIES	
Equity	10,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	25,000

On 7 March, the business managed to sell all of the inventories for £5,000 and received a cheque immediately from the customer for this amount. The statement of financial position on 7 March, after this transaction has taken place, will be:

Jerry and Company
Statement of financial position as at 7 March

	£
ASSETS	
Cash at bank (17,000 + 5,000)	22,000
Motor van	5,000
Inventories (3,000 − 3,000)	–
Total assets	27,000
EQUITY AND LIABILITIES	
Equity (10,000 + (5,000 − 3,000))	12,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	27,000

We can see that the inventories (£3,000) have now disappeared from the statement of financial position, but the cash at bank has increased by the selling price of the inventories (£5,000). The net effect has therefore been to increase assets by £2,000 (that is, £5,000 less £3,000). This increase represents the net increase in wealth (the profit) that has arisen from trading. Also note that the equity of the business has increased by £2,000, in line with the increase in assets. This increase in equity reflects the fact that wealth generated, as a result of trading or other operations, will be to the benefit of the owners and will increase their stake in the business.

Activity 2.8

What would have been the effect on the statement of financial position if the inventories had been sold on 7 March for £1,000 rather than £5,000?

The statement of financial position on 7 March would then have been:

Jerry and Company
Statement of financial position as at 7 March

	£
ASSETS	
Cash at bank (17,000 + 1,000)	18,000
Motor van	5,000
Inventories (3,000 − 3,000)	–
Total assets	23,000
EQUITY AND LIABILITIES	
Equity (10,000 + (1,000 − 3,000))	8,000
Liabilities – borrowing	12,000
Liabilities – trade payable	3,000
Total equity and liabilities	23,000

As we can see, the inventories (£3,000) will disappear from the statement of financial position, but the cash at bank will rise by only £1,000. This will mean a net reduction in assets of £2,000. This reduction represents a loss arising from trading and will be reflected in a reduction in the equity of the owners.

What we have just seen means that the accounting equation can be extended as follows:

Assets (at the end of the period) = Equity (amount at the start of the period)
+ Profit (or Loss) for the period)
+ Liabilities (at the end of the period)

(This is assuming that the owner makes no injections or withdrawals of equity during the period.)

Any funds introduced or withdrawn by the owners also affect equity. If the owners withdrew £1,500 for their own use, the equity of the owners would be reduced by £1,500. If these drawings were in cash, the cash balance would decrease by £1,500 in the statement of financial position.

Like all items in the statement of financial position, the amount of equity is cumulative. This means that any profit not taken out as drawings by the owner(s) remains in the business. These retained (or 'ploughed-back') earnings have the effect of expanding the business.

CLASSIFYING ASSETS

In the statement of financial position, assets and claims are usually grouped into categories. This is designed to help users, as a haphazard listing of these items could be confusing. Assets are usually categorised as being either current or non-current.

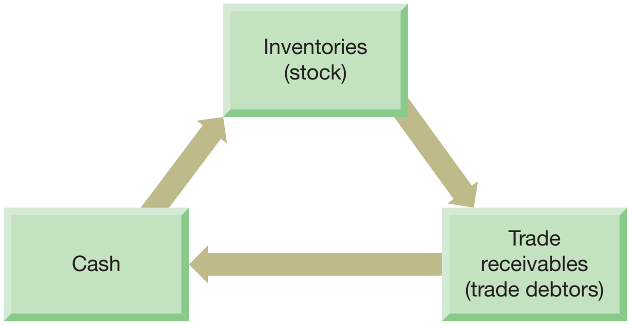
Current assets

Current assets are basically assets that are held for the short term. To be more precise, they are assets that meet any of the following conditions:

- they are held for sale or consumption during the business's normal operating cycle;
- they are expected to be sold within a year after the date of the relevant statement of financial position;
- they are held principally for trading; and
- they are cash, or near cash such as easily marketable, short-term investments.

The operating cycle of a business, mentioned above, is the time between buying and/or creating a product or service and receiving the cash on its sale. For most businesses, this will be less than a year. (It is worth mentioning that sales made by most businesses are made on credit. The customer pays some time after the goods are received or the service is rendered.)

The most common current assets are inventories, trade receivables (amounts owed by customers for goods or services supplied to them on credit) and cash. For businesses that sell goods, rather than render a service, the current assets of inventories, trade receivables and cash are interrelated. They circulate within a business as shown in Figure 2.3. We can see that cash can be used to buy inventories, which then are sold on credit. When the credit customers (trade receivables) pay, the business receives an injection of cash and so on.



Inventories may be sold on credit to customers. When the customers pay, the trade receivables will be converted into cash, which can then be used to purchase more inventories. Then the cycle begins again.

Figure 2.3 The circulating nature of current assets

For purely service businesses, the situation is similar, except that inventories are not involved.

Non-current assets

Non-current assets (also called *fixed assets*) are simply assets that do not meet the definition of current assets. They tend to be held for long-term operations. Non-current assets may be either tangible or intangible. Tangible non-current assets normally consist of **property, plant and equipment**. We shall refer to them in this way from now on. This is a rather broad term that includes items such as land and buildings, machinery, motor vehicles and fixtures and fittings.

The distinction between those assets continuously circulating (current) and those used for long-term operations (non-current) may help readers of the statement of financial position when assessing the mix of assets held. Most businesses need a certain amount of both types of asset to operate effectively.

Activity 2.9

Can you think of two examples of assets that may be classified as non-current assets for an insurance business?

Examples of assets that may be defined as being non-current include:

- property;
- furniture;
- motor vehicles;
- computers;
- computer software; and
- reference books.

This is not an exhaustive list. You may have thought of others.

The way in which a particular asset is classified (that is, between current and non-current) may vary according to the nature of the business. This is because the *purpose* for which the asset is held may vary. For example, a motor van retailer will normally hold inventories of motor vans for sale; it would, therefore, classify them as part of the current assets. On the other hand, a business that buys one of these vans to use for delivering its goods to customers (that is, as part of its long-term operations) would classify it as a non-current asset.

Activity 2.10

The assets of Kunalun and Co., a large advertising agency, are as follows:

- **cash at bank;**
- **fixtures and fittings;**
- **office equipment;**
- **motor vehicles;**
- **property;**
- **computers; and**
- **work in progress (that is, partly completed work for clients).**

Which of these do you think should be defined as non-current assets and which should be defined as current assets?

Your answer should be as follows:

Non-current assets	*Current assets*
Fixtures and fittings	Cash at bank
Office equipment	Work in progress
Motor vehicles	
Property	
Computers	

CLASSIFYING CLAIMS

As we have already seen, claims are normally classified into equity (owner's claim) and liabilities (claims of outsiders). Liabilities are further classified as either current or non-current.

Current liabilities

Current liabilities are basically amounts due for settlement in the short term. To be more precise, they are liabilities that meet any of the following conditions:

- they are expected to be settled within the business's normal operating cycle;
- they arise principally as a result of trading;
- they are due to be settled within a year after the date of the relevant statement of financial position; and
- there is no right to defer settlement beyond a year after the date of the relevant statement of financial position.

Non-current liabilities

Non-current liabilities represent amounts due that do not meet the definition of current liabilities and so represent longer-term liabilities.

Activity 2.11

Can you think of one example of a current liability and one of a non-current liability?

An example of a current liability would be amounts owing to suppliers for goods supplied on credit (**trade payables**) or a bank overdraft (a form of short-term bank borrowing that is repayable on demand). An example of a non-current liability would be long-term borrowings.

It is quite common for non-current liabilities to become current liabilities. For example, borrowings to be repaid 18 months after the date of a particular statement of financial position will normally appear as a non-current liability. Those same borrowings will, however, appear as a current liability in the statement of financial position as at the end of the following year, by which time they would be due for repayment after six months.

This classification of liabilities between current and non-current helps to highlight those financial obligations that must shortly be met. It may be useful to compare the amount of current liabilities with the amount of current assets (that is, the assets that either are cash or will turn into cash within the normal operating cycle). This should reveal whether the business can cover its maturing obligations.

The classification of liabilities between current and non-current also helps to highlight the proportion of total long-term finance that is raised through borrowings rather than equity. Where a business relies on borrowings, rather than relying solely on funds provided by the owner(s), the financial risks increase. This is because borrowing brings a commitment to make periodic interest payments and capital repayments. The business may be forced to stop trading if this commitment cannot be fulfilled. Thus, when raising finance, a reasonable balance must be struck between borrowings and owners' equity. We shall consider this issue in more detail in Chapter 8.

STATEMENT LAYOUTS

Having looked at the classification of assets and liabilities, we shall now consider the layout of the statement of financial position. Although there is an almost infinite number of ways in which the same information on assets and claims could be presented, we shall consider two basic layouts. The first of these follows the style that we adopted with Jerry and Company earlier (see pages 42 to 47). A more comprehensive example of this style is shown in Example 2.3.

Example 2.3

Brie Manufacturing
Statement of financial position as at 31 December 2018

	£000
ASSETS	
Non-current assets	
Property	45
Plant and equipment	30
Motor vans	19
	94
Current assets	
Inventories	23
Trade receivables	18
Cash at bank	12
	53
Total assets	147
EQUITY AND LIABILITIES	
Equity	60
Non-current liabilities	
Long-term borrowings	50
Current liabilities	
Trade payables	37
Total equity and liabilities	147

The non-current assets have a total of £94,000 which, together with the current assets total of £53,000, gives a total of £147,000 for assets. Similarly, the equity totals £60,000 which, together with the £50,000 for non-current liabilities and £37,000 for current liabilities, gives a total for equity and liabilities of £147,000.

Within each category of asset (non-current and current) shown in Example 2.3, the items are listed in reverse order of liquidity (nearness to cash). Thus, the assets that are furthest from cash come first and the assets that are closest to cash come last. In the case of Brie manufacturing's non-current assets, property is listed first as this asset is tends to be the most difficult to turn into cash and motor vans are listed last as there is usually a ready market for them. In the case of current assets, we have already seen that inventories are converted to trade receivables and then trade receivables are converted to cash. As a result, under the heading of current assets, inventories are listed first, followed by trade receivables and finally cash itself. This ordering of assets will occur irrespective of the layout used.

Note that, in addition to a grand total for assets held, subtotals for non-current assets and current assets are shown. Subtotals are also used for non-current liabilities and current liabilities when more than one item appears within these categories.

A slight variation from the layout illustrated in Example 2.3 is as shown in Example 2.4.

Example 2.4

Brie Manufacturing
Statement of financial position as at 31 December 2018

	£000
ASSETS	
Non-current assets	
Property	45
Plant and equipment	30
Motor vans	19
	94
Current assets	
Inventories	23
Trade receivables	18
Cash at bank	12
	53
Total assets	147
LIABILITIES	
Non-current liabilities	
Long-term borrowings	(50)
Current liabilities	
Trade payables	(37)
Total liabilities	(87)
Net assets	60
EQUITY	60

We can see that the total liabilities are deducted from the total assets. This derives a figure for net assets – which is equal to equity. Using this format, the basic accounting equation is rearranged so that:

Assets − Liabilities = Equity

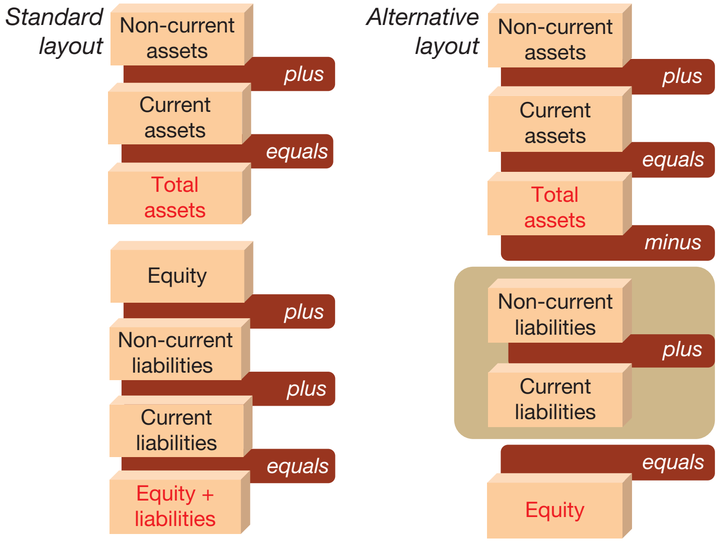
This rearranged equation highlights the fact that equity represents the residual interest of the owner(s) after deducting all liabilities of the business.

Figure 2.4 summarises the two types of layout discussed in this section.

The layout shown in Example 2.3 seems to be much the most popular in practice and so will be used throughout the book.

CAPTURING A MOMENT IN TIME

As we have already seen, the statement of financial position reflects the assets, equity and liabilities of a business at *a specified point in time.* It has been compared to a photograph. A photograph 'freezes' a particular moment in time and will represent the situation only at that moment. Hence, events may be quite different immediately before and immediately after the photograph was taken. When examining a statement of financial position, therefore, it is important to establish the date for which it has been drawn up. This information should be prominently displayed in the heading to the statement, as shown above in Example 2.4.



The standard layout reflects the accounting equation Assets = Equity + Liabilities, whereas the alternative layout reflects a re-arrangement of this equation: Assets − Liabilities = Equity.

Figure 2.4 Layouts for the statement of financial position

When we are trying to assess current financial position, the more recent the statement of financial position date, the more helpful it is likely to be.

A business will normally prepare a statement of financial position as at the close of business on the last day of its annual reporting period. In the UK, businesses are free to choose the date of the end of their reporting period and, once chosen, it will normally change only under exceptional circumstances. When making a decision on which year-end date to choose, commercial convenience can often be a deciding factor. For example, a business operating in the retail trade may choose to have a year-end date early in the calendar year (for example, 31 January) because trade tends to be slack during that period and more staff time is available to help with the tasks involved in the preparation of the annual financial statements (such as checking the amount of inventories held ('stocktaking')). Since trade is slack, the amount of inventories held by the retail business is likely to be unusually low compared with other times of the year.

Activity 2.12

Does this pose a problem for external users seeking to assess the business's financial health?

While the statement of financial position may provide a fair view of the inventories held at the time it was drawn up, it will not be typical of the position over the rest of the year.

THE ROLE OF ACCOUNTING CONVENTIONS

Accounting has a number of conventions, or rules, that have evolved over time. They have evolved as attempts to deal with practical problems experienced by preparers and users of financial statements, rather than to reflect some theoretical ideal. In preparing the statements of financial position earlier in this chapter, we have followed various **accounting conventions**, although they have not been explicitly mentioned. We shall now identify and discuss the major conventions that we have applied.

Business entity convention

For accounting purposes, the business and its owner(s) are treated as being quite separate and distinct. This is why owners are treated as being claimants against their own business in respect of their investment. The **business entity convention** must be distinguished from the legal position that may exist between businesses and their owners. For sole proprietorships and partnerships, the law does not make any distinction between the business and its owner(s). For limited companies, on the other hand, there is a clear legal distinction between the business and its owners. (As we shall see in Chapter 4, the limited company is regarded as having a separate legal existence.) For accounting purposes, these legal distinctions are irrelevant and the business entity convention applies to all businesses.

Historic cost convention

The **historic cost convention** holds that the value of assets shown on the statement of financial position should be based on their historic cost (that is, acquisition cost). The use of historic cost means that problems of measurement reliability are minimised, as the amount paid for a particular asset is often a matter of demonstrable fact. Reliance on opinion is avoided, or, at least reduced, which should enhance the credibility of the information in the eyes of users. A key problem, however, is that the information provided may not be relevant to user needs. Even quite early in the life of some assets, historic costs may become outdated compared to current market values. This can be misleading when assessing current financial position.

Many argue that recording assets at their current value would provide a more realistic view of financial position and would be relevant for a wide range of decisions. A system of measurement based on current value does, however, bring its own problems. The term 'current value' can be defined in different ways. It can be defined broadly, as either the current replacement cost or the current realisable value (selling price) of an asset. These two types of valuation may result in quite different figures being produced to represent the current value of an item. Furthermore, the broad terms 'replacement cost' and 'realisable value' can be defined in different ways. We must therefore be clear about what kind of current value accounting we wish to use.

Activity 2.13 illustrates some of the problems associated with current value accounting.

Activity 2.13

Plumber and Company has a fleet of motor vans that are used for making deliveries to customers. The owners want to show these vans on the statement of financial position at their current values rather than at their historic cost. They would like to use either current replacement cost (based on how much would have to be paid to buy vans of a similar type, age and condition) or current realisable value (based on how much a motor van dealer would pay for the vans, if the business sold them).

Why is the choice between the two current valuation methods important? Why would both current valuation methods present problems in establishing reliable values?

The choice between the two current valuation methods is important because the values derived under each method are likely to be quite different. Normally, replacement cost values for the motor vans will be higher than their current realisable values.

Establishing current values will usually rely on opinions, which may well vary from one dealer to another. Thus, instead of a single, unambiguous figure for, say, the current replacement cost for each van, a range of possible current replacement costs could be produced. The same problem will arise when trying to establish the current realisable value for each van.

We should bear in mind that the motor vans discussed in Activity 2.13 are less of a problem than are many other types of asset. There is a ready market for motor vans, which means that a value can be obtained by contacting a dealer. For a custom-built piece of equipment, however, identifying a replacement cost or, worse still, a selling price, could be very difficult.

Where the current values of assets are based on the opinion of managers of the business, there is a greater risk that they will lack credibility. Some form of independent valuation, or verification, may therefore be required to reassure users.

Despite the problems associated with current values, they are increasingly used when reporting assets in the statement of financial position. This has led to a steady erosion in the importance of the historic cost convention. Thus, many businesses now prepare financial statements on a modified historic cost basis. We shall consider the valuation of assets in more detail a little later in the chapter.

Prudence convention

In broad terms, the **prudence convention** holds that caution should be exercised when preparing financial statements. This may not seem to be a contentious issue: it would, after all, be difficult to argue that an incautious approach should be taken. Nevertheless, the prudence convention has excited much debate over the years. The root cause has been the way in which the convention is often applied. It can be used to support a bias towards the understatement of financial strength: that is, the understatement of assets and profit and the overstatement of liabilities.

Those who support this approach to prudence argue that it is better to understate than to overstate financial strength. They make the point that, by overstating financial strength, users of financial statements may be misled into making poor decisions.

Activity 2.14

What sort of poor decisions may be made as a result of overstating the financial strength of a business? Try to think of at least two.

Examples of poor decisions may include:

- excessive amounts being paid out of profit to the owners, thereby, depleting their equity and undermining the financial health of the business;
- excessive bonuses being paid to managers based on overstated profits;
- new owners paying more to acquire a part, or the whole, of a business than is justified; and
- lenders providing funds to a business based on a rosier picture of financial strength than is warranted by the facts.

You may have thought of others.

The bias towards the understatement of financial strength evolved in order to counteract the excessive optimism of managers. However, just as overstatement can lead to poor decisions, understatement can lead to the same. It may, for example, result in existing owners selling their business too cheaply, lenders refusing a loan application based on a distortedly pessimistic picture of financial strength and so on.

The systematic bias towards understatement just described clashes with the need for *neutrality* in preparing financial statements.

Activity 2.15

In Chapter 1 we discussed neutrality as a desirable element of one of the major qualitative characteristics of financial information. Can you remember which one?

Neutrality is one of three elements needed to ensure faithful representation. (The other two elements are completeness and freedom from error.)

Neutrality, by definition, requires that financial statements are not slanted or weighted so as to present either a favourable or unfavourable picture to users. To accommodate the concept of neutrality, therefore, prudence must be interpreted and applied in a different way than described above. Adopting a cautious approach to preparing financial statements should not result in the deliberate understatement of financial strength. In other words, assets and profit should not be understated and liabilities should not be overstated.

Going concern convention

Under the **going concern convention**, the financial statements should be prepared on the assumption that a business will continue operations for the foreseeable future, unless there is evidence to the contrary. In other words, it is assumed that there is no intention, or need, to sell off the non-current assets of the business.

Where a business is in financial difficulties, however, non-current assets may have to be sold to repay those with claims against the business. The realisable (sale) value of many non-current assets is often much lower than the values reported in the statement of financial position. In the event of a forced sale of assets, therefore, significant losses might arise. These losses must be anticipated and fully reported when, but only when, a business's going concern status is called into question.

Dual aspect convention

The **dual aspect convention** asserts that each transaction has two aspects, both of which will affect the statement of financial position. This means that, for example, the purchase of a computer for cash results in an increase in one asset (computer) and a decrease in another (cash). Similarly, the repayment of borrowings results in the decrease in a liability (borrowings) and the decrease in an asset (cash).

Activity 2.16

What are the two aspects of each of the following transactions?

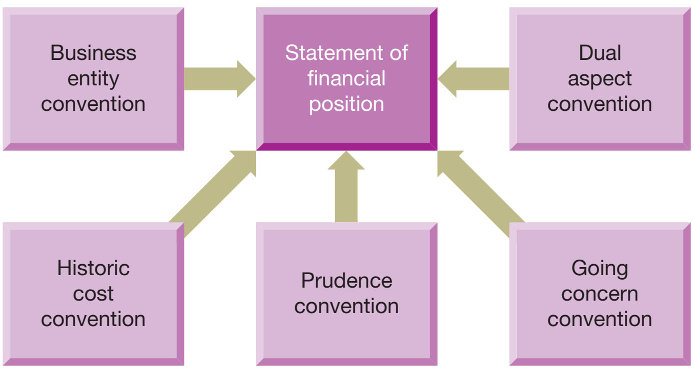
1. **Purchasing £1,000 of inventories on credit.**
2. **Owner withdrawing £2,000 in cash.**
3. **Paying a supplier £1,000 for inventories bought on credit a few weeks earlier.**

Your answer should be as follows:

1. Inventories increase by £1,000, trade payables increase by £1,000.
2. Equity reduces by £2,000, cash reduces by £2,000.
3. Trade payables reduce by £1,000, cash reduces by £1,000.

Recording the dual aspect of each transaction ensures that the statement of financial position will continue to balance, that is the accounting equation will continue to be valid.

Figure 2.5 summarises the main accounting conventions that exert an influence on the construction of the statement of financial position.



These are the key accounting conventions relating to the statement of financial position.

Figure 2.5 Accounting conventions influencing the statement of financial position

MONEY MEASUREMENT

We saw earlier that a resource will only be regarded as an asset and included on the statement of financial position where it is capable of being measured in monetary terms with a reasonable degree of certainty. Unless a measure can faithfully portray the resource, it is unlikely to be useful.

Various resources of a business fail to meet this criterion and so are excluded from the statement of financial position.

Activity 2.17

Can you identify any of these resources? Try to think of at least two.

They may include:

- human resources;
- business reputation;
- business location; and
- customer and supplier relationships.

From time to time, attempts are made to measure and report some of these resources in order to provide a more complete picture of financial position. However, these attempts usually attract little support. Measures with a high degree of uncertainty lead to inconsistency in reporting and create doubts in the minds of users. This, in turn, can undermine the integrity and credibility of the financial statement.

Let us now move on to discuss some key economic resources that normally pose measurement problems.

Goodwill and brands

Some intangible non-current assets are similar to tangible non-current assets: they have a clear and separate identity and the cost of acquiring the asset can be measured with a reasonable degree of certainty. Examples normally include patents, trademarks, copyrights and licences. Other intangible non-current assets, however, are quite different. They lack a clear and separate identity and reflect a hotch-potch of attributes, which are part of the essence of the business. Goodwill and product brands are often examples of assets that lack a clear and separate identity.

The term '**goodwill**' is often used to cover various attributes such as the quality of the products, the skill of employees and the relationship with customers. The term 'product brands' is also used to cover various attributes, such as the brand image, the quality of the product, the trademark and so on. Where goodwill and product brands have been generated internally by the business, it is often difficult to determine their cost or to measure their current market value or even to be clear that they really exist. They are, therefore, excluded from the statement of financial position.

When such assets are acquired through an 'arm's-length transaction', however, the problems of uncertainty about their existence and measurement are resolved. (An arm's-length transaction is one that is undertaken between two unconnected parties.) If goodwill is acquired, when taking over another business, or if a business acquires a particular product brand, from another business, these items will be separately identified and a price agreed for them. Under these circumstances, they can be regarded as assets (for accounting purposes) by the business that acquired them and included in the statement of financial position.

To agree a price for acquiring goodwill or product brands means that some form of valuation must take place and this raises the question as to how it is done. Usually, the valuation will be based on estimates of future earnings from holding the asset – a process that is fraught with difficulties. Nevertheless, a number of specialist businesses now exist that are prepared to take on this challenge.

Human resources

Attempts have been made to place a monetary measurement on the human resources of a business, but without any real success. There are, however, certain limited circumstances in which human resources are measured and reported in the statement of financial position. Professional football clubs provide an example of where these circumstances normally arise. While football clubs cannot own players, they can own the rights to the players' services. Where these rights are acquired by compensating other clubs for releasing the players from their contracts with those other clubs, an arm's-length transaction arises and the amounts paid provide a reliable basis for measurement. This means that the rights to services can be regarded as an asset of the club for accounting purposes (assuming, of course, the player will bring benefits to the club).

Real World 2.2 describes how one leading club reports its investment in players on the statement of financial position.

Real World 2.1

United players appear on the team sheet and on the statement of financial position

Manchester United Football Club has acquired several key players as a result of paying transfer fees to other clubs. In common with most UK football clubs. The club reports the cost of acquiring the rights to the players' services on its statement of financial position. The club's statement as at 30 June 2017 shows the total cost of registering its squad of players at more than £645 million. A total of 70 players were under contract at the year end, which included reserve team and youth team players. The club treats a proportion of each player's transfer fee as an expense each year. The exact proportion depends on the length of the particular player's contract.

The £645 million does not include 'home-grown' players such as Jesse Lingard, because United did not pay a transfer fee for them and so no clear-cut value can be placed on their services. During the year to 30 June 2017, the club was active in the transfer market and spent more than £205 million on acquiring new players, including Paul Pogba from Juventus, Henrikh Mkhitaryan from Borussia Dortmund and Anthony Martial from AS Monaco. Some players also left the club during the year, including Angel Di Maria and Morgan Schneiderlin.

The item of players' registrations is shown as an intangible asset in the statement of financial position as it is the rights to services, not the players, that are the assets. It is shown net of depreciation (or *amortisation* as it is usually termed for intangible non-current assets). The net amount at 30 June 2017 was more than £290 million and represented almost 19 per cent of Manchester United's total assets, as shown in the statement of financial position.

Source: Manchester United plc, Annual Report 2017.

Monetary stability

When using money as the unit of measurement, we normally fail to recognise the fact that it will change in value over time, despite the fact that in the UK, and throughout much of the world, inflation has been a persistent problem. This has meant that the value of money has declined in relation to other assets. In past years, high rates of inflation have resulted in statements of financial position, which were prepared on a historic cost basis, reflecting figures for assets that were much lower than if current values were employed. Rates of inflation have been relatively low in recent years and so the disparity between historic cost values and current values has been less pronounced. Nevertheless, it can still be significant. The problem of inflation has added fuel to the more general debate concerning how to measure asset values in the statement of financial position. It is to the issue of valuing assets that we now turn.

VALUING ASSETS

We saw earlier that, when preparing the statement of financial position, the historic cost convention is normally applied for the reporting of assets. This point requires further explanation as, in practice, things are a little more complex than this. Large businesses throughout much of the world adhere to asset valuation rules set out in International Financial Reporting Standards. We shall now consider the key valuation rules.

Non-current assets

Non-current assets have useful lives that are either *finite* or *indefinite.* Those with a finite life provide benefits to a business for a limited period of time, whereas those with an indefinite life provide benefits without a foreseeable time limit. This distinction between the two types of non-current assets applies equally to both tangible and intangible assets.

Initially, non-current assets are recorded at their historic cost, which will include any amounts spent on getting them ready for use.

Non-current assets with finite lives

Benefits from assets with finite useful lives will be used up over time as a result of market changes, wear and tear and so on. The amount used up, which is referred to as *depreciation* (or *amortisation,* in the case of intangible non-current assets), must be measured for each reporting period for which the assets are held. Although we shall leave a detailed examination of depreciation until Chapter 3, we need to know that when an asset has been depreciated, this must be reflected in the statement of financial position.

The total depreciation that has accumulated over the period since the asset was acquired must be deducted from its cost. This net figure (that is, the cost of the asset less the total depreciation to date) is referred to as the carrying amount. It is sometimes also known as *net book value* or *written-down value.* The procedure just described is not really a contravention of the historic cost convention. It is simply recognition of the fact that a proportion of the historic cost of the non-current asset has been consumed in the process of generating, or attempting to generate, benefits for the business.

Non-current assets with indefinite useful lives

Benefits from assets with indefinite lives may, or may not, be used up over time. Property, in the form of land, is usually an example of a tangible non-current asset with an indefinite life. Purchased goodwill could be an example of an intangible one, although this is not always the case. These assets are not subject to routine depreciation each reporting period.

Activity 2.18

Try to identify *two* non-current assets of a large manufacturing business that have a finite useful life and that can be classified as:

1 tangible and
2 intangible.

Tangible assets normally considered to have a finite life include:

- machinery and equipment;
- motor vehicles; and
- computers.

Intangible assets normally considered to have a finite life include:

- patents (many patents are granted for a period of 20 years);
- leases taken out on assets (such as a property); and
- licences (such as a royalty licence).

Fair values

Initially, non-current assets of all types (tangible and intangible) are recorded at cost. Subsequently, however, an alternative form of measurement may be allowed. Non-current assets may be recorded using **fair values** provided that these values can be measured with a reasonable degree of certainty. Fair values are market based. They represent the selling price that can be obtained in an orderly transaction under current market conditions. The use of fair values, rather than cost, provides users with more up-to-date information. This could well be more relevant to their needs. It may also place the business in a better light, as assets such as property may have increased significantly in value over time. Increasing the statement of financial position value of an asset does not, of course, make that asset more valuable. Perceptions of the business may, however, be altered by such a move.

One consequence of upwardly revaluing non-current assets with finite lives is that the depreciation charge will be increased. This is because the depreciation charge is based on the new (increased) value of the asset.

Real World 2.3 shows the effect of the revaluation of non-current assets on the financial position of one large business.

Real World 2.2

Rising asset levels

During the year to 31 March 2010, Veolia Water UK plc, which owns Thames Water, changed its policy on the valuation of certain types of non-current assets. These assets included land and buildings, infrastructure assets and vehicles, plant and machinery. The business switched from the use of historic cost to the use of fair values and a revaluation exercise was carried out by independent qualified valuers.

The effect of this policy change was to report a revaluation gain of more than £436 million during the year. There was a 40 per cent increase in owners' (shareholders') equity, which was largely due to this gain.

Source: Veolia Water UK plc, Annual Report 2009/10.

Activity 2.19

Refer to the statement of financial position of Brie Manufacturing shown earlier in Example 2.3 (page 51). What would be the effect of revaluing the property to a figure of £110,000 in the statement of financial position? Show the revised statement.

The effect on the statement of financial position would be to increase the figure for property to £110,000 and the gain on revaluation (that is, £110,000 − £45,000 = £65,000) would be added to equity, as it is the owner(s) who will have benefited from the gain. The revised statement of financial position would therefore be as follows:

Brie Manufacturing
Statement of financial position as at 31 December 2018

	£000
ASSETS	
Non-current assets	
Property	110
Plant and equipment	30
Motor vans	19
	159
Current assets	
Inventories	23
Trade receivables	18
Cash at bank	12
	53
Total assets	212
EQUITY AND LIABILITIES	
Equity (60 + 65)	125
Non-current liabilities	
Long-term borrowings	50
Current liabilities	
Trade payables	37
Total equity and liabilities	212

Once non-current assets are revalued, the frequency of revaluation becomes an important issue. Reporting assets on the statement of financial position at out-of-date revaluations is the worst of both worlds. It lacks the objectivity and verifiability of historic cost; it also lacks the realism of current values. Thus, where fair values are used, revaluations should be frequent enough to ensure that the carrying amount of the revalued asset does not differ materially from its fair value at the statement of financial position date.

When an item of property, plant or equipment (a tangible asset) is revalued on the basis of fair values, all assets within that particular group must be revalued. It is not therefore acceptable to revalue some items of property but not others. Although this rule provides some degree of consistency within a particular group of assets, it does not prevent the statement of financial position from containing a mixture of valuations.

Intangible assets are not usually revalued to fair values. This is because an active market is required to determine fair values. For most intangible assets, an active market does not exist. A few intangible assets, however, such as transferable taxi licences, fishing licences and production quotas, provide the exception.

It has been argued that recent emphasis on the use of fair values in accounting has resulted in the exercise of prudence becoming less important. **Real World 2.4** is an extract from an article by John Kay that explains why this change has taken place. The article, which is well worth reading in full, is highly critical of the change.

Real World 2.3

It's really not fair

Once upon a time, values were based on cost, unless assets were no longer worth their cost, in which case they had to be written down. A bird in the hand was worth more than any number in the bush: only when the bird emerged from the bush were you permitted to count it at all.

Like finance, however, accounting became cleverer, and worse. By the 1980s accounting had become the principal means by which UK graduates prepared for business. Many of these trainees found jobs in the finance sector; others took jobs in non-financial business – and, since they were smart, many rose to senior positions. Young accountants were smarter, greedier, less schooled in prudence and better schooled in economics. 'Fair value' increasingly replaced conservatism (prudence) as a guiding principle. But this route to the 'true and fair view' – the traditional holy grail of the accountant – often led to an outcome that was just the opposite of fair.

FT *Source*: Kay, J. (2015) Playing dice with your money, ft.com, 4 September.

The impairment of non-current assets

All types of non-current asset are at risk of suffering a significant fall in value. This may be caused by changes in market conditions, technological obsolescence and so on. In some cases, this results in the carrying amount of the asset being higher than the amount that could be recovered from the asset; either through its continued use or through its sale. When this occurs, the asset value is said to be impaired and the general rule is to reduce the carrying amount on the statement of financial position to the recoverable amount. Unless this is done, the asset value will be overstated. The amount by which the asset value is reduced is known as an **impairment loss**. Note that this type of impairment in value should not be confused with routine depreciation of assets with finite lives. Routine depreciation arises from 'wear and tear' of the asset and/or the passage of time. Impairment results from a fundamental shift in market conditions or technological obsolescence.

Activity 2.20

With which one of the accounting conventions that we discussed earlier is this accounting treatment of impaired assets consistent?

The answer is prudence, which requires that we should adopt a cautious approach when preparing financial statements. The value of assets should not be overstated in the statement of financial position.

Real World 2.5 provides an example of where one large business incurred large impairment losses on the value of its assets.

Real World 2.4

All going impaired shape

More than £430 million was wiped off the market value of Daily Mail and General Trust (DMGT) on Monday as the company said revenues from its media division would fall in 2018 and warned of 'challenging' trading conditions. Shares in the group, which owns the Daily Mail and MailOnline website as well as an events business and a portfolio of business information companies, fell close to 24 per cent on concerns about 2018 trading and a £206 million impairment charge against several of its investments.

'I think they're in a real pickle,' said Alex DeGroote at Cenkos Securities. He pointed to the impairment charges taken against DMGT investments in Genscape, its energy information business, and Xceligent and SiteCompli, which provide property information, describing the charges as 'pretty devastating'. 'What does it say about the growth potential or scalability of these assets?' he added.

In common with other UK newspaper groups, DMGT has been diversifying in recent years to reduce its reliance on a turbulent media sector – but in the process has created a complex web of investments and assets.

FT *Source*: Extracts from Garrahan, M. (2017) Daily Mail and General Trust shares drop 24%, ft.com, 30 November.

Intangible non-current assets with indefinite useful lives must be tested for impairment as at the end of each reporting period. Other non-current assets, however, must also be tested where events suggest that impairment has taken place.

Activity 2.21

Why might it be a good idea to have impairment tests carried out by independent experts?

Impairment tests involve making judgements about the appropriate value to place on assets. Employing independent valuers to make these judgements will normally give users of the financial statements greater confidence in the information reported. There is always a risk that managers will manipulate impairment values to portray a picture that they would like users to see.

When a non-current asset with a finite useful life has its value impaired, the future, periodic, depreciation expense for that asset will be based on the new (lower) impaired value.

Inventories

It is not only non-current assets that run the risk of a significant fall in value. The inventories of a business could also suffer this fate as a result of changes in market taste, obsolescence, deterioration, damage and so on. Where a fall in value means that the amount likely to be recovered from the sale of the inventories will be lower than their cost, this loss must be reflected in the statement of financial position. Thus, if the net realisable value (that is, selling price less any selling costs) falls below the historic cost of inventories held, the former should be used as the basis of valuation. This reflects, once again, the influence of the prudence convention on the statement of financial position.

The published financial statements of large businesses will normally show the basis on which inventories are valued. **Real World 2.6** shows how one business reports this information.

Real World 2.5

Reporting inventories

The 2016/17 annual report of Ted Baker plc, a leading designer clothes brand, includes the following explanation concerning inventories:

> **Inventories and work in progress are stated at the lower of cost and net realisable value. Cost includes materials, direct labour and inward transportation costs. Net realisable value is based on estimated selling price, less further costs expected to be incurred to completion and disposal. Provision is made for obsolete, slow moving or defective items where appropriate.**

Source: Ted Baker plc, Annual Report and Accounts 2016/17, p. 90.

MEETING USER NEEDS

The statement of financial position is the oldest of the three main financial statements and may help users in the following ways:

- *It provides insights about how the business is financed and how its funds are deployed.* The statement of financial position shows how much finance the owners contribute and how much is contributed by outside lenders. It also shows the different kinds of assets acquired and how much is invested in each kind.
- *It can provide a basis for assessing the value of the business.* Since the statement of financial position lists, and places a value on, the various assets and claims, it can provide a starting point for assessing the value of the business. We have seen earlier, however, that accounting rules may result in assets being shown at their historic cost, which may vary quite considerably from the current valuation, and that the restrictive definition of assets may completely exclude certain business resources from the statement of financial position.
- *Relationships between assets and claims can be assessed.* It can be useful to look at relationships between various statement of financial position items, for example the relationship between how much wealth is tied up in current assets and how much is owed in the short term (current liabilities). From this relationship, we can see whether the business has sufficient short-term assets to cover its maturing obligations. We shall look at this and other relationships between statement of financial position items in some detail in Chapter 8.