Part 1

A conceptual framework: setting the scene

Chapter 1

Who needs accounting?

REAL WORLD CASE

Summary financial highlights

Summary	2005	2004	% change
Retail Sales (£m)	**708.7**	672.5	**+5%**
Turnover (£m)	**419.0**	381.1	**+10%**
Operating Profit (£m)	**36.2**	30.3	**+19%**
Earnings per share (pence)	**13.1**	10.7	**+22%**
Dividend per share (pence)	**5.7**	5.7	**0%**
Net debt (£m)	**4.7**	9.4	**–50%**

Delivering value to stakeholders

The Body Shop has an established reputation as a socially and environmentally responsible company. We believe that our values are consistent with strong and sustained financial performance, and that profits with principles must be achieved in order to sustain the long-term future of the Group. The Body Shop is committed to maintaining high standards of social and environmental performance.

We believe in doing business with integrity and transparency. This means using our ethical principles to inform the way we do business, setting ourselves and our business partners clear standards of practice. It also involves engaging stakeholders with our business aims and publicly reporting on our performance within the overall context of our business strategy.

The overall strategic direction of the Group's values is reviewed periodically by the Board in consultation with the Director of Values. The Director of Values reports into the Chief Executive Officer and has overall responsibility for directing the Group's social and environmental programme. Strategic values objectives are aligned with the business objectives as well as stakeholder perceptions and expectations. These objectives are fully embraced by the senior management team, who have responsibility for balancing the interests of all key stakeholder groups.

Sub-committees help direct the social and environmental approach of the business. These include an Issues Management Group, which reports into the Risk Committee; a Corporate Health and Safety Strategy Group; an Environmental Steering Group; and an Animal Protection Steering Group.

Source: The Body Shop International PLC, *Annual Report and Accounts 2005*, p. 1 (Table) and p. 20 (Text).

Discussion points

1 Who might be included in the 'key stakeholder groups' mentioned the extract?

2 To what extent does the 'Summary' meet the needs of users of financial statements?

Contents

Learning outcomes

After studying this chapter you should be able to:

- Define, and explain the definition of, accounting.
- Explain what is meant by a *conceptual framework*.
- Explain the distinguishing features of a sole trader, a partnership and a limited company.
- List the main users of financial information and their particular needs.
- Discuss the usefulness of financial statements to the main users.

Additionally, for those who choose to study the Supplement:

- Define the basic terminology of business transactions.

1.1 Introduction

Activity 1.1

Before starting to read this section, write down one paragraph stating what you think the word 'accounting' means. Then read this section and compare it with your paragraph.

There is no single 'official' definition of accounting but for the purposes of this text the following wording will be used:

Definition

> **Accounting** is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.[1]

This definition may appear short but it has been widely quoted over a number of years and is sufficient to specify the entire contents of this introductory textbook.

Taking the definition word by word, it leads to the following questions:

1. What is the process?
2. How is financial information identified?
3. How is financial information measured?
4. How is financial information communicated?
5. What is an entity?
6. Who are the users of financial information about an entity?
7. What types of judgements and decisions do these users make?

Writing the questions in this order is slightly dangerous because it starts by emphasising the process and waits until the final question to ask about the use of the information. The danger is that accountants may design the process first and then hope to show that it is suitable to allow judgements and decisions by users. This is what has often happened over many years of developing the process by accountants.

In order to learn about, and understand, accounting by taking a critical approach to the usefulness of the current processes and seeing its limitations and the potential for improvement, it is preferable to reverse the order of the questions and start by specifying the users of financial information and the judgements and decisions they make. Once the users and their needs have been identified, the most effective forms of communication may be determined and only then may the technical details of measurement and identification be dealt with in a satisfactory manner.

Reversing the order of the questions arising from the definition of accounting is the approach to be used in this book because it is the approach which has been taken by those seeking to develop a **conceptual framework** of accounting.

This chapter outlines the meaning of the words conceptual framework and in particular the *Framework for the Preparation and Presentation of Financial Statements* which has been developed for international use in accounting practice. The chapter explains the nature of three common types of business **entity** and concludes by drawing on various views relating to the users of accounting information and their information needs.

Because the understanding of users' needs is essential throughout the entire text, the chapter introduces David Wilson, a **fund manager** working for a large insurance company. In order to balance the demands of users with the restrictions and constraints on preparers of financial information, the chapter also introduces Leona Rees who works as an **audit manager** with an **accountancy firm**. Both of them will offer comments and explanations as you progress through the text.

Activity 1.2

> *How does this section compare with your initial notions of what* accounting *means? If they are similar, then it is likely that the rest of this book will meet your expectations. If they are different, then it may be that you are hoping for more than this book can achieve. If that is the case, this may be a useful point at which to consult your lecturer, tutor or some other expert in the subject to be sure that you are satisfied that this book will meet your personal learning outcomes.*

1.2 The development of a conceptual framework

A **conceptual framework** for accounting is a statement of principles which provides generally accepted guidance for the development of new reporting practices and for challenging and evaluating the existing practices. Conceptual frameworks have been developed in several countries around the world, with the UK arriving a little late on the scene. However, arriving late does give the advantage of learning from what has gone before. It is possible to see a pattern emerging in the various approaches to developing a conceptual framework.

The conceptual frameworks developed for practical use by the **accountancy profession** in various countries all start with the common assumption that **financial statements** must be useful. The structure of most conceptual frameworks is along the following lines:

- Who are the users of financial statements?
- What are the information needs of users?
- What types of financial statements will best satisfy their needs?
- What are the characteristics of financial statements which meet these needs?
- What are the principles for defining and recognising items in financial statements?
- What are the principles for measuring items in financial statements?

The most widely applicable conceptual framework is the *Framework for the Preparation and Presentation of Financial Statements* produced by the International Accounting Standards Board (IASB). This *Framework* was issued in 1989 and either reflects, or is reflected in, national conceptual frameworks of the USA, Canada, Australia and the UK. The thinking in all those documents can be traced to two discussion papers of the 1970s in the UK and the USA. In the UK, *The Corporate Report*[2] was a slim but highly influential document setting out the needs of users and how these might be met. Two years earlier the *Trueblood Report*[3] in the USA had taken a similar approach of identifying the needs of users, although perhaps coming out more strongly in support of the needs of shareholders and creditors than of other user groups. In the UK, various documents on the needs of users have been prepared by individuals invited to help the process[4] or those who took it on themselves to propose radical new ideas.[5]

Since January 2005, all **listed** companies in member states of the European Union (EU) have been required by an accounting regulation called the IAS regulation[6] to use a system of international financial reporting standards set by the International Accounting Standards Board. The UK ASB has been influential in the development of these international reporting standards and, over a period of years, has been moving UK accounting practice closely into line with the international standards. For **unlisted** companies and other organisations not covered by the IAS regulation of the EU, the UK ASB has a conceptual framework of its own, called the *Statement of Principles*.[7] This document has many similarities to the IASB's *Framework*.

Activity 1.3

Most conceptual frameworks start with the question: Who are the users of financial statements? Write down a list of the persons or organisations you think would be interested in making use of financial statements, and their possible reasons for being interested. Have you included yourself in that list? Keep your list available for comparing with a later section of this chapter.

1.3 Framework for the preparation and presentation of financial statements

The IASB's *Framework* has seven main sections.

1 Introduction – purpose of the *Framework*, users and their information needs.
2 The objective of financial statements.
3 Underlying assumptions.
4 Qualitative characteristics of financial statements.
5 The elements of financial statements.
6 Recognition of the elements of financial statements.
7 Measurement of the elements of financial statements.

Sections 1 and 2 of the *Framework* are written at a general level and a reader would find no difficulty in reviewing these at an early stage of study, to gain a flavour of what is expected of financial statements. The remaining sections are a mixture of general principles, which are appropriate to first-level study of the subject, and some quite specific principles which deal with more advanced problems. Some of those problems need an understanding of accounting which is beyond a first level of study. This book will refer to aspects of the various sections of the *Framework*, as appropriate, when particular issues are dealt with. You should be aware, however, that this book concentrates on the basic aspects of the *Framework* and does not explore every complexity.

A conceptual framework is particularly important when practices are being developed for reporting to those who are not part of the day-to-day running of the business. This is called **external reporting** or **financial accounting** and is the focus of the *Financial Accounting* half of this book. For those who are managing the business on a day-to-day basis, special techniques have been developed and are referred to generally as **internal reporting** or **management accounting**. That is the focus of the *Management Accounting* half of this book.

Before continuing with the theme of the conceptual framework, it is useful to pause and consider the types of business for which accounting information may be required.

Activity 1.4

web activity

Visit the website of the International Accounting Standards Board at ***www.iasb.org.uk*** *and find the link to the* IASB Framework. *(You may have to follow the link to 'standards' although the* Framework *is not a formal standard.) What does the IASB say about the purpose of the* Framework*? How was it developed? What are the similarities and differences between the ASB and IASB in the way each describes its conceptual framework?*

Visit the website of the Accounting Standards Board at ***www.asb.org.uk*** *and find the link to the Statement of Principles. What does the ASB say about the purpose of the Statement of Principles? How was it developed?*

1.4 Types of business entity

The word **entity** means 'something that exists independently'. A business entity is a business that exists independently of those who own the business. There are three main categories of business which will be found in all countries, although with different titles in different ones. This chapter uses the terminology common to the UK. The three main categories are: **sole trader**, **partnership** and **limited liability company**. This list is by no means exhaustive but provides sufficient variety to allow explanation of the usefulness of most accounting practices and their application.

Activity 1.5

Before reading the next sections, take out a newspaper with business advertisements or a business telephone directory, or else take a walk down your local high street or drive round the trading estate. Write down the names of five businesses, shops or other organisations. Then read the sections and attempt to match your list against the information provided in each.

1.4.1 Sole trader

An individual may enter into business alone, either selling goods or providing a service. Such a person is described as a **sole trader**. The business may be started because the sole trader has a good idea which appears likely to make a profit, and has some cash to buy the equipment and other resources to start the business. If cash is not available, the sole trader may borrow from a bank to enable the business to start up. Although this is the form in which many businesses have started, it is one which is difficult to expand because the sole trader will find it difficult to arrange additional finance for expansion. If the business is not successful and the sole trader is unable to meet obligations to pay money to others, then those persons may ask a court of law to authorise the sale of the personal possessions, and even the family home, of the sole trader. Being a sole trader can be a risky matter and the cost of bank borrowing may be at a relatively unfavourable rate of interest because the bank fears losing its money.

From this description it will be seen that the sole trader's business is very much intertwined with the sole trader's personal life. However, for accounting purposes, the business is regarded as a separate economic entity, of which the sole trader is the owner who takes the risk of the bad times and the benefit of the good times. Take as an example the person who decides to start working as an electrician and advertises his or her services in a newspaper. The electrician travels to jobs from home and has no business premises. Tools are stored in the loft at home and the business records are in a cupboard in the kitchen. Telephone calls from customers are received on the domestic phone and there are no clearly defined working hours. The work is inextricably intertwined with family life.

For accounting purposes that person is seen as the owner of a business which provides electrical services and the business is seen as being separate from the person's other interests and private life. The owner may hardly feel any great need for accounting information because he or she knows the business very closely, but accounting information will be needed by other persons or entities, mainly the government (in the form of **HM Revenue and Customs**) for tax collecting purposes. It may also be required by a bank for the purposes of lending money to the business or by another sole trader who is intending to buy the business when the existing owner retires.

1.4.2 Partnership

One method by which the business of a sole trader may expand is to enter into **partnership** with one or more people. This may permit a pooling of skills to allow more efficient working, or may allow one person with ideas to work with another who has the money to provide the resources needed to turn the ideas into a profit. There is thus more potential for being successful. If the business is unsuccessful, then the consequences are similar to those for the sole trader. Persons to whom money is owed by the business may ask a court of law to authorise the sale of the personal property of the partners in order to meet the obligation. Even more seriously, one partner may be required to meet all the obligations of the partnership if the other partner does not have sufficient personal property, possessions and cash. This is described in law as **joint and several liability** and the risks have to be considered very carefully by those entering into partnership.

Partnership may be established as a matter of fact by two persons starting to work together with the intention of making a profit and sharing it between them. More often there is a legal agreement, called a **partnership deed**, which sets out the rights and duties of each partner and specifies how they will share the profits. There is also **partnership law**, which governs the basic relationships between partners and which they may use to resolve their disputes in a court of law if there is no partnership deed, or if the partnership deed has not covered some aspect of the partnership.

For accounting purposes the partnership is seen as a separate economic entity, owned by the partners. The owners may have the same intimate knowledge of the business as does the sole trader and may therefore feel that accounting information is not very important for them. On the other hand, each partner may wish to be sure that he or she is receiving a fair share of the partnership profits. There will also be other persons requesting accounting information, such as HM Revenue and Customs, banks who provide finance, and individuals who may be invited to join the partnership so that it may expand even further.

1.4.3 Limited liability company

The main risk attached to either a sole trader or a partnership is that of losing personal property and possessions, including the family home, if the business fails. That risk would inhibit many persons from starting or expanding a business. Historically, as the UK changed from a predominantly agricultural to a predominantly industrial economy in the nineteenth century, it became apparent that owners needed the protection of **limited liability**. This meant that if the business failed, then the owners might lose all the money they had put into the business but their personal wealth would be safe.

There are two forms of limited liability company. The **private limited company** has the word 'Limited' (abbreviated to 'Ltd') in its title. The **public limited company** has the abbreviation 'plc' in its title. The private limited company is prohibited by law from offering its **shares** to the public, so it is a form of limited liability appropriate to a family-controlled business. The public limited company is permitted to offer its shares to the public. In return it has to satisfy more onerous regulations. Where the shares of a public limited company are bought and sold on a **stock exchange**, the public limited company is called a **listed company** because the shares of the company are on a list of share prices.

In either type of company, the owners are called **shareholders** because they share the ownership and share the profits of the good times and the losses of the bad times (to the defined limit of liability). Once they have paid in full for their shares, the owners face no further risk of being asked to contribute to meeting any obligations of the business. Hopefully, the business will prosper and the owners may be able to receive a share of that prosperity in the form of a cash **dividend**. A cash dividend returns to the owners, on a regular basis and in the form of cash, a part of the profit created by the business.

If the company is very small, the owners may run the business themselves. If it is larger, then they may prefer to pay someone else to run the business. In either case, the persons running the business on a day-to-day basis are called the **directors**.

Because limited liability is a great privilege for the owners, the company must meet regulations set out by Parliament in the form of a **Companies Act**. At present the relevant law is the Companies Act 1985.

For accounting purposes the company is an **entity** with an existence separate from the owners. In the very smallest companies the owners may not feel a great need for accounting information, but in medium or large size companies, accounting information will be very important for the shareholders as it forms a report on how well the directors have run the company. As with other forms of business there will be a need to provide accounting information to HM Revenue and Customs for tax-collecting purposes. The list of other users will expand considerably because there will be a greater variety of sources of finance, the company may be seeking to attract more **investors**, employees will be concerned about the well-being of the business, and even the customers and suppliers may want to know more about the financial strength of the company.

Although the law provides the protection of limited liability, this has little practical meaning for many small family-controlled companies because a bank lending money to the business will ask for personal guarantees from the shareholder directors. Those personal guarantees could involve a mortgage over the family home, or an interest in life assurance policies. The potential consequences of such personal guarantees, when a company fails, are such that the owners may suffer as much as the sole trader whose business fails.

Exhibit 1.1 summarises the differences between a partnership and a limited liability company that are relevant for accounting purposes.

Exhibit 1.1
Differences between a partnership and a limited liability company

	Partnership	**Limited liability company**
Formation	Formed by two or more persons, usually with written agreement but not necessarily in writing.	Formed by a number of persons registering the company under the Companies Act, following legal formalities. In particular there must be a written **memorandum** and **articles of association** setting out the powers allowed to the company.
Running the business	All partners are entitled to share in the running of the business.	Shareholders must appoint **directors** to run the business (although shareholders may appoint themselves as directors).
Accounting information	Partnerships are not obliged to make accounting information available to the wider public.	Companies must make accounting information available to the public through the **Registrar of Companies**.
Meeting obligations	All members of a general partnership are jointly and severally liable for money owed by the firm.	The personal liability of the owners is limited to the amount they have agreed to pay for shares.
Powers to carry out activities	Partnerships may carry out any legal business activities agreed by the partners.	The company may only carry out the activities set out in its **memorandum** and **articles of association**.
Status in law	The partnership is not a separate legal entity (under English law), the partnership property being owned by the partners. (Under Scots law the partnership is a separate legal entity.)	The company is seen in law as a separate person, distinct from its members. This means that the company can own property, make contracts and take legal action or be the subject of legal action.

Exhibit 1.2 identifies the differences between the public limited company and the private limited company that are relevant for accounting purposes.

Exhibit 1.2
Brief comparison of private and public companies

<table>
<tr><th></th><th>Public company</th><th>Private company</th></tr>
<tr><td rowspan="2">Running the business</td><td>Minimum of two directors.</td><td>Minimum of one director.</td></tr>
<tr><td>Must have a company secretary who holds a relevant qualification (responsible for ensuring the company complies with the requirements of company law).</td><td>The sole director may also act as the company secretary and is not required to have a formal qualification.</td></tr>
<tr><td>Ownership</td><td>Shares may be offered to the public, inviting subscription.

Minimum share capital £50,000.</td><td>Shares must not be offered to the public. May only be sold by private arrangements.

No minimum share capital.</td></tr>
<tr><td rowspan="2">Accounting information</td><td>Extensive information required on transactions between directors and the company.</td><td>Less need for disclosure of transactions between directors and the company.</td></tr>
<tr><td colspan="2">Information must be made public through the Registrar of Companies. Provision of financial information to the public is determined by size of company, more information being required of medium and large companies.

Accounting information must be sent to all shareholders.</td></tr>
</table>

Activity 1.6

Look at the list of five organisations which you prepared before reading this section. Did the list match what you have just read? If not, there are several possible explanations. One is that you have written down organisations which are not covered by this book. That would apply if you have written down 'museum', 'town hall' or 'college'. These are examples of public sector bodies that require specialised financial statements not covered by this text. Another is that you did not discover the name of the business enterprise. Perhaps you wrote down 'Northern Hotel' but did not find the name of the company owning the hotel. If your list does not match the section, ask for help from your lecturer, tutor or other expert in the subject so that you are satisfied that this book will continue to meet your personal learning outcomes.

1.5 Users and their information needs

Who are the users of the information provided by these reporting entities? This section shows that there is one group, namely the **management** of an organisation, whose information needs are so specialised that a separate type of accounting has evolved called **management accounting**. However, there are other groups, each of which may believe it has a reasonable right to obtain information about an organisation, that do not enjoy unrestricted access to the business and so have to rely on management to supply suitable information. These groups include the owners, where the owners are not also the managers, but extend further to employees, lenders, suppliers, customers, government and its branches, and the public interest. Those in the wider interest groups are sometimes referred to as **stakeholders**.

Definition

> **Stakeholder** A general term to indicate all those who might have a legitimate interest in receiving financial information about a business because they have a 'stake' in it.

1.5.1 Management

Many would argue that the foremost users of accounting information about an organisation must be those who manage the business on a day-to-day basis. This group is referred to in broad terms as **management**, which is a collective term for all those persons who have responsibilities for making judgements and decisions within an organisation. Because they have close involvement with the business, they have access to a wide range of information (much of which may be confidential within the organisation) and will seek those aspects of the information which are most relevant to their particular judgements and decisions. Because this group of users is so broad, and because of the vast amount of information potentially available, a specialist branch of accounting has developed, called management accounting, to serve the particular needs of management.

It is management's responsibility to employ the resources of the business in an efficient way and to meet the objectives of the business. The information needed by management to carry out this responsibility ought to be of high quality and in an understandable form so far as the management is concerned. If that is the case, it would not be unreasonable to think that a similar quality (although not necessarily quantity) of information should be made available more widely to those stakeholders who do not have the access available to management.[8] Such an idea would be regarded as somewhat revolutionary in nature by some of those who manage companies, but more and more are beginning to realise that sharing information with investors and other stakeholders adds to the general atmosphere of confidence in the enterprise.

1.5.2 Owners as investors

Where the owners are the managers, as is the case for a sole trader or a partnership, they have no problem in gaining access to information and will select information appropriate to their own needs. They may be asked to provide information for other users, such as HM Revenue and Customs or a bank which has been approached to provide finance, but that information will be designed to meet the needs of those particular users rather than the owners.

Where the ownership is separate from the management of the business, as is the case with a limited liability company, the owners are more appropriately viewed as investors who entrust their money to the company and expect something in return, usually a **dividend** and a growth in the value of their investment as the company prospers. Providing money to fund a business is a risky act and investors are concerned with the **risk** inherent in, and **return** provided by, their investments. They need information to help them decide whether they should buy, hold or sell.[9] They are also interested in information on the entity's financial performance and financial position that helps them to assess both its cash-generation abilities and the stewardship of management.[10]

Much of the investment in shares through the Stock Exchange in the UK is carried out by **institutional investors**, such as pension funds, insurance companies, unit trusts and investment trusts. The day-to-day business of buying and selling shares is carried out by a **fund manager** employed by the institutional investor. Private investors are in the minority as a group of investors in the UK. They will often take the advice of an **equities analyst** who investigates and reports on share investment. The fund managers and the equities analysts are also regarded as users of accounting information.

The kinds of judgements and decisions made by investors could include any or all of the following:

(a) Evaluating the performance of the entity.
(b) Assessing the effectiveness of the entity in achieving objectives (including compliance with **stewardship** obligations) established previously by its management, its members or owners.
(c) Evaluating managerial performance, efficiency and objectives, including investment and dividend distribution plans.
(d) Ascertaining the experience and background of company directors and officials including details of other directorships or official positions held.
(e) Ascertaining the economic stability and vulnerability of the reporting entity.
(f) Assessing the **liquidity** of the entity, its present or future requirements for additional **working capital**, and its ability to raise long-term and short-term finance.
(g) Assessing the capacity of the entity to make future reallocations of its resources for economic purposes.
(h) Estimating the future prospects of the entity, including its capacity to pay **dividends**, and predicting future levels of investment.
(i) Making economic comparisons, either for the given entity over a period of time or with other entities at one point in time.
(j) Estimating the value of present or prospective interests in or claims on the entity.
(k) Ascertaining the ownership and control of the entity.[11]

That list was prepared in 1975 and, while it is a valid representation of the needs of investors, carries an undertone which implies that the investors have to do quite a lot of the work themselves in making estimates of the prospects of the entity. Today there is a stronger view that the management of a business should share more of its thinking and planning with the investors. The list may therefore be expanded by suggesting that it would be helpful for investors (and all external users) to know:

(a) the entity's actual performance for the most recent accounting period and how this compares with its previous plan for that period;
(b) management's explanations of any significant variances between the two; and
(c) management's financial plan for the current and forward accounting periods, and explanations of the major assumptions used in preparing it.[12]

If you look through some annual reports of major listed companies you will see that this is more a 'wish list' than a statement of current practice, but it is indicative of the need for a more progressive approach. In the annual reports of large companies you will find a section called the *Operating and Financial Review* (or similar title). This is where the more progressive companies will include forward-looking statements which stop short of making a **forecast** but give help in understanding which of the trends observed in the past are likely to continue into the future.

1.5.3 Employees

Employees and their representatives are interested in information about the stability and profitability of their employers. They are also interested in information that helps them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.[13] Employees continue to be interested in their employer after they have retired from work because in many cases the employer provides a pension fund.

The matters which are likely to be of interest to past, present and prospective employees include: the ability of the employer to meet wage agreements; management's intentions regarding employment levels, locations and working conditions; the pay, conditions and terms of employment of various groups of employees; job security; and the contribution made by employees in other divisions of the organisation. Much of this is quite specialised and detailed information. It may be preferable to supply this to employees by means of special purpose reports on a frequent basis rather than waiting for the annual report, which is slow to arrive and more general in nature. However, employees may look to financial statements to confirm information provided previously in other forms.

1.5.4 Lenders

Lenders are interested in information that enables them to determine whether their loans, and the related interest, will be paid when due.[14]

Loan **creditors** provide finance on a longer-term basis. They will wish to assess the economic stability and vulnerability of the borrower. They are particularly concerned with the risk of **default** and its consequences. They may impose conditions (called **loan covenants**) which require the business to keep its overall borrowing within acceptable limits. The financial statements may provide evidence that the loan covenant conditions are being met.

Some lenders will ask for special reports as well as the general financial statements. Banks in particular will ask for **cash flow projections** showing how the business plans to repay, with interest, the money borrowed.

1.5.5 Suppliers and other trade creditors

Suppliers of goods and services (also called **trade creditors**) are interested in information that enables them to decide whether to sell to the entity and to determine whether amounts owing to them will be paid when due. Suppliers (trade creditors) are likely to be interested in an entity over a shorter period than lenders unless they are dependent upon the continuation of the entity as a major customer.[15] The amount due to be paid to the supplier is called a **trade payable** or an **account payable**.

Trade creditors supply goods and services to an entity and have very little protection if the entity fails because there are insufficient assets to meet all **liabilities**. They are usually classed as **unsecured creditors**, which means they are a long way down the queue for payment. So they have to exercise caution in finding out whether the business is able to pay and how much risk of non-payment exists. This information need not necessarily come from accounting statements; it could be obtained by reading the local press and trade journals, joining the Chamber of Trade, and generally listening in to the stories and gossip circulating in the geographic area or the industry. However, the financial statements of an entity may confirm the stories gained from other sources.

In recent years there has been a move for companies to work more closely with their suppliers and to establish 'partnership' arrangements where the operational and financial plans of both may be dovetailed by specifying the amount and the timing of goods and services required. Such arrangements depend heavily on confidence, which in turn may be derived partly from the strength of financial statements.

1.5.6 Customers

Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent upon, its prosperity.[16] In particular, customers need information concerning the current and future supply of goods and services offered, price and other product details, and conditions of sale. Much of this information may be obtained from sales literature or from sales staff of the enterprise, or from trade and consumer journals.[17]

The financial statements provide useful confirmation of the reliability of the enterprise itself as a continuing source of supply, especially when the customer is making payments in advance. They also confirm the capacity of the entity in terms of **non-current assets** (also called **fixed assets)** and working capital and give some indication of the strength of the entity to meet any obligations under guarantees or warranties.[18]

1.5.7 Governments and their agencies

Governments and their agencies are interested in the allocation of resources and, therefore, in the activities of entities. They also require information in order to regulate the activities of entities, assess taxation and provide a basis for national income and economic statistics.[19]

Acting on behalf of the UK government's Treasury Department, HM Revenue and Customs collects taxes from businesses based on profit calculated according to commercial accounting practices (although there are some specific rules in the taxation legislation which modify the normal accounting practices). HM Revenue and Customs has the power to demand more information than appears in published financial statements, but will take these as a starting point.

Other agencies include the regulators of the various utility companies. Examples are Ofcom[20] (the Office of Communications) and Ofgem[21] (the Office of Gas and Electricity Markets). They use accounting information as part of the package by which they monitor the prices charged by these organisations to consumers of their services. They also demand additional information designed especially to meet their needs.

1.5.8 Public interest

Enterprises affect members of the public in a variety of ways. For example, enterprises may make a substantial contribution to the local economy by providing employment and using local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.[22]

A strong element of public interest has been aroused in recent years by environmental issues and the impact of companies on the environment. There are costs imposed on others when a company pollutes a river or discharges harmful gases into the air. It may be perceived that a company is cutting corners to prune its own reported costs at the expense of other people. Furthermore, there are activities of companies today which will impose costs in the future. Where an oil company has installed a drilling rig in the North Sea, it will be expected one day to remove and destroy the rig safely. There is a question as to whether the company will be able to meet that cost. These costs and future liabilities may be difficult to identify and quantify, but that does not mean that companies should not attempt to do so. More companies are now including descriptions of environmental policy in their annual reports, but regular accounting procedures for including environmental costs and obligations in the financial statements have not yet been developed.

Activity 1.7

Look back to the list of users of financial statements which you prepared earlier in this chapter. How closely does your list compare with the users described in this section? Did you have any in your list which are not included here? Have you used names which differ from those used in the chapter? Are there users in the chapter which are not in your list? If your list does not match the section, ask for help from your lecturer, tutor or other expert in the subject so that you are satisfied that this book will continue to meet your personal learning outcomes.

1.6 General purpose or specific purpose financial statements?

Some experts who have analysed the needs of users in the manner set out in the previous section have come to the conclusion that no single set of general purpose financial statements could meet all these needs. It has been explained in the previous section that some users already turn to special reports to meet specific needs. Other experts hold that there could be a form of general purpose financial statements which would meet all the needs of some user groups and some of the needs of others.

This book is written on the assumption that it *is* possible to prepare a set of general purpose financial statements which will have some interest for all users. The existence of such reports is particularly important for those who cannot prescribe the information they would like to receive from an organisation. That is perhaps because they have no bargaining power, or because they are many in number but not significant in economic influence.

Preparers of general purpose financial statements tend to regard the owners and long-term lenders as the primary users of the information provided. There is an expectation or hope that the interests of these groups will overlap to some extent with the interests of a wider user group and that any improvements in financial statements will be sufficient that fewer needs will be left unmet.[23]

The primary focus of the *Framework* is on general purpose financial statements.[24] It takes the view that many users have to rely on the financial statements as their major source of financial information. Financial statements should be prepared with their needs in mind. The *Framework* assumes that if financial statements meet the needs of investors, they will also meet the needs of most other users.[25]

1.7 Stewards and agents

In an earlier section, the needs of investors as users were listed and the word 'stewardship' appeared. In the days before an industrial society existed, 'stewards' were the people who looked after the manor house and lands while the lord of the manor enjoyed the profits earned. Traditionally, accounting has been regarded as having a particular role to play in confirming that those who manage a business on behalf of the owner take good care of the resources entrusted to them and earn a satisfactory profit for the owner by using those resources.

As the idea of a wider range of users emerged, this idea of the 'stewardship' objective of accounting was mentioned less often (although its influence remains strong in legislation governing accounting practice). In the academic literature it has been reborn under a new heading – that of **agency**. Theories have been developed about the relationship between the owner, as 'principal', and the manager, as 'agent'. A conscientious manager, acting as an agent, will carry out his or her duties in the best interest of the owners, and is required by the law of agency to do so. However, not all agents will be perfect in carrying out this role and some principals will not trust the agent entirely. The principal will incur costs in monitoring (enquiring into) the activities of the agent and may lose some wealth if the interests of the agent and the interests of the principal diverge. The view taken in **agency theory** is that there is an inherent conflict between the two parties and so they spend time agreeing contracts which will minimise that conflict. The contracts will include arrangements for the agent to supply information on a regular basis to the principal.

While the study of agency theory in all its aspects could occupy a book in itself, the idea of conflicts and the need for compromise in dealing with pressures of demand for, and supply of, accounting information may be helpful in later chapters in understanding why it takes so long to find answers to some accounting issues.

1.8 Who needs financial statements?

In order to keep the flavour of debate on accounting issues running through this text, two people will give their comments from time to time. The first of these is David Wilson, a fund manager of seven years' experience working for an insurance company. He manages a UK **equity portfolio** (a collection of company shares) and part of his work requires him to be an equities analyst. At university he took a degree in history and has subsequently passed examinations to qualify as a chartered financial analyst (CFA).[26]

The second is Leona Rees, an audit manager with a major accountancy firm. She has five years' experience as a qualified accountant and had previously spent three years in training with the same firm. Her university degree is in accounting and economics and she has passed the examinations to qualify for membership of one of the major accountancy bodies.

David and Leona had been at school together but then went to different universities. More recently they have met again at workout sessions at a health club, relaxing afterwards at a nearby bar. David is very enthusiastic about his work, which demands long hours and a flexible attitude. He has absorbed a little of the general scepticism of audit which is expressed by some of his fund manager colleagues.

Leona's main role at present is in company audit and she is now sufficiently experienced to be working on the audit of one listed company as well as several private companies of varying size. For two years she worked in the corporate recovery department of the accountancy firm, preparing information to help companies find sources of finance to overcome difficult times. She feels that a great deal of accounting work is carried out behind the scenes and the careful procedures are not always appreciated by those who concentrate only on the relatively few well-publicised problems.

We join them in the bar at the end of a hectic working week.

DAVID: *This week I've made three visits to companies, attended four presentations of preliminary announcements of results, received copies of the projector slides used for five others that I couldn't attend, and collected around 20 annual reports. I have a small mound of brokers' reports, all of which say much the same thing but in different ways. I've had to read all those while preparing my monthly report to the head of Equities Section on the performance of my fund and setting out my strategy for three months ahead consistent with in-house policy. I think I'm suffering from information overload and I have reservations about the reliability of any single item of information I receive about a company.*

LEONA: *If I had to give scores for reliability to the information crossing your desk, I would give top marks to the 20 annual reports. They have been through a very rigorous process and they have been audited by reputable audit firms using established standards of auditing practice.*

DAVID: *That's all very well, but it takes so long for annual reports to arrive after the balance sheet date that they don't contain any new information. I need to get information at the first available opportunity if I'm to keep up the value of the share portfolio I manage. The meetings that present the preliminary announcements are held less than two months after the accounting year-end. It can take another six weeks before the printed annual report appears. If I don't manage to get to the meeting I take a careful look at what the company sends me in the way of copies of projector slides used.*

LEONA: *Where does accounting information fit in with the picture you want of a company?*

DAVID: *It has some importance, but accounting information is backward-looking and I invest in the future. We visit every company in the portfolio once a year and I'm looking for a confident management team, a cheerful-looking workforce and a general feeling that things are moving ahead. I'll also ask questions about prospects: how is the order book; which overseas markets are expanding; have prices been increased to match the increase in raw materials?*

LEONA: *Isn't that close to gaining insider information?*

DAVID: *No – I see it as clarification of information which is already published. Companies are very careful not to give an advantage to one investor over another – they would be in trouble with the Stock Exchange and perhaps with the Financial Services Authority if they did give price-sensitive information. There are times of the year (running up to the year-end and to the half-yearly results) when they declare a 'close season' and won't even speak to an investor.*

LEONA: *So are you telling me that I spend vast amounts of time auditing financial statements which no one bothers to read?*

DAVID: *Some people would say that, but I wouldn't. It's fairly clear that share prices are unmoved by the issue of the annual report, probably because investors already have that information from the preliminary announcement. Nevertheless, we like to know that there is a regulated document behind the information we receive – it allows us to check that we're not being led astray. Also I find the annual report very useful when I want to find out about a company I don't know. For the companies I understand well, the annual report tells me little that I don't already know.*

LEONA: *I'll take that as a very small vote of confidence for now. If your offer to help me redecorate the flat still stands, I might try to persuade you over a few cans of emulsion that you rely on audited accounts more than you realise.*

Activity 1.8

As a final activity for this chapter, go back to the start of the chapter and make a note of every word you have encountered for the first time. Look at the Glossary at the end of the book for the definition of each technical word. If the word is not in the Glossary it is probably in sufficiently general use to be found in a standard dictionary.

1.9 Summary

This chapter has explained that accounting is intended to provide information that is useful to a wide range of interested parties (stakeholders).

Key points are:

- **Accounting** is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.
- A **conceptual framework** for accounting is a statement of principles which provides generally accepted guidance for the development of new reporting practices and for challenging and evaluating the existing practices.
- The *Framework* of the IASB provides broad principles that guide accounting practice in many countries.

- The *Statement of Principles* of the UK ASB has many similarities to the IASB's *Framework*.
- Since January 2005, all **listed companies** in member states of the EU have been required by an accounting regulation to use a system of international financial reporting standards (IFRS) set by the IASB.
- Business **entities** in the UK are either **sole traders**, **partnerships** or **limited liability** companies.
- **Users** of accounting information include management, owners, employees, lenders, suppliers, customers, governments and their agencies, and the public interest.
- **Stakeholders** are all those who might have a legitimate interest in receiving financial information about a business because they have a 'stake' in it.
- General purpose **financial statements** aim to meet the needs of a wide range of users.
- The relationship between the owner, as 'principal', and the manager, as 'agent' is described in the theory of **agency** relationships. Accounting information helps to reduce the potential conflicts of interest between principal and agent.

Further reading

IASB (1989) *Framework for the Preparation and Presentation of Financial Statements*, International Accounting Standards Board.

ASSC (1975) *The Corporate Report*, Accounting Standards Steering Committee.

Beattie, V. (ed.) (1999) *Business Reporting: The Inevitable Change?*, Research Committee of The Institute of Chartered Accountants of Scotland.

ICAS (1988) *Making Corporate Reports Valuable*, discussion paper of the Research Committee of The Institute of Chartered Accountants of Scotland.

Marston, C. (1999) *Investor Relations Meetings: Views of Companies, Institutional Investors and Analysts*, Research Committee of The Institute of Chartered Accountants of Scotland.

Weetman, P. and Beattie, A. (eds) (1999) *Corporate Communication: Views of Institutional Investors and Lenders*, Research Committee of The Institute of Chartered Accountants of Scotland.

QUESTIONS

The Questions section of each chapter has three types of question. 'Test your understanding' questions to help you review your reading are in the 'A' series of questions. You will find the answers to these by reading and thinking about the material in the book. 'Application' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in problem solving and evaluation are in the 'C' series of questions. A letter [S] indicates that there is a solution at the end of the book.

A Test your understanding

A1.1 Define 'accounting' and identify the separate questions raised by the definition. (Section 1.1)

A1.2 The following technical terms appear for the first time in this chapter. Check that you know the meaning of each. (If you can't find them again in the text, there is a Glossary at the end of the book.)

- accounting standards
- agency
- annual report
- broker
- business entity
- capital
- cash flow projections
- conceptual framework
- directors
- entity
- equities analyst
- external reporting
- financial accounting
- financial information
- financial statements
- fund manager
- general purpose financial statements
- HM Revenue and Customs
- limited liability company
- liquidity
- loan covenants
- management accounting
- partnership
- portfolio [of investment]
- portfolio of shares
- Registrar of Companies
- share capital
- shareholders
- sole trader
- specific purpose financial statements
- stakeholders
- stewardship
- unsecured creditors

B Application

B1.1

Brian and Jane are planning to work in partnership as software consultants. Write a note (100–200 words) to explain their responsibilities for running the business and producing accounting information about the financial position and performance of the business.

B1.2

Jennifer has inherited some shares in a public company which has a share listing on the Stock Exchange. She has asked you to explain how she can find out more about the financial position and performance of the company. Write a note (100–200 words) answering her question.

B1.3

Martin is planning to buy shares in the company that employs him. He knows that the directors of the company are his employers but he wonders what relationship exists between the directors and the shareholders of the company. Write a note (100–200 words) answering his question.

C Problem solving and evaluation

C1.1

The following extracts are typical of the annual reports of large listed companies. Which of these extracts satisfy the definition of 'accounting'? What are the user needs that are most closely met by each extract?

(a) Suggestions for improvements were made by many employees, alone or in teams. Annual savings which have been achieved total £15m. The best suggestion for improvement will save around £0.3m per year for the next five years.
(b) As of 31 December, 3,000 young people were learning a trade or profession with the company. This represents a studentship rate of 3.9%. During the reporting period we hired 1,300 young people into training places. This is more than we need to satisfy our employment needs in the longer term and so we are contributing to improvement of the quality of labour supplied to the market generally.
(c) During the year to 31 December our turnover (sales) grew to £4,000 million compared to £2,800 million last year. Our new subsidiary contributed £1,000 million to this increase.
(d) It is our target to pay our suppliers within 30 days. During the year we achieved an average payment period of 33 days.

(e) The treasury focus during the year was on further refinancing of the group's borrowings to minimise interest payments and reduce risk.
(f) Our plants have emission rates that are 70% below the national average for sulphur dioxide and 20% below the average for oxides of nitrogen. We will tighten emissions significantly over the next ten years.

C1.2
Explain how you would class each of the following – as a sole trader, partnership or limited company. List any further questions you might ask for clarification about the nature of the business.

(a) Miss Jones works as an interior decorating adviser under the business name 'U-decide'. She rents an office and employs an administrative assistant to answer the phone, keep files and make appointments.
(b) George and Jim work together as painters and decorators under the business name 'Painting Partners Ltd'. They started the business ten years ago and work from a rented business unit on a trading estate.
(c) Jenny and Chris own a hotel jointly. They operate under the business name 'Antler Hotel Company' and both participate in the running of the business. They have agreed to share profits equally.

Activities for study groups (4 or 5 per group)

Obtain the annual report of a listed company. Each member of the group should choose a different company. Most large companies will provide a copy of the annual report at no charge in response to a polite request – or you may know someone who is a shareholder and receives a copy automatically. Many companies have websites with a section for 'Investor Relations' where you will find a document file containing the annual report.

1 Look at the contents page. What information does the company provide?

2 Find the financial highlights page. What are the items of accounting information which the company wants you to note? Which users might be interested in this highlighted information, and why?

3 Is there any information in the annual report which would be of interest to employees?

4 Is there any information in the annual report which would be of interest to customers?

5 Is there any information in the annual report which would be of interest to suppliers?

6 Find the auditors' report. To whom is it addressed? What does that tell you about the intended readership of the annual report?

7 Note the pages to which the auditors' report refers. These are the pages which are regulated by company law, accounting standards and Stock Exchange rules. Compare these pages with the other pages (those which are not regulated). Which do you find more interesting? Why?

8 Each member of the group should now make a five-minute presentation evaluating the usefulness of the annual report examined. When the presentations are complete the group should decide on five criteria for judging the reports and produce a score for each. Does the final score match the initial impressions of the person reviewing it?

9 Finally, as a group, write a short note of guidance on what makes an annual report useful to the reader.

Notes and references

1. AAA (1966), *A Statement of Basic Accounting Theory*, American Accounting Association, Evanston, Ill., p. 1.
2. ASSC (1975), *The Corporate Report*, Accounting Standards Steering Committee.
3. AICPA (1973), *Report of a Study Group on the Objectives of Financial Statements* (The Trueblood Committee), American Institute of Certified Public Accountants.

4. Solomons, D. (1989), *Guidelines for Financial Reporting Standards*, Research Board of The Institute of Chartered Accountants in England and Wales.
5. ICAS (1988), *Making Corporate Reports Valuable*, Research Committee of The Institute of Chartered Accountants of Scotland.
6. The IAS Regulation (2002) – see Chapter 4.
7. ASB (1999), *Statement of Principles for Financial Reporting*, Accounting Standards Board.
8. ICAS (1988), para. 3.3.
9. IASB (1989), para. 9(a).
10. IASB (1989), para. 14.
11. ASSC (1975), para. 2.8.
12. ICAS (1988), para. 3.12.
13. IASB (1989), para. 9(b).
14. *Ibid*., para. 9(c).
15. *Ibid*., para. 9(d).
16. *Ibid*., para. 9(e).
17. ASSC (1975), para. 2.25.
18. *Ibid*., para. 2.26.
19. IASB (1989), para. 9(f).
20. www.ofcom.org.uk
21. www.ofgem.gov.uk
22. IASB (1989), para. 9(g).
23. ICAS (1988), para. 3.7.
24. IASB (1989), Introduction, para. 6.
25. IASB (1989), para. 10.
26. www.cfainstitute.org

Supplement to Chapter 1

Introduction to the terminology of business transactions

The following description explains the business terminology which will be encountered frequently in describing transactions in this textbook. The relevant words are highlighted in bold lettering. These technical accounting terms are defined in the Financial Accounting Terms Defined *section at the end of the book.*

Most businesses are established with the intention of earning a **profit**. Some do so by selling goods at a price greater than that paid to buy or manufacture the goods. Others make a profit by providing a service and charging a price greater than the cost to them of providing the service. By selling the goods or services the business is said to earn *sales revenue*.

Profit arising from transactions relating to the operation of the business is measured by deducting from sales revenue the expenses of earning that revenue.

Revenue from sales (often abbreviated to 'sales' and sometimes referred to as 'turnover') means the value of all goods or services provided to customers, whether for *cash* or for *credit*. In a *cash sale* the customer pays immediately on receipt of goods or services. In a *credit sale* the customer takes the goods or service and agrees to pay at a future date. By agreeing to pay in the future the customer becomes a **debtor** of the business. The amount due to be collected from the debtor is called a **trade receivable** or an **account receivable**. The business will send a document called a **sales invoice** to the credit customer, stating the goods or services provided by the business, the price charged for these and the amount owing to the business.

Eventually the credit customer will pay cash to settle the amount shown on the invoice. If (s)he pays promptly the business may allow a deduction of discount for prompt payment. This deduction is called *discount allowed* by the business. As an example, if the customer owes £100 but is allowed a 5% discount by the business, he will pay £95. The business will record cash received of £95 and discount allowed of £5.

The business itself must buy goods in order to manufacture a product or provide a service. When the business buys goods it *purchases* them and holds them as an **inventory** of goods (also described as a 'stock' of goods) until they are used or sold. The goods will be purchased from a supplier, either for **cash** or for **credit**. In a **credit purchase** the business takes the goods and agrees to pay at a future date. By allowing the business time to pay, the supplier becomes a **creditor** of the business. The name creditor is given to anyone who is owed money by the business. The business will receive a purchase invoice from the supplier describing the goods supplied, stating the price of the goods and showing the amount owed by the business.

Eventually the business will pay cash to settle the amount shown on the purchase invoice. If the business pays promptly the supplier may permit the business to deduct a discount for prompt payment. This is called **discount received** by the business. As an example, if the business owes an amount of £200 as a **trade payable** but is permitted a 10% discount by the supplier, the business will pay £180 and record the remaining £20 as **discount received** from the supplier.

The purchase price of goods sold is one of the **expenses** of the business, to be deducted from sales revenue in calculating profit. Other expenses might include wages, salaries, rent, rates, insurance and cleaning. In each case there will be a document providing evidence of the expense, such as a wages or salaries slip, a landlord's bill for rent, a local authority's demand for rates, an insurance renewal note or a cleaner's time sheet. There will also be a record of the cash paid in each case.

Sometimes an expense is incurred but is not paid for until some time later. For example, electricity is consumed during a quarter but the electricity bill does not arrive until after the end of the quarter. An employee may have worked for a week but not yet have received a cash payment for that work. The unpaid expense of the business is called an *accrued expense* and must be recorded as part of the accounting information relevant to the period of time in which the expense was incurred.

On other occasions an expense may be paid for in advance of being used by the business. For example, a fire insurance premium covering the business premises is paid annually in advance. Such expenditure of cash will benefit a future time period and must be excluded from any profit calculation until that time. In the meantime it is recorded as a **prepaid expense** or a **prepayment**.

Dissatisfaction may be expressed by a customer with the quantity or quality of goods or service provided. If the business accepts that the complaint is justified it may replace goods or give a cash refund. If the customer is a credit customer who has not yet paid, then a cash refund is clearly inappropriate. Instead the customer would be sent a **credit note** for sales returned, cancelling the customer's debt to the business for the amount in dispute. The credit note would record the quantity of goods or type of service and the amount of the cancelled debt.

In a similar way the business would expect to receive a credit note from a supplier for *purchases returned* where goods have been bought on credit terms and later returned to the supplier because of some defect.

S Test your understanding

S1.1 The following technical terms appear for the first time in this Supplement. Check that you know the meaning of each.

- Profit
- Sales revenue
- Cash sale
- Credit sale
- Debtor
- Trade receivable
- Discount allowed
- Purchases
- Cash purchase
- Credit purchase
- Creditor
- Trade payable
- Discount received
- Expense
- Accrued expense
- Prepaid expense
- Credit note for sales returned
- Credit note for purchases returned