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introduction to financial accounting, stewardship and regulation	

Accounting classifications

Accounting is frequently divided into two major categories:

- 1 Financial accounting, and
- 2 Management accounting.

Financial accounting is primarily concerned with recording, processing and presenting historic information for the benefit of users external to the business. This area of accounting is concerned with preparing accounts for a business and then interpreting the information. Financial accounting is subject to a detailed regulatory framework of accounting and legal rules.

Management accounting is aimed at providing information to enable managers to operate, control and plan the future direction of their business. Management accounting includes topics such as costing, budgeting and the planning of resources.

Management accounting is largely unregulated by accounting and legal frameworks.

In this book, we are only concerned with financial accounting.

Financial accounting

In your studies of financial accounting, you must understand how to collect and record data, prepare a **trial balance** and produce various types of business **financial statements**. In this book the most important financial statements are covered and these consist of the:

- trading and profit and loss account
- **balance sheet**
- cash flow statement.

You will also be required to understand the nature of accounting adjustments that businesses frequently have to make to financial data and, importantly, be able to interpret the final financial statements.

You must also understand why financial statements are prepared, their purpose and the types of organisations and individuals who are commonly interested in reading them.

Stewardship

Traditionally, ensuring high standards of 'stewardship' has been seen as an important objective of financial accounting. In many businesses, managers and directors are trusted with taking care of business assets on behalf of the legal owners. For example, shareholders are the legal owners of a company's assets but the directors of a **company** control and manage the **assets** on a day-to-day basis on behalf of, or in trust for the shareholders. In other words, the directors are said to have 'stewardship' of the company's assets.


In the UK, the largest companies are referred to as quoted or listed companies, that is they are quoted or listed on the London Stock Exchange. Such companies can be identified by the letters **Plc** (public limited company) after their name. One of these large companies might have several billion shares and several hundred thousand shareholders. These shareholdings are often fragmented, which means that no single individual on their own is in a position to control the operations of the company. Even large pension funds and insurance companies own only a small proportion of the total shares. In these circumstances, it is often said that in modern large quoted companies there is a separation of ownership and control. Separation of ownership and control means that the shareholders (owners) are separate from the board of directors who control the company. It is therefore vital that the owners receive good quality information (via the financial statements) so that they can judge how well (or, perhaps, how badly!) the company's affairs are being managed. The auditors also have a major role to play in ensuring that the financial statements which have been prepared by the company's accountants, give a **true and fair view** of its financial performance and financial position at the accounting year end.

Accountability

Stewardship is usually linked with the term **accountability**. In a business, 'accountability' means explaining your actions and decisions. For

example, the directors of a company will have to be accountable to the **shareholders** because they are looking after (i.e. have 'stewardship') of the company's assets. At the end of the financial year, the directors will explain what they have achieved with the shareholders' assets – such as the level of **profits** they have obtained by using the assets. The directors' explanation is conventionally communicated to shareholders through the preparation of the annual report and accounts.

Over the years the annual report and accounts have become more and more complex. It is now not uncommon for the annual report and accounts of a large company to run to 200 pages. Nevertheless, the fundamental principles of accounting apply, whether we are considering the largest quoted company or the smallest private limited company (those which have the letters **Ltd** after their name, denoting private limited company and whose shares are not traded on a **stock** exchange).



It is quite common for examiners to test your understanding of the terms stewardship and accountability. You must ensure that you understand these terms.

Regulation

Over the years, government and regulatory bodies have become increasingly interested in monitoring and regulating the quality and quantity of information provided by companies to their investors and other users. The main regulations which **limited liability** companies have to observe are those based on *company law* and also *accounting standards*.

Company law

In the UK, companies with limited liability must conform to the provisions of the **Companies Acts** which have been enacted by Parliament. For instance, the requirement to carry out an **audit** is imposed by company law and if you look at the auditor's report for any large company it will usually include a statement to the effect that the financial statements have been properly prepared in accordance with the Companies Act 1985 and that they give a 'true and fair view' of the state of the company's affairs at the year end and of its profit and **cash flows** for the financial year.

Accounting standards

Companies are also required to comply with accounting standards. These can take the form of UK accounting standards or international accounting standards.

In the UK, private limited companies are required to comply with accounting standards issued by the **Accounting Standards Board (ASB)**. The ASB is itself supervised by the **Financial Reporting Council (FRC)**. In the UK, accounting standards are technically referred to as **financial reporting standards (FRS)** and these have been produced by the ASB since 1991 when the very first FRS (FRS 1, *Cash Flow Statements*) was published. Before 1991 the predecessor body of the ASB was the Accounting Standards Committee (ASC) which published **Statements of Standard Accounting Practice (SSAP)**. Some of those SSAPs are still valid today, so that UK accounting standards now consist of a mixture of SSAPs and FRSs.

International accounting standards

Until 2005 it was also the case that quoted companies in the UK were required to comply with UK accounting standards. But it is important to be aware that the UK is becoming increasingly influenced by the changes which are taking place in international accounting standards. The growth in **international accounting standards** has largely been encouraged by stock markets around the world who want one consistent set of accounting standards to apply to all companies. A main reason is that companies based in different countries are often keen to be listed on international stock exchanges.

The terminology used in this context is sometimes confusing so let's try to clarify what is going on. The idea of accounting standards, which could be used internationally, goes back over 30 years when the **International Accounting Standards Committee (IASC)** was formed. Then in the 1990s, as investors were becoming attracted to the idea of investing in companies in foreign countries, the notion of international standards found substantial support. The old IASC was substantially reorganised and renamed as the **International Accounting Standards Board (IASB)**. In order to distinguish new standards from the old standards, the new standards were given a different title: **International financial reporting standards (IFRS)**. So the current set of international standards includes both IAS and IFRS. The problem is that when

you read the financial press, discussion often uses terms such as 'international standards', 'international accounting standards' or 'international financial reporting standards' to mean more or less the same thing. But usually you can tell by the context of an article what is intended.

Another factor promoting the importance of international accounting standards is the fact that the European Union has required quoted companies (from 2005 onwards) to comply with international standards (that is IAS and IFRS). To be precise, the European Union (EU) requires all quoted companies in the EU to comply with international accounting standards for accounting years beginning 1 January 2005 or thereafter. Non-quoted companies (that is, companies which do not have a stock exchange quotation) in the UK may implement international accounting standards, if they wish, but there is not yet a requirement to do so. It is likely that most UK non-quoted companies will not use international accounting standards for some years yet.

For the purposes of this book we intend to concentrate on the *principles* of accounting rather than the detailed *rules*. It is fortunate that UK accounting standards are broadly similar in many respects to international accounting standards. There are some differences though. For instance, international accounting standards refer to the **income statement** whereas UK accounting standards refer to the **profit and loss account**. International accounting standards refer to 'receivables' whereas UK accounting standards refer to **debtors**. Since the UK is in a period of transition as it learns to adjust to the new international accounting standards, we will be incorporating both types of terminology.

Types of businesses

There are a number of types of businesses that are required to produce accounts:

- 1 **Sole trader** – this is where an individual is also the owner of the business.
- 2 **Partnership** – this is where at least two individuals decide to operate a business – usually sharing profits and losses.
- 3 **Limited company** (larger companies may be termed public limited companies) – this is where the limited company is treated as a separate legal entity from its owners (shareholders).

4 Other organisations such as central and local government, social clubs, voluntary organisations and charities. These types of organisations often place more emphasis on providing a service for the public (or for the organisation's members) rather than primarily concentrating on making a profit.

User groups

When you are preparing accounts, it is useful to remember just whom you are preparing the information for and for what purposes users might require the information.

Key user groups

The key users of financial accounting information are usually identified as:

- shareholders/investors;
 - trade **creditors** and suppliers;
 - employees;
 - banks and other financial institutions;
 - customers;
 - others – such as the government, financial analysts and the public.
- Shareholders (both actual and potential investors) may find information in the financial statements to assist in evaluating the profitability of their actual or proposed investment in the organisation. These users may wish to attempt to assess future growth potential and perhaps evaluate whether a company will have, for example, the resources to pay a **dividend**.
 - Trade creditors and suppliers may use the financial statements to attempt to assess whether it appears that an organisation is credit worthy and will be able to pay for the goods that have been supplied on **credit**.
 - Employees and trade unions may be interested in financial statements to attempt to assess whether the organisation appears to be in a position to continue trading in the future (known as being a **going concern**). This going concern concept is important in helping employees to assess whether they will have future continuity of employment. Trade unions and employees might also wish to use accounting information in salary and wage negotiations to assess whether an organisation has the resources to deliver a higher pay offer.
 - Banks and other financial institutions may wish to use accounting information to assess whether an organisation should be granted a loan. In particular, banks will want to ensure that an organisation appears to have assets that can be used as collateral or security for a loan or mortgage. Banks will also

wish to assess whether organisations have, or will have, sufficient cash flow in order to meet the interest payments on loans.

- Customers who undertake business with an organisation might wish to judge whether an organisation can continue to trade and not cease operations in the near future – which might also cause disruption to their business as well.
- There are also other groups in society that are interested such as the public and other special interest groups. Many organisations such as multinational companies are large enough to be able to exercise economic and political influence in society. As a result, members of the public and pressure groups may wish to monitor their accounts in an attempt to find any information that can be used to make these organisations more accountable for their actions and policies. National and local government may find some reported information useful for national and local monitoring and planning purposes.

*Examiners often ask questions about **user groups**. In particular you should be able to identify the key 'user groups' and be able to explain what type of information the various user groups can extract from the accounts.*

Limitations of financial statements

However, there are a number of limitations of financial accounting information that affect all the above user groups. For example, the information in the accounts is often out of date and restricted in its use by the time it is published. Companies can take many months to produce their financial statements after their year end – which means that the information may have restricted or limited use because of its age. For potential shareholders in particular, it may be too late to decide to purchase shares by the time the financial statements have been prepared and released.

Likewise, banks and other lending institutions also find the accounts too limited in the information they require in assessing the eligibility of a business for a loan. Many banks will require more recent accounts and quite often will require information from the management accounts.

Modern finance theory also refers to the idea of efficient capital markets, whereby share prices rapidly move up and down to reflect new or unexpected information. One of the interesting implications of the **efficient markets hypothesis** (EMH) is that an individual investor, on their

own, is not able to consistently achieve a superior investment return compared to the return achieved by the market. An exception might possibly be if an individual possessed superior analytical skills compared to other investors in the market.

Financial accounting has an important role to play in making sure that financial statements provide investors and others with the information they need to make their decisions and that this information is provided in a timely manner to relevant users.

Accounting policies

Companies need to produce their financial statements by adopting a number of accounting policies.

FRS 18, *Accounting Policies*, describes accounting policies as the 'principles, bases, conventions, rules and practices applied by an entity that specify how the effects of transactions and other events are to be reflected in the financial statements ...' (see FRS 18, para. 4). Companies should select those accounting policies 'judged to be the most appropriate to its particular circumstances for the purpose of giving a true and fair view' (see FRS 18, para. 17).

These policies typically explain how a company has treated such issues as fixed assets, research and development, foreign currency, stocks and pensions, etc.

FRS 18 makes a distinction between *accounting policies* and *estimation techniques*. For example, in relation to fixed assets, a firm's *accounting policy* might be to show these items at the cost of purchase less provisions for depreciation and impairment. The firm's choice of *estimation technique* for depreciation might be the reducing balance method (instead of, say, straight line method).

In addition there are four accounting concepts that play a particularly significant role in financial statements, namely, going concern, accruals, consistency and prudence.

Going concern concept

This concept requires companies to prepare their financial statements on the going concern basis, in other words, it is assumed that the business will continue in operational existence for the foreseeable future and has no intention to curtail operations significantly.

Accruals concept

Under this concept, (sometimes referred to as ‘matching’) it is assumed that companies use the **accruals concept** to prepare their financial statements. The accruals concept means that companies should prepare their financial statements by accounting for transactions as and when they arise or are incurred and not necessarily when any cash involved is received or paid.

Consistency concept

Under this concept, companies should adopt similar accounting treatments from one year to the next. In other words they should not change their accounting treatment in order to produce a favourable result in their accounts.

Prudence concept

Under this concept, revenues and profits are not anticipated, but are only recognised when realised in the form of cash or other assets (such as debtors). On the other hand, provision is made for expenses and losses even though they can only be estimated. This concept implies that firms are likely to err on the side of conservatism when preparing their accounts.

It is useful to note that international accounting standards and UK accounting standards regard going concern and accruals as the two most important concepts and FRS 18 argues that consistency and prudence are ‘desirable qualities of information rather than the bedrock of accounting’ (see FRS 18, App. IV, para. 12).

Realisation

FRS18 also highlights the importance of the term: realisation. In preparing financial statements, a company should ‘have regard to requirements in companies legislation that only profits realised at the balance sheet date should be included in the profit and loss account ... profits shall be treated as realised ... only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty’ (FRS 18, para. 28).

Objectives in selecting accounting policies

The objectives against which a company should judge the appropriateness of its accounting policies are:

Relevance

Financial information is relevant 'if it has the ability to influence the economic decisions of users ...' (see FRS 18, para. 33). A company should select those accounting policies that 'will result in financial information being presented that is relevant'. Information is regarded as being 'relevant' if it has the ability to influence the economic decisions of users and is provided in time to influence those decisions.

Reliability

Financial information is reliable if:

- a it can 'be depended upon by users to represent faithfully (what) ... it purports to represent and therefore reflects the substance of the transactions and other events that have taken place';
- b it is free from deliberate or systematic bias (i.e. it is neutral);
- c it is free from material error;
- d it is complete within the bounds of materiality;
- e under conditions of uncertainty, it has been prudently prepared (a degree of caution has been applied in exercising judgement and making the necessary estimates)
(see FRS 18, para. 35).

Comparability

Appropriate accounting policies will result in financial information that is comparable over time and between companies in the same business sector. Comparability can usually be achieved through a combination of consistency and disclosure.

Understandability

Financial information must be readily understandable by users. It is assumed that the users of accounting information have a reasonable

knowledge of business and economic activities and accounting and have a willingness to study this information with a reasonable degree of diligence. However, this description does not mean that complex material should be omitted or ignored. Complex financial information may be significant because it is relevant to assist users make economic decisions.

Overall, a company's accounting policies should be reviewed regularly to ensure they continue to provide a true and fair view.

*Make sure that you understand and can explain these key terms: going concern, accruals, consistency, prudence, realisation, **relevance**, **reliability**, comparability and understandability.*

Information sources

Don't forget that there is a great deal of information available on the web – learn to take maximum advantage of this resource. For example the ASB and IASB have very informative websites which give historical background to the development of these organisations and progress on new accounting standards. For the ASB see www.asb.org.uk and for the IASB see www.iasb.org.uk. The large accounting firms also have informative websites and it is helpful to keep in touch with them. For instance Deloitte (www.deloitte.co.uk) publish *IFRS in Your Pocket*, a useful summary of current international accounting standards. This publication can be downloaded as a pdf from www.iasplus.com.

EXAMPLE QUESTION

What do you understand by the term 'user groups'? With reference to *two* user groups of your choice explain the nature and use of the information that these users could obtain from financial statements.

Suggested answer

A full answer to this question could usefully include the following points:

- User groups refer to those groups who might benefit from the financial information produced by an organisation.
- User groups may not necessarily have a legal commitment or contract with the firm but could include members of the public who might be interested in, say, environmental issues.
- Briefly compare and contrast different types of user such as shareholders, lenders, customers and suppliers.
- Choose two types of user and discuss their different information needs. It would be a good idea to choose users who have contrasting information needs and this will make an interesting answer. Your choice could be, say, shareholders and employees.
- Shareholders are interested in forward looking information and need information which will help them predict the firm's future profitability since this will have an impact on future dividends and share prices. Thus the profit and loss account will provide useful information on sales revenues, the profile of costs and also **earnings** per share.
- Information on asset values will help shareholders to contrast the book value of the assets of the company with the market value (or market **capitalisation**). A market capitalisation which is relatively high to the book value might indicate that the market has confidence in the firm's future growth prospects.
- Information on **equity** and gearing levels can help to indicate the level of risk associated with the firm.
- Employees are likely to be interested in the level of wage increases that the firm can afford as well as their future job security.
- As regards wage increases, employees (and their representatives, such as trade unions) will be interested in the level of profitability. Can the firm pay increased levels of wages and benefits without jeopardising future investment in productive assets?
- Is the firm financially sound? In other words can it continue or increase current levels of production without fear of liquidation of some or all of its divisions?
- Does the company's pension scheme show a deficit and, if so, what steps is management taking to try to reduce the deficit?

Textbook guide

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BRITTON AND WATERSTON: *Chapter 1*

HAND, ISAACS AND SANDERSON: *Chapter 7*

JONES: *Chapters 1 and 2*