

Chapter 1 revision notes

Underlying principles – the building blocks

Uses and purpose of accounting

The main branches of accounting within commercial and industrial organisations are financial accounting, management accounting, treasury management, financial management and corporate finance.

The original, basic purposes of accounting were to classify and record monetary transactions and present the financial results of the activities of an entity, the scorecard that shows how the business is doing. There are three questions that are generally answered by accounting information:

- ◆ how are we doing, and are we doing well or badly? a scorecard (like scoring a game of cricket, for example)
- ◆ which problems should be looked at attention directing
- ◆ which is the best alternative for doing a job problem solving

In order to be useful to the users of financial information, the accounting data from which it is prepared, together with its analysis and presentation must be:

- ◆ accurate – free from error of content or principle
- ◆ reliable – representing the information that users believe it represents
- ◆ timely – available in time to support decision-making
- ◆ relevant – applicable to the purpose required, for example a decision regarding a future event or to support an explanation of what has already happened
- ◆ consistent – the same methods and standards of measurement of data and presentation of information to allow like-for-like comparison
- ◆ clear – capable of being understood by those for whom the information has been prepared

Financial accounting, management accounting, and financial management

The main branches of accounting that provide services to commercial and industrial organisations are auditing, corporate taxation, personal taxation, VAT, and consultancy.

Financial accounting

Financial accounting is the function responsible in general for the reporting of financial information to the owners of a business, and specifically for preparation of the periodic external reporting of financial information, statutorily required, for shareholders. It also provides such similar information as required for Government and other interested third parties, such as potential investors, employees, lenders, suppliers, customers, and financial analysts. Financial accounting is concerned with the three key financial statements: the balance sheet; profit and loss account; cash flow statement. It assists in ensuring that financial statements are included in published reports and accounts in a way that provides ease of analysis and interpretation of company performance.

Management accounting

Management accounting is primarily concerned with the provision of information to managers within the organisation for product costing, planning and control, and decision-making, and to a lesser extent involved in providing information for external reporting.

Financial management

Financial management is broadly defined as the management of all the processes associated with the efficient acquisition and deployment of both short and long-term financial resources. Financial management assists an organisation's operations management to reach its financial objectives. This may include responsibility, for example, for corporate finance, and treasury management, which is concerned with cash management, and the management of interest rate and foreign currency exchange rate risk.

Accounting and accountancy

Accountancy is the practice of accounting. The term 'accounting' may be defined as:

- ◆ the classification and recording of monetary transactions; and

- ◆ the presentation and interpretation of the results of those transactions in order to assess performance over a period and the financial position at a given date; and
- ◆ the monetary projection of future activities arising from alternative planned courses of action

Users of financial information

There is a wide range of users of financial information: external to the organisation for example potential investors, suppliers and financial analysts; internal to the organisation for example managers, shareholders, employees.

Financial information is important to a wide range of groups both internal and external to the organisation. Such information is required, for example, by individuals outside the organisation to make decisions about whether or not to invest in one company or another, or by potential suppliers who wish to assess the reliability and financial strength of the organisation. It is also required by managers within the organisation as an aid to decision-making.

Types of business entity

The large variety of types of business entity include profit and not-for-profit organisations, both privately and Government owned, involved in providing products and services.

Business entities are either involved in manufacturing (for example, food and automotive components) or in providing services (for example retailing, hospitals or television broadcasting). Such entities include profit-making and not-for-profit organisations, and charities.

Sole traders and partnerships

A sole trader entity is owned and financed by one individual even though more than one person may work in the business. The individual has complete flexibility regarding:

- ◆ the type of (legal) activities in which the business may be engaged
- ◆ when to start up or cease the business
- ◆ the way in which business is conducted

Unlike limited companies, sole traders are not required to file a formal report and accounts each year with the Registrar of Companies, but they must submit annual accounts for tax purposes to the Inland Revenue. Legally, a sole trader is not separate from the business, unlike the legal position of owners, or shareholders, of limited and unlimited companies who are recognised as separate legal entities from the businesses they own.

Partnerships are similar to sole traders except that the ownership of the business is in the hands of two or more persons. The main differences are in respect of how much each of the partners puts into the business, who is responsible for what, and how the profits are to be shared. These factors are normally set out in formal partnership agreements, and if the partnership agreement is not specific then the provisions of the Partnership Act 1890 apply. Apart from certain professions, the number of persons in a partnership is limited to twenty.

Limited companies

A limited company is a legal entity separate from the owners of the business. The owners limit their obligations to the amount of finance they have put into the company by way of the share of the company they have paid for. Normally, the maximum that may be claimed from shareholders is no more than the have paid for their shares, regardless of what happens to the company. Equally, there is no certainty that shareholders may recover their original investment if they wish to dispose of their shares or if the business is wound up, for whatever reason.

Public limited companies must have a minimum issued share capital of (currently) £50,000, and may offer their shares for sale to the public but private limited companies may not. Private limited companies tend to be family businesses and smaller business with the ownership split between a few shareholders, although there have been many examples of very large private limited companies. Accounting requirements are the same for private and public limited liability companies. Limited companies must produce annual accounts that are filed with the Registrar of Companies and are available to the public. Sole traders do not have to comply with any such requirement.

The framework of accounting

The framework of accounting is bounded by concepts (or rules) and standards, covering what data should be included within an accounting system and how that data should be recorded.

Many countries have sought to produce a 'conceptual framework'. In the UK this has been titled a Statement of Principles (SOP). The key issues are:

- ◆ the definition of a conceptual framework
- ◆ the development of a conceptual framework.

The 1975 Corporate Report was the first UK attempt at a conceptual framework. The SOP is a basic structure for determining objectives, in which there is a thread from the theory to the practical application of accounting standards to transactions that are reported in published accounts. The SOP is not an accounting standard, but it is a statement of guidelines; it is, by virtue of the subject, constantly in need of revision.

Accounting concepts

Accounting concepts are the principles underpinning the preparation of accounting information. Fundamental accounting concepts are the broad basic assumptions, which underlie the periodic financial accounts of business enterprises. The five most important concepts are as follows:

- ◆ the prudence concept
- ◆ the accruals concept
- ◆ the consistency concept
- ◆ the going concern concept
- ◆ the separate valuation concept

Further fundamental accounting concepts are:

- ◆ the business entity concept
- ◆ the money measurement concept
- ◆ the historical cost concept
- ◆ the materiality concept
- ◆ the periodicity concept
- ◆ the realisation concept
- ◆ the substance over form concept

Accounting standards

The Accounting Standards Board (ASB), which is comprised of members of the accountancy profession, and on which the Government has an observer status, has responsibility for development, issue, and withdrawal of accounting standards.

The accounting standards are called Financial Reporting Standards (FRSs). Up to 1990 the accounting standards were known as Statements of Standard Accounting Practice (SSAPs). Although some SSAPs have now been withdrawn there are, in addition to the new FRSs, a large number of SSAPs that are still in force. A list of all FRSs and SSAPs that are currently in force may be found in Appendix 3 at the end of *Business Accounting and Finance*. The website accompanying the book contains the up-to-date position with regard to changes in accounting standards.

Within the scope of current legislation, best practice and accounting standards each company needs to develop its own specific accounting policies. Accounting policies are the specific accounting bases selected and consistently followed by an entity as being, in the opinion of the management, appropriate to its circumstances and best suited to present fairly its results and financial position. Examples are the various alternative methods of valuing stocks of materials, or charging the cost of a machine over its useful life, its depreciation.

Accounting processes

Accounting processes follow a system of recording and classifying data, followed by a summarisation of financial information for subsequent interpretation and presentation.

Accounting is sometimes referred to as a process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information, and also, to provide information which is potentially useful for making economic and social decisions.

An accounting system is a series of tasks and records of an entity by which the transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, summarise and report transactions.

An introduction to financial statements

The three main financial statements that appear with a business's annual report and accounts, together with the chairman's statement, directors' report, and auditors' report, are the balance sheet, profit and loss account and cash flow statement.

Companies are also obliged to provide similar financial statements at each year end to provide information for their shareholders, the Inland Revenue, and the Registrar of Companies. This information is frequently used by City analysts, investing institutions and the public in general.

After each year end companies prepare their annual report and accounts for their shareholders. Copies of the annual report and accounts are filed with the Registrar of Companies and copies are available to other interested parties such as financial institutions, major suppliers and other investors. In addition to the profit and loss account and cash flow statement for the year and the balance sheet as at the year end date, the annual report and accounts includes Notes to the Accounts, and much more financial and non-financial information such as company policies, financial indicators, corporate governance compliance, directors' remuneration, employee numbers, business analysis, and segmental analysis. The annual report also includes an Operating and Financial Review of the business, a report of the auditors of the company, and the chairman's statement.

Accountability and financial reporting

Accountability is maintained by the reporting to shareholders on a yearly and half-yearly basis of sales and other activities and profits or losses arising from those activities, and the audit function.

Ownership of a business is separated from its stewardship, or management, by the shareholders' assignment to a board of directors the responsibility of running the company. The directors of the company are accountable to the shareholders, and both parties must play their part in making that accountability effective.

The reporting made in the form of the financial statements includes the balance sheet, profit and loss account, and cash flow statement.

External auditors are appointed by, and report independently to, the shareholders. They are professional qualified accountants who are required to provide objective verification to shareholders and other users that the financial statements have been prepared properly and in accordance with legislative and regulatory requirements; that they present the information truthfully and fairly and that they conform to the best accounting practice in their treatment of the various measurements and valuations.