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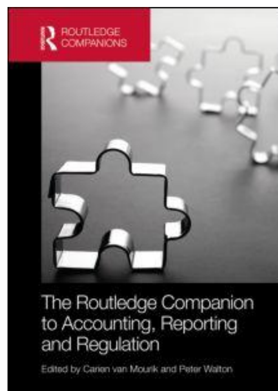

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Carien van Mourik, Peter Walton

What is Accounting?

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Anne Britton
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Part 1
Accounting

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1 What is Accounting?

Anne Britton

1. Introduction

Accounting is a necessary requirement for any business or organization be it a large multinational business such as BP or the society or club you belong to in your local community. It is essential for a business or organization to keep track of its resources. They need to know if they have any cash available, if they have made a profit/surplus or loss/deficit, if they can meet the future needs or requirements of the business, if they can possibly remain in existence, or if they should change their operations in any way. These requirements can be divided into the need for stewardship of resources and the need for decision making. It is also necessary that owners and other interested parties have information on the stewardship of resources and decisions taken or to be taken by a business or organization. For example you might wish to know the uses your subscription money paid to the local tennis club was put to and what changes are going to be made to the club in the future so that you can decide whether you should continue with your membership or not. In the same way a shareholder in BP will also wish to know how the resource of their share capital has been used, if a dividend will be paid now and in the future and how future decisions in BP could affect that dividend. Accounting is the language of business that we use to answer these types of question and, as with all languages, in order to understand it we need to learn its rules and vocabulary.

2. Accounting definitions

The most often quoted definition of accounting is that given by the committee of the American Accounting Association (AAA), 'the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information' (AAA, 1966: 1). Another definition is that given by the American Institute of Certified Public Accountants (AICPA), 'the art of recording, classifying and summarizing, in a significant manner and in terms of money, transactions and events which are in part at least, of a financial character, and interpreting the results thereof' (AICPA, 1953: Par. 5). In 1970 the AICPA defined accounting as, 'a service activity. Its function is to provide quantitative information primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making resolved choices among alternative courses of action' (AICPA, 1970: Par. 40).

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From the above we can deduce that accounting is an art form, possibly a language as we have already stated, but not necessarily a science. If it is providing a service, we therefore have to determine to whom that service is given, that is, who are the users of accounting information. Accounting is about quantitative information generally and it should enable decisions to be made about the business or organization by users. If accounting is to facilitate decision making then we can also deduce that it must be core to any successful business. Accounting therefore needs both 'an effective and efficient data handling and recording system and the ability to use that system to provide something useful to somebody' (Alexander *et al.*, 2009: 4).

3. Types of accounting compared

3.1 Accounting and book-keeping

We stated above that accounting needed an effective and efficient data handling and recording system. This is generally referred to as a book-keeping system. This system may be a manual system or it can be computerized. Book-keeping systems primarily perform the stewardship function of accounting and have been around for a number of years. Indeed, modern accounting is usually stated as commencing in 1494 when Luca Pacioli, a Franciscan friar, wrote about a system of double entry book-keeping in his book *Summa de Arithmetica Geometria, Proportioni et Proportionalita.* This text reflected the practices current at the time in Venice for recording the transactions of merchants. Book-keeping according to Pacioli was to give the trader information as to his assets and liabilities and to do this three books were required: a memorandum, a journal and a ledger. Pacioli also recorded the fact that all entries in the ledgers had to be double entries and thus for every debit there had to be a credit.

This all sounds quite simple but the book-keeping system and therefore its final output is highly dependent on what we choose to identify as our data inputs. This choice of data input is governed by what the user of such information wants to know. For example if a shareholder of a business wants to know what the business can be sold for then we need to feed into the recording system, the book-keeping system, information on the selling prices of resources held by the business not the historical price we paid for these resources. However, if a shareholder wants to know where cash raised from share issues has been spent, then we need to feed into the system historical cost of resources. Accounting therefore consists of data input decisions, a data recording system (book-keeping system) and the provision of useful information to users. Book-keeping can be seen as a subset of accounting when we identify the separate functions within the accounting process. The accounting process is shown in Figure 1.1.

3.1.1 Brief outline of the book-keeping process

The book-keeping process can be broken down into two sections: the initial recoding of transactions, and then the production of ledger accounts and a trial balance. All businesses need to record cash received and paid in some form of cash book and ensure that this is reconciled with any bank statement supplied. In addition details of sales and purchases will be made in what are generally known as day books: primarily a sales day book and a purchases day book. There may well be other day books for example to record sale returns. There is also a book of prime entry, known as the journal, where the few transactions that cannot be allocated to the cash or day books are entered. These are such items as adjustments to debtor balances or closing entries, for example inventory, so that end of period accounts can be drawn up for users. The day books and

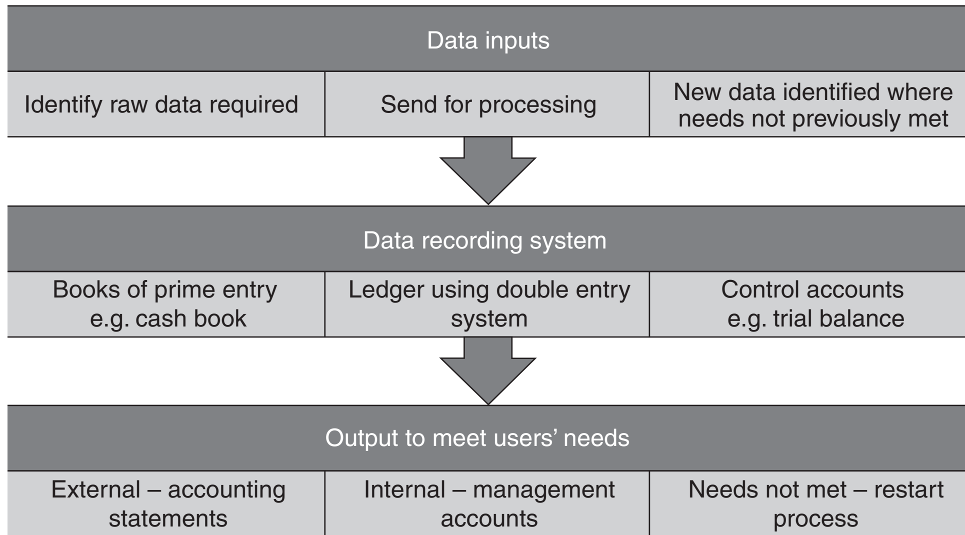

Figure 1.1 The accounting system

the cash book must be subject to controls and checks to ensure that only appropriate and correct entries are made in them as from these books the double entry ledgers will be constructed.

The double entry system codified by Pacioli is based on the accounting equation:

Assets = Capital + Liabilities

All transactions entered in the cash and day books are entered into the ledgers in accordance with this equation and to reflect that for every transaction there are two equal and opposite effects. For example the purchase of an item of equipment by cash will decrease the asset of cash and increase the asset of equipment.

A control used to check the accuracy of the double entry is the trial balance. This is a list of all the balances remaining in the ledgers at the end of a specific period and from which useful information can be summarized for users to meet their needs. At this point it is useful to identify who these users are and what their needs are.

3.1.2 Users and their needs

A comprehensive list of users of accounting information and their needs is provided by the International Accounting Standards Board in their *Framework for the Preparation and Presentation of Financial Statements* (IASB, 2001) paragraphs 9–11:

> The users of financial statements include present and potential investors. Employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:
>
> a. Investors. The providers of risk capital and their advisors are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.

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b. Employees. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information which enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.
c. Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.
d. Suppliers and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. 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.
e. Customers. Customers have an interest in information about the continuance of the entity, especially when they have a long-term involvement with, or are dependent on, the entity.
f. Governments and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.
g. Public. Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

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

The management of an entity has the primary responsibility for the preparation and presentation of the financial statements of the entity. Management is also interested in the information contained in the financial statements even though it has access to additional management and financial information that helps it carry out its planning, decision making and control responsibilities. Management has the ability to determine the form and content of such additional information in order to meet its own needs. The reporting of such information, however, is beyond the scope of this framework. Nevertheless, published financial statements are based on the information used by management about the financial position, performance and changes in financial position of the entity.

The IASB has begun a programme of updating the framework and the users as specified by the framework have now changed. A primary group of users has now been defined so that financial reports can be focused on them without having to take account of the needs of other more peripheral users. The primary group is identified as existing and potential investors, lenders and other creditors. In other words those users who provide or are considering providing resources to the entity. The 2010 *Conceptual Framework for Financial Reporting* (IASB, 2010: 46–7) in its basis for conclusions states:

a. Existing and potential investors, lenders and other creditors have the most critical need for the information in financial reports and many cannot require the entity to provide the information to them directly.

b. The Board's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.
c. Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders.

3.2 Financial accounting and management accounting compared

Accounting is generally divided into two areas: financial accounting, and management accounting. Financial accounting is concerned with the provision of information to external users such as shareholders, creditors and customers, whereas management accounting is concerned with the provision of information to internal users, i.e. management, to enable them to make decisions about the future operations of the business. Both types of accounting consist of the functions we described above: identification of data input, a data recording system and the provision of useful information to the external or internal user. It is essential to note that the basic information for both financial and management accounting information is the same and both can use the same recording system.

The difference between the two is the purpose of the information:

- financial accounting provides information to external users on the overall performance of the business, the financial position of the business at a point in time and how cash has been used during a period of time;
- management accounting is concerned with the costs and revenues within the overall performance, with making decisions about which products to produce or which assets to purchase to make those products. It is primarily concerned with providing information needed by internal users to manage the business.

Charles T. Horngren (1965) suggested that 'financial accounting would be better labelled as external accounting and management accounting as internal accounting'. The differences between financial accounting and management accounting are summarized in Table 1.1.

Table 1.1 Comparison of financial accounting and management accounting

Comparator	*Financial accounting*	*Management accounting*
Users	External primarily investors	Internal primarily management
Basis	Past and present information	Present and future information
Regulation	Highly regulated by company law and IASB	None
Purpose	To report on performance and position of entity	For planning, decision-making and control
Time	At a point in time for a particular period	At management request
Essential characteristics	Relevant and faithful representation plus comparability, verifiability, timeliness and understandability	Relevant, timely, useful

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4. Management accounting

Let's start with a formal definition:

> The application of the principles of accounting and financial management to create, protect, preserve and increase value so as to deliver that value to the stakeholders of profit and not-for profit enterprises, both public and private. Management accounting is an integral part of management, requiring the identification, generation, presentation, interpretation and use of relevant information relevant to:
>
> - inform strategic decisions and formulate business strategy;
> - plan long, medium and short-run operations;
> - determine capital structure and fund that structure;
> - design reward strategies for executives and shareholders;
> - inform operational decisions;
> - control operations and ensure the efficient use of resources;
> - measure and report financial and non-financial performance to management and other stakeholders;
> - safeguard tangible and intangible assets; and
> - implement corporate governance procedures, risk management and internal controls (CIMA, 2005).

Within management accounting there is also something named cost accounting. CIMA defines this as 'gathering of cost information and its attachment to cost objects, the establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds'.

4.1 Decision making

Management accounting is about making decisions which will maximize the value of the business. Value is not necessarily defined in terms of increased profit here. Value may, for example, be achieved by the business focusing on environmental issues or other social issues. This value needs to be interpreted within the objectives of a business. Management accountants will then seek to rank any choices the business has in terms of maximizing that value.

Such decisions, however, need to be made using certain principles. First, we can only take account of costs in our decisions based on the future, that is, all previous costs are assumed to be 'sunk costs'. Future decisions will not make these costs disappear or change them in any way as they have already been incurred. Second, when costing any particular course of action from all opportunities available we need to compare with the next best alternative. This introduces the idea of opportunity cost: a cost which measures the opportunity that is lost or sacrificed when the choice of one course of action requires that an alternative course of action be given up.

When costing decisions we will also enter into the realms of what is known as cost accounting. Costs can be classified in many ways but the four most common are by function, behaviour, nature and element. Function refers to whether the cost is a cost associated with production, administration, research and development, marketing, etc. Behaviour refers to whether that cost is fixed or variable. A fixed cost is one that is insensitive to activity level or, put more simply, does not change when activity levels change. In the final analysis there are no truly fixed costs as when all production ceases then all costs can be avoided. Examples of fixed costs are

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depreciation and executive remuneration packages. Conversely a variable cost is one that does vary with activity. Examples are production labour and materials. Variable costs are also referred to as direct costs, which brings us to our third classification of nature, that is whether costs are direct or indirect. Our fourth classification by element refers to whether the cost is material expense, labour expense, etc. To cost a particular item of production the management accountant has various methods available such as absorption costing, activity based costing and marginal costing. All three will give a different answer to the cost of production and managers need to decide which technique is appropriate for the particular circumstance under review.

The decision making we have referred to so far has been concerned with the short term but managers also need to make decisions in the long term. The techniques used here are known as capital investment appraisal techniques and involve taking account of the time value of money. For further information on all the topics identified above you should refer to a textbook on management accounting.

4.2 Planning

Business planning is vital for any business be it large or small. For the sole trader a business plan is necessary in order to raise finance from the bank. For a larger business considering an expansion it is also vital as new capital may well be required which could lead to the issue of new shares. At the heart of any new business plan is the financial plan which consists of:

- forecast cash flows;
- sales, production and capital expenditure plans;
- projected statements of income and statements of financial position; and
- performance targets.

4.3 Budgeting and control

Budgeting is part of planning and is an exercise all businesses need to buy into as it translates the long-term plans into short-term operating plans. Budgets are a method used to:

- plan the use of resources;
- identify the planned production;
- control the activities of groups or functions with the business;
- motivate individuals to achieve certain agreed performance levels;
- communicate managers' plans; and
- resolve conflict within the business.

There are various methods for the creation of budgets from planned budgeting, through incremental budgeting to zero-based budgeting. Whatever the method used once budgets are in place they can then be used to control the business. However, budgets must be used with care as, for example, if the targets contained within them are too high this could demotivate staff. There is also the phenomenon of 'spend to budget', where managers who have a budget to spend on a particular item will make that expenditure whether or not it is, at the time of spend, actually needed. Therefore budgets must be reviewed and kept up to date and reasonable; they must be flexed. Budgeting is also costly in terms of time to prepare, monitor and control and that it can lead to unethical behaviour by both managers and employees. Indeed, some managers believe

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it is not worth the effort and are moving 'beyond budgeting'. 'Beyond budgeting' according to official terminology issues by CIMA in 2005 is:

> An idea that companies need to move beyond budgeting because of the inherent flaws in budgeting especially when used to set contracts. It is argued that a range of techniques, such as rolling forecasts and market related budgets, can take the place of traditional budgeting.

Hope and Fraser (2003: 7) define it as:

> A set of guiding principles that, if followed, will enable an organization to manage its performance and decentralize its decision making process without the need for traditional budgets. Its purpose is to enable the organization to meet the success factors of the information economy (e.g. being adaptive in unpredictable conditions).

Beyond budgeting aims to address the many flaws in traditional budgeting identified as:

- rarely focusing on strategy and often contradictory;
- time consuming and costly to put together;
- constraining responsiveness and flexibility;
- deterring change;
- adding little value, especially given the time taken to prepare them;
- focusing on cost reduction rather than value creation; and
- strengthening vertical command and control.

5. Financial accounting

Financial accounting is concerned with the recording, processing and presentation of economic information after the event to those people outside the organization who are interested in it. But what economic information do users require? The IASB assumes that the information needs of investors mostly encompass the information needs of other financial statement users, and hence considers investors, lenders and other creditors the primary users of financial statements (IASB, 2010: OB5). This assumption can be queried, but, if it is accepted, measuring income, identified as the difference between revenues and expenses (i.e. profit or performance) and measuring wealth (identified as 'what you have got at a point in time') in some manner would meet the primary users' needs. Wealth also changes over time and in a business sense this is represented by the accounting equation:

Wealth at the beginning + profit for the period – drawings = wealth at the end of the period

$$W1 + P - D = W2$$

The recognition and measurement of assets, liabilities, income and wealth is perhaps the central problem in financial accounting. This is the topic of Chapter 6. Below is an outline of the essential issues.

5.1 Measuring income/performance

Income and performance in the traditional accounting sense, as can be seen from the equation above, are synonymous with profit. They are one and the same. Profit represents an increase in capital, again shown in the above equation. The accountant uses a Statement of Income, to show the calculation of this income. This view of income/profit is derived to some extent from that

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of Sir John Hicks, who stated that 'income is the maximum value which a man can consume during a week and still expect to be as well off at the end of the week as he was at the beginning' (Hicks, 1948: 172). This definition was made more specific to business by the Sandilands Committee (IAC, 1975), which adapted Hicks's statement to 'the maximum value which the company can distribute during the year and still expect to be as well off at the end of the year as it was at the beginning'. However, this is not the only view of income possible and it does cause the accountant some problems.

Adam Smith (1890) defined income as 'an increase in wealth'. Fisher (1912: 38) defined income in three parts:

- Psychic income – the actual personal consumption of goods and services that produces a psychic enjoyment and satisfaction of wants.
- Real income – an expression of the events that give rise to psychic enjoyments.
- Money income – all the money received and intended to be used for consumption to meet the cost of living.

5.1.1 The problem of capital maintenance

The problem with the traditional accountant's view of income can be best described by using as an example a very simple business. Let's suppose Richard is in business buying and selling laptop computers. We will presume for simplicity that he has no expenses within the business except the cost of the laptops to sell. Richard commences his business with £1,000 on 1 April and spends £250 on a laptop. At this stage he therefore has, according to our accounting equations given earlier, inventory of £250 and cash of £750 and therefore a capital of £1,000. On 5 April he sells the laptop for £300 and buys another for £280. His balance sheet is now as follows:

Cash	770	Original capital	1000
Inventory	280	Profit/income	50
	1050	Closing capital	1050

This would imply that Richard could withdraw £50 from the business and remain as well off as he was on 1 April. If he did this, his balance sheet would be:

Cash	720	Capital	1000
Inventory	280		
	1000		

But is he as well off? If we compare his physical position on 1 April with that on 5 April we can see that on 1 April he had one laptop and £750, whereas on 5 April he has one laptop and only £720; he has 'lost' £30. This would lead us to state that his profit/income was only £20, not £50, and if he only withdrew £20 then on 5 April he would have one laptop plus £750 as he did on 1 April. This implies that he should only declare profit/income of £20, i.e. sale £300 minus the cost of replacing the lap top sold £280. By declaring his income as only £20 Richard

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has evaluated his position in terms of his capacity to carry on his business, that of buying and selling laptops. This view of profit/income given here (operating capital maintenance) is different from the one the accountant currently uses that of money financial capital maintenance where the profit/income would be declared as £50.

Another possible method of valuing income/profit is real financial capital maintenance. This method is based on the purchasing power of the owner's interest in the business. Returning to our example of Richard, if the general price level increased by 5 per cent during the period 1 April to 5 April, then profit will only be made after capital of £1,050 has been maintained. Thus, under real financial capital maintenance Richard would not declare a profit.

5.2 Measuring wealth

Wealth we defined earlier as 'what you have got at a point in time'. Thus we need to be able to value our assets and liabilities. This gives rise to two questions:

- What are our assets and liabilities at a point in time?
- How do we value them?

5.2.1 What are our assets and liabilities?

We could group all the assets and liabilities of a business together and state that our wealth is the present value of the expected future net cash flows. This would lead to problems in estimating future cash flows and which discount rate to use, which in turn could lead to problems with the need to give a faithful representation. We could also take the view that the business is more than just the sum of its tangible assets minus its liabilities. For example, if you were evaluating your own personal wealth you may take the view that your wealth was more than just the sum of the assets you owned, e.g. your house, car, household articles and cash, less any loans you had. You could view your health or family as part of your wealth. For a business the intangible asset that exists is goodwill and is usually the difference between evaluating the business as a whole, which occurs generally when a sale value is placed on a whole business, and the sum of its individual assets and liabilities.

5.2.2 How do we measure the assets and liabilities?

According to the IASB:

> Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement (IASB, 2010: Chapter 4, Par. 4.54).

Measurement bases discussed in the 2010 IASB Conceptual Framework include the following four valuation methods, which all have one thing in common: our measuring unit is money and we assume that this is a stable measuring stick.

Historical cost

We could value at the amount we originally paid for the asset, historical cost. We could also reduce this figure according to the life of the asset as when we use an asset we are consuming part

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of its wealth. This is the idea of depreciation. Liabilities are recorded at the amounts of proceeds received in exchange for the obligation, or at the amount of cash the entity is expected to pay to satisfy its liability.

Current cost

We could value the asset at the amount we would have to pay to buy a new asset, i.e., replacement cost. We could extend this and reduce the value of the new asset by an amount of depreciation to match the life used up of our existing asset. We could also take the cost of buying the same asset in actually the same condition as the asset we are trying to value. Another variant here would be to identify the cost of an asset that replaces the function of the asset we wish to value. In the case of liabilities, current cost means the undiscounted amount required to settle the liability at the time of preparation of the balance sheet.

Net realizable value

We could value the asset at the amount of money less any expenses of sale we would incur if we sold it. In the case of liabilities, settlement value or realizable value means the undiscounted amount of cash expected to be paid to satisfy the liability in the normal course of business.

Net present value or economic value

We could value the asset at the present value of its current usefulness to us. This requires us to estimate the future useful values and then to discount them back to current day prices at an appropriate discount rate. Similarly, liabilities are carried at the present discount value of the cash expected to be paid to settle the liability in the normal course of business.

5.3 The different systems

In theory, if we combine the three methods of income measurement with the four methods of valuation of assets, we would have 12 versions of profit. All these profit figures would be correct in some defined way, but should the accountant show all these figures to users or just choose one to declare? In practice, the accountant's scope for choosing an accounting policy is limited by accounting principles and standards. Nevertheless, if there is a choice, the decision perhaps hinges on the objective of the information the accountant is trying to provide. We present below the objective of financial statements as given in the 2010 IASB Conceptual Framework.

> The objective of general purpose financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. These decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (OB2).
>
> Existing and potential investors, lenders and creditors need information to help them assess the prospects for future net cash flows to an entity (OB3).

This objective would not lead to the view that the only profit declared should be that based on historical cost valuation of assets and monetary financial capital maintenance but that is the traditional system used in financial statements currently. Note that the above objective statement from the IASB focuses on general purpose financial statements, which are not able to provide all information users need as non-financial information is absent. We will address this issue later.

A simple example is given below to demonstrate the profit and capital figures that the combination of asset valuation and capital maintenance systems could provide.

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Table 1.2 Asset valuation per laptop

Asset valuation per laptop	*Start of year £*	*End of year £*
Historical cost	250	310
Replacement cost	280	340
Net realizable value	300	360

Example: Suppose Richard has an inventory of five laptops at the start of a year, which are all sold during the year, and seven laptops at the end of the year and no other assets or liabilities. Table 1.2 shows the asset valuation per laptop.

Under monetary financial capital maintenance and historical cost:

	£	
Opening value of assets	1,250	(5 × 250)
Closing value of assets	2,170	(7 × 310)
Therefore profit	920	

Under operating capital value maintenance and historical cost:

Operating capital has increased by two laptops and therefore profit is £620.

Under monetary financial capital maintenance and net realizable value:

Opening value of assets	1,500	(5 × 300)
Closing value of assets	2,520	(7 × 360)
Therefore profit	1,020	

Under operating capital maintenance and net realizable value:

Operating capital has increased by two laptops and therefore profit is £720.

Just using four of the possible combinations of capital maintenance and asset valuation gives us four profit figures in our simple example, £620, £720, £920 and £1,020. Which is the correct profit figure? All are correct but which figure do users require? Users may well require all the figures depending upon the decisions they need to take but such a plethora of profit figures can lead to confusion in the information system and therefore mislead users. Traditionally financial accounting has reported profit using monetary financial capital maintenance and historical cost valuation of assets.

5.4 Deprival value

One method of valuing assets that we did not consider in 5.2 above was deprival value which is a mixed valuation method. The asset worth to the business under this method is based on what a rational businessperson would do. The deprival value is the loss the businessperson would suffer if he/she was deprived of the asset.

Example: A business has three assets, A, B and C with valuations as in Table 1.3.

Table 1.3 Three assets with valuations

Asset	*Historical cost HC£*	*Replacement cost RC£*	*Net realisable value NRV£*	*Economic value EV£*
A	100	200	300	400
B	900	1200	1000	1100
C	1700	1600	1500	1800

All three assets are destroyed in a fire. What loss would a rational owner of the business consider he/she has suffered?

- For A more value can be obtained by replacing the asset as both NRV and EV are higher than replacement cost. Therefore the asset will be replaced and the loss is clearly RC of £200.
- For B the asset will cost more to replace than can be derived by either selling (NRV) or continuing to use (EV) therefore the asset will not be replaced and the loss will be the EV foregone, £1,100.
- For C EV is higher than RC so the asset will be replaced and the loss is clearly RC of £1,600.

In each case above the loss is termed deprival value and we can define deprival value as the lower of replacement cost and recoverable amount, which in turn is the higher of economic value and net realizable value (see Figure 1.2). It is interesting to note here that historical cost, which is traditionally used in financial accounting, is totally irrelevant when calculating deprival values.

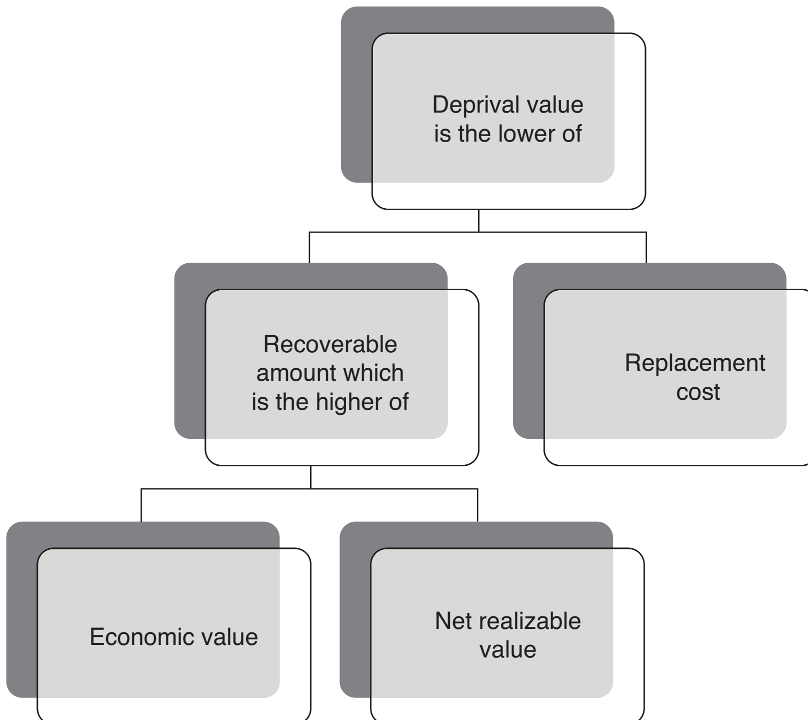

Figure 1.2 Deprival value

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Deprival value is not a panacea to the problems of valuing assets as it also has some disadvantages. It leads, for example, to mixed values on a balance sheet and it fails to take account of changes in the value of the monetary measuring stick.

We end here with quotes from the preface of the IASB's 2001 *Framework for the Preparation and Presentation of Financial Statements and the Conceptual Framework for Financial Reporting*:

> Financial statements are most commonly prepared in accordance with an accounting model based on recoverable historical cost and the nominal financial capital maintenance concept. Other models and concepts may be more appropriate in order to meet the objective of providing information that is useful for making economic decisions although there is presently no consensus for change. This framework has been developed so that it is applicable to a range of accounting models and concepts of capital and capital maintenance (preface FPPFS).

The *Conceptual Framework for Financial Reporting* 2010 from the IASB para 4.65 states:

> The selection of the measurement bases and concept of capital maintenance will determine the accounting model used in the preparation of the financial statements. Different accounting models exhibit different degrees of relevance and reliability and, as in other areas, management must seek a balance between relevance and reliability. This conceptual framework is applicable to a range of accounting models and provides guidance on preparing and presenting the financial statements constructed under the chosen model. At the present time, it is not the intention of the Board to prescribe a particular model other that in exceptional circumstances, such as for those entities reporting in the currency of a hyperinflationary economy. This intention will, however, be reviewed in the light of world developments.

It is to be hoped, given that management/directors have to choose the concept of capital maintenance they believe is relevant and reliable, that we are told somewhere in the financial reports of a business which concept they are using otherwise any comparisons we make with other businesses may be invalid if those other businesses are using a different concept.

6. Financial statements

The traditional financial statements required to be prepared by a business are identified by the IASB in International accounting Standard 1 (IAS 1, 1975): Presentation of Financial Statements. According to IAS 1 paragraph 10:

> A complete set of financial statements comprises:
>
> a. A statement of financial position at the end of the period;
> b. A statement of comprehensive income for the period;
> c. A statement of changes in equity for the period;
> d. A statement of cash flows for the period;
> e. Notes, comprising a summary of significant accounting policies and other explanatory information; and
> f. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.
>
> An entity may use titles for the statements other than those used in this standard.

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In this extract, (a) was traditionally known as the balance sheet and (b) as the profit and loss account. The statement of financial position is a listing of the assets, liabilities and capital of a business and represents the accounting equation:

Assets = capital + liabilities.

In principle the statement of financial position tells us what the business is worth but whether this is useful to users is questionable given we have already questioned the capital maintenance issue, the valuation of assets and the fact that it only shows those assets and liabilities that can be measured using a monetary measuring stick. It does not necessarily show the goodwill of the business or the effect the business has on the environment. One question we haven't considered so far is: when does an entity recognize an asset and a liability? For example, is a leased asset an asset of the entity? Does this statement of financial position provide relevant information to users and faithfully represent the worth? The IASB, as you will discover later, provides copious requirements on how to prepare these financial statements in an attempt to give useful information to users.

6.1 Goodwill

The accounting treatment of goodwill and other associated intangible assets in financial statements has caused great problems for accountants over a number of years. When one entity acquires another then the price it is willing to pay is generally computed with reference to the underlying value of the assets of the entity and not the book value of those assets as shown in the statement of financial position. For example, in Tesco's group balance sheet (see Table 1.4) the net assets are shown as worth £16,623m but the actual price to purchase Tesco would be a great deal higher than this. If you look up the market capitalization of Tesco on the internet the figure will be somewhere in the region of £25bn. Some of this difference will be represented by goodwill. The problem is how to recognize and measure goodwill objectively. Goodwill is generally items of benefit to an entity, such as a highly skilled and experienced workforce, regular customers, a well-known brand name, a good reputation. Placing a value on this goodwill can only be objectively measured when it is actually purchased, that is, when an entity is bought and goodwill is regarded as the difference between the cost of an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities. This would then become the historical cost of goodwill. However, this value is only true at a particular point in time and will constantly change as goodwill constantly changes. Goodwill is in fact inherent in all entities, and it may even be a negative value. Accountants tend to differentiate between purchased goodwill, which we can place an objective measure on at a point in time, and inherent goodwill, which is always there in a business. But goodwill is incapable of realization separately from the business as a whole and this differentiates it from other assets of a business such as property. The value of goodwill in a business is very useful information to a provider of capital and is therefore relevant but we also need to faithfully represent its value: this proves very difficult for accountants.

6.2 Exemplar financial statements

Annual reports, which include the financial statements required by the IASB, are readily available for a wide range of entities on the world-wide-web. We have here an example taken from Tesco's 2011 annual report which includes the group balance sheet (Table 1.4), the group

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Table 1.4 Group balance sheet

	Notes	***26 February 2011 £m***	*27 February 2010 £m*
Non-current assets			
Goodwill and other intangible assets	10	**4,338**	4,177
Property, plant and equipment	11	**24,398**	24,203
Investment property	12	**1,863**	1,731
Investments in joint ventures and associates	13	**316**	152
Other investments	14	**1,108**	863
Loans and advances to customers	17	**2,127**	1,844
Derivative financial instruments	22	**1,139**	1,250
Deferred tax assets	6	**48**	38
		35,337	34,258
Current assets			
Inventories	15	**3,162**	2,729
Trade and other receivables	16	**2,314**	1,888
Loans and advances to customers	17	**2,514**	2,268
Loans and advances to banks and other financial assets	18	**404**	144
Derivative financial instruments	22	**148**	224
Current tax assets		**4**	6
Short-term investments		**1,022**	1,314
Cash and cash equivalents	19	**1,870**	2,819
		11,438	11,392
Non-current assets classified as held for sale	7	**431**	373
		11,869	11,765
Current liabilities			
Trade and other payables	20	**(10,484)**	(9,442)
Financial liabilities:			
Borrowings	21	**(1,386)**	(1,529)
Derivative financial instruments and other liabilities	22	**(255)**	(146)
Customer deposits	24	**(5,074)**	(4,357)
Deposits by banks	25	**(36)**	(30)
Current tax liabilities		**(432)**	(472)
Provisions	26	**(64)**	(39)
		(17,731)	(16,015)
Net current liabilities		**(5,862)**	**(4,250)**
Non-current liabilities			
Financial liabilities:			
Borrowings	21	**(9,689)**	(11,744)
Derivative financial instruments and other liabilities	22	**(600)**	(776)

(*Continued*)

Table 1.4 Continued

	Notes	***26 February 2011 £m***	*27 February 2010 £m*
Post-employment benefit obligations	28	**(1,356)**	(1,840)
Deferred tax liabilities	6	**(1,094)**	(795)
Provisions	26	**(113)**	(172)
		(12,852)	(15,327)
Net assets		**16,623**	**14,681**
Equity			
Share capital	29	**402**	399
Share premium account		**4,896**	4,801
Other reserves		**40**	40
Retained earnings		**11,197**	9,356
Equity attributable to owners of the parent		**16,535**	14,596
Non-controlling interests		**88**	85
Total equity		**16,623**	14,681

income statement (Table 1.5) and the group statement of comprehensive income (Table 1.6), the group statement of changes in equity (Table 1.7), the group cash flow statement (Table 1.8) and the note pertaining to the reconciliation of net cash flow to movement in net debt (Table 1.9)

Table 1.5 Group income statement

Year ended 26 February 2011	*Notes*	***52 weeks 2011 £m***	*52 weeks 2010 £m*
Continuing operations			
Revenue (sales excluding VAT)	2	**60,931**	56,910
Cost of sales		**(55,871)**	(52,303)
Gross profit		**5,060**	4,607
Administrative expenses		**(1,676)**	(1,527)
Profit arising on property-related items	3	**427**	377
Operating profit		**3,811**	3,457
Share of post-tax profits of joint ventures and associates	13	**57**	33
Finance income	5	**150**	265
Finance costs	5	**(483)**	(579)
Profit before tax	3	**3,535**	3,176
Taxation	6	**(864)**	(840)
Profit for the year		**2,671**	2,336
Attributable to:			
Owners of the parent		**2,655**	2,327

(*Continued*)

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Table 1.5 Continued

Year ended 26 February 2011	*Notes*	***52 weeks 2011 £m***	*52 weeks 2010 £m*
Non-controlling interests		**16**	9
		2,671	2,336
Earnings per share			
Basic	9	**33.10p**	29.33p
Diluted	9	**32.94p**	29.19p
Non-GAAP measure: underlying profit before tax		**3,535**	3,176
Profit before tax			
Adjustments for			
IAS 32 and IAS 39 'Financial Instruments'— fair value remeasurements	1/5	**(19)**	(151)
IAS 19 'Employee Benefits'— non-cash Group Income Statement charge for pensions	1/28	**113**	24
IAS 17 'Leases' — impact of annual uplifts in rent and rent-free periods	1	**50**	41
IFRS 3 'Business Combinations'— intangible asset amortisation charges and costs arising from acquisitions	1	**42**	127
IFRIC13 'Customer Loyalty Programmes'— fair value of awards	1	**8**	14
IAS 36 'Impairment of Assets'— impairment of goodwill arising on acquisitions	1	**55**	131
Restructuring costs	1	**29**	33
Underlying profit before tax	1	**3,813**	3,395

Table 1.6 Group statement of comprehensive income

Year ended 26 February 2011	*Notes*	***52 weeks 2011 £m***	*52 weeks 2010 £m*
Change in fair value of available-for-sale financial assets and investments		**2**	1
Currency translation differences		**(344)**	343
Actuarial gains/(losses) on defined benefit pension schemes	28	**595**	(322)
(Losses)/gains on cash flow hedges:			
Net fair value losses		**(22)**	(168)
Reclassified and reported in the Group Income Statement		**8**	5
Tax relating to components of other comprehensive income for the year	6	**(153)**	54
Total other comprehensive income for the year		**86**	(87)
Profit for the year		**2,671**	2,336
Total comprehensive income for the year		**2,757**	2,249
Attributable to:			
Owners of the parent		**2,746**	2,222
Non-controlling interests		**11**	27
		2,757	2,249

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Table 1.7 Group statement of changes in equity

	Attributable to owners of the parent										
	Issued share capital £m	*Share premium £m*	*Other reserves £m*	*Capital redemption reserve £m*	*Hedging reserve £m*	*Translation reserve £m*	*Treasury shares £m*	*Retained earnings £m*	*Total £m*	*Non-controlling interests £m*	*Total equity £m*
At 27 February 2010	399	4,801	40	13	12	463	(180)	9,048	14,596	85	14,681
Profit for the year	–	–	–	–	–	–	–	2,655	2,655	16	2,671
Other comprehensive income											
Change in fair value of available-for-sale financial assets	–							2	2		2
Currency translation differences	–	–	–	–	–	(339)	–	–	(339)	(5)	(344)
Actuarial gains on defined benefit pension schemes	–							595	595		595
Losses on cash flow hedges	–	–	–	–	(14)	–	–	–	(14)	–	(14)
Tax relating to components of other comprehensive income					1	31		(185)	(153)		(153)
Total other comprehensive income	–	–	–	–	(13)	(308)	–	412	91	(5)	86
Total comprehensive income	–	–	–	–	(13)	(308)	–	3,067	2,746	11	2,757

(*Continued*)

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Table 1.7 Continued

	Issued share capital £m	*Share premium £m*	*Other reserves £m*	*Capital redemption reserve £m*	*Hedging reserve £m*	*Translation reserve £m*	*Treasury shares £m*	*Retained earnings £m*	*Total £m*	*Non-controlling interests £m*	*Total equity £m*
Transactions with owners											
Purchase of treasury shares	–	–	–	–	–	–	(50)	–	(50)	–	(50)
Share-based payments	–	–	–	–	–	–	89	131	220	–	220
Issue of shares	3	95	–	–	–	–	–	–	98	–	98
Purchase of non-controlling interests	–	–	–	–	–	–	–	6	6	(6)	–
Dividends paid to non-controlling interests	–									(2)	(2)
Dividends authorised in the year	–	–	–	–	–	–	–	(1,081)	(1,081)	–	(1,081)
Total transactions with owners	3	95	–	–	–	–	39	(944)	(807)	(8)	(815)
At 26 February 2011	402	4,896	40	13	(1)	155	(141)	11,171	16,535	88	16,623
					Attributable to owners of the parent						
At 28 February 2009	395	4,638	40	13	175	173	(229)	7,644	12,849	57	12,906
Profit for the year	–	–	–	–	–	–	–	2,327	2,327	9	2,336
Other comprehensive income											
Change in fair value of											
available-for-sale financial assets	–	–	–	–	–			1	1		1

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Currency translation differences	–	–	–	–	–	325	–	–	325	18	343
Actuarial losses on defined benefit pension schemes	–	–			–	(2)		(320)	(322)		(322)
Losses on cash flow hedges	–	–	–	–	(163)	–	–	–	(163)	–	(163)
Tax relating to components of other comprehensive income	–	–	–			(33)		87	54		54
Total other comprehensive income	–	–	–	–	(163)	290	–	(232)	(105)	18	(87)
Total comprehensive income	–	–	–	–	(163)	290	–	2,095	2,222	27	2,249
Transactions with owners											
Purchase of treasury shares	–	–	–	–	–	–	(24)	–	(24)	–	(24)
Share-based payments	–	–	–	–	–	–	73	168	241	–	241
Issue of shares	4	163	–	–	–	–	–	–	167	–	167
Purchase of non-controlling interests	–	–	–	–	–	–	–	91	91	3	94
Dividends paid to non-controlling interests	–	–	–		–					(2)	(2)

(*Continued*)

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Table 1.7 Continued

	Issued share capital £m	*Share premium £m*	*Other reserves £m*	*Capital redemption reserve £m*	*Hedging reserve £m*	*Translation reserve £m*	*Treasury shares £m*	*Retained earnings £m*	*Total £m*	*Non-controlling interests £m*	*Total equity £m*
Dividends authorised in the year	–	–	–	–	–	–	–	(968)	(968)	–	(968)
Tax on items charged to equity	–	–	–	–	–	–	–	18	18	–	18
Total transactions with owners	4	163	–	–	–	–	49	(691)	(475)	1	(474)
At 27 February 2010	399	4,801	40	13	12	463	(180)	9,048	14,596	85	14,681

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Table 1.8 Group cash flow statement

Year ended 26 February 2011	*Notes*	*52 weeks 2011 £m*	*52 weeks 2010 £m*
Cash flows from operating activities			
Cash generated from operations	31	5,366	5,947
Interest paid		(614)	(690)
Corporation tax paid		(760)	(512)
Net cash from operating activities		3,992	4,745
Cash flows from investing activities			
Acquisition of subsidiaries, net of cash acquired		(89)	(65)
Proceeds from sale of property, plant and equipment		1,906	1,820
Purchase of property, plant and equipment and investment property		(3,178)	(2,855)
Proceeds from sale of intangible assets		3	4
Purchase of intangible assets		(373)	(163)
Increase in loans to joint ventures		(219)	(45)
Decrease in loans to joint ventures		25	-
Investments in joint ventures and associates		(174)	(4)
Investments in short-term and other investments		(1,264)	(1,918)
Proceeds from sale of short-term investments Dividends received		1,314 62	1,233 35
Interest received		128	81
Net cash used in investing activities		(1,859)	(1,877)
Cash flows from financing activities			
Proceeds from issue of ordinary share capital		98	167
Increase in borrowings		2,175	862
Repayment of borrowings		(4,153)	(3,601)
Repayment of obligations under finance leases		(42)	(41)
Dividends paid to equity owners		(1,081)	(968)
Dividends paid to non-controlling interests		(2)	(2)
Own shares purchased		(31)	(24)
Net cash from refinancing activities		(3,036)	(3,607)
Net decrease in cash and cash equivalents		(903)	(739)
Cash and cash equivalents at beginning of year		2,819	3,509
Effect of foreign exchange rate changes		(46)	49
Cash and cash equivalents at end of year	19	1,870	2,819

Table 1.9 Note pertaining to the reconciliation of net cash flow to movement in net debt

Year ended 26 February 2011	*Note*	*52 weeks 2011 £m*	*52 weeks 2010 £m*
Net decrease in cash and cash equivalents		(903)	(739)
Investment in Tesco Bank		(446)	(230)
Elimination of net increase in Tesco Bank cash and cash equivalents		56	(167)
Debt acquired on acquisition		(17)	–
Net cash outflow to repay debt and lease financing		2,870	2,780
Dividend received from Tesco Bank		150	150
(Decrease)/increase in short-term investments		(292)	81
Increase in joint venture loan receivables		159	45
Other non-cash movements		(438)	(249)
Decrease in net debt in the year		1,139	1,671
Opening net debt	32	(7,929)	(9,600)
Closing net debt	32	(6,790)	(7,929)

7. Financial reporting

The *Conceptual Framework for Financial Reporting* was first published by the IASC in July 1989 and has since been the subject of much discussion to update it and ensure relevance in financial reports for users. The IASB completed the first phase of a joint project with the FASB in September 2010 to develop a converged and improved conceptual framework. The IASB does acknowledge that the full review of the framework will take years to complete given the inherent problems within financial reporting several of which we have already identified.

In the September 2010 update one of the first changes we note is the change of name of the framework from 'Preparation and Presentation of Financial Statements' to 'Conceptual Framework for Financial Reporting', but it as yet has not given us a definition of financial reporting nor stated its boundaries. The second change is the updating of the objectives of financial reporting:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

This is much more specific than the previous objective statement and does not include all users as it did before. It now identifies 'primary users' as investors, lenders and other creditors and quite clearly directs financial reporting at them. The 2010 document also changes the fundamental characteristics of useful information from relevance, reliability, understandability and comparability to just two characteristics: relevance and faithful representation. Also identified are enhancing qualities: comparability, verifiability, timeliness and understandability.

Financial reporting appears to be more than just financial accounting and perhaps when it is defined it will include information about such items as goodwill, environmental and social effects of the entity and even forecast information. Even though forecast information might be

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difficult to faithfully represent, it would prove useful to those providers of capital who are now the prime users according to the IASB.

7.1 Possible extensions to the traditional financial accounting statements

Statement of future prospects

Providers of capital to an entity would welcome information on future prospects of an entity, such as future profit levels, future employment levels and prospects, future investment levels, but such information would be highly subjective and could mislead users. Presentation of such information also carries other dangers such as:

- management may be judged on how well it meets these forecasts and therefore they may lower these forecasts to ensure they are attained; and
- for those entities suffering difficulties the provision of forecast information may lead to a collapse that could have been avoided.

Social accounting

This was proposed in 1975 in the UK by the Corporate Report published by the UK Accounting Standards Committee and is generally taken to be the:

> Process of communicating the social and environmental effects of organizations' economic activities to particular groups within society at large. As such, it involves extending the accountability of organizations, beyond the traditional role of providing a financial account to the owners of capital, in particular, shareholders. Such an extension is predicted upon the assumption that companies do have wider responsibilities than simply to make money for their shareholders.

Information in this area is important to users as society is imposing duties on entities to comply with antipollution measures, safety and health and other socially beneficial requirements. Figure 1.3 provides an extract from Tesco's corporate responsibility report 2011.

Integrated reporting

This is an attempt to bring together information about an organization's strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It is being driven by the International Integrated Reporting Committee, which was in part established by the International Federation of Accountants. In its discussion paper 'Towards Integrated Reporting: Communicating Value in the 21st Century', published in September 2011, it states:

> Since the current business reporting model was designed, there have been major changes in the way business is conducted, how business creates value and the context in which business operates. These changes are interdependent and reflect trends such as:
>
> - globalization;
> - growing policy activity around the world in response to financial, governance and other crises;
> - heightened expectations of corporate transparency and accountability;
> - population growth; and
> - environmental concerns.

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Community Promise	How did we do?	Performance 2008/9		Performance 2009/10	
Buying and selling our products responsibly	Supplier Viewpoint: average score (% of scores that are positive)	68%	NEW	80%	✓
	Supplier Viewpoint: response rate of suppliers	37%	NEW	51%	✓
Caring for the environment	Reduce CO_2 emissions from our 2006/7 baseline portfolio of stores and distribution centres by 50% by 2020. Annual target reported as percentage reduction against previous year	7%	✓	7.8%	✓
	Reduce CO_2e emissions from new stores and distribution centres built after 2006 by 50% by 2020, compared to new stores and distribution centres built in 2006	Environmental format developed 20.5% reduction vs. 2006	✓	28.8%	✓
	Reduce the amount of CO_2 used in our distribution network to deliver a case of goods by 50% by 2012, compared to 2006. Annual target reported as percentage reduction against previous year	9.2% (UK)	✗	6.4%	✗
Providing customers with healthy choices	Staff and customers active with Tesco	4.7m people	NEW	6.2m people	✓
Actively supporting local communities	Staff and customer fundraising		✓		✓
	Donate at least 1% of pre-tax profits to charities and good causes	1.9%	✓	1.94%	✓
Creating good jobs and careers	Staff being trained for their next job	1 in 30 (UK)	NEW	6%	✗

Figure 1.3 Extract from Tesco's Corporate Responsibility Report 2011

Against this background, the type of information that is needed to assess the past and the current performance of organizations and their future resilience is much wider than is provided for by the existing business reporting model. While there has been an increase in the information provided, key disclosure gaps remain. Reports are already long and are getting longer. But, because reporting has evolved in separate, disconnected strands, critical interdependencies between strategy, governance, operations and financial and non-financial performance are not made clear. To provide for the growing demand for a broad information set from markets, regulators and civil society, a framework is needed that can support the future development of reporting, reflecting this growing complexity. Such a framework needs to bring together the diverse but currently disconnected strands of reporting into a coherent, integrated whole and demonstrate an organization's ability to create value now and in the future.

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The provision of such a report would no doubt be welcomed by users, particularly those providers of capital but is it achievable?

7.2 Financial reporting and corporate governance

Corporate governance is the system by which businesses are directed and controlled. This system specifies the distribution of rights and responsibilities among different participants in the business such as the board, managers, shareholders and other stakeholders. Corporate scandals such as Enron, Worldcom, Parmalat and the 2008 world banking crisis have focused attention on governance, accountability and disclosure. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the business and its shareholders and should facilitate effective monitoring. Good corporate governance helps to provide a degree of confidence that is necessary for the proper functioning of a market economy; as a result the cost of capital is lower and business is encouraged to use resources more efficiently. Several bodies have reported on corporate governance and given detailed codes. For example the UK Financial Reporting Council published *The UK Corporate Governance Code* in May 2010 and a revised code was due in 2012. The code states in paragraph 1 that:

> The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company. The code is broken down into five principles as follows:
>
> - Leadership. Every company should be headed by an effective board which is collectively responsible for the long-term success of the company.
> - Effectiveness. For example the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively.
> - Accountability. For example the board should present a balanced and understandable assessment of the company's prospects and position.
> - Remuneration. Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.
> - Relations with shareholders. There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place.

7.3 Financial reporting and auditing requirements

Financial reports as we have seen are required to provide information that is relevant and is a faithful representation. Mistakes can be made in the preparation of financial reports either consciously or unconsciously. It is possible that those involved in the preparation, if their bonus is linked to the reported profit of the business, may bend the rules of preparation to present a more favourable picture. To address these issues most businesses are required to have an audit. There are two types of audit, external and internal.

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7.3.1 External audit

This is carried out by persons outside the business who should be both expert and independent. They investigate the accounting systems and transactions and then ensure that the financial statements have been prepared in accordance with the underlying books and with the law and accounting standards. The purpose of an external audit is for the auditor to be in a position to express an opinion on whether the financial statements being reported on show a true and fair view or not. Box 1.1. shows an example of such a report taken from Tesco's 2011 annual report.

Box 1.1
Independent auditors' report to the members of Tesco PLC

We have audited the Group financial statements of Tesco PLC for the 52 weeks ended 26 February 2011 which comprise the Group Income Statement, the Group Statement of Comprehensive Income, the Group Balance Sheet, the Group Cash Flow Statement, the Group Statement of Changes in Equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the European Union.

Respective responsibilities of directors and auditors

As explained more fully in the Statement of Directors' responsibilities set out on page 92, the Directors are responsible for the preparation of the Group financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the Group financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors.

This report, including the opinions, has been prepared for and only for the Company's members as a body in accordance with Chapter 3 of Part 16 of the Companies Act 2006 and for no other purpose. We do not, in giving these opinions, accept or assume responsibility for any other purpose or to any other person to whom this report is shown or into whose hands it may come save where expressly agreed by our prior consent in writing.

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. This includes an assessment of: whether the accounting policies are appropriate to the Group's circumstances and have been consistently applied and adequately disclosed; the reasonableness of significant accounting estimates made by the Directors; and the overall presentation of the financial statements.

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Box 1.1 (*Continued*)

Opinion on financial statements

In our opinion the Group financial statements:

- give a true and fair view of the state of the Group's affairs as at 26 February 2011 and of its profit and cash flows for the 52 weeks then ended;
- have been properly prepared in accordance with IFRSs as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006 and Article 4 of the IAS Regulation.

Opinion on other matter prescribed by the Companies Act 2006

In our opinion the information given in the Directors' Report for the 52 weeks ended 26 February 2011 for which the Group financial statements are prepared is consistent with the Group financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:
Under the Companies Act 2006 we are required to report to you if, in our opinion:

- certain disclosures of Directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

Under the listing Rules we are required to review:

- the Directors' statement, set out on page 45, in relation to going concern;
- the part of the Corporate Governance Statement relating to the Company's compliance with the nine provisions of the June 2008 Combined Code specified for our review; and
- certain elements of the report to shareholders by the Board on Directors' remuneration.

Other matter

We have reported separately on the Parent Company financial statements of Tesco PLC for the 52 weeks ended 26 February 2011 and on the information in the Directors' Remuneration Report that is described as having been audited.

Richard Winter (Senior Statutory Auditor)
for and on behalf of PricewaterhouseCoopers LLP
Chartered Accountants and Statutory Auditors
London
6 May 2011

Audit is not, however, an attempt to find fraud, nor is it a management control. Fraud may be discovered during an audit and the auditor will be well placed to give advice to management about potential improvements in the internal control system but these benefits are incidental. External auditing is regulated by the International Auditing and Assurance Standards Board

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which issues international standards on auditing. ISA 200 identifies the overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing. The overall objectives of the auditor are given in paragraph 11 of this standard:

a. To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared in all material respects in accordance with an applicable reporting framework; and
b. To report on the financial statements, and communicate as required by the ISA's in accordance with the auditor's findings.

7.3.2 Internal audit

Internal audit is a management tool and it is generally only found in larger organizations where the cost is justified by the benefits of monitoring complex accounting systems. As internal audit is a management tool, then the standards and procedures of it are determined by the management. External auditors often use the work of internal audit to inform their own audit.

7.4 Function of financial reporting in financial and capital markets

Put simply the function of financial reporting is to provide information on the performance and position of a business to users. Some of the users are investors and potential investors in businesses and these users form the financial and capital markets. What a potential investor is prepared to pay for shares in a business is influenced obviously by their view of the business and the financial reports are some of the main pieces of information that investor has for guidance. Investors trying to make a decision on which shares to buy will compare the financial reports of businesses and will need to ensure the information is comparable in terms of:

- valuation method of assets and liabilities;
- capital maintenance concept used; and
- accounting standards applied.

The investor will also need to be aware of the industry characteristics, business and corporate strategy in order to make the investment decision. However, the investor must also be aware that, as financial reports are used to communicate the underlying business realities to outsiders, managers may use those financial reports to manipulate investors' or other stakeholders' perceptions. This is one of the reasons why so much regulation is issued by the IASB, for example, and why there is a need for external audits of business. Even with all this regulation managers are still able to choose the accounting and disclosure policies that most favour the view they wish to give. There are several incentives available to management in order to manage the financial statements:

- those driven by the contract with shareholders include:
  - low earnings volatility – high volatility of results is viewed as risky and leads to low share price;
  - recurrent and increasing stream of earnings – smooth upward trend in results is viewed as low risk and therefore higher share price. This is generally attempted by managers before a new capital issue;

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- need to meet earnings targets and benchmarks – when a business does not meet its previously issued targets it generally faces a drop in share price;
- small loss avoidance – reporting of a small loss as opposed to a small profit can lead to a drop in share price;
- big bath accounting – if a loss is unavoidable by choosing particular accounting methods managers may go for a one-time large loss to 'get the bad news over in one year'.

- those driven by debt contracts – managers will choose accounting methods and estimates that reduce the violation of debt covenants often expressed in terms of accounting ratios such as interest cover;
- those driven by contracts with governments and other regulatory authorities – accounting data is used as a basis for taxation charges therefore managers will be careful to ascertain the effect on charges of particular accounting policies;
- those driven by contracts with managers – compensation/remuneration to managers is often based on reported profits;
- those driven by competitive pressures – information available in financial reports is also freely available to competitors thus managers will seek to minimise the information wherever possible; and
- those driven by contracts with employees – managers may seek to achieve low earnings when in a period of salary negotiation.

With all these incentives there is clearly a need to regulate financial reporting so that a true and fair view of the business is given to users.

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