Part 1

THE CONTEXT OF ACCOUNTING

1 Introduction
2 Some fundamentals
3 Frameworks and concepts
4 The regulation of accounting
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Chapter 1

Introduction

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Objectives

After studying this chapter carefully, you should be able to:
- explain the scope and uses of accounting;
- outline the role of national and international regulators;
- give some examples of the usages of accounting terms in different varieties of English.
### 1.1 Purposes and users of accounting

There is no single authoritative and generally accepted definition of financial accounting, or of accounting in general. Accounting began as a practical activity in response to perceived needs, and for most of its development it has progressed in the same way, adapting to meet changes in the demands made on it. Where the needs differed in different countries or environments, accounting tended to develop in different ways as a response to a particular environment, essentially on the Darwinian principle: useful accounting survived. Because accounting developed in different ways, it is likely that definitions suggested in different surroundings will vary.

At a general level, accounting exists to provide a service. In the box below there are three definitions. These have all been taken from the same economic and cultural source (the United States) because that country has the longest history of attempting explicit definitions of this type. Note that each suggested definition seems broader than the previous one, and the third one does not restrict accounting to financially quantifiable information. Many would not accept this last point. As will be explored in this book, attitudes to accounting and its role differ substantially around the world and certainly between European countries.

<table>
<thead>
<tr>
<th>Some definitions of accounting</th>
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<tr>
<td>Accounting is 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.</td>
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<tr>
<td>Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.</td>
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<tr>
<td>Accounting is 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.</td>
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If information is to be useful, then some obvious questions arise: useful to whom and for what purposes? A number of different types of people are likely to be dealing with business entities:

1. **Managers.** These are the people who have to take decisions, both day-to-day and strategically, about how the scarce resources within their control are to be used. They need information that will enable them to predict the likely outcomes of alternative courses of action. As part of this process, they need feedback on
1.1 Purposes and users of accounting

the results of their previous decisions in order to extend successful aspects of the decisions, and to adapt and improve the unsuccessful aspects.

2. **Investors**. A large entity may have many investors who are not the managers of the entity. Some investors are owners (the shareholders); others provide long-term debt capital. These providers of capital are concerned with the risk inherent in, and return provided by, their investments. They need to determine whether they should buy, hold or sell their investments. Shareholders are also interested in information to assess the ability of the entity to pay them a return (known as a dividend). Potential investors have similar interests.

3. **Other lenders**. Lenders (such as banks) are interested in whether loans, and the interest attaching to them, will be paid when due.

4. **Employees**. Employees and their representative groups are interested in the profitability of their employers. They also want to assess the ability of the entity to continue to provide remuneration, retirement benefits and employment opportunities.

5. **Suppliers**. These want to be able to assess whether amounts owing will be paid when due. Suppliers are likely to be interested in an entity over a shorter period than lenders, unless they depend upon the entity as a major continuing customer.

6. **Customers**. Customers need information about the continuance of an entity, especially when they have a long-term involvement with the entity.

7. **Governments**. Governments and their agencies need information in order to regulate the activities of entities and to collect taxation, and as the basis for national income and similar statistics.

8. **Public**. Entities affect members of the public in a variety of ways; for example, entities pollute the atmosphere or despoil the countryside. Accounting statements (generally called ‘financial statements’) may give the public information about the trends and recent developments of the entity and the range of its activities.

This list leads to a very important distinction, namely that between *management accounting* and *financial accounting*. Management accounting is that branch of accounting concerned with the provision of information intended to be useful to management within the business. Financial accounting is the branch of accounting intended for users outside the business itself, i.e. groups 2–8 above. The above descriptions of these groups is closely based on a document called *Framework for the Preparation and Presentation of Financial Statements* of the International Accounting Standards Board (IASB), discussed further in Chapter 3.

It is clear from the previous paragraphs that the needs of users to whom financial accounting is addressed are very diverse, and so the same information will not necessarily be valid for all their purposes. Nevertheless, it is usually assumed that one set of financial statements in the public domain should be able to satisfy most needs. The IASB Framework (paragraph 10) goes on to assert that:

> 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 enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.
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This last sentence would earn a fail mark on any course in logic or philosophy, but the view is widely followed in practice; that is, financial reporting is seen by the IASB as largely designed to supply investors with useful information. Accepting, however, that the needs of different users are likely to be different and that different users may predominate in different countries, it is clear that different national environments (cultural, political and economic) are likely to lead to different accounting practices. Indeed, financial reporting to various users (as opposed to the mere recording of transactions, which is known as bookkeeping) reflects the biases and norms of the societies in which it is embedded. This relationship is developed later in Chapter 5.

Activity 1.A

In what various ways can and should financial reporting (the end product of financial accounting) be different from reporting to management? Think about the different purposes of these two types of accounting, and how these purposes affect their operation.

Feedback

Management accounting can be carried out on the basis that no information need be kept secret for commercial reasons and that the preparers will have no incentive to disguise the truth. This is because the management is giving information to itself. So, the information does not need to be externally checked. It can be more detailed and more frequent than for financial reporting because there is no expense of external checking or publication. Also, the management will not want any biases, whereas some outside users may prefer a tendency to understate profits and values where there is uncertainty. Management may be happy for many estimates about the future to be made, which might be too subjective for external reporting. Indeed, some management accounting figures involve forecasting all the important figures for the next year, whereas financial reporting concentrates on the immediate past.

Another point is that there do not need to be any rules imposed on management accounting, because management can trust itself. By contrast, financial reporting probably works best with some clear rules from outside the entity in order to control the management and help towards comparability of one entity with another.

Having distinguished financial accounting from management accounting, there are some further possible confusions to address. The function of external auditing is quite separate from that of financial accounting. Auditing is a control mechanism designed to provide an external and independent check on the financial statements and reports published by those entities. Financial reports on the state of affairs and the past results of entities are prepared by accountants under the control of the managers of the entities, and then the validity of the statements is assessed by auditors. The wording used by auditors in their reports on financial statements varies considerably between countries, and the meaning and significance of the words that they use varies even more. There is inevitably some conflict between the necessity for an auditor to keep the management of the entity happy, and the necessity for provision of an expert and independent check. A study of auditing is outside the scope of this book, but the reader from any particular country should note that the role, objectives and effectiveness of the audit function in
other countries may differ from those of his or her experience. For example, in Japan, the statutory auditors of most companies are not required to be either expert or independent; in contrast, in some other countries, statutory auditors have to comply with stringent technical and independence requirements.

Another set of distinctions which must be made clear are those between finance, financial management and financial accounting. Very broadly, finance is concerned with the optimal means of raising money, financial management is concerned with the optimal means of using it, and financial accounting is the reporting on the results from having used it. Finally, financial accounting must be carefully distinguished from bookkeeping. Bookkeeping underlies other types of accounting. It is about recording the data – about keeping records of money and financially related movements. It is financial accounting (and management accounting) that takes these raw data, and then chooses and presents them as appropriate for various purposes. It is financial accounting that acts as the communicating process to those outside the entity.

### 1.2 Accounting regulation and the accountancy profession

**Activity 1.B** How should the provision of accounting information to users outside the entity be controlled? Think of as many regulators and ways of regulating as you can.

**Feedback** Accounting could be regulated in many ways, for example by:

- the market
- the government, through ministries
- parliament, through laws or codes
- a stock exchange
- a governmental regulator of stock exchanges
- the accountancy profession
- a committee of members from large companies
- an independent foundation or trust.

Two extreme answers to the question of regulation can be envisaged. The first is that it should be determined purely by market forces. A potential supplier of finance will be more willing to supply it if a business gives relevant and reliable information about how and by whom the finance will be used. So, a business providing a good quality and quantity of financial information will obtain more and cheaper finance. Therefore, entities have their own market-induced incentive to provide accounting information that meets the needs of users. The second extreme answer is that the whole process should be regulated entirely by the ‘state’, and some legal or bureaucratic body should specify what is to be reported and should provide an enforcement mechanism.

Neither extreme is consistent with modern capitalist-based economies, but the balance adopted between the two varies quite sharply around the world. The points mentioned so far in this section only consider the market and the state,
but there is a third important force to consider, namely the private sector, including the accountancy profession.

The profession is organized into associations under national jurisdictions. For example, the European Union requires two types of organization: qualifying bodies (which set exams and might set technical rules) and regulatory bodies (which are under government control and which supervise statutory audit). In some countries, such as the United Kingdom, various accountancy bodies are allowed to fulfil both roles, and many members of the profession do not work as auditors. In some other countries, such as France and Germany, the roles are fulfilled by separate bodies of ‘accountants’ and ‘auditors’, e.g. in France by *experts comptables* and *commissaires aux comptes* respectively. Professional bodies are responsible for monitoring the activities of their members and for standards of both general ethics and professional competence. However, in some countries the profession also takes on much of the role of creating the auditing rules under which its members will operate. In some countries (e.g. Australia, Denmark, the Netherlands, the United Kingdom and the United States), the rules that govern how entities perform their financial reporting are also set by professional bodies or by independent private-sector committees of accountants and others (as standard setters).

There is now widespread agreement within EU member states, and others elsewhere, of the need for carefully thought-out comprehensive regulation. This statement leaves open two important points of detail. The first is the extent to which comprehensive regulation needs to be flexible in detailed application, or (alternatively) to be precise but inflexible. The second is the relative position and importance of state regulation (e.g. Companies Acts or Commercial Codes) compared with private-sector regulation (e.g. accounting standards). As will be seen later (particularly in Chapter 4), differences in attitudes to both these questions can be significant in their effects on accounting practice in different jurisdictions.

The coordinating organization for the accountancy profession around the world is the International Federation of Accountants (IFAC). Its stated purpose is ‘to develop and enhance a coordinated world-wide accountancy profession with harmonized standards’. International auditing standards are produced by IFAC’s International Auditing and Assurance Standards Board. An important aspect of IFAC was its relationship with the IASC and its predecessor, the International Accounting Standards Committee (IASC). The latter was created in 1973 and, until 2001, all member bodies of IFAC were automatically members of IASC.

As discussed in more detail in Chapter 5, with effect from 2001 the International Accounting Standards Committee and the organisations surrounding it were completely restructured. The old IASC disappeared and was replaced by the IASC Foundation whose main operating arm is the International Accounting Standards Board (IASB). We generally refer to the IASB in this book, unless temporal specificity requires otherwise. The IASC’s International Accounting Standards (IASs) were adopted by the IASB but new standards are called International Financial Reporting Standards (IFRSs). Taken together, IASs and IFRSs are generically called IFRSs.
The IASB is independent and has total autonomy in the setting of international standards. The objectives of the IASC Foundation are as follows:

(a) to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users to make economic decisions;

(b) to promote the use and rigorous application of those standards;

(c) in fulfilling (a) and (b), to take account of, as appropriate, the special needs of small and medium-sized entities and emerging economies; and

(d) to bring about convergence of national accounting standards and IFRS to high quality solutions.

The implications of diverse national backgrounds and attitudes, of diverse regulatory groupings, and of diverse attitudes to such factors as the role of law, professional independence and so on are a major underlying theme of this book.

### 1.3 Language

Many readers of this book will be trying not only to master a subject new to them but also doing so in a language that is not their first. One added difficulty is that there are several forms of the English language, particularly for accounting terms. UK terms and US terms are extensively different. Some examples are shown in the first two columns of Table 1.1. At this stage, you are not expected to understand all of these terms; they will be introduced later, as they are needed.

The International Accounting Standards Board operates and publishes its standards in English, although there are approved translations in several languages. The IASB uses a mixture of UK and US terms, as shown in the third column of Table 1.1. On the whole, this book uses IASB terms.

<table>
<thead>
<tr>
<th>UK</th>
<th>US</th>
<th>IASB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>Inventory</td>
<td>Inventory</td>
</tr>
<tr>
<td>Shares</td>
<td>Stock</td>
<td>Shares</td>
</tr>
<tr>
<td>Own shares</td>
<td>Treasury stock</td>
<td>Treasury shares</td>
</tr>
<tr>
<td>Debtors</td>
<td>Receivables</td>
<td>Receivables</td>
</tr>
<tr>
<td>Creditors</td>
<td>Payables</td>
<td>Payables</td>
</tr>
<tr>
<td>Finance lease</td>
<td>Capital lease</td>
<td>Finance lease</td>
</tr>
<tr>
<td>Turnover</td>
<td>Sales (or revenue)</td>
<td>Sales (or revenue)</td>
</tr>
<tr>
<td>Merger</td>
<td>Pooling of interests</td>
<td>Uniting of interests</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>Non-current assets</td>
<td>Non-current assets</td>
</tr>
<tr>
<td>Profit and loss account</td>
<td>Income statement</td>
<td>Income statement</td>
</tr>
<tr>
<td>Associate</td>
<td>Equity accounted affiliate</td>
<td>Associate</td>
</tr>
</tbody>
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1.4 Excitement in accounting

Accounting is not universally regarded as an exciting and exhilarating area of activity or study, but it can be fascinating, in several ways:

- in itself, because it is an incomplete and rapidly evolving discipline and its study contains uncertainty and discovery;
- in application, because the theoretical ideas become intimately bound up with human attitude and human nature;
- in effects, because it has a major impact on financial decisions, share prices, etc.;
- in the international sphere, because of its integration with cultural, economic and political change.

At present, a further element exists that increases the interest of accounting. In the early years of this millennium there is enormous change in several factors connected with accounting. Business is increasingly being carried out electronically; old types of industry are giving way to new; markets have become global; accounting information can travel faster and more cheaply. In Europe in particular, closer cooperation is underway. A common currency (the euro) operates and expansion of the European Union continues.

The final reason – one that particularly relates to the authors – is that we are seeking to communicate the importance of accounting in a genuinely international rather than a national context. We hope that our work leads to greater understanding by readers (and between readers), whatever their background and starting point.

1.5 The path ahead

The structure of the remainder of this book is as follows. Part 1 continues by investigating the fundamental principles and conventions that form the basis of accounting thought and practice. Chapter 2 outlines the basic financial statements, and their relationships. There is also a substantial appendix to the book to introduce double-entry bookkeeping. Chapter 3 looks at the main conventions underlying accounting, and particularly at the framework of concepts used by the IASB. For the reader with no accounting background, it is essential to understand the thinking that underlies what accountants do; for the reader with previous accounting or possibly bookkeeping experience, the two chapters should still be regarded as essential reading, for they bring out the interrelationships between the various ideas and techniques. Depending on the nature of the students and the course, a study of the double-entry material in Appendix A might be suitable before, after or alongside Chapter 3.

Chapter 4 then looks at ways in which financial reporting can be regulated, and how it is regulated in several countries. Chapter 5 introduces the influences on, and the nature of, international differences in accounting. Chapter 6 outlines the normal contents of the annual reports of large commercial entities. The standards of the IASB are used as the main point of reference. Finally in Part 1, Chapter 7 introduces the topic of analysis: how to interpret financial statements and how to compare one entity with another.
Part 2 (comprising Chapters 8–16) explores the major topics of financial reporting in some detail. In many cases a variety of theoretical conclusions are possible, and a variety of different practices can be found in different countries. These are explored both for themselves and for their causes and implications. Again, the main context for the discussions is the standards of the IASB.

Finally, in Part 3 (Chapters 17 and 18) the techniques of analysing financial statements that were introduced in Part 1 are taken further, and the valuation of entities is examined. This Part can be seen as the culmination of what has gone before. Financial accounting is about communication, and study of the various influences on accounting in Part 1 and of the ways of tackling the problem issues in Part 2 should help in appreciating the real information content of accounting numbers – both what they mean and, just as importantly, what they do not mean.

**Summary**

- Accounting is designed to give financial information to particular groups of users. Different users may need different information.
- This book is especially concerned with financial reporting by business entities to outside investors.
- Because the managers of an entity are often different people from the investors, the reports prepared by managers for those investors and other users need to be checked by auditors.
- The state and the accountancy profession may both play roles in the regulation of financial reporting.
- The International Accounting Standards Board (IASB) is an independent body that sets standards for financial reporting.

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**EXERCISES**

*Feedback on the first two of these exercises is given in Appendix D.*

1.1 Is financial accounting really necessary?

1.2 At least eight different groups of users of accounting information can be distinguished, i.e.:

- Managers
- Investors
- Lenders
- Employees
- Suppliers and other creditors
- Customers
- Governments and their agencies
- Public

Suggest the information that each is likely to need from accounting statements and reports. Are there likely to be difficulties in satisfying the needs of all the groups you have considered with one common set of information?
1.3 Outline the relative benefits to users of financial reports of:
   (a) information about the past;
   (b) information about the present;
   (c) information about the future.

1.4 Do you think that users know what to ask for from their accountant or financial adviser? Explain your answer.

1.5 In the context of your own national background, rank the seven ‘external’ user groups suggested in the text (i.e. omitting managers), in order of the priority that you think should be given to their needs. Explain your reasons.

1.6 If at all possible, compare your answer to Exercise 1.5 with the answers of students from different national backgrounds. Try to explore likely causes of any major differences that emerge, in terms of legal, economic and cultural environments.