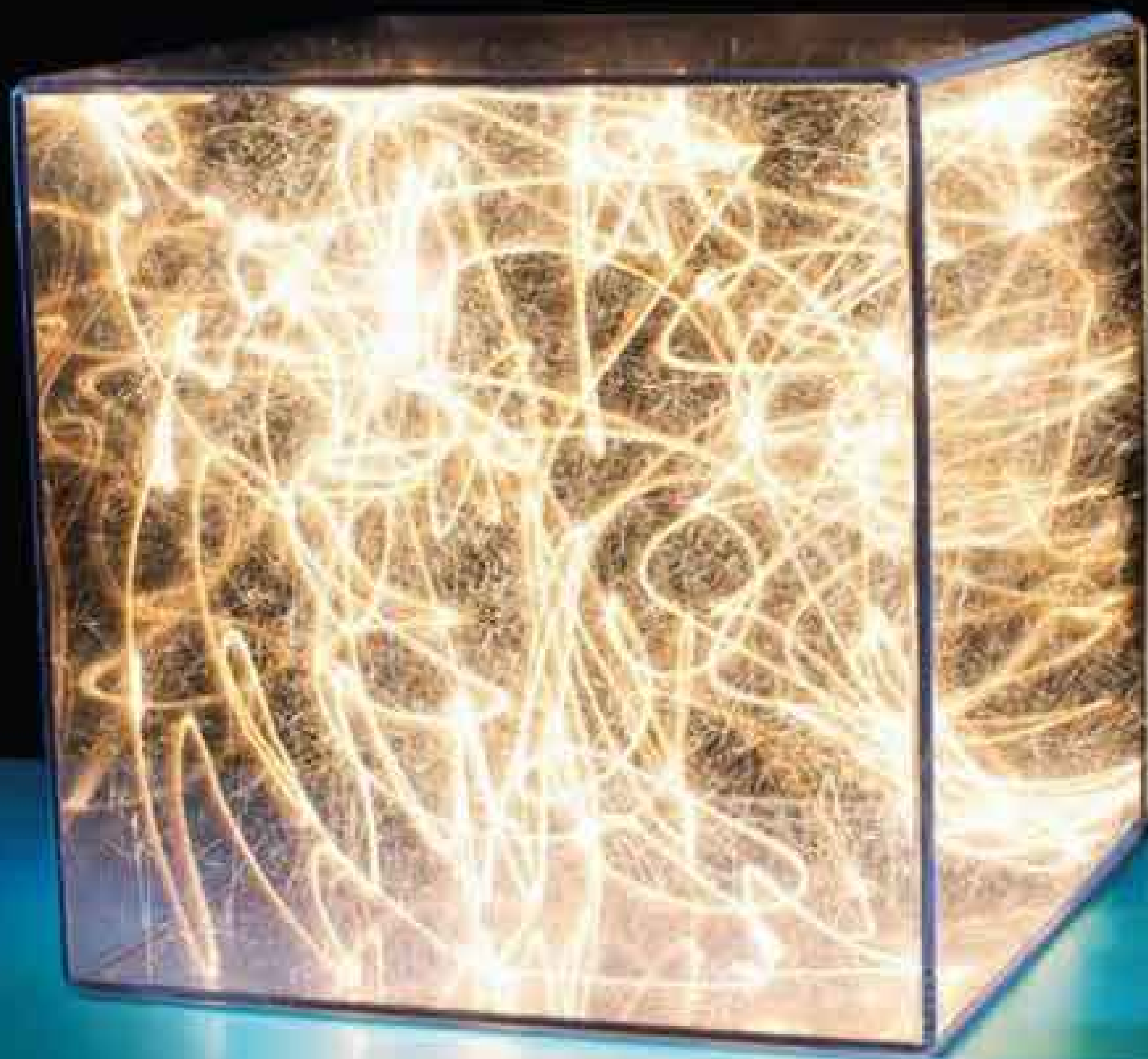
FINANCIAL ACCOUNTING AND REPORTING

BARRY ELLIOTT
JAMIE ELLIOTT



EIGHTEENTH EDITION

Financial Accounting and Reporting

Pearson

At Pearson, we have a simple mission: to help people make more of their lives through learning.

We combine innovative learning technology with trusted content and educational expertise to provide engaging and effective learning experiences that serve people wherever and whenever they are learning.

From classroom to boardroom, our curriculum materials, digital learning tools and testing programmes help to educate millions of people worldwide – more than any other private enterprise.

Every day our work helps learning flourish, and wherever learning flourishes, so do people.

To learn more, please visit us at **www.pearson.com/uk**

Financial Accounting and Reporting

EIGHTEENTH EDITION

Barry Elliott and Jamie Elliott

Harlow, England • London • New York • Boston • San Francisco • Toronto • Sydney • Dubai • Singapore • Hong Kong
Tokyo • Seoul • Taipei • New Delhi • Cape Town • São Paulo • Mexico City • Madrid • Amsterdam • Munich • Paris • Milan

Pearson Education Limited
Edinburgh Gate
Harlow CM20 2JE
United Kingdom
Tel: +44 (0)1279 623623
Web: www.pearson.com/uk

First published 1993 (print)
Second edition 1996 (print)
Third edition 1999 (print)
Fourth edition 2000 (print)
Fifth edition 2001 (print)
Sixth edition 2002 (print)
Seventh edition 2003 (print)
Eighth edition 2004 (print)
Ninth edition 2005 (print)
Tenth edition 2006 (print)
Eleventh edition 2007 (print)
Twelfth edition 2008 (print)
Thirteenth edition 2009 (print)
Fourteenth edition 2011 (print)
Fifteenth edition 2012 (print and electronic)
Sixteenth edition 2013 (print and electronic)
Seventeenth edition 2015 (print and electronic)
Eighteenth edition 2017 (print and electronic)

© Pearson Education Limited 2000, 2011 (print)
© Pearson Education Limited 2012, 2013, 2015, 2017 (print and electronic)

The rights of Barry Elliott and Jamie Elliott to be identified as authors of this work have been asserted by them in accordance with the Copyright, Designs and Patents Act 1988.

The print publication is protected by copyright. Prior to any prohibited reproduction, storage in a retrieval system, distribution or transmission in any form or by any means, electronic, mechanical, recording or otherwise, permission should be obtained from the publisher or, where applicable, a licence permitting restricted copying in the United Kingdom should be obtained from the Copyright Licensing Agency Ltd, Saffron House, 6–10 Kirby Street, London EC1N 8TS.

The ePublication is protected by copyright and must not be copied, reproduced, transferred, distributed, leased, licensed or publicly performed or used in any way except as specifically permitted in writing by the publishers, as allowed under the terms and conditions under which it was purchased, or as strictly permitted by applicable copyright law. Any unauthorised distribution or use of this text may be a direct infringement of the authors' and the publisher's rights and those responsible may be liable in law accordingly.

ISBN: 978-1-292-16240-9 (print)
978-1-292-16243-0 (PDF)
978-1-292-16242-3 (ePub)

British Library Cataloguing-in-Publication Data
A catalogue record for the print edition is available from the British Library

Library of Congress Cataloging-in-Publication Data
10 9 8 7 6 5 4 3 2 1
18 17 16 15 14

Front cover image: PM Images/GettyImages

Print edition typeset in 10/12 pt Ehrhardt MT Std by SPi Global
Printed and bound in Malaysia

NOTE THAT ANY PAGE CROSS REFERENCES REFER TO THE PRINT EDITION

Brief contents

Preface xxi
Publisher's acknowledgements xxvii

Part 1
INTRODUCTION TO ACCOUNTING ON A CASH FLOW AND ACCRUAL ACCOUNTING BASIS 1

1 Accounting and reporting on a cash flow basis 3
2 Accounting and reporting on an accrual accounting basis 21

Part 2
PREPARATION OF INTERNAL AND PUBLISHED FINANCIAL STATEMENTS 31

3 Preparation of financial statements of comprehensive income, changes in equity and financial position 33
4 Annual report: additional financial disclosures 70
5 Statements of cash flows 102

Part 3
REGULATORY FRAMEWORK – AN ATTEMPT TO ACHIEVE UNIFORMITY 129

6 Financial reporting – evolution of global standards 131
7 Concepts – evolution of an international conceptual framework 155
8 Ethical behaviour and implications for accountants 173

Part 4
INCOME AND ASSET VALUE MEASUREMENT SYSTEMS 199

9 Income and asset value measurement: an economist's approach 201
10 Accounting for price-level changes 220
11 Revenue recognition 253

Part 5
STATEMENT OF FINANCIAL POSITION – EQUITY, LIABILITY AND ASSET MEASUREMENT AND DISCLOSURE 277

12 Share capital, distributable profits and reduction of capital 279
13 Liabilities 303
14 Financial instruments 326
15 Employee benefits 359
16 Taxation in company accounts 386
17 Property, plant and equipment (PPE) 410
18 Leasing 443
19 Intangible assets 465
20 Inventories 493
21 Construction contracts 519

Part 6
CONSOLIDATED ACCOUNTS 543

22 Accounting for groups at the date of acquisition 545
23 Preparation of consolidated statements of financial position after the date of acquisition 565
24 Preparation of consolidated statements of income, changes in equity and cash flows 579
25 Accounting for associates and joint arrangements 601
26 Introduction to accounting for exchange differences 627

Part 7
INTERPRETATION 649

27 Earnings per share 651
28 Review of financial ratio analysis 677
29 Analysis of published financial statements 713
30 An introduction to digital financial reporting 755

Part 8
ACCOUNTABILITY 779

31 Corporate governance 781
32 Integrated reporting: sustainability, environmental and social 817

Index 853

Contents

Preface xxi
Publisher's acknowledgements xxvii

Part 1
INTRODUCTION TO ACCOUNTING ON A CASH FLOW AND ACCRUAL ACCOUNTING BASIS 1

1 Accounting and reporting on a cash flow basis 3
1.1 Introduction 3
1.2 Shareholders 3
1.3 What skills does an accountant require in respect of external reports? 4
1.4 Managers 4
1.5 What skills does an accountant require in respect of internal reports? 5
1.6 Procedural steps when reporting to internal users 5
1.7 Agency costs 8
1.8 Illustration of periodic financial statements prepared under the cash flow concept to disclose realised operating cash flows 8
1.9 Illustration of preparation of statement of financial position 13
1.10 Treatment of non-current assets in the cash flow model 14
1.11 What are the characteristics of these data that make them reliable? 15
1.12 Reports to external users 16
Summary 17
Review questions 18
Exercises 18
Notes 20

2 Accounting and reporting on an accrual accounting basis 21
2.1 Introduction 21
2.2 Historical cost convention 22
2.3 Accrual basis of accounting 22
2.4 Mechanics of accrual accounting – adjusting cash receipts and payments 23
2.5 Reformatting the statement of financial position 24
2.6 Accounting for the sacrifice of non-current assets 24
2.7 Published statement of cash flows 27

Summary 28
Review questions 28
Exercises 29
Notes 30

Part 2
PREPARATION OF INTERNAL AND PUBLISHED FINANCIAL STATEMENTS 31

3 Preparation of financial statements of comprehensive income, changes in equity and financial position 33
3.1 Introduction 33
3.2 Preparing an internal statement of income from a trial balance 33
3.3 Reorganising the income and expenses into one of the formats required for publication 36
3.4 Format 1: classification of operating expenses and other income by function 37
3.5 Format 2: classification of operating expenses according to their nature 40
3.6 Other comprehensive income 40
3.7 How non-recurring or exceptional items can affect operating income 41
3.8 How decision-useful is the statement of comprehensive income? 43
3.9 Statement of changes in equity 43
3.10 The statement of financial position 44
3.11 The explanatory notes that are part of the financial statements 45
3.12 Has prescribing the formats meant that identical transactions are reported identically? 48
3.13 Fair presentation 51
3.14 What does an investor need in addition to the primary financial statements to make decisions? 52
Summary 56
Review questions 57
Exercises 58
Notes 68

4 Annual report: additional financial disclosures 70
4.1 Introduction 70
4.2 IAS 10 *Events after the Reporting Period* 70
4.3 IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* 73
4.4 What do segment reports provide? 75
4.5 IFRS 8 *Operating Segments* 75
4.6 Benefits and continuing concerns following the issue of IFRS 8 79
4.7 Discontinued operations – IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* 82
4.8 Held for sale – IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* 83
4.9 IAS 24 *Related Party Disclosures* 85
Summary 90
Review questions 90
Exercises 91
Notes 101

5 Statements of cash flows **102**
5.1 Introduction 102
5.2 Development of statements of cash flows 102
5.3 Applying IAS 7 (revised) Statements of Cash Flows 103
5.4 Step approach to preparation of a statement of cash flows – indirect method 106
5.5 Additional notes required by IAS 7 109
5.6 Analysing statements of cash flows 110
5.7 Approach to answering questions with time constraints 116
5.8 Preparing a statement of cash flows when no statement of income is available 118
5.9 Critique of cash flow accounting 120
Summary 120
Review questions 121
Exercises 121
Notes 128

Part 3
REGULATORY FRAMEWORK – AN ATTEMPT TO ACHIEVE UNIFORMITY **129**

6 Financial reporting – evolution of global standards **131**
6.1 Introduction 131
6.2 Why do we need financial reporting standards? 131
6.3 Why do we need standards to be mandatory? 132
6.4 Arguments in support of standards 134
6.5 Arguments against standards 135
6.6 Standard setting and enforcement by the Financial Reporting Council (FRC) in the UK 135
6.7 The International Accounting Standards Board 138
6.8 Standard setting and enforcement in the European Union (EU) 139
6.9 Standard setting and enforcement in the US 142
6.10 Advantages and disadvantages of global standards for publicly accountable entities 144
6.11 How do reporting requirements differ for non-publicly accountable entities? 145
6.12 IFRS for SMEs 146
6.13 Why have there been differences in financial reporting? 146
6.14 Move towards a conceptual framework 150
Summary 151
Review questions 151
Exercises 152
Notes 153

7 Concepts – evolution of an international conceptual framework **155**
7.1 Introduction 155
7.2 Different countries meant different financial statements 155
7.3 Historical overview of the evolution of financial accounting theory 156

7.4 Framework for the Preparation and Presentation of Financial Statements 158
7.5 Conceptual Framework for Financial Reporting 2010 159
7.6 Chapter 4 content 163
7.7 The *Conceptual Framework for Financial Reporting* – latest developments 164
7.8 Current developments – concept of materiality 167
Summary 169
Review questions 170
Exercises 170
Notes 172

8 Ethical behaviour and implications for accountants 173
8.1 Introduction 173
8.2 The meaning of ethical behaviour 173
8.3 The accounting standard-setting process and ethics 174
8.4 The IFAC *Code of Ethics for Professional Accountants* 175
8.5 Implications of ethical values for the principles – versus rules-based approaches to accounting standards 178
8.6 Ethics in the accountant's work environment – a research report 181
8.7 Implications of unethical behaviour for stakeholders using the financial reports 183
8.8 The increasing role of whistle-blowing 188
8.9 Legal requirement to report – national and international regulation 190
8.10 Why should students learn ethics? 191
Summary 192
Review questions 193
Exercises 195
Notes 197

Part 4
INCOME AND ASSET VALUE MEASUREMENT SYSTEMS 199

9 Income and asset value measurement: an economist's approach 201
9.1 Introduction 201
9.2 Role and objective of income measurement 201
9.3 Accountant's view of income, capital and value 204
9.4 Critical comment on the accountant's measure 207
9.5 Economist's view of income, capital and value 208
9.6 Critical comment on the economist's measure 214
9.7 Income, capital and changing price levels 214
Summary 216
Review questions 216
Exercises 217
Notes 219
Bibliography 219

10 Accounting for price-level changes **220**

10.1 Introduction 220
10.2 Review of the problems of historical cost accounting (HCA) 220
10.3 Inflation accounting 221
10.4 The concepts in principle 221
10.5 The four models illustrated for a company with cash purchases and sales 222
10.6 Critique of each model 226
10.7 Operating capital maintenance – a comprehensive example 229
10.8 Critique of CCA statements 240
10.9 Measurement bases 241
10.10 The IASB position where there is hyperinflation 241
10.11 Future developments 242
Summary 244
Review questions 245
Exercises 245
Notes 252
Bibliography 252

11 Revenue recognition **253**

11.1 Introduction 253
11.2 IAS 18 *Revenue* 254
11.3 The issues involved in developing a new standard 255
11.4 The challenges under both IAS 18 and IFRS 15 256
11.5 IFRS 15 *Revenue from Contracts with Customers* 257
11.6 Five-step process to identify the amount and timing of revenue 258
11.7 Disclosures 269
Summary 270
Review questions 270
Exercises 272
Notes 276

Part 5
STATEMENT OF FINANCIAL POSITION – EQUITY, LIABILITY AND ASSET MEASUREMENT AND DISCLOSURE **277**

12 Share capital, distributable profits and reduction of capital **279**

12.1 Introduction 279
12.2 Common themes 279
12.3 Total owners' equity: an overview 280
12.4 Total shareholders' funds: more detailed explanation 281
12.5 Accounting entries on issue of shares 283
12.6 Creditor protection: capital maintenance concept 284
12.7 Creditor protection: why capital maintenance rules are necessary 284
12.8 Creditor protection: how to quantify the amounts available to meet creditors' claims 285
12.9 Issued share capital: minimum share capital 286

12.10 Distributable profits: general considerations 286
12.11 Distributable profits: how to arrive at the amount using relevant accounts 288
12.12 When may capital be reduced? 288
12.13 Writing off part of capital which has already been lost and is not represented by assets 288
12.14 Repayment of part of paid-in capital to shareholders or cancellation of unpaid share capital 294
12.15 Purchase of own shares 294
Summary 296
Review questions 296
Exercises 297
Notes 302

13 Liabilities 303
13.1 Introduction 303
13.2 Provisions – a decision tree approach to their impact on the statement of financial position 304
13.3 Treatment of provisions 305
13.4 The general principles that IAS 37 applies to the recognition of a provision 305
13.5 Management approach to measuring the amount of a provision 306
13.6 Application of criteria illustrated 308
13.7 Provisions for specific purposes 308
13.8 Contingent liabilities 311
13.9 Contingent assets 311
13.10 ED IAS 37 *Non-financial Liabilities* 312
13.11 ED/2010/1 *Measurement of Liabilities in IAS 37* 319
Summary 319
Review questions 320
Exercises 320
Notes 325

14 Financial instruments 326
14.1 Introduction 326
14.2 Financial instruments – the IASB's problem child 326
14.3 IAS 32 *Financial Instruments: Disclosure and Presentation* 329
14.4 IFRS 9 *Financial Instruments* 335
14.5 IFRS 7 *Financial Instruments: Disclosure* 345
Summary 351
Review questions 351
Exercises 352
Notes 358

15 Employee benefits 359
15.1 Introduction 359
15.2 Greater employee interest in pensions 359
15.3 Financial reporting implications 360
15.4 Types of scheme 360

15.5 Defined contribution pension schemes 363
15.6 Defined benefit pension schemes 363
15.7 IAS 19 (revised 2011) *Employee Benefits* 364
15.8 The asset or liability for pension and other post-retirement costs 364
15.9 Changes in the pension asset or liability position 365
15.10 Comprehensive illustration 368
15.11 Multi-employer plans 369
15.12 Disclosures 369
15.13 Other long-service benefits 370
15.14 Short-term benefits 370
15.15 Termination benefits 371
15.16 IFRS 2 *Share-based Payment* 372
15.17 Scope of IFRS 2 373
15.18 Recognition and measurement 373
15.19 Equity-settled share-based payments 373
15.20 Cash-settled share-based payments 376
15.21 Transactions which may be settled in cash or shares 377
15.22 IAS 26 *Accounting and Reporting by Retirement Benefit Plans* 377
Summary 380
Review questions 380
Exercises 381
Notes 385

16 Taxation in company accounts 386
16.1 Introduction 386
16.2 Corporation tax 386
16.3 Corporation tax systems – the theoretical background 387
16.4 Corporation tax and dividends 388
16.5 Corporation tax systems – avoidance and evasion 389
16.6 IAS 12 – accounting for current taxation 393
16.7 Deferred tax 394
16.8 A critique of deferred taxation 402
16.9 Value added tax (VAT) 404
Summary 405
Review questions 405
Exercises 406
Notes 409

17 Property, plant and equipment (PPE) 410
17.1 Introduction 410
17.2 PPE – concepts and the relevant IASs and IFRSs 410
17.3 What is PPE? 411
17.4 How is the cost of PPE determined? 412
17.5 What is depreciation? 414
17.6 What are the constituents in the depreciation formula? 415
17.7 Calculation of depreciation 417
17.8 Measurement subsequent to initial recognition 421
17.9 IAS 36 *Impairment of Assets* 423
17.10 IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* 428

17.11 Disclosure requirements 429
17.12 Government grants towards the cost of PPE 430
17.13 Investment properties 432
17.14 Effect of accounting policy for PPE on the interpretation of the financial statements 433
Summary 435
Review questions 435
Exercises 436
Notes 442

18 Leasing 443
18.1 Introduction 443
18.2 Need for an accounting standard on leasing 444
18.3 Distinction between finance leases and operating leases 447
18.4 Reason for a replacement standard for IAS 17 448
18.5 IFRS 16 *Leases* – the criteria that determine whether it's a lease 449
18.6 Leases in the financial statements of lessees 451
18.7 Leases in the financial statements of lessors 455
18.8 Sale and leaseback transactions 457
18.9 An evaluation of the new IFRS 16 460
Summary 460
Review questions 461
Exercises 462
Note 464

19 Intangible assets 465
19.1 Introduction 465
19.2 Intangible assets defined 465
19.3 Accounting treatment for research and development 468
19.4 Why is research expenditure not capitalised? 469
19.5 Capitalising development costs 470
19.6 Disclosure of R&D 471
19.7 *IFRS for SMEs*' treatment of intangible assets 471
19.8 Internally generated and purchased goodwill 472
19.9 The accounting treatment of goodwill 472
19.10 Critical comment on the various methods that have been used to account for goodwill 474
19.11 Negative goodwill/badwill 476
19.12 Brands 477
19.13 Accounting for acquired brands 479
19.14 Intellectual capital disclosures (ICDs) in the annual report 480
19.15 Review of the implementation of IFRS 3 481
19.16 Review of the implementation of identified intangibles under IAS 38 481
Summary 483
Review questions 483
Exercises 485
Notes 491

20 Inventories **493**
20.1 Introduction 493
20.2 Inventory defined 493
20.3 The impact of inventory valuation on profits 494
20.4 IAS 2 *Inventories* 495
20.5 Inventory valuation 496
20.6 Work in progress 502
20.7 Inventory control 504
20.8 Creative accounting 505
20.9 Audit of the year-end physical inventory count 507
20.10 Published accounts 509
20.11 Agricultural activity 510
Summary 513
Review questions 513
Exercises 514
Notes 518

21 Construction contracts **519**
21.1 Introduction 519
21.2 The need to replace IAS 11 *Construction Contracts* 519
21.3 Identification of contract revenue under IAS 11 521
21.4 Identification of contract costs under IAS 11 521
21.5 IFRS 15 treatment of construction contracts 524
21.6 An approach when a contract can be separated into components 526
21.7 Accounting for a contract – an example 527
21.8 Illustration – loss-making contract using the step approach 529
21.9 Public–private partnerships (PPPs) 531
Summary 534
Review questions 535
Exercises 535
Notes 542

Part 6
CONSOLIDATED ACCOUNTS **543**

22 Accounting for groups at the date of acquisition **545**
22.1 Introduction 545
22.2 Preparing consolidated accounts for a wholly owned subsidiary 545
22.3 IFRS 10 *Consolidated Financial Statements* 545
22.4 Fair values 547
22.5 Illustration where there is a wholly owned subsidiary 548
22.6 Preparing consolidated accounts when there is a partly owned subsidiary 549
22.7 The treatment of differences between a subsidiary's fair value and book value 552
22.8 The parent issues shares to acquire shares in a subsidiary 553
22.9 IFRS 3 *Business Combinations* treatment of goodwill at the date of acquisition 554

22.10 When may a parent company not be required to prepare consolidated accounts? 554
22.11 When may a parent company exclude or not exclude a subsidiary from a consolidation? 555
22.12 IFRS 13 *Fair Value Measurement* 555
22.13 What advantages are there for stakeholders from requiring groups to prepare consolidated accounts? 557
Summary 557
Review questions 557
Exercises 558
Notes 564

23 Preparation of consolidated statements of financial position after the date of acquisition 565
23.1 Introduction 565
23.2 Uniform accounting policies and reporting dates 565
23.3 Pre- and post-acquisition profits/losses 565
23.4 The Bend Group – assuming there have been no inter-group transactions 566
23.5 Inter-company transactions 568
23.6 The Prose Group – assuming there have been inter-group transactions 569
Summary 571
Review questions 572
Exercises 572
Notes 578

24 Preparation of consolidated statements of income, changes in equity and cash flows 579
24.1 Introduction 579
24.2 Eliminate inter-company transactions 579
24.3 Preparation of a consolidated statement of income – the Ante Group 580
24.4 The statement of changes in equity (SOCE) 582
24.5 Other consolidation adjustments 582
24.6 A subsidiary acquired part-way through the year 584
24.7 Published format statement of income 586
24.8 Consolidated statements of cash flows 587
Summary 589
Review questions 589
Exercises 590
Notes 600

25 Accounting for associates and joint arrangements 601
25.1 Introduction 601
25.2 Definitions of associates and of significant influence 601
25.3 The treatment of associated companies in consolidated accounts 602
25.4 The Brill Group – group accounts with a profit-making associate 602
25.5 The Brill Group – group accounts with a loss-making associate 605
25.6 The acquisition of an associate part-way through the year 607

25.7 Joint arrangements 608
25.8 Disclosure in the financial statements 612
25.9 Parent company use of the equity method in its separate financial statements 613
Summary 615
Review questions 615
Exercises 616
Notes 626

26 Introduction to accounting for exchange differences 627

26.1 Introduction 627
26.2 How to record foreign currency transactions in a company's own books 628
26.3 Boil plc – a more detailed illustration 630
26.4 IAS 21 *Concept of Functional and Presentation Currencies* 631
26.5 Translating the functional currency into the presentation currency 633
26.6 Preparation of consolidated accounts 633
26.7 How to reduce the risk of translation differences 637
26.8 Critique of the use of presentational currency 638
26.9 IAS 29 *Financial Reporting in Hyperinflationary Economies* 638
Summary 640
Review questions 640
Exercises 641
Notes 648

Part 7
INTERPRETATION 649

27 Earnings per share 651

27.1 Introduction 651
27.2 Why is the earnings per share figure important? 651
27.3 How is the EPS figure calculated? 652
27.4 The use to shareholders of the EPS 653
27.5 Illustration of the basic EPS calculation 654
27.6 Adjusting the number of shares used in the basic EPS calculation 654
27.7 Rights issues 657
27.8 Adjusting the earnings and number of shares used in the diluted EPS calculation 662
27.9 Procedure where there are several potential dilutions 664
27.10 Exercise of conversion rights during the financial year 666
27.11 Disclosure requirements of IAS 33 666
27.12 The Improvement Project 668
27.13 The Convergence Project 668
Summary 669
Review questions 669
Exercises 670
Notes 676

28 Review of financial ratio analysis **677**
28.1 Introduction 677
28.2 Overview of techniques for the analysis of financial data 678
28.3 Ratio analysis – a case study 679
28.4 Introductory review 680
28.5 Financial statement analysis, part 1 – financial performance 683
28.6 Financial statement analysis, part 2 – liquidity 690
28.7 Financial statement analysis, part 3 – financing 693
28.8 Peer comparison 695
28.9 Report based on the analysis 696
28.10 Caution when using ratios for prediction 697
Summary 699
Review questions 699
Exercises 700
Note 712

29 Analysis of published financial statements **713**
29.1 Introduction 713
29.2 Improvement of information for shareholders 714
29.3 Published financial statements – their limitations for interpretation purposes 716
29.4 Published financial statements – additional entity-wide cash-based performance measures 717
29.5 Ratio thresholds to satisfy Shariah compliance 720
29.6 Use of ratios in restrictive loan covenants 721
29.7 Investor-specific ratios 724
29.8 Determining value 727
29.9 Predicting corporate failure 732
29.10 Professional risk assessors 736
29.11 Valuing shares of an unquoted company – quantitative process 737
29.12 Valuing shares of an unquoted company – qualitative process 740
29.13 Possible effect of 'Brexit' on financial statements 742
Summary 743
Review questions 744
Exercises 745
Notes 753

30 An introduction to digital financial reporting **755**
30.1 Introduction 755
30.2 The objectives of financial reporting 755
30.3 Reports and the flow of information pre-XBRL 757
30.4 What are HTML, XML and XBRL? 758
30.5 Reports and the flow of information post-XBRL 759
30.6 Why are companies adopting XBRL? 760
30.7 What are the processes followed to adopt XBRL for outputting information? 763
30.8 What is needed when receiving XBRL output information? 766
30.9 Progress of XBRL development for internal accounting 771
30.10 Real-time reporting 771

Stakeholder interaction with XBRL data 772
Summary 773
Review questions 774
Exercises 774
Notes 775
Bibliography 776

Part 8
ACCOUNTABILITY **779**

31 Corporate governance **781**
31.1 Introduction 781
31.2 A systems perspective 781
31.3 Different jurisdictions have different governance priorities 783
31.4 Pressures on good governance behaviour vary over time 785
31.5 Types of past unethical behaviour 785
31.6 The effect on capital markets of good corporate governance 786
31.7 Risk management 787
31.8 The role of internal control, internal audit and audit committees in corporate governance 789
31.9 External audits in corporate governance 790
31.10 Executive remuneration in the UK 796
31.11 Corporate governance, legislation and codes 800
31.12 Corporate governance – the UK experience 801
Summary 810
Review questions 811
Exercises 813
Notes 815

32 Integrated reporting: sustainability, environmental and social **817**
32.1 Introduction 817
32.2 Environmental and social disasters and the adverse consequences that can follow 818
32.3 Management accountability for environmental and social responsibility 821
32.4 Integrated reporting concepts 825
32.5 The historical context of the evolution of integrated reporting including the drivers of this movement 828
32.6 The efforts on which integrated reporting builds 832
32.7 The contribution of accountants 837
32.8 Integrated reporting – its impact on the future development of financial reporting and accounting 843
Review questions 844
Exercises 846
Notes 851

Index 853

Supporting resources

Lecturer resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit catalogue.pearsoned.co.uk where you will be able to find suitable material.

Preface

Our objective is to provide a balanced and comprehensive framework to enable students to acquire the requisite knowledge and skills to appraise current practice critically and to evaluate proposed changes from a theoretical base. To this end, the text contains:

- extracts from current IASs and IFRSs;
- illustrations from published accounts;
- a range of review questions;
- exercises of varying difficulty;
- extensive references.

Solutions to selected exercises marked in the text with * can be found on MyAccountingLab.

We have assumed that readers will have an understanding of financial accounting to a foundation or first-year level, although the text and exercises have been designed on the basis that a brief revision is still helpful. For the preparation of financial statements in Parts 1, 2 and 5 we have structured the chapters to assist readers who may have no accounting knowledge.

Lecturers are using the text selectively to support a range of teaching programmes for second-year and final-year undergraduate and postgraduate programmes. We have therefore attempted to provide subject coverage of sufficient breadth and depth to assist selective use.

The text has been adopted for financial accounting, reporting and analysis modules on:

- second-year undergraduate courses for Accounting, Business Studies and Combined Studies;
- final-year undergraduate courses for Accounting, Business Studies and Combined Studies;
- MBA courses;
- specialist MSc courses; and
- professional courses preparing students for professional accountancy examinations.

Changes to the eighteenth edition

Our emphasis has been on keeping the text current and responsive to constructive comments from reviewers and lecturers.

National accounting standards and the IASB

Since 2005 UK listed companies have followed international standards EU-IFRS for their consolidated accounts.

Accounting standards – eighteenth edition updates

Chapters covering the following International Standards have been revised. They are as follows:

Chapter 3	Preparation of financial statements	IAS 1
Chapter 4	Preparation of additional financial statements	IAS 10, IAS 24, IFRS 5 and IFRS 8
Chapter 5	Statements of cash flows	IAS 7
Chapter 10	Accounting for price-level changes	IAS 29
Chapter 11	Revenue recognition	IFRS 15 and IAS 18
Chapter 13	Liabilities	IAS 37/ED/2010/1
Chapter 14	Financial instruments	IAS 32, IFRS 7 and IFRS 9
Chapter 15	Employee benefits	IAS 19 (revised 2011), IAS 26 and IFRS 2
Chapter 16	Taxation in company accounts	IAS 12
Chapter 17	Property, plant and equipment (PPE)	IAS 16, IAS 20, IAS 23, IAS 36, IAS 40 and IFRS 5
Chapter 18	Leasing	IFRS 16
Chapter 19	Intangible assets	IAS 38 and IFRS 3
Chapter 20	Inventories	IAS 2
Chapter 21	Construction contracts	IAS 11 and IFRS 15
Chapters 22–26	Consolidation	IAS 21, IAS 28, IFRS 3, 10, 11, 12 and 13
Chapter 27	Earnings per share	IAS 33

Part 1 Introduction to accounting on a cash flow and accrual accounting basis

Chapters 1 and 2 continue to cover accounting and reporting on a cash flow and accrual basis.

Part 2 Preparation of internal and published financial statements

Chapters 3 to 5 have been revised. They cover the preparation of statements of income, changes in equity, financial position and cash flows.

Part 3 Regulatory framework – an attempt to achieve uniformity

Chapters 6 and 7 have been revised.

Part 4 Income and asset value measurement systems

Chapters 9 and 10 covering the economic income approach and accounting for price-level changes have been retained. Chapter 11 discusses the application of IFRS 15 and IAS 18.

Part 5 Statement of financial position

Chapters 12–21 are core chapters which have been retained and updated as appropriate.

Part 6 Consolidated accounts

Chapters 22–26 have been updated and revised to improve accessibility with explanations from first principles.

Part 7 Interpretation

Chapters 28 and 29 are retained, aiming at encouraging good report writing based on the pyramid approach to ratios and an introduction to other tools and techniques for specific assignments. Chapter 30 has been revised to discuss an overview of financial reporting on the internet.

Part 8 Accountability

Chapters 31 and 32 have been updated and continue to focus on the accountant's role in corporate governance and in the development of Integrated Reporting.

Recent developments

We cover the issue by the IASB of IFRS 16 *Leases* and the IFRS 9 *Financial Instruments* provisions on the impairment requirements, which follow an 'expected loss' model.

In addition we discuss Integrated Reporting and relevant EU proposals, such as that the remuneration policy for company directors should also contribute to the long-term growth of the company, and SEC requirements such as the publication of pay ratios which might be adopted by the UK government.

The content of financial reports continues to be subjected to discussion with tension between preparers, stakeholders, auditors, academics and standard setters; this is mirrored in the tension that exists between theory and practice.

- Preparers favour reporting transactions on a historical cost basis, which is reliable but does not provide shareholders with relevant information to appraise past performance or to predict future earnings.
- Shareholders favour forward-looking reports relevant in estimating future dividend and capital growth and in understanding environmental and social impacts.
- Stakeholders favour quantified and narrative disclosure of environmental and social impacts and the steps taken to reduce negative impacts.
- Auditors favour reports that are verifiable so that the figures can be substantiated to avoid them being proved wrong at a later date.
- Academic accountants favour reports that reflect economic reality and are relevant in appraising management performance and in assessing the capacity of the company to adapt.

- Standard setters lean towards the academic view and favour reporting according to the commercial substance of a transaction.

In order to understand the tensions that exist, students need:

- the skill to prepare financial statements in accordance with the historical cost and current cost conventions, both of which appear in annual financial reports;
- an understanding of the main thrust of mandatory and voluntary standards;
- an understanding of the degree of flexibility available to the preparers and the impact of this on reported earnings and the figures in the statement of financial position;
- an understanding of the limitations of financial reports in portraying economic reality; and
- an exposure to source material and other published material in so far as time permits.

Acknowledgements

Financial reporting is a dynamic area and we see it as extremely important that the text should reflect this and be kept current. Assistance has been generously given by colleagues and many others in the preparation and review of the text and assessment material. This eighteenth edition continues to be very much a result of the authors, colleagues, reviewers and Pearson editorial and production staff working as a team and we are grateful to all concerned for their assistance in achieving this.

We owe particular thanks to Charles Batchelor, formerly of FTC Kaplan, for 'Financial instruments' (Chapter 14); Ozer Erman of Kingston University for 'Share capital, distributable profits and reduction of capital' (Chapter 12); Paul Robins of the Financial Training Company for 'Leasing' (Chapter 18); Professor Garry Tibbits of the University of Western Sydney for 'Integrated Reporting' (Chapter 32); Hendrika Tibbits of the University of Western Sydney for 'An introduction to digital financial reporting' (Chapter 30); and David Towers, formerly of Keele University, for 'Taxation in company accounts' (Chapter 16).

The authors are grateful for the constructive comments received over various editions from the following reviewers who have assisted us in making improvements: Andreas Scholze of Osnabruck University; Christos Kallandranis of Regent's University London; Ian Money of The University of York; Katherine Martin of University Of Nottingham; Kathryn Heam of University of Greenwich; Svend Erik Thomsen of University of Southern Denmark; Pik Liew of Essex University; Anitha Majeed of Coventry University; Allison Wylde of London Metropolitan University; Terry Morris of Queen Mary University of London; Ajjay Mandal of London South Bank University; and Michael Jeffrey of Manchester Metropolitan University. We would also like to thank the reviewers of this new edition of the book.

Thanks are owed to Keith Brown, formerly of De Montfort University; Kenneth N. Field of the University of Leeds; David Murphy of Manchester Business School; Bahadur Najak of the University of Durham; Graham Sara of the University of Warwick; and Laura Spira of Oxford Brookes University.

Thanks are also due to the following organisations: the Financial Reporting Council, the International Accounting Standards Board, the Association of Chartered Certified Accountants, the Association of International Accountants, the Chartered Institute of Management Accountants, the Institute of Certified Public Accountants (CPA) in Ireland, the Institute of Chartered Accountants of England and Wales, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Secretaries and Administrators.

We would also like to thank the authors of some of the end-of-chapter exercises. Some of these exercises have been inherited from a variety of institutions with which we have been associated, and we have unfortunately lost the identities of the originators of such material with the passage of time. We are sorry that we cannot acknowledge them by name and hope that they will excuse us for using their material.

We are indebted to Rebecca Pedley and the editorial team at Pearson Education for active support in keeping us largely to schedule and the attractively produced and presented text.

Finally we thank our wives, Di and Jacklin, for their continued good-humoured support during the period of writing and revisions, and Giles Elliott for his critical comment from the commencement of the project. We alone remain responsible for any errors and for the thoughts and views that are expressed.

Barry and Jamie Elliott

Publisher's acknowledgements

We are grateful to the following for permission to reproduce copyright material:

Figures

Figure on p. 49 from Annual Report, Inventories, http://www.astrazeneca-annualreports.com/2007/financial_statements/accounting_policies_group.asp.; Figure on p. 259 from Hewlett-Packard Company and Subsidiaries, Annual Report 2013, Note 1, pp. 86–8; Figures 30.1, 30.2, 30.3 from www.xbrl.org.au/training/NSWWorkshop.pdf

Text

Extract on p. 54 from IFRS Practice Statement Management Commentary. International Financial Reporting Standards Foundation (IFRS / IASB). http://www.ifrs.org/Current-Projects/IASB-Projects/Management-Commentary/P.s/Management-Commentary.aspx. This publication contains copyright material of the IFRS Foundation in respect of which all rights are reserved. Reproduced by Pearson with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation please visit http://eifrs.ifrs.org; Exercise on p. 67 from F1 November 2014 Question Paper, p. 10. http://www.cimaglobal.com/Documents/Student%20docs/2010%20syllabus%20docs/F1/F1%20November%202014%20Question%20Paper.pdf ; Extract on p. 88 from IAS 24 (BC 43). IAS 24 Related Party Disclosures, IASB, revised 2009 © 2014 International Accreditation Service, © Copyright IFRS Foundation; Exercises on pp. 99, 437, 438, 439, 563, 750 from Association of Chartered Certified Accountants (ACCA), We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer bank have been prepared by us, unless otherwise stated.; Exercise on p. 100 from Institute of Certified Public Accountants (CPA), Professional Stage 1 Corporate Reporting Examination, August 2011), p. 9, http://www.cpaireland.ie/docs/default-source/Students/Study-Support/P1-Corporate-Reporting/august-2011.pdf?sfvrsn=0; Exercise on p. 125 from Institute of Certified Public Accountants (CPA) Professional Stage 1 Corporate Reporting Examination, April 2013; Extracts on pp. 313, 315, 316, 317 from ED IAS 37 Non-financial Liabilities, IASB, 2005. IAS © 2014 International Accreditation Service, © Copyright IFRS Foundation; Extract on p. 328 from Statement from G-20 Summit, Summit on Financial Markets and the World Economy, 15 November 2008. https://georgewbush-whitehouse.archiv. . . ; Extracts on pp. 340, 347 from IFRS 9 Financial Instruments, © Copyright IFRS Foundation; Extracts on pp. 346, 348 from IAS 7 Statement of Cash Flow, © Copyright IFRS Foundation; Extract on p. 348 from Findel plc 2015 Annual Report, p. s 105–108 http://www.findel.co.uk/content/financial-reports/145-Annual-Report-and-Accounts-2015/WEB_Findel%20ra2015.pdf; Exercise on p. 382 from Dip IFR Diploma in International Financial Reporting Monday 11 December 2006, p. 10. Association of Chartered Certified Accountants (ACCA). We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer

bank have been prepared by us, unless otherwise stated; Extract on p. 362 from J Sainsbury plc Annual Report and Financial Statements 2014, Notes to the financial statements, p. 90. http://annualreport2014.j-sainsbury.co.uk/media/47785/notes_to_the_financial_statements.pdf, Reproduced by kind permission of Sainsbury's Supermarkets Ltd; Extract on p. 398 from Statement of Financial Accounting Standards no. 109. FAS109 Status P., FAS109 Summary. Accounting for Income Taxes February 1992. p. 31 no. 77, 78. Reproduced with permission, Copyright © 2010 by Financial Accounting Foundation; Extract on p. 403 from Conceptual Framework for Financial Reporting, IASB, 2010, OB17, © Copyright IFRS Foundation; Extract on p. 403 from Conceptual Framework for Financial Reporting, IASB, 2010, OB17, para. 4.8, © Copyright IFRS Foundation; Extract on p. 403 from Conceptual Framework for Financial Reporting, IASB, 2010, OB17, BC3.26, © Copyright IFRS Foundation; Exercises on pp. 66, 97, 99, 441, 440, 539, 575, 623, 628, 645, 674, 674, 703, 751 from Association of International Accountants (AIA), © 2012 AIA. All rights reserved; Exercise on p. 441 from Institute of Certified Public Accountants (CPA), Professional Stage 1 Corporate Reporting Examination, April 2015; Exercise on p. 489 from © First published in 2014 by The Chartered Institute of Public Finance and Accountancy (CIPFA) from CIPFA Advanced Diploma in International Public Financial Management – FINANCIAL REPORTING, p. 2; Exercise on p. 517 from ACCA DipIFR 2004. Association of Chartered Certified Accountants (ACCA). We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer bank have been prepared by us, unless otherwise stated; Exercise on p. 541 from Cima F1 March 2014 Past Papers (approximate) p. 8 http://www.cimapastpapers.com/cima-f1-mrach-2014-past-papers; Exercise on p. 597 from Institute of Certified Public Accountants (ICPA), Professional I Stage I Corporate Reporting Examination, August 2014; Exercise on p. 599 from © First published in 2014 by The Chartered Institute of Public Finance and Accountancy (CIPFA) from CIPFA Advanced Diploma in International Public Financial Management – Financial Reporting, p. 7; Extract on p. 615 from IAS 28 Investments in Associates and Joint Ventures, p. 619 paragraph 30 from IAS 28, © Copyright IFRS Foundation. Used by permission © Copyright IFRS Foundation; Extract on p. 628 from IAS 21 The Effects of Changes in Foreign Exchange Rates, © Copyright IFRS Foundation; Extract on p. 633 from IAS 21 The Effects of Changes in Foreign Exchange Rates, paragraph 39, © Copyright IFRS Foundation; Exercise on p. 647 from Institute of Certified Public Accountants (CPA), Professional Stage 1 Corporate Reporting Examination, August 2013; Exercise on p. 710 from Institute of Certified Public Accountants (CPA) Professional Stage 1 Corporate Reporting Examination, April 2014; Extract on p. 796 from Vince Cable, UK Secretary of State for business and industry, in 2012, licensed under the Open Government Licence v.3.0.

PART I

Introduction to accounting on a cash flow and accrual accounting basis

CHAPTER 1

Accounting and reporting on a cash flow basis

1.1 Introduction

Accountants are communicators. Accountancy is the art of communicating financial information about a business entity to users such as shareholders and managers. The communication is generally in the form of financial statements that show in money terms the economic resources under the control of the management. The art lies in selecting the information that is relevant to the user and is reliable.

Shareholders require periodic information that the managers are accounting properly for the resources under their control. This information helps the shareholders to evaluate the performance of the managers. The performance measured by the accountant shows the extent to which the economic resources of the business have grown or diminished during the year.

The shareholders also require information to **predict future performance.** At present companies are not required to publish forecast financial statements on a regular basis and the shareholders use the report of past performance when making their predictions.

Managers require information in order to control the business and make investment decisions.

Objectives

By the end of this chapter, you should be able to:

- explain the extent to which cash flow accounting satisfies the information needs of shareholders and managers;
- prepare a cash budget and operating statement of cash flows;
- explain the characteristics that make cash flow data a reliable and fair representation;
- critically discuss the use of cash flow accounting for predicting future dividends.

1.2 Shareholders

Shareholders are external users. As such, they are unable to obtain access to the same amount of detailed historical information as the managers, e.g. total administration costs are disclosed in the published profit and loss account, but not an analysis to show how the figure is made up. Shareholders are also unable to obtain associated information, e.g. budgeted sales and costs. Even though the shareholders own a company, their entitlement to information is restricted.

The information to which shareholders are entitled is restricted to that specified by statute, e.g. the Companies Acts, or by professional regulation, e.g. Financial Reporting Standards, or by market regulations, e.g. listing requirements. This means that there may be a tension between the **amount** of information that a shareholder would like to receive and the amount that the directors are prepared to provide. For example, shareholders might consider that forecasts of future cash flows would be helpful in predicting future dividends, but the directors might be concerned that such forecasts could help competitors or make directors open to criticism if forecasts are not met. As a result, this information is not disclosed.

There may also be a tension between the **quality** of information that shareholders would like to receive and that which directors are prepared to provide. For example, the shareholders might consider that judgements made by the directors in the valuation of long-term contracts should be fully explained, whereas the directors might prefer not to reveal this information given the high risk of error that often attaches to such estimates. In practice, companies tend to compromise: they do not reveal the judgements to the shareholders, but maintain confidence by relying on the auditor to give a clean audit report.

The financial reports presented to the shareholders are also used by other parties such as lenders and trade creditors, and they have come to be regarded as general-purpose reports. However, it may be difficult or impossible to satisfy the needs of all users. For example, users may have different timescales – shareholders may be interested in the long-term trend of earnings over three years, whereas creditors may be interested in the likelihood of receiving cash within the next three months.

The information needs of the shareholders are regarded as the primary concern. The government perceives shareholders to be important because they provide companies with their economic resources. It is shareholders' needs that take priority in deciding on the nature and detailed content of the general-purpose reports.[1]

1.3 What skills does an accountant require in respect of external reports?

For external reporting purposes the accountant has a twofold obligation:

- an obligation to ensure that the financial statements comply with statutory, professional and listing requirements; this requires the accountant to possess **technical expertise**;
- an obligation to ensure that the financial statements present the substance of the commercial transactions the company has entered into; this requires the accountant to have **commercial awareness**.

1.4 Managers

Managers are internal users. As such, they have access to detailed financial statements showing the current results, the extent to which these vary from the budgeted results and the future budgeted results. Other examples of internal users are sole traders, partners and, in a company context, directors and managers.

There is no statutory restriction on the amount of information that an internal user may receive; the only restriction would be that imposed by the company's own policy. Frequently, companies operate a 'need to know' policy and only the directors see all the financial statements; employees, for example, would be most unlikely to receive information that would assist them in claiming a salary increase – unless, of course, it happened to be a time of

recession, when information would be more freely provided by management as a means of containing claims for an increase.

1.5 What skills does an accountant require in respect of internal reports?

For the internal user, the accountant is able to tailor his or her reports. The accountant is required to produce financial statements that are specifically relevant to the user requesting them.

The accountant needs to be skilled in identifying the information that is needed and conveying its implication and meaning to the user. The user needs to be confident that the accountant understands the user's information needs and will satisfy them in a language that is understandable. The accountant must be a skilled communicator who is able to instil confidence in the user that the information is:

- relevant to the user's needs;
- measured objectively;
- presented within a timescale that permits decisions to be made with appropriate information;
- verifiable, in that it can be confirmed that the report represents the transactions that have taken place;
- reliable, in that it is as free from bias as is possible;
- a complete picture of material items;
- a fair representation of the business transactions and events that have occurred or are being planned.

The accountant is a trained reporter of financial information. Just as for external reporting, the accountant needs commercial awareness. It is important, therefore, that he or she should not operate in isolation.

1.5.1 Accountants' reporting role

The accountant's role is to ensure that the information provided is useful for making decisions. For external users, the accountant achieves this by providing a general-purpose financial statement that complies with statute and is reliable. For internal users, this is done by interfacing with the user and establishing exactly what financial information is relevant to the decision that is to be made.

We now consider the steps required to provide relevant information for internal users.

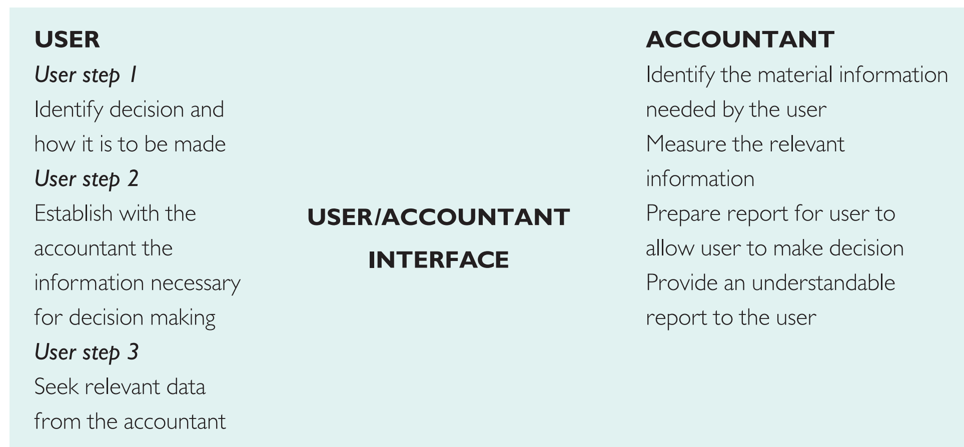
1.6 Procedural steps when reporting to internal users

A number of user steps and accounting action steps can be identified within a financial decision model. These are shown in Figure 1.1.

Note that, although we refer to an accountant/user interface, this is not a single occurrence because the user and accountant interface at each of the user decision steps.

At **step 1,** the accountant attempts to ensure that the decision is based on the appropriate appraisal methodology. However, the accountant is providing a service to a user and, while the accountant may give guidance, the final decision about methodology rests with the user.

Figure 1.1 General financial decision model to illustrate the user/accountant interface



At **step 2,** the accountant needs to establish the information necessary to support the decision that is to be made.

At **step 3,** the accountant needs to ensure that the user **understands** the full impact and financial implications of the accountant's report, taking into account the user's level of understanding and prior knowledge. This may be overlooked by the accountant, who feels that the task has been completed when the written report has been typed.

It is important to remember in following the model that the accountant is attempting to satisfy the information needs of the individual user rather than those of a 'user group'. It is tempting to divide users into groups with apparently common information needs, without recognising that a group contains individual users with different information needs. We return to this later in the chapter, but for the moment we continue by studying a situation where the directors of a company are considering a proposed capital investment project.

Let us assume that there are three companies in the retail industry: Retail A Ltd, Retail B Ltd and Retail C Ltd. The directors of each company are considering the purchase of a warehouse. We could assume initially that, because the companies are operating in the same industry and are faced with the same investment decision, they have identical information needs. However, enquiry might establish that the directors of each company have a completely different attitude to, or perception of, the primary business objective.

For example, it might be established that Retail A Ltd is a large company and under the Fisher–Hirshleifer separation theory the directors seek to maximise profits for the benefit of the equity investors; Retail B Ltd is a medium-sized company in which the directors seek to obtain a satisfactory return for the equity shareholders; and Retail C Ltd is a smaller company in which the directors seek to achieve a satisfactory return for a wider range of stakeholders, including, perhaps, the employees as well as the equity shareholders.

The accountant needs to be aware that these differences may have a significant effect on the information required. Let us consider this diagrammatically in the situation where a capital investment decision is to be made, referring particularly to user step 2: 'Establish with the accountant the information necessary for decision making'.

Figure 1.2 Impact of different user attitudes on the information needed in relation to a capital investment proposal

	USER A Directors of Retail A Ltd	**USER B** Directors of Retail B Ltd	**USER C** Directors of Retail C Ltd
User attitude	PROFIT MAXIMISER for SHAREHOLDERS	PROFIT SATISFICER for SHAREHOLDERS	PROFIT SATISFICER for SHAREHOLDERS/ STAFF
Relevant data to measure	CASH FLOWS	CASH FLOWS	CASH FLOWS
Appraisal method (decided on by user)	IRR	NPV	NPV
Appraisal criterion (decided on by user)	HIGHEST IRR	NPV but only if positive	NPV possibly even if negative

We can see from Figure 1.2 that the accountant has identified that:

- the relevant financial data are the same for each of the users, i.e. cash flows; but
- the appraisal methods selected, i.e. internal rate of return (IRR) and net present value (NPV), are different; and
- the appraisal criteria employed by each user, i.e. higher IRR and NPV, are different.

In practice, the user is likely to use more than one appraisal method, as each has advantages and disadvantages. However, we can see that, even when dealing with a single group of apparently homogeneous users, the accountant has first to identify the information needs of the particular user. Only then is the accountant able to identify the relevant financial data and the appropriate report. It is the user's needs that are predominant.

If the accountant's view of the appropriate appraisal method or criterion differs from the user's view, the accountant might decide to report from both views. This approach affords the opportunity to improve the user's understanding and encourages good practice.

The diagrams can be combined (Figure 1.3) to illustrate the complete process. The user is assumed to be Retail A Ltd, a company that has directors who are profit maximisers.

The accountant is reactive when reporting to an internal user. We observe this characteristic in the Norman example set out in Section 1.8. Because the cash flows are identified as relevant to the user, it is these flows that the accountant will record, measure and appraise.

The accountant can also be proactive, by giving the user advice and guidance in areas where the accountant has specific expertise, such as the appraisal method that is most appropriate to the circumstances.

Figure 1.3 User/accountant interface where the user is a profit maximiser

General model	Specific application for Retail A Ltd		General model	Specific application for Retail A Ltd
USER	**A PROFIT MAXIMISER**		**ACCOUNTANT**	**ACCOUNTANT**
Step 1 Decision to be made	Appraise which project warrants capital investment	**USER/ ACCOUNTANT INTERFACE**	Identify information needed by the user	User decision criterion is IRR
			Measure	Measure the project cash flows
Step 2 Information needed	Project with the highest IRR		Prepare report	Prepare report of highest IRR
Step 3 Seek relevant data	Report of IRR project		Provide report	Submit report of project with highest IRR per £ invested

1.7 Agency costs[2]

The information in Figure 1.2 assumes that the directors have made their investment decision based on the assumed preferences of the shareholders. However, in real life, the directors might also be influenced by how the decision impinges on their own position. If, for example, their remuneration is a fixed salary, they might select not the investment with the highest IRR, but the one that maintains their security of employment. The result might be suboptimal investment and financing decisions based on risk aversion and over-retention. To the extent that the potential cash flows have been reduced, there will be an agency cost to the shareholders. This agency cost is an opportunity cost – the amount that was forgone because the decision making was suboptimal – and, as such, it will not be recorded in the books of account and will not appear in the financial statements.

1.8 Illustration of periodic financial statements prepared under the cash flow concept to disclose realised operating cash flows

In the above example of Retail A, B and C, the investment decision for the acquisition of a warehouse was based on an appraisal of cash flows. This raises the question: 'Why not continue with the cash flow concept and report the financial changes that occur after the investment has been undertaken using that same concept?'

To do this, the company will record the consequent cash flows through a number of subsequent accounting periods; report the cash flows that occur in each financial period; and produce a balance sheet at the end of each of the financial periods. For illustration we follow this procedure in Sections 1.8.1 and 1.8.2 for transactions entered into by Mr S. Norman.

1.8.1 Appraisal of the initial investment decision

Mr Norman is considering whether to start up a retail business by acquiring the lease of a shop for five years at a cost of £80,000.

Our first task has been set out in Figure 1.1 above. It is to establish the information that Mr Norman needs, so that we can decide what data need to be collected and measured. Let us assume that, as a result of a discussion with Mr Norman, it has been ascertained that he is a profit satisficer who is looking to achieve at least a 10% return, which represents the time value of money. This indicates that, as illustrated in Figure 1.2:

- the relevant data to be measured are **cash flows,** represented by the outflow of cash invested in the lease and the inflow of cash represented by the realised operating cash flows;
- the appropriate appraisal method is **NPV**; and
- the appraisal criterion is a **positive NPV** using the discount rate of 10%.

Let us further assume that the cash to be invested in the lease is £80,000 and that the realised operating cash flows over the life of the investment in the shop are as shown in Figure 1.4. This shows that there is a forecast of £30,000 annually for five years and a final receipt of £29,000 in 20X6 when he proposes to cease trading.

We already know that Mr Norman's investment criterion is a positive NPV using a discount factor of 10%. A calculation (Figure 1.5) shows that the investment easily satisfies that criterion.

Figure 1.4 Forecast of realised operating cash flows

	Annually years 20X1–20X5	*Cash in year 20X6 after shop closure*
	£	£
Receipts from		
Customers	400,000	55,000
Payments to		
Suppliers	(342,150)	(20,000)
Expense creditors	(21,600)	(3,000)
Rent	(6,250)	(3,000)
Total payments	(370,000)	(26,000)
Realised operating cash flows	30,000	29,000

Figure 1.5 NPV calculation using discount tables

	£	£
Cost of lease		(80,000)
£30,000 annually for 5 years (30,000 × 3.79)	113,700	
£29,000 received in year 6 (29,000 × 0.564)	16,356	
		130,056
Positive net present value		50,056