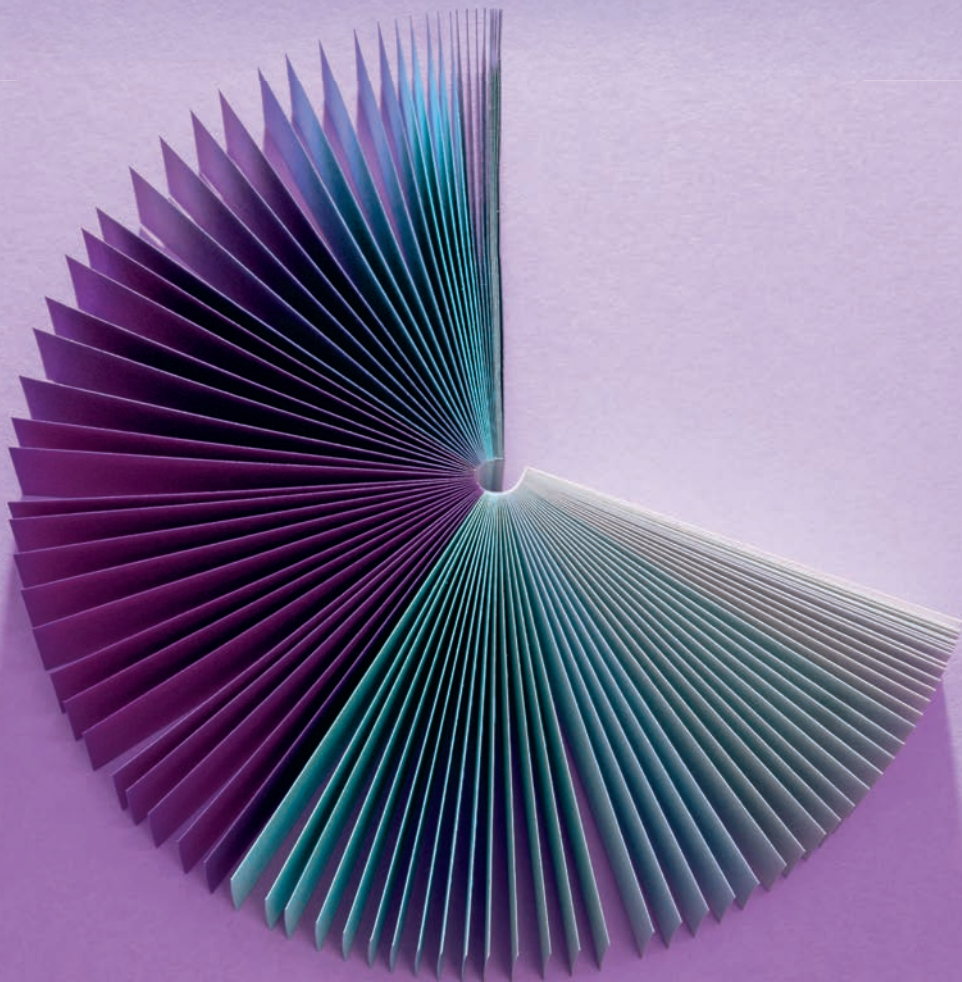


# Financial Accounting

## An introduction

Pauline Weetman



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EIGHTH EDITION

# FINANCIAL ACCOUNTING

## AN INTRODUCTION

PAULINE WEETMAN

Professor of Accounting, University of Edinburgh



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# PREFACE TO THE EIGHTH EDITION

## Introduction

This book uses the international *Conceptual Framework* (as revised in 2018) and International Financial Reporting Standards (IFRS) as its primary focus. It enables students in their early stages of study to understand and analyse the published annual reports and financial statements of our largest businesses and public sector institutions. IFRS are now applied in many aspects of government, local authority and other public sector accounting. Where relevant it also refers to the approach used in small and medium-sized businesses where the traditions of UK GAAP continue to be applied.

The book is written for the first level of undergraduate degree study in accounting and business studies, or equivalent introductory accounting courses for any professional training where an understanding of accounting is a basic requirement. While UK listed companies apply IFRS in their published financial statements, the remainder of the annual report is governed by UK-based regulations and codes. All UK companies operate under the Companies Act 2006. Their annual reports are influenced by the regulatory process applied to listed companies in the UK. This eighth edition is thoroughly revised to reflect these regulatory changes, particularly the restructuring of the Financial Reporting Council to take responsibility for the standards previously issued by the UK Accounting Standards Board, and the introduction of the strategic report.

All 'Real World' case studies at the start of each chapter have been updated to reflect current conditions. The underlying pedagogy of previous editions has been retained in response to encouraging comments from reviewers and from users of the book.

As academic institutions come under increasing scrutiny for the quality of the teaching and learning experience offered, a textbook must do more than present the knowledge and skills of the chosen subject. It must make explicit to the students what targets are to be achieved and it must help them to assess realistically their own achievements of those targets. It must help the class lecturer prepare, deliver, explain and assess the knowledge and skills expected for the relevant level of study. This is achieved by stating learning outcomes at the start of each chapter and by ensuring that the chapter headings and the end-of-chapter questions address the stated outcomes.

An accompanying website at [www.pearsoned.co.uk/weetman](http://www.pearsoned.co.uk/weetman) provides the lecturer with a complete resource pack for each chapter. Student handouts containing a skeleton outline of each chapter, leaving slots for students to complete; powerpoints that match the lecture handouts; additional multiple-choice questions and further graded questions in application of knowledge and in problem solving; all are features for this eighth edition.

End-of-chapter questions are graded according to the skills being assessed. There are tests of retained knowledge, tests of application of knowledge in straightforward situations and tests of problem solving and evaluation using the acquired knowledge in less familiar situations.

Overall the aim of the eighth edition is to provide an introduction to financial accounting which engages the interest of students and encourages a desire for further study. It also contributes to developing the generic skills of application, problem solving, evaluation and communication, all emphasised by employers.

The eighth edition has been updated throughout. It aims to provide a full understanding of the key aspects of the annual report, concentrating in particular on companies in the private sector but presenting principles of wider application which are relevant also to organisations operating in the public sector.

## Distinctive approach

*An international perspective* reflects the convergence in accounting standards across the European Union for listed companies. *Features specific to the UK* are retained where these continue to be relevant to other enterprises.

*Concepts* of financial accounting are identified by applying the principles enunciated by the International Accounting Standards Board in its *Conceptual Framework*. The *Conceptual Framework* emphasises the desirability of meeting the needs of users of financial statements and it takes a balance sheet-oriented approach. That approach is applied consistently throughout the book, with some indication of the problems which may arise when it is clear that the established emphasis on the matching of revenues and costs may give a more rational explanation of existing practice.

*User needs* are explained in every chapter and illustrated by including first-person commentary from a professional fund manager, holding a conversation with an audit manager. The conversations are based on the author's research in the area of communication through the annual report.

The *accounting equation* is used throughout the financial accounting section for analysis and processing of transactions. It is possible for students who do not seek a technical specialism to complete the text without any reference to debit and credit bookkeeping. It is, however, recognised that particular groups of students may wish to understand the basic aspects of debit and credit bookkeeping and for this purpose the end-of-chapter supplements revisit, on a debit and credit recording basis, material already explored in the chapter. Debit and credit aspects of management accounting are not covered since these are regarded as best reserved for later specialist courses if the student so chooses.

*Practical illustration* is achieved by drawing on the financial information of a fictitious major listed company, taking an overview in early chapters and then developing the detailed disclosures as more specific matters are explored.

*Interpretation* of financial statements is a feature of all financial reporting chapters, formally brought together in Chapters 13 and 14. The importance of the wider range of corporate communication is reinforced in Chapter 14. This chapter also includes a discussion of some *current developments* that are under debate in the context of international convergence.

A *running case study example* of the fictitious company Safe and Sure plc provides illustration and interpretation throughout the chapters. Safe and Sure plc is in the service sector. The Instructor's Manual contains a parallel example, Craigielaw plc, in the manufacturing sector. In the Instructor's Manual there are questions on Craigielaw to accompany most of the chapters.

*Self-evaluation* is encouraged by setting learning outcomes at the start of each chapter and reviewing these in the chapter summaries. Activity prompts are placed at the ends of the main sections of each chapter. The activities are designed to develop student learning by: recognising assumptions; evaluating arguments; and drawing conclusions through expressing an opinion. Self-testing questions at the end of each of the main sections of the chapter may be answered by referring again to the text. Further end-of-chapter questions provide a range of practical applications. Group activities are suggested at the

end of each chapter with the particular aim of encouraging participation and interaction. Answers are available to all computational questions, either at the end of the book or in the Instructor's Manual.

A *sense of achievement* is engendered in the reader of the financial accounting section by providing a general understanding of the entire annual report by the end of Chapter 7. Thereafter specific aspects of the annual report are explored in Chapters 8–12. Lecturers who wish to truncate a first-level course or leave specific aspects to a later level will find Chapters 8–12 may be used on a selective basis.

A *spreadsheet* approach to financial accounting transactions is used in the body of the relevant chapters to show processing of transactions using the accounting equation. The author is firmly convinced, after years of trying every conceivable approach, that the spreadsheet encourages students to apply the accounting equation analytically, rather than trying to memorise T-account entries. Furthermore students now use spreadsheets as a tool of analysis on a regular basis and will have little difficulty in applying suitable software in preparing spreadsheets. In the bookkeeping supplementary sections, the three-column ledger account has been adopted in the knowledge that school teaching is moving increasingly to adopt this approach which cuts out much of the bewilderment of balancing T-accounts. Computerised accounting systems also favour the three-column presentation with continuous updating of the balance.

## Flexible course design

This text is written for a course comprising one semester of 12 weeks but may need selective guidance to students for a module of lesser duration.

Chapters 1–4 provide an essential conceptual framework which sets the scene. For a general appreciation course, Chapters 5 and 6 are practical so that one or both could be omitted, leading directly to Chapter 7 as a guide to published accounts. Chapters 8–12 are structured so that the explanation of principles is contained early in each chapter, but the practical implementation is later in each chapter. For a general appreciation course, it would be particularly important to refer to the section of each chapter which analyses users' needs for information and discusses information provided in the financial statements. However, the practical sections of these chapters could be omitted or used on a selective basis rather than attempting full coverage. Chapters 13 and 14 are important to all readers for a sense of interpretation and awareness of the range of material within corporate reports. Chapter 15 takes the reader through a cash flow statement item-by-item with the emphasis on understanding and interpretation.

## Approaches to teaching and learning

### Learning outcomes

Targets for student achievement in relation to knowledge and understanding of the subject are specified in learning outcomes at the head of each chapter. The achievements represented by these learning outcomes are confirmed against graded questions at the end of each chapter. The achievement of some learning outcomes may be confirmed by Activities set out at the appropriate stage within the chapter. Activities encourage students to: recognise assumptions; evaluate arguments; and draw conclusions by expressing an opinion.



### **Skills outcomes**

Questions test not only subject-specific knowledge and technical skills but also the broader general skills that are transferable to subsequent employment or further training.

### **Graded questions**

Questions are graded and each is matched to one or more learning outcomes. Where a solution is provided to a question this is shown by an **[S]** after the question number.

### **A series questions: self-test**

The A series questions, placed at the end of the section to which they relate, confirm essential understanding and the application of technical skills. These are skills specific to the subject of accounting which add to the specialist expertise of the student. More generally they show the student's capacity to acquire and apply a technical skill of this type.

The answers to these questions can be found in the relevant sections of the chapter, in which the questions are located.

### **B series questions: application**

The B series questions apply the knowledge gained from reading and practising the material of the chapter. They resemble closely in style and content the technical material of the chapter. Confidence is gained in applying knowledge in a situation that is very similar to that illustrated. Answers are given in Appendix II or in the Instructor's Manual. These questions test skills of problem solving and evaluation that are relevant to many subjects and many activities in life, especially in subsequent employment. Some initiative is required in deciding how to apply relevant knowledge and in solving problems.

### **C series questions: problem solving and evaluation**

The C series questions apply the knowledge gained from reading the chapter, but in a varied style of question. Problem-solving skills are required in selecting relevant data or in using knowledge to work out what further effort is needed to solve the problem. Evaluation means giving an opinion or explanation of the results of the problem-solving exercise. Some answers are given in Appendix II but others are in the Instructor's Manual so that they can be used in tutorial preparation or class work.

### **Group and individual cases**

Cases apply knowledge gained from the chapter but they also test communication skills. Communication may involve writing or speaking, or both. It may require, for example, explanation of a technical matter to a non-technical person, or discussion with other students to explore and form an opinion on a controversial issue, or presentation of a report to a business audience.

### **S series questions in supplementary sections**

The S series questions test knowledge of the accounting records system (bookkeeping entries) to confirm understanding by those who have chosen to study the supplementary bookkeeping sections.

### **Instructor's Manual**

These resources are available at [www.pearsoned.co.uk/weetman](http://www.pearsoned.co.uk/weetman) by password access to lecturers adopting this book. The Instructor's Manual contains additional problem questions for each chapter, with full solutions to these additional questions as well as

any solutions not provided in the book. The Instructor's Manual also includes basic tutorial instructions and notes that can be used for class presentation to support each chapter.

### *Target readership*

This book is targeted at a broad-ranging business studies type of first-level degree course. It is intended to support the equivalent of one semester of 12 teaching weeks. There is sufficient basic bookkeeping (ledger accounts) in the end-of-chapter supplements to make the book suitable for those intending to pursue a specialised study of accounting beyond the first level but the bookkeeping material is optional for those who do not have such special intentions. The book has been written with undergraduate students particularly in mind, but may also be suitable for professional and postgraduate business courses where financial reporting is taught at an introductory level.

### *Acknowledgements*

I am grateful to academic colleagues and to reviewers of the text for helpful comments and suggestions. I am also grateful to undergraduate students of five universities who have taken my courses and thereby helped in developing an approach to teaching and learning the subject. Professor Graham Peirson and Mr Alan Ramsay of Monash University provided a first draft of their text based on the conceptual framework in Australia which gave valuable assistance in designing the structure of this book, which was also guided from the publishing side by Pat Bond and Ron Harper. Professor Ken Shackleton of the University of Glasgow helped plan the structure of the management accounting chapters. The Institute of Chartered Accountants of Scotland gave permission for use of some of the end-of-chapter questions.

Subsequently I have received valuable support in successive editions from the editorial staff at Pearson Education. For this latest edition I am grateful to colleagues and students who have used the book in their teaching and learning. I have also been helped by constructive comments from reviewers and by guidance from Rebecca Pedley, formerly Acquisitions Editor, as well as Richard Townrow, Senior Portfolio Manager, and Anita Atkinson, Senior Content Producer.

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## Text

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# **FINANCIAL ACCOUNTING**





# PART 1

## A conceptual framework: setting the scene

- 1 Who needs accounting?
- 2 A systematic approach to financial reporting:  
the accounting equation
- 3 Financial statements from the accounting equation
- 4 Ensuring the quality of financial statements

# CHAPTER 1

## Who needs accounting?

### Real World Case

#### Oxfam: meeting users' needs

##### Extracts from Annual Report and Accounts

##### Purpose and charitable objects

Oxfam Great Britain's purpose is to help create lasting solutions to the injustice of poverty.

As stated in its Memorandum of Association, the objects for which Oxfam is established for the public benefit are:

- to prevent and relieve poverty and to protect vulnerable people, including through humanitarian intervention;
- to advance sustainable development;
- to promote human rights, equality and diversity, in particular where to do so contributes to the prevention and relief of poverty;
- in all cases working anywhere in the world.

##### Highlights (page 10)

11.6 million people reached directly in 51 countries

Nearly 9 million people supported in 31 humanitarian emergencies

1,168 grants to 737 partner organisations

450,000 people in the UK made a regular donation

##### How do we judge the impact of our work?

Oxfam is committed to ensuring that, in all that we do, we are accountable to those with whom we work, from our programme partners, communities and donors to other stakeholders such as our staff, volunteers, or those that we campaign through and with. We use several tools to monitor, evaluate, assess and learn from our stakeholders, including:

- reporting data on the numbers of people and communities reached by our programmes
- completing review exercises to understand – and speak about – our outcome achievements as well as our challenges, and how we deal with them



Penny Tweedie/Alamy Stock Photo

- undertaking evaluations to assess our overall strategies, test the core assumptions about how we contribute to social change, and assess our effectiveness in different contexts
- consulting with key stakeholders to gather their insights and assessments about our overall efforts.

Our success in achieving this commitment to accountability is measured annually through our membership of, and compliance with, the International NGO Accountability Charter and International Aid Transparency Initiative. More detail on our accountability objectives and achievements is set out on page 29.

### Accounting conventions (page 38)

Oxfam is a public benefit entity. The financial statements are prepared in compliance with the Companies Act 2006, the Charities Act 2011, the Charities Statement of Recommended Practice (FRS 102), the Charities Accounts (Scotland) Regulations 2006 and Charities and Trustee Investment (Scotland) Act 2005, and FRS 102, the Financial Reporting Standard applicable in the UK and Republic of Ireland.

Source: Oxfam, Annual report and accounts, 2015/16, pp. 9, 10, 12, 38, 50. <http://www.oxfamannualreview.org.uk/>

### Discussion points

- 1 Who might be included in the stakeholders to whom Oxfam is accountable?
- 2 To what extent do the 'Highlights' meet the information needs of users of the annual report?

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## Learning outcomes

After studying this chapter you should be able to:

- Define, and explain the definition of, accounting.
- Explain what is meant by a *conceptual framework*.
- Explain the distinguishing features of a sole trader, a partnership and a limited company.
- List the main users of financial information and their particular needs.
- Discuss the usefulness of financial statements to the main users.

Additionally, for those who choose to study the supplement:

- Define the basic terminology of business transactions.

## 1.1 Introduction

There is no single ‘official’ definition of accounting, but for the purposes of this text the following wording will be used:

### Definition

**Accounting** is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.<sup>1</sup>

This definition may appear short, but it has been widely quoted over a number of years and is sufficient to specify the entire contents of this introductory textbook.

Taking the definition word by word, it leads to the following questions:

- 1 What is the process?
- 2 How is financial information identified?
- 3 How is financial information measured?
- 4 How is financial information communicated?
- 5 What is an entity?
- 6 Who are the users of financial information about an entity?
- 7 What types of judgements and decisions do these users make?

Writing the questions in this order is slightly dangerous because it starts by emphasising the process and waits until the final question to ask about the use of the information. The danger is that accountants may design the process first and then hope to show that it is suitable to allow judgements and decisions by users. This is what has often happened over many years of developing the process by accountants.

In order to learn about, and understand, **accounting** by taking a critical approach to the usefulness of the current processes and seeing its limitations and the potential for improvement, it is preferable to reverse the order of the questions and start by specifying the users of **financial information** and the judgements and decisions they make. Once the users and their needs have been identified, the most effective forms of communication may be determined and only then may the technical details of measurement and identification be dealt with in a satisfactory manner.

Reversing the order of the questions arising from the definition of accounting is the approach used in this book, because it is the one which has been taken by those seeking to develop a **conceptual framework** of accounting.

This chapter outlines in particular the *Conceptual Framework* of the International Accounting Standards Board which has been developed for international use in accounting practice. The chapter explains the nature of three common types of **business entity** and concludes by drawing on various views relating to the users of accounting information and their information needs.

Because the understanding of users' needs is essential throughout the entire text, the chapter introduces David Wilson, a **fund manager** working for a large insurance company. In order to balance the demands of users with the restrictions and constraints on preparers of financial information, the chapter also introduces Leona Rees who is a member of the **accountancy profession** and who works as an **audit manager** with an **accountancy firm**. Both of them will offer comments and explanations as you progress through the text.

### Activity 1.1

The definition set out at the start of this section assumes that we are able to identify the users of accounting information. The Real World Case at the start of the chapter refers to 'stakeholders' rather than 'users'. Choose any three of those stakeholders and say what you could assume about the judgements and decisions each one might make.

### Self test

**A1.1** Define 'accounting'.

**A1.2** Identify the separate questions raised by the definition.

**A1.3** The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- accountancy firm
- accountancy profession
- accounting
- audit manager
- business entity
- conceptual framework
- financial information
- fund manager.

## 1.2 The development of a conceptual framework

A **conceptual framework** for accounting is a statement of principles which provides generally accepted guidance for the development of new reporting practices and for challenging and evaluating the existing practices. Conceptual frameworks have been developed in several countries around the world. The structure of most conceptual frameworks is along the following lines:

- Who are the users of **financial statements**?
- What are the information needs of users?
- What types of financial statements will best satisfy their needs?
- What are the characteristics of financial statements which meet these needs?
- What are the principles for defining and recognising items in financial statements?
- What are the principles for measuring items in financial statements?

The most widely applicable conceptual framework originated as the *Framework for the Preparation and Presentation of Financial Statements* issued by the International

Accounting Standards Board (IASB) in 1989. In 2010 the *Framework* was partially updated. The new *Conceptual Framework* was completed in 2018, after some challenging accounting issues had been addressed. The thinking about concepts can be traced to two discussion papers of the 1970s in the UK and the USA. In the UK, *The Corporate Report*<sup>2</sup> was a slim but highly influential document setting out the needs of users and how these might be met. Two years earlier the *Trueblood Report*<sup>3</sup> in the USA had taken a similar approach of identifying the needs of users, although perhaps coming out more strongly in support of the needs of shareholders and creditors than of other user groups. In the UK, various documents on the needs of users have been prepared by individuals invited to help the process<sup>4</sup> or those who took it on themselves to propose radical new ideas.<sup>5</sup>

Since January 2005, all **listed companies** in member states of the European Union (EU) have been required by an accounting regulation called the IAS Regulation<sup>6</sup> to use a system of international **financial reporting standards** set by the International Accounting Standards Board. The UK standard-setter was influential in the development of these international reporting standards and, over a period of years, has been moving UK accounting practice closely into line with the international standards. For **unlisted companies** and other organisations not covered by the IAS Regulation of the EU, the UK Financial Reporting Council (FRC) has a conceptual framework of its own, called the *Statement of Principles*.<sup>7</sup> This document has many similarities to the IASB's *Conceptual Framework*.

### Activity 1.2

Most conceptual frameworks start with the question: Who are the users of financial statements? The frameworks then assume that we know the information needs of those users. Assume you are the owner of five restaurants located in different parts of the same city. Write down three items of accounting information that you would want to know about your business in order to help you make judgements and decisions.

### Self test

**A1.4** The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- business entity
- conceptual framework
- financial reporting standards
- financial statements
- listed companies
- unlisted companies.

## 1.3 The Conceptual Framework for Financial Reporting

The *Conceptual Framework* issued in 2018 has been in the process of gradual revision over several years, as a joint project of the IASB and the Financial Accounting Standards Board (FASB) of the USA. Progress was delayed by the financial crisis of 2007–08 and eventually the IASB decided to complete the project alone. The chapter topics are:

- 1 The objective of general purpose financial reporting.
- 2 Qualitative characteristics of useful financial information.
- 3 Financial statements and the reporting entity.
- 4 The elements of financial statements.
- 5 Recognition and derecognition.

- 6 Measurement.
- 7 Presentation and disclosure.
- 8 Concepts of capital and capital maintenance.

Chapters 1 and 2 of the *Conceptual Framework* are written at a general level and a reader would find no difficulty in reviewing these at an early stage of study, to gain a flavour of what is expected of financial statements. The remaining sections are a mixture of general principles, which are appropriate to first-level study of the subject, and some quite specific principles which deal with more advanced problems. Some of those problems need an understanding of accounting which is beyond a first level of study. This book will refer to aspects of the various sections of the *Conceptual Framework*, as appropriate, when particular issues are dealt with. You should be aware, however, that this book concentrates on the basic aspects of the *Conceptual Framework* and does not explore every complexity.

A conceptual framework is particularly important when practices are being developed for reporting to those who are not part of the day-to-day running of the business. This is called **external reporting** or **financial accounting** and is the focus of the *Financial Accounting* studied in this book. For those who are managing the business on a day-to-day basis, special techniques have been developed and are referred to generally as **internal reporting** or **management accounting**.

Before continuing with the theme of the conceptual framework, it is useful to pause and consider the types of business for which accounting information may be required.

### Activity 1.3

“Accounting standards aim to portray economic reality, rather than shape it.” This statement appears in a document entitled ‘Working in the public interest’. The definition of accounting in section 1.1 refers to ‘informed judgements and decisions’. Is there an argument for saying that accounting standards should aim towards shaping economic reality?

<http://archive.ifrs.org/About-us/Documents/Working-in-the-Public-Interest.pdf>

### Self test

**A1.5** The following technical terms are used in this section. Check that you understand the meaning of each (if you need help, use the glossary at the end of the book).

- external reporting
- financial accounting
- internal reporting
- management accounting.

## 1.4 Types of business entity

The word **entity** means ‘something that exists independently’. A business entity is a business that exists independently of those who own the business. The owner provides an amount of finance to enable the business to acquire assets and sustain its operations. This is called the owner’s **capital**. There are three main categories of business which will be found in all countries, although with different titles in different ones. This chapter uses the terminology common to the UK. The three main categories are: **sole trader**, **partnership** and **limited liability company**. This list is by no means exhaustive but provides sufficient variety to allow explanation of the usefulness of most accounting practices and their application.