

LEARNING MADE EASY



2nd UK Edition

Financial Accounting

for
dummies[®]
A Wiley Brand



Tackle accounting
concepts

—
Understand
financial statements

—
Start a career in
financial accounting

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Financial Accounting

2nd UK Edition

by Steve Collings and Maire Loughran

for
dummies[®]
A Wiley Brand

Financial Accounting For Dummies®, 2nd UK Edition

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Introduction

Accountancy is known as the language of business because it communicates financial and economic facts about a business to all sorts of interested parties – both *internal* (employees of the company) and *external* (people not employed by the company in question). External users include investors, creditors, banks and regulatory agencies such as HM Revenue and Customs and the stock markets.

Focusing on the external users of accounting information, this book is about financial accounting. *Financial* accounting serves the needs of external users by providing them with understandable, materially correct financial statements. Three financial statements, which this book is concerned with are; the income statement (often termed the *profit and loss account* in the UK), balance sheet (or the *statement of financial position*) and the cash flow statement (or the *statement of cash flows*). This book is a step-by-step guide on how to prepare and interpret all three.

You also find out the purposes of the financial statements:

- » To report on the financial position of the company – what types of assets the company owns and what types of liabilities it owes.
- » To show how well the company performs over a period of time, which is referred to as an *accounting period*. You measure performance by seeing whether the company made or lost money during the accounting period.

A lot of people considering starting out in the world of accountancy are often afraid they won't do well in their accountancy studies because they haven't done well in maths. Forget about the maths (I was rubbish at maths at school!) – that's why you have a calculator! Financial accounting is less about adding and subtracting and more about using logic-based and analytical skills. Added to the mix is the importance of gaining a working understanding of the standards set in place by regulators and professional accountancy bodies.

The reason I've written this book is to breathe some life into the subject of financial accounting and make it more understandable to students, trainee accountants and those seeking a career change into the world of accountancy. If you run your own business, this book is equally as relevant to you as you'll no doubt sometimes need to make important decisions about the future direction of your business based on the numbers you see in your accounts.

About This Book

This book, like all *For Dummies* books, is written so that each chapter stands on its own. I always assume that whatever chapter you're reading is the first one you've tackled in the book. Therefore, you can understand the concepts I explain in each chapter regardless of whether it's your first chapter or your last.

However, certain terms and concepts are relevant to more than one subject in this book. To avoid writing the same explanations over and over, whenever I refer to a financial accounting term, method or other type of fact that I fully explain in another chapter, I give you a brief overview and direct you to the chapter where you can get more information. For example, I may suggest that you 'flick to Chapter 11' (which, by the way, discusses the statement of cash flows).

Also, in this book I break financial accounting down to its lowest common denominator. I avoid using jargon that only accountants with several years' experience already under their belts will understand. Please keep in mind that the list of financial accounting topics and methods I present in this book isn't exhaustive. I simply can't cover every possible transaction and event related to preparing financial accounting data and statements. This book is meant to give a basic introduction to the world of financial accounting in a down-to-earth, easy-to-understand and light-hearted manner.

Keep in mind that references to company names in this book are entirely fictional and the names are made up by me. If there does happen to be a real-life company with the same name as one in this book, the example bears no relation to that real-life business.

Foolish Assumptions

I assume you don't have more than a basic understanding of accountancy, and I'm guessing you're one of the following people:

- » A financial accounting student who just isn't getting it by reading (and rereading) the relevant textbook.
- » A non-accountancy student currently enrolled in either business or another course who's considering changing direction to go down the accountancy route.
- » A business owner (particularly someone operating a small business with a relatively small/modest turnover) who wants to attempt preparing their

own financial statements or just wants to have a better understanding of the financial statements prepared by the in-house or external accountant.

- » A brand-new accountant working in financial accounting who needs a plain-English refresher of accountancy concepts.

Icons Used in This Book

Throughout the book, you see the following icons in the left-hand margin:



TIP

Text accompanied by this icon contains useful hints that you can apply during your studies (or on the job) to make your studies (or work) a bit easier and more successful.



REMEMBER

When you see this icon, get those brain cells in gear, because it sits next to information you want to commit to memory.



WARNING

Looking for what not to do in the world of financial accounting? Check out the paragraphs next to this icon because they alert you to what can trip you up during your studies or while working in the field.



TECHNICAL
STUFF

This icon includes information that enhances the topic under discussion but isn't necessary to understand the topic.



EXAMPLE

This icon shows you that a financial accounting concept is demonstrated by working through an example.

Beyond the Book

In addition to the abundance of information and guidance related to financial accounting provided in this book, you get access to even more help and information online at Dummies.com. Check out this book's online Cheat Sheet. Just go to www.dummies.com and search for "Accounting For Dummies UK Edition Cheat Sheet".

Where to Go from Here

Each chapter stands on its own, so no matter where you start, you won't feel like you've missed anything fundamental beforehand. Your motivation for purchasing this book will probably dictate which chapters you want to read first and which you'll read only if you have some spare time in the future.

If you're an accountancy student, flip to the chapter explaining a topic you're a little confused with after reading your textbook. Business owners can get a good overview of the financial accounting process by starting with Chapters 1 and 3; these two chapters explain the nuts and bolts of financial accounting and its concepts. Otherwise, check out the table of contents or index for a topic that interests you, or jump in anywhere in the book that covers the financial accounting information you're wondering about.

1

Getting Started with Financial Accounting

IN THIS PART . . .

Come to grips with the qualitative characteristics of financial accounting.

Kickstart a career in financial accounting.

Understand the three key financial statements and what they tell us about a business.

Discover who is responsible for setting the standards that businesses must follow when preparing financial statements.

IN THIS CHAPTER

- » Knowing why financial accounting matters
- » Meeting the stakeholders
- » Exploring the most important principles in financial reporting
- » Introducing key accounting characteristics
- » Understanding the limitations of financial accounting
- » Accepting ethical responsibilities

Chapter **1**

Looking at the Bigger Picture of Financial Accounting

I assume that you have a very good reason for buying this book; most people don't randomly buy a title like *Financial Accounting For Dummies*. The chances are you're embarking on your first accountancy course and want to be sure you do well in it. However, it may be the case that you're a business owner wanting to get a better grip on the way your financial statements are prepared or to improve your bookkeeping. Whatever your reasons, this chapter is your key to the car to start the journey on the road of financial accounting.

I explain what financial accounting is and why it's so important to many different individuals and businesses. I identify the various users of financial information and explain why they need that info. Finally, I briefly introduce two all-important characteristics of financial information: fundamental qualitative characteristics

and enhancing qualitative characteristics. Whether you're a financial accounting student or a business owner, you need to understand these crucial financial accounting terms as they underpin everything to do with financial statements right from the word 'go'.

Knowing the Objective of Financial Accounting

Broadly speaking, *accounting* is the process of organising facts and figures and communicating the results of that organisation to any parties interested in that information. This process doesn't just relate to numbers churned out by a computer software program; it pertains to any type of reconciliation.

Here's an example that a parent can possibly relate to that doesn't involve numbers or money: a teenager sneaks in after a curfew set by their parents, and their parents ask for a complete account of why they're late. When the teenager tells them the facts, we have information (their car broke down in an area with no mobile phone signal), the individual producing the information (the mischievous teenager) and the interested party, also known as the user of the information (the worried parents).



REMEMBER

The subject of this book, financial accounting, is a subset of accountancy. *Financial accounting* involves the process of preparing financial statements for a business. (Not sure what financial statements are? No worries – you find an overview of them in the next section.) Here are the key pieces of the financial accounting jigsaw:

- » **Information:** Any accounting transactions taking place within the business during the accounting period. These include generating revenue from the sale of goods or rendering of services, paying business-related expenses, buying company assets and incurring debt to run the company.
- » **Business entity:** The company incurring the accounting transactions.
- » **Users:** The third parties that need to see the accounting transactions organised into financial statements to make informed decisions of their own. (You can find more about these users in the 'Getting to Know the Users of Financial Statements' section of this chapter.)

Preparing financial statements

If you're starting an accountancy course, your entire course can well centre on the proper preparation of financial statements: the income statement (profit and loss account), balance sheet (statement of financial position), cash flow statement (statement of cash flows) and statement of changes in equity. Financial accountants can't just stick accounting transaction information in the financial statements wherever they feel like. Many rules and regulations exist that dictate how financial accountants must organise the information in the financial statements; these rules are called *generally accepted accounting practice* (GAAP), and I discuss them in Chapter 4. The rules pertain to both how the financial accountant shows the accounting transactions and in which financial statements the information relating to the transactions appears.



REMEMBER

Curious about the purpose of each financial statement? Here's a run through of each one:

» **Income statement (or profit and loss account):** This financial statement shows the results of business operations consisting of revenue, expenses, gains and losses. The end result is net profit or net loss. I talk about the income statement again in Chapter 3, and then I cover it from start to finish in Chapter 10. For now, here are the basic facts on the four different income statement components:

- *Revenue:* Sales earned by the company from selling its goods or services.
- *Expenses:* The costs a company incurs in earning its revenue.
- *Gains:* Income from non-operating-related transactions, such as selling a company asset.
- *Losses:* The flip side of gains, such as losing money when selling a company car.



REMEMBER

A lot of accountants call the income statement a *profit and loss account* or simply a *P&L* (as it's commonly known in the UK). These terms are fine to use because they address the spirit of the statement.

» **Balance sheet:** This statement has three sections: assets, liabilities and equity. Standing on their own, these sections contain valuable information about a company. However, a user has to see all three interacting together on the balance sheet to form a reasonably reliable opinion of the company.

Part 3 of this book is all about the balance sheet, but for now, here are the basics about each balance sheet component:

- *Assets:* Resources owned by a company, such as buildings, equipment and cash.

- **Liabilities:** Debt the business incurs for operating and expansion purposes.
- **Equity:** The amount of ownership left in the business after deducting total liabilities from total assets.

» **Statement of cash flows:** This statement contains certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show cash sources and uses during a specific period of time – in other words, how a company brings in cash and for what costs the cash goes back out the door. This statement is often referred to as the *cash flow statement* in the UK.

» **Statement of changes in equity:** This statement shows any movements in the equity accounts of the balance sheet – such as share capital, share premium, revaluation reserve account and retained earnings. So if a company issues additional share capital, the additional capital it has issued during the accounting period is presented within the statement of changes in equity.

Showing historic performance

The information reflected in the financial statements allows its users to make reasoned decisions about the business, for example, whether or not they want to invest in it. But the users cannot make informed decisions based solely on one set of financial statements. Here's why:

- » The income statement is finite in what it reflects. For example, it may report net profit for the 12-month period ended 31 March 2026. This means any accounting transactions taking place prior to or after this 12-month window are not included.
- » The statement of cash flows is also finite in nature, showing cash ins and outs only for the reporting period.
- » The balance sheet only shows a snapshot of the state of a company's affairs *as at* the close of play on the last working day of the accounting period.



REMEMBER

Savvy financial statement users are interested in trends and performance over time and know that they need to compare several years' worth of financial statements to get a true sense of business performance. Users employ tools such as ratios and measurements involving financial statement data (a topic I cover in Chapter 14) to evaluate the relative merit of one company over another by analysing each company's historic performance.

Pulling information together for the annual accounts

After all the rigmarole of preparing the financial statements, many companies including *publicly traded companies* (those whose shares are bought and sold in the open market) employ independent professionally-qualified accountants to audit the financial statements for their inclusion in the annual report to the shareholders. The main thrust of a company's annual report is not only to provide financial reporting but also to promote the company and satisfy any regulatory requirements.

The preparation of an annual report is a fairly detailed subject, and if you're a student accountant, you probably won't be expected to prepare a full annual report for your course but may need to know what goes in one. I provide a more in-depth look at annual reports in Chapter 16.

Getting to Know the Users of Financial Statements

Well, who are these inquisitive financial statement users I've been referring to so far in this chapter? If you've ever purchased some shares in a company or invested money in a pension plan, you are one of these users. In this section, I explain why certain groups of people and businesses need access to reliable financial statements.

Identifying the most likely users

Financial statement users fall into three categories:

- » Existing or potential investors in the company's shares.
- » Individuals or businesses thinking about extending credit terms to the company. Examples of creditors include banks, finance companies and the suppliers from which a company purchases its stock (sometimes called *inventory*) or office supplies.
- » Governmental agencies, such as HM Revenue and Customs, that want to make sure the company is paying the right amount of corporation tax on its profits.

Understanding users' needs



REMEMBER

All three categories of financial statement users share a common need: they require assurance that the information they're looking at is both materially correct and useful. *Materially correct* means the financial statements don't contain any serious or substantial misstatements. In order to be useful, the information has to be understandable to anyone not privy to the day-to-day activities of the company.

Investors and creditors, though sitting at different ends of the table, have something else in common: they're looking for a financial return in exchange for allowing the business to use their cash. Governmental agencies, on the other hand, don't have a profit motive for reviewing the financial statements; they just want to make sure the company is abiding by tax legislation, regulations or generally accepted accounting practice.

Providing information for decision making



REMEMBER

The legal responsibility for ensuring a company's financial statements are materially correct rests with the directors or management. Even if the business engages the services of an external professional accountant to prepare the year-end financial statements, that legal responsibility does not pass to the accountant. However, the professional accountant is bound by strict ethical rules which require a high standard of work be carried out. I look at some of these rules in the section 'Considering Your Ethical Responsibilities', later in this chapter.

Two of the three groups of financial statement users are making decisions based on those financial statements: investors and creditors. Creditors look to the financial statements to make sure the business has the cash flow and potential future earnings to pay back both principal (sometimes called *capital*) and interest according to the terms of the loan. Suppliers (another form of creditor) are looking to ensure the business is financially stable enough to pay off invoices as they fall due.

Investors fall into two groups:

» **Those looking for growth:** These investors want the value of their shares in a company to increase over time. Here's an example of growth at work: you do some research on a fairly unknown company that's poised to introduce a ground-breaking new computer into the market. You have £1,000 sitting in a bank account that pays no interest. You believe, based on your research, that if you purchase some shares in this company now, you'll be able to sell the shares for £2,000 shortly after the company releases the new computer.

» **Those looking for income:** These investors are satisfied with a steady share price that weathers ebbs and flows in the market. The share price neither increases nor decreases in value per share by an enormous amount, but it pays a consistent, reasonable dividend. (Keep in mind that reasonableness varies for each person and their investment income goals as well as attitude to risk.)

Two ways to make money exist: the active way (you work to earn money) and the passive way (you invest money to make more money). Passive is better, no? The wise use of investing allows individuals to make housing choices, maybe educate their children and make provision for their retirement. And wise investment decisions can be made only when potential investors have certain information, including materially correct financial statements for the businesses in which they're considering investing.

Introducing Concepts and Pervasive Principles



REMEMBER

These are probably the most important principles in financial reporting because they underlie the way in which financial statements are prepared. *Accounting standards* prescribe the recognition, measure, presentation and disclosure methods a business uses when drawing up its financial statements. In the UK and Ireland, accounting standards for private companies consist of the following:

- » FRS 100 Application of Financial Reporting Requirements
- » FRS 101 Reduced Disclosure Framework
- » FRS 102 The Financial Reporting Standard applicable in the UK and Republic of Ireland
- » FRS 103 Insurance Contracts
- » FRS 104 Interim Financial Reporting
- » FRS 105 The Financial Reporting Standard applicable to the Micro-entities Regime

Chapter 4 goes into a more detailed review of the above accounting standards. But, if you want to have a look at the accounting standards themselves, they're available at www.frc.org.uk/library/standards-codes-policy/accounting-and-reporting/uk-accounting-standards.

The Concepts and Pervasive Principles can be found in Section 2 of FRS 102 and FRS 105.



Public Limited Companies and Public Interest Entities in the UK prepare their accounts using UK-adopted IFRS Accounting Standards, which are issued by the International Accounting Standards Board (IASB) and endorsed for use in the UK by the UK Endorsement Board. The IASB has its own version of the Concepts and Pervasive Principles, which is the *Conceptual Framework for Financial Reporting* (the equivalent to the UK and Ireland Concepts and Pervasive Principles).

The Concepts and Pervasive Principles do not have the force of an accounting standard. Instead, its purpose is to assist the Financial Reporting Council (FRC), which eventually becomes the Audit, Reporting and Governance Authority to develop new or revised sections of FRS 102 and FRS 105. It also assists preparers of financial statements in applying standards and in dealing with issues that are not addressed by an accounting standard.



FRS 102 and FRS 105 are split into 'Sections' (for example, Section 11 of FRS 102 deals with financial instruments and Section 13 deals with inventory). If there is ever a conflict between the Concepts and Pervasive Principles and a section of FRS 102 or FRS 105, the relevant section prevails.

Included within the Concepts and Pervasive Principles are the characteristics that financial statements must contain. These are called the *qualitative characteristics* (discussed in the next section of this chapter).

Understanding the Qualitative Characteristics of Financial Statements

Now that you understand who uses financial accounting information, I want to discuss the substantive characteristics of that information. If financial accountants don't make sure that financial statement information has these characteristics, the financial statements aren't worth the paper on which they're printed. I discuss the qualitative characteristics in further detail in Chapter 6.



There are two types of qualitative characteristics the financial statements must possess:

- » Fundamental qualitative characteristics
- » Enhancing qualitative characteristics

These are considered in more detail in the next sections.

Fundamental qualitative characteristics

The two fundamental qualitative characteristics are relevance and faithful representation. This section describes what each characteristic means.

Relevance

Relevance is a hallmark of good evidence; it means the information directly relates to the facts you're trying to evaluate or understand. The inclusion or absence of relevant information has a definite effect on a user's decision-making process.

Relevant information has *predictive value*, which means it helps a user look into the future. By understanding and evaluating the information, the user can form an opinion as to how future company events may pan out. For example, comparing financial results from prior years, which are gleaned from the financial statements, can give investors an idea as to the future value of a company's share price. If assets and revenue are decreasing while liabilities are increasing, that's a pretty good indicator that investing in this company may not be such a good idea.

Relevant information also has *confirmatory value*, which means that new relevant information either confirms or rebuts the user's prior expectations. For example, you review a company's financial statements for 2026, and your analysis indicates that the company's sales can increase two-fold in the subsequent year. When you later check out the 2027 income statement, the company's revenue has, indeed, doubled. Woohoo! With the relevant information in hand, you see that your prediction was right.



A sub-set of 'relevance' is *materiality*. Information is material if omitting, misstating or obscuring it can reasonably be expected to influence the decisions that the users make on the basis of those financial statements. Materiality is very much an entity-specific issue. What may be material in one company may not be material in another. So, an electricity bill for £200 that's been missed out of the accounts may not make a user bat an eyelid if the company has made a profit of, say, £100,000. However, a £50,000 omission or duplication is more than likely going to make them change their view of the business. Getting the materiality balance right is a fine art! I discuss materiality in a bit more detail later on in this chapter. See 'Appreciating the Limitations of Financial Accounting'.

Faithful representation

Faithful representation means that the financial statements accurately reflect the commercial reality (the substance) of the transactions and events it purports to represent.



REMEMBER

To be a faithful representation, the information must be:

- » **Complete:** Meaning that all necessary information is included and no material information is excluded.
- » **Neutral:** Meaning that the information is free from bias and has not been manipulated to achieve a desired result or outcome.
- » **Free from error:** This does not mean 'perfectly accurate' but instead means there are no significant errors or omissions and that estimates and judgements used are reasonable and based on a sound methodology.

Enhancing qualitative characteristics

The four enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability. This section looks at each of these characteristics in turn.

Comparability

Comparability means the quality of the information is such that users can identify differences and similarities among companies they're evaluating – or among different financial periods for the same company. For example, users need to know what particular GAAP the different companies they're examining are using to recognise revenue or depreciate their assets. Without this knowledge, the users cannot accurately evaluate the relative worth of one company over another.

Verifiability

Verifiability means that different users can reach the same conclusion – although not necessarily absolute agreement – that a particular depiction is a faithful representation. It provides assurance to the users that the information accurately depicts what it claims to represent. For example, verifying the bank balance in the accounts through reviewing a bank statement or bank reconciliation.

Timeliness

Timeliness means that the financial information is made available to the users in time to influence their decisions. Generally, information loses its relevance if its publication is delayed.

Understandability

It isn't always possible to present a piece of relevant, reliable and comparable information in a way that a user can fully understand. Now that doesn't mean that if a piece of information is complex it can be left out – because it most certainly can't! Something that is material and left out because users won't be able to understand it results in the financial statements being misleading. Therefore, all information that's relevant and reliable must be included in the financial statements and cannot be excluded just because it's too difficult for some users to understand. The users would be expected to seek professional advice to help interpret any complex pieces of information.

Appreciating the Limitations of Financial Accounting

While preparing financial statements, accountants realise that time is money and a limit exists to the amount of cost that can be incurred for any reporting benefit. The regulators that set accounting standards (which I introduce in Chapter 4) always perform a cost–benefit analysis before finalising any reporting requirements. Associated with this financial accounting limitation is the concept of materiality.



REMEMBER

Materiality is the importance you place on an area of financial reporting based upon its overall significance. You have to consider the size of the company, the size of the financial statement transaction, the particular circumstances in which the transaction occurred and any other factors that can help you judge whether the issue is truly significant to the financial statement users.

For example, an expense totalling £10,000 would be material if the total expense amount is £50,000 but would likely be immaterial if the total expense was £500,000. But the nature of the transaction may make the difference material even if the comparative size is immaterial. For example, £10,000 that's deliberately – not accidentally – excluded from income may be material even if the amount is a small percentage of overall income. That's because the deliberate exclusion may be an attempt by the owner of the company to avoid paying tax on the income.

MATERIALITY AS A COST-BENEFIT ISSUE

It's not unheard of for some bookkeepers to spend hours tracking down the reason why the company bank reconciliation has a difference of £2.00 to make sure the bank hasn't made a mistake. (Preparing a *bank reconciliation* means you take the balance in the bank account per the bank at a certain date, add in any deposits that got to the bank too late to hit the statement and subtract any cheques the company has written that have not yet cleared.)

Now, is this an effective and efficient use of the bookkeeper's time and salary expense? No, of course not. Let's say they were paid £30 per hour. It cost the company £150 for the bookkeeper to confirm that the bank account balance was indeed out by £2, and it wasn't just a mistake on the part of the bank.

Considering Your Ethical Responsibilities



WARNING

Every professional – and, frankly, every individual – should operate using a code of conduct. This means you should always attempt to act in an ethical manner and do the right thing, regardless of whether doing the right thing is the best choice for you personally.

In this section, I give you the nuts and bolts of the code of conduct that financial accountants must follow. Plus, you find out about the goals toward which financial accountants strive: integrity, objectivity and independence.

Following the accountant's code of conduct

When you're looking into becoming an accountant, you'll see lots of different options available (I discuss some of these options in Chapter 2). Financial accountants who are serious about their profession normally become *chartered* or *chartered certified accountants* with the various professional bodies, which means they have to take several accountancy, audit and tax exams and have a certain number of years' practical work experience under their belts in order to become fully-fledged members of a professional body such as the Institute of Chartered Accountants in England and Wales (ICAEW), the Association of Chartered Certified Accountants (ACCA) or the Chartered Institute of Management Accountants (CIMA), to name just a few.



All professionally-qualified accountants at any level have to abide by their country's code of conduct and also follow the code of conduct established by their respective professional body.

But what if you're a financial accountant who isn't a member of a professional body? Do you still have to worry about abiding by a code of conduct? Of course you do! Any profession lacking ethical behaviour descends into chaos. Financial accountants must have high professional standards, a strict code of professional ethics and a commitment to serving the public interest. They achieve these goals through their integrity, objectivity and independence.

Having integrity

In the world of financial accounting, *integrity* means you act according to a code or standard of values. You demonstrate integrity when you do the right thing, regardless of whether doing so is best for you personally.

Specifically, having integrity means that you serve, to the best of your ability, your employer and/or the client for whom you're preparing financial statements, keeping in mind that doing so may not be the same thing as completely agreeing with the way the employer or client wants you to prepare the financial statements. You can't be worried that your employer or client is going to be mad at you or fire you if you disagree with them. Many laws protect individuals from any recourse if they uphold their integrity values and refuse to be involved in anything that can put them or their career in jeopardy.

Maintaining objectivity

Whether you work in public practice (you have multiple clients) or for a company (you provide accountancy services only for your employer), you must be *objective*, meaning impartial and intellectually honest:

- » Being *impartial* means you're neutral and unbiased in all decision-making processes. You base your opinion and reporting only on the facts, not on any preconceived notions or prejudices.
- » Being *intellectually honest* means you interpret rules and policies in a truthful and sincere manner, staying true to both their form and spirit.

If you're objective, you keep an open mind until all facts are revealed, despite what you hear from your client's managers, employees or anyone else privy to the work you're doing.



WARNING

Financial accountants must be objective, and the users of the financial statements must perceive that the accountants are objective. You never want to compromise your objectivity because doing so means you risk creating the perception that your work – and the financial statements that result from your work – cannot be trusted.

Achieving independence and objectivity

Many types of accountancy services, such as auditing, require the professional accountant to be independent in both mind and appearance. Being *independent* while providing services means that you have no special relationship with, or financial interest in, the client that would cause you to disregard evidence and facts when evaluating your client.

What does it mean to be independent in both mind and appearance? The biggie is that you avoid any real or perceived conflicts of interest: you don't perform services for any client with whom you have either a personal or non-audit-related business relationship. For example, if you have a significant financial interest in a major competitor of your client, your client may question whose best interests you have in mind while performing the services.

Financial accountants providing tax and consultancy services don't necessarily have to be independent; however, they still have to be objective.



REMEMBER

The concepts of independence and objectivity differ somewhat depending on whether you work in public practice or for a company. *Public practice* is when a financial accountant, most likely an accounting technician, chartered or chartered certified accountant, works for an accountancy firm providing services such as auditing or financial statement preparation for clients. *Working for a company* is when you do accountancy work for your own employer as an in-house bookkeeper rather than for a client. Obviously, you can't strive for independence when you're doing accountancy work for your own employer. So when you're working for a company, objectivity is key.

Making sure that you're professionally competent and take due care

To work for a client, or a company, you have to ensure that you're competent to do the work, are up-to-date with technical developments (such as accounting standard changes or changes in tax laws) and act in accordance with applicable

technical and professional standards. If you're a member of one of the professional bodies I mention earlier in this chapter (namely, ICAEW or ACCA) you'll have to complete a minimum amount of annual continuing professional development (CPD).

Keeping information confidential

During the course of their work, a financial accountant must ensure they keep all information they acquire confidential and do not disclose it to third parties without express authority from either the client or a responsible individual within the company. A financial accountant must never disclose confidential information for personal advantage.

Behaving professionally

A financial accountant must make sure that they behave in a professional manner at all times and does not undertake any action that discredits the accountancy profession.



WARNING

This extends to behaviour on social media platforms. There have been cases where professionally qualified accountants have been frogmarched to the professional body's disciplinary panel for abusive comments and behaviour on social media platforms, as this is deemed as bringing the accountancy profession into disrepute. So, minding your manners in your private life does creep into how you are treated in your professional life as well.

- » Spelling out qualifications and college courses
- » Considering financial accounting employment opportunities
- » Examining the future of financial accounting

Chapter 2

Making a Career in Financial Accounting

This chapter gives you the lowdown on the making of a qualified accountant. If you're wondering about the types of college courses you may take in addition to a degree in accountancy, you've come to the right place! I outline the various business and non-business courses you can expect to take to achieve a degree in accountancy and other courses that offer a springboard into the world of financial accounting.

Also, I describe the many different career paths a financial accountant can follow, from being self-employed to working for a large accountancy firm to working for not-for-profit entities such as charitable organisations.

In this chapter, you find out how much you can expect to earn as a financial accountant fresh out of college. You also get some perspective on the changing nature of business and the effect of that change on financial accounting.

The Making of a Financial Accountant

Personally, I believe that if you have an interest in the world of business, being a financial accountant is a pretty good gig. A plethora of career options is open to you, whether you dream of setting up your own business or see yourself working for a larger business, and whether your dream job is part-time or full-time.

Before you consider your employment possibilities, I want to walk through the education and licensing requirements for financial accountants so you know what to expect if you pursue this career path.

Getting educated

Some students interested in financial accounting attend a university, receiving a degree in accounting. Keeping in mind that each college or university has different accounting degree requirements, here's an example of the courses often included in a degree in accounting:

- » **General education core requirements:** You'll generally need basic subjects under your belt, such as maths and English. Degree courses will often require additional qualifications, such as A-levels with minimum grades.
- » **Business subjects:** These courses generally apply to a variety of business subjects, regardless of specific degree:
 - *Financial Accounting:* Focuses on the preparation of financial statements – the topic of this book!
 - *Management Accounting:* Approaches accounting from the business management angle and focuses on how accounting is used for internal reporting and decision making.
 - *Business Law and Ethics:* Covers the routine legal problems encountered in the business environment, such as contracts and employment law. The ethics side covers how all accountants should behave and how to handle varying degrees of threat to things like independence and objectivity.
 - *Principles of Management:* Introduces the basic processes and concepts of business management, such as planning, leading, controlling and organising business processes.
 - *Economics:* Introduces supply and demand and marketplace forces and how they affect business and individual decision-making.
 - *Finance:* Provides an introduction to the sources of business and financial market information, including the time value of money, the nature and

measurement of risk, financial institutions, investments and corporate finance, and financial statement analysis.

- *Marketing*: Introduces the planning and implementation of business activities designed to bring a buyer and seller together.

» **Accountancy subjects:** Here's a typical list and brief descriptions of the accountancy subjects you may encounter. Once again, keep in mind that requirements may vary from college to college and university to university:

- *Intermediate Accounting*: More in-depth accountancy courses than the Financial Accounting or Management Accounting courses. Accounting theory is taught, along with the development of generally accepted accounting practice (GAAP, which I discuss in Chapter 4).
- *Taxation*: Covers both business and individual taxation. Topics include corporation tax, personal tax, inheritance tax, capital gains tax and value added tax (VAT).
- *Leadership and Financial Planning*: Looks at how accountants demonstrate organisational leadership and senior consultancy or advisory capabilities to help a business become successful.
- *Auditing*: Studies the process involved in auditing both a for-profit and not-for-profit entity, including the planning, internal control review, evidence gathering and audit procedures to audit the financial statements. Also covered are professional standards, ethics and liabilities of chartered/chartered certified accountants. I look at chartered/chartered certified accountancy roles in the next section.



REMEMBER

Depending on the university you attend, a bachelor's degree with a concentration in accounting can either be a Bachelor of Science or a Bachelor of Arts.

Aiming for chartered or chartered certified status

Many students often wonder what their next educational step after undergraduate graduation can potentially be. You can get a job in financial accounting with a bachelor's degree. But to stand out from the crowd, I recommend studying for one of the chartered qualifications such as those offered by the Association of Chartered Certified Accountants (ACCA), Chartered Institute of Management Accountants (CIMA), Chartered Institute of Public Finance and Accountancy (CIPFA), or Institute of Chartered Accountants in England and Wales (ICAEW). See the nearby sidebar "Piggybacking Your Degree and Chartered Courses" for more information about chartered qualifications.



TIP

Check out each professional body by looking at their websites at:

- » ACCA: www.accaglobal.com
- » CIMA: www.aicpa-cima.com
- » CIPFA: www.cipfa.org
- » ICAEW: www.icaew.com

Another popular qualification is that offered by the Association of Accounting Technicians (AAT). The AAT is a professional qualification within its own right and is very flexible to study for. As an added bonus, even if you don't go on to chartered qualifications after qualifying with the AAT, you still have a respected qualification under your belt. Visit the AAT's website for more information at www.aat.org.uk.

In relation to qualifications, a familiar pattern is that students leave school or college with GCSEs or A-levels, and then pursue the AAT qualification. Why do this and not just go straight on to chartered qualifications, I hear you ask? Well, the AAT is a fantastic springboard onto the chartered qualifications because it starts with the very basic fundamentals, and you work your way through the qualification gaining valuable study experience at the accounting technician level before going on to the higher advanced chartered courses. In my experience (having completed both the AAT and ACCA myself), I find that students tend to handle the chartered qualifications better having been through the AAT mill. In many cases, students may leave school or college and take up an apprenticeship that offers part-time study for AAT so you get on-the-job training as well – bonus!



TIP

PIGGYBACKING YOUR DEGREE AND CHARTERED COURSES

Passing a chartered qualification course is the Holy Grail for financial accountants, so if you plan to work in *public practice*, which means doing accounting or auditing work for businesses that don't directly employ you, I think becoming a chartered or chartered certified accountant is the way to go. The chartered qualifications require you to pass a set number of examinations (you may get exemptions depending on the degree courses you've already done and the relevance of those courses to the specific chartered qualification you're planning to study). Some qualifications, such as ACCA, also require both the completion of an ethics module and a minimum number of months' work experience in order to qualify with their professional body. The ICAEW, on the other hand, prefers to integrate ethics throughout its syllabus.

Certain qualifications, such as the ICAEW, require students to have a training contract in place with an employer before being able to qualify. Many of the large accountancy practices have a set number of places to offer to graduates; they put them through chartered or chartered certified qualifications whilst simultaneously allowing them to gain valuable work experience that will then enable them to qualify with the relevant accountancy body.

Looking at some alternative qualifications

In addition to the chartered qualifications, you may want to earn other professional qualifications that can improve your professional reputation as well as provide opportunities for advancement:

- » **Certificate in international auditing:** Some of the professional bodies now offer the certificate in international standards on auditing (ISAs). Some of these qualifications can be studied for online and at your leisure. The course itself is designed to test your ability to apply the ISAs to given situations and requires a high degree of technical knowledge. So, if you're an auditor who conducts audits according to the ISA process, this type of additional qualification may be for you.
- » **Diploma in IFRS:** Some of the respected professional bodies also offer a diploma in International Financial Reporting Standards (IFRSs). These sorts of courses can be undertaken for two reasons: first, an accountant may want to add an additional qualification such as the diploma in IFRSs to their existing qualifications (as I did) and be able to handle preparing financial statements to, say, UK-adopted IFRS Accounting Standards; second, a professional accountant may have studied financial reporting under national standards (such as UK and Ireland GAAP), and want to gain technical knowledge in IFRS Accounting Standards because of their increasing global use.
- » **Association of Tax Technicians:** As you progress through your accountancy studies, you'll probably find that you become specialised in certain areas. For example, I specialise in accounting, financial reporting and auditing. However, some accountants decide they love tax and so go on to study for the Association of Tax Technicians (ATT) course. This course is purely focused on taxation and offers a good springboard onto more advanced taxation studies. The ATT has a very good reputation and many students also find that studying for these exams is a brilliant way of gaining continuing professional development (CPD) credits, so you can get the best of both worlds. Visit the ATT's website at www.att.org.uk for more information on their qualifications.

» **Chartered Institute of Taxation:** Whilst we're on the theme of taxation, the Chartered Institute of Taxation (CIOT) is the major taxation body in the UK and is very influential in the taxation profession. Many of its members come from a practice background and have studied for chartered or chartered certified qualifications before embarking on their CIOT qualification. This qualification is very prestigious in the tax profession, so if tax floats your boat, this qualification may be for you. The CIOT's website at www.tax.org.uk gives you the lowdown on their qualification structure.

Keeping up to date

Once you qualify as an accountant, the story doesn't end there! Things such as accounting standards and tax change quite frequently, so keeping up to date with changes is important. All of the professional accountancy bodies make it mandatory for the professional accountant to undertake regular *continuing professional development* (CPD). Fortunately, this need not be arduous or boring. Professional bodies tend to leave how to keep abreast of changes in things such as UK-adopted IFRS or UK and Ireland GAAP up to you and you can do so in a number of ways, such as reading technical articles, attending seminars, doing research and even looking at websites such as my own at www.stevecollings.co.uk or www.accountingweb.co.uk. Over the last few years, online and on-demand courses have become very popular because they enable the accountant to do the course at a convenient time.



TIP

The key is to make sure that your CPD is relevant to your day-to-day working life and that you can apply what you've learnt to your working life as well. You must record your CPD activities so that you can demonstrate what you've learned to the relevant professional body at the end of each year.

DO YOU HAVE WHAT IT TAKES?

Are you wondering whether financial accounting would be a good fit for you? Good accountants tend to have the following characteristics and personality traits, which are vital to enjoying the job:

- **The desire to work independently:** You must be able to work independently to succeed as a financial accountant. Even auditors who work in teams divide the tasks up and work independently on different pieces of the accountancy jigsaw, bringing everything together at the end.

- **A love for research, detail and logic:** Accountants do a tremendous amount of research and use this research to make decisions. Attention to detail is very important. Accountants need to be logical thinkers to work their way through tax legislation and accounting standards.
- **Great communication skills:** As a financial accountant, you must explain your decisions and results to other employees, clients and outside users. Communication skills, both oral and written, are very important. The people with whom you communicate will have different backgrounds, and many of them may have zero knowledge of accountancy, so you need to be able to explain your work clearly.
- **Decent computer skills:** Reasonable computer software skills and the ability to learn software programs are also a must. The good news is that, after you understand one accountancy software package, picking up how other accountancy software works is usually quite easy. Some employers use *bespoke* software (which is written for their own exclusive use), so specific training is required. Even if they don't use bespoke software, most employers realise that new employees need to be trained to use the company's preferred off-the-shelf software package (*off-the-shelf* means you buy it from a shop or online rather than have an accountancy software package tailored to your specific needs).
- **The willingness to listen and learn:** The ability to *learn* is crucial. Here's what I mean: If you're doing the accounts for a skiing shop, you don't need to be up to speed on every aspect of running the business – you don't even need to be able to ski! But to do a professional, competent job, you must know basic industry facts (for example, having a bit of knowledge on the average markup on a pair of skis and ski jackets). Without the basic knowledge of the way a company does its business, you won't know if your facts and figures make sense.

Considering Your Employment Opportunities

As an educated financial accountant with at least a couple of years' experience under your belt, your career options are pretty wide-ranging. Over the years, I've been everything from a bookkeeper to an accountancy author. I've worked in various companies such as a plant hire company and a dental laboratory. I now work as the technical partner at an accountancy firm with offices in Cheshire and Warrington, as well as writing books and lecturing to fellow professionals. One thing I can say about being a financial accountant is that it's never boring!

Working for an accountancy practice or setting up in practice

Many accountants start their career working in practice and then move on to another branch of the accountancy tree, such as working for a company as, say, a financial controller or director. I was different in that respect: I started off working for different companies and then eventually found my niche in practice. Many accountants bite the bullet and set up their own accountancy practice, but doing so takes guts and sheer determination. Many of those who set up on their own do succeed, however.

But not everyone seeks the flexibility of self-employment. If you want the challenge of working for many clients (which is the nature of public practice) but desire the stability of working for an employer, you may prefer to focus on jobs at an accountancy firm. These firms range in size from the Big Four (KPMG, Ernst & Young [EY], PricewaterhouseCoopers [PwC] and Deloitte) to regional accountancy firms, such as Azets and a plethora of others.

Here are a few examples of the work you can do as an accountant in practice:



TIP

» **Financial statement preparation:** Many small and medium-sized businesses require help preparing their financial statements. An accountant is contracted to do a *compilation assignment*, which consists of using client source documents (such as bank statements and invoices) to show revenue, expenses, costs, gains and losses on the income statement (profit and loss account), balance sheet and statement of cash flows (cash flow statement). Most clients now use software such as XERO or SAGE so access is provided to this software by the client to enable the accounts to be completed.

Most financial accountants who prepare financial statements also do the year-end tax returns for the same companies. Being a chartered or a chartered certified accountant is not a pre-requisite in carrying out compilation work. However, good people skills and patience are required. (In my experience, compilation work requires quite a bit of client handholding.)

» **Forensic accounting:** A *forensic accountant* investigates financial discrepancies and irregularities, often in cases of potential fraud or legal disputes. The forensic accountant may be hired by a company that plans to pursue fraud charges against an employee, a lawyer in a divorce case who suspects a spouse is hiding assets or anyone else involved in litigation. The accountant gathers facts, considers the circumstances and applies relevant legislation to come to an opinion about what a business or individual has done. Then, they may be asked to stand as an expert witness in court during the legal proceedings.

» **Audit and assurance services:** You must be an accountant qualified with one of the Consultative Committee of Accountancy Bodies (CCAB; such as ICAEW, ACCA, CIPFA, ICAS and Chartered Accountants Ireland) to work in the field of auditing. Auditors gather audit evidence to form an opinion as to whether the financial statements of the business give a true and fair view. This involves various tasks, including looking at how effective a company's *internal controls* (policies and procedures set in place to provide guidelines on how employees do their jobs) are. Some assurance work does not require the accountant to be qualified as a member of CCAB. For example, all business owners and managers want to know how well their businesses are doing. That's where you come in. Because you're an outsider, you can take a step back and cast a fresh, independent eye on the way a company is doing business. You can give company management a firm foundation upon which to base any needed changes.

A subset of assurance is *attestation* services, meaning the accountant issues written documents expressing their conclusion about the reliability of a written assertion that's the responsibility of another party. The number of topics you may focus on during an attestation engagement is pretty much limitless. For example, you may be asked to conduct a *breakeven point analysis*, which requires figuring out how much revenue the client has to bring in to cover expenses.

Working for a company

Not every accountant has multiple business clients. Someone who does accountancy work for a single company is called a *private* or *industry accountant*. Quite a few private/industry accountancy jobs are available. Depending on the size of the business, the job can be tailored to a specific task or cover the whole thing from start to finish – from recording accounting transactions to preparing financial statements.

Here are a few examples of the types of private accounting jobs available to financial accountants. Being a fully-qualified accountant may not be a requirement but can certainly be helpful:

» **Finance director:** A *finance director* is responsible for both financial and managerial accounting functions. In a small business, a finance director may carry out every function from bookkeeping to preparing the financial statements.

In a larger company, the finance director oversees all other aspects of the accounts department and is responsible for reporting the results of financial operations to the managers of the company and to the board of directors. Depending on the size of the company, a professional accountancy qualification

may not be necessary for this role, but larger companies tend to want a qualified accountant as the finance director.

- » **Departmental accountant:** In this position, you can handle a variety of financial accounting tasks; you can handle purchase ledger or credit control, account for company assets or handle stock exchange issues. Departmental accountants also take care of cash payments and receipts.

This position can be managerial because this person is responsible for such tasks as assisting in the monthly completion of the financial statements and consolidation of domestic and international subsidiaries, co-ordination and support of annual and interim audits, and tax compliance. Departmental accountants interact frequently with senior management and play a critical supporting role in business processes and management analyses pertaining to the effectiveness and efficiency of business operations.

- » **Bookkeeper:** A *bookkeeper* is a para-professional who works in accountancy. No specific education, experience or licensing is required for this designation. Many bookkeepers learn accountancy by doing; they start at a business in the purchase or sales ledger department and then fill in the gaps in their accounting knowledge by perhaps doing a bookkeeping or accountancy course at college.

Bookkeepers record the daily transactions in the accounting cycle, and they carry out routine tasks and calculations such as paying bills and bank statement reconciliation. In small businesses, the bookkeeper may also double as the receptionist and secretary. Depending on their knowledge base, bookkeepers can sometimes prepare the initial financial statements, which are then reviewed and adjusted by an independent accountant hired by the business.

Working in public finance

Not-for-profit organisations are those lacking a profit motive, such as a charity. Here is a quick look at the accountancy work in each:

- » **Not-for-profit accountants** work for organisations that are run for the public benefit – not because of any profit motive. In fact, not-for-profit organisations render goods and services to the community regardless of whether the costs they incur to provide the goods or services will ever be recouped from the recipients. These types of organisations include some schools, religious organisations and charities.



TIP

» **Public sector accountants** work for regional and central government. Their job is similar to that of the not-for-profit accountant in that no profit motive exists. The motive comes from providing services to a community, city or nation or working for public organisations such as a hospital or schools. Public sector accountants prepare financial statements that are open to the general public. The financial statements must show accountability to citizens while pursuing the goals of efficiency and effectiveness.

Another good financial accounting job is working on government audits for your local or central government. Consider HM Revenue and Customs (HMRC).

HMRC inspectors examine business and individual tax returns to ensure compliance with tax legislation. HMRC also employs technical accountants whose job is to check that a company, partnership or individual has correctly applied accounting standards and the requirements of the Companies Act 2006. Technical accountants work alongside tax inspectors and may flag up instances of non-compliance with UK and Ireland GAAP or company law.

Looking at the Future of Financial Accounting

The world of accountancy has dominated the headlines in the last few years and not for all the right reasons! Scandals such as Carillion (2018) and Thomas Cook (2019) cast a bad light over the accounting and auditing professions, so much work needs to be done to restore the general public's trust (especially in auditors). Demand for highly skilled accountants is still high, but competition is stiff; 50 people applying for one accountancy vacancy in practice isn't uncommon. To be successful in your application, you need to stand out from the crowd; you've got to be prepared for hard work and be dedicated. While accountants can earn mega bucks, that comes at a price: the price tag is the amount of graft that you must put in to be a successful accountant. Don't be under any illusions that as soon as you make partner or become a finance director that life is a bed of roses – the decisions you make (or don't make) can end the company's or the firm's life!

Wondering about the money? Many qualified accountants can earn in excess of £100,000; some a lot less. Because the job market is saturated with high-level accountants seeking alternative employment, salary levels have fallen considerably over the last five years. Trainee accountants in practice can earn around £20,000 to £25,000 depending on the job involved. Practice trainees tend to earn

less than their industry counterparts because of the costs incurred by the firm in putting a trainee through their training. Equity partners in an accountancy practice usually take a share of the profit made by the practice, which is based on the agreement in place; if the practice has a good year, their earnings can thus be significant. Many recruitment agencies publish average salary expectations across the UK, so if you're unsure of how much a trainee or a qualified accountant can expect in your area, check out one of the main recruitment agencies' salary guides to give you an indication. If the pay sounds good to you, keep reading. Next, I explain how changes in the accounting profession and the business world in general will affect the work you may do in the future.

Examining the evolution of financial accounting

In addition to the shift in student career paths, new business start-ups are on the rise as a result of redundancies in the corporate world. Gone are the days when you'd be assured of a job for life with a large company. The small business has now become the backbone of our economy. In fact, a survey by the Financial Reporting Council confirmed that at the start of 2024, there were just under 5.5 million small-medium entities (SMEs) in the private sector. SMEs makes up 99 per cent of the entire private business sector. Small businesses need financial accountants to help with start-up advice, financial statement preparation, budgeting and tax-return preparation.

Additionally, accounting scandals in the past decade have resulted in a change in financial laws and regulations. Enhanced regulation has increased the demand for financial accountants and auditors. For more information about this topic, see Chapter 4. Financial misbehaviours have also opened up new, interesting accounting specialisms such as forensic accounting, described earlier in this chapter. (See Chapter 21 for a quick rundown of ten common financial shenanigans.)

Factoring in the changing nature of business

The circumstances under which businesses operate have changed dramatically in the last couple of decades. The combination of the introduction of e-commerce in the late 1990s and technological advances that allow businesses to connect electronically with one another and with their customers has changed the way companies and individuals do business. Accountants now need to be savvy with a computer (gone are the A3 analysis pads and different-coloured pens that graced

many accountancy firms in the 1980s and 1990s). Laptops, Artificial Intelligence, spreadsheets and sophisticated software dominate the profession today, which is great news for Gen Zs coming into the profession.



I have good news for computer geeks who are also interested in accountancy! In the past, businesses produced paper trails that auditors, investors and other interested parties can follow to discover various information when examining the financial statements. But these days, those trails are usually in electronic form. Electronic data can be manipulated when a company's internal controls are lacking, and the info is more difficult to track down than a piece of paper in a filing cabinet. So financial accountants (and auditors) who are savvy in computer forensics are – and will continue to be – in high demand. And especially forensic accountants who know their way around a computer. An example of computer forensics is knowing how to retrieve password-protected data from a memory stick.

Thanks to technological advances, more small businesses are doing business globally. Thus, financial accountants and auditors with knowledge of IFRSs and of standards on ethics and auditing used by other countries are in great demand. As the number of multinational companies increases, interest is also growing in IFRS Accounting Standards that use principles-based accounting for transactions such as working out the fair value of assets and liabilities.

Of course, no one has a crystal ball. But how the world of accountancy operates today indicates that, if you're interested in making a career in financial accounting, you should have great employment prospects – especially if you keep your technology skills up to date.

IN THIS CHAPTER

- » Understanding why the financial statements are important
- » Seeing a company's financial position: the balance sheet
- » Looking at the income statement/profit and loss account
- » Finding out what's happened to the cash in the statement of cash flows

Chapter 3

Introducing the Primary Financial Statements

This chapter provides a brief overview of the three key financial statements: the balance sheet (also known as the *statement of financial position*), income statement/statement of profit or loss (commonly known as the *profit and loss account*) and statement of cash flows (often called the *cash flow statement*). If you're going to be an accountant, or plan to be involved in preparing financial statements, you'll need to know financial statements inside out and what each one means. Later in the book, I go into much more detail about each one, but to get you moving in the right direction, in this chapter, I show you the purpose of each financial statement and what you would expect to see in each one. I also give you an overview of how items included in one financial statement interact with those in another.

You'll find out about the three balance sheet components: assets (things a company owns), liabilities (stuff a company owes) and equity (the bit that's left over that belongs to shareholders). I also discuss the various sections in the income statement, including the difference between revenue from the company's operations (sometimes known as *sales* or *turnover*) and other gains and losses that a

company may record over its lifetime. You'll also learn why a statement of cash flows is so crucially important to users of financial statements that are prepared using the accruals basis of accounting (accounting for things as and when they arise rather than when they are paid or received). And finally, I introduce the three sections of the statement of cash flows – operating, investing and financing activities – and explain what types of information you record in each.



REMEMBER

The *official* definitions of assets, liabilities and equity are much more complex than something a company owns or owes – I'm just giving you an insight as to what they are in the section above. Financial statements and financial accounting may never become the love of your life, but if you pursue a career in accountancy, you need to enjoy spending time with them at least a little, because they're crucial in the work you will do.

Understanding How Healthy a Business Actually is

Financial statements are the final output of the accounting process, and these written reports are used by many different people and entities (collectively referred to as *stakeholders* or *users*) to make their own important investment and business decisions.



REMEMBER

As I explain in Chapter 1, *financial accounting* is the process of classifying and recording everything that takes place during the normal course of a company's business. The results of these events are included in the relevant financial statement and reported to the external users of the financial statements. External users include investors, creditors, banks and regulatory authorities such as HM Revenue and Customs (HMRC) and Companies House.

External users of the financial statements differ from internal users in that the external user is generally less savvy than the internal user. When I say *less savvy*, I'm not referring to this person's educational qualifications; an external user may very well hold a PhD from Oxford University! What I mean is that the external user will often have less knowledge about the company's operations. The external user usually has no idea what's going on within the company because this person isn't privy to the day-to-day operations.

In contrast, the internal users of the financial statements are employees, directors and other forms of management – all the individuals who work at the company.

The facts and figures shown in the financial statements give the stakeholders using them a bird's-eye view of how well the business is performing. For example, by looking at a company's balance sheet, you can see how much money the business owes to trade and other creditors and what resources it has to pay that debt. In other words, it shows you how financially stable the business is (the company's *financial position*). The income statement shows how much profit the company is making, both before and after business expenses are deducted. The income statement, therefore, shows you the financial performance of the business. Finally, the statement of cash flows shows how well the company is generating and spending its cash. A company can bring in a boat-load of cash, but if it's spending that cash unwisely, or not collecting what it's owed on time, it's not going to be a healthy business.

This chapter only gives a brief overview of each primary financial statement. While you prepare each statement using the same accounting concepts (see Chapter 5), each one tells a different story. I provide more detailed information about the three financial statements in other sections of this book: flick over to Part III for balance sheet info, Chapter 10 for the lowdown on the income statement and Chapter 11 for a discussion of counting pounds and pence in the statement of cash flows.

Reporting Assets and Liabilities in the Balance Sheet

The balance sheet (or *statement of financial position*, as it is sometimes called) shows the financial position of a business (meaning how financially stable it is). It is prepared on the *balance sheet date*, which is usually a month-, quarter- or year-end date. Therefore, it reflects the business's financial position at a specific point in time. The balance sheet is a snapshot of the company's financial position at a given point in time. In other words, when you look at the balance sheet as at 30 June 2026, you know the company's financial position as at that date.



REMEMBER

Accountancy is based upon the *double-entry system*. Put simply, this means that for every action, there must be an equal reaction. In accountancy lingo, these actions and reactions are called *debits* and *credits* (see Chapter 5). The net effect of these actions and reactions is zero, which results in the books balancing.

The proof of this balancing act is shown in the balance sheet when the three balance sheet components (assets, liability and equity) perfectly interact with each other. This interaction is called the *fundamental accounting equation* and takes place when:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

When a company reports under UK-adopted International Financial Reporting Standards (IFRSs), the above equation sometimes changes slightly to:

$$\text{Assets} = \text{Equity} + \text{Liabilities}$$



TIP

The fundamental accounting equation is also referred to as the *accounting equation*.

Not sure what assets, liabilities and equity are? Fear not – you find out about each later in this section. But first, I kick off by explaining the classification of the balance sheet.

Understanding the structure of a balance sheet

A balance sheet groups similar accounts together. For example, all current assets (see Chapter 7) such as trade debtors/receivables and prepayments show up in one grouping, and all current liabilities (see Chapter 8) such as trade creditors/payables and other *short-term debt* (debts falling due within one year) show up in another grouping. This grouping is done for the ease of the balance sheet user so that it's easy to see how financially stable a business is. If this grouping did not take place, the balance sheet would be a complete nightmare to interpret.

Also, people who aren't accounting geeks may not even know which accounts are short term versus *long term* (by 'long term', I mean they fall due after more than one year from the accounting period-/year-end). By classifying accounts in a logical way on the balance sheet, the financial accountant gives the user information that is easy to use and more comparable.

Homing in on the balance sheet components

Generally, three sections appear on the balance sheet: assets, liabilities and equity. Standing on their own, they contain valuable information about a company. However, a user has to see all three interacting together on the balance sheet to form a reliable opinion about the company.

Assets

Assets are resources a company owns. Examples of assets are fixed assets (sometimes known as *non-current assets* or *property, plant and equipment*), stock/inventory, trade debtors/receivables, prepayments, sundry assets and cash. I discuss each of these assets in detail in other chapters in this book (starting with Chapter 7), but here's a brief description of each to get you started:

- » **Fixed assets:** The company's property, plant and equipment are all fixed assets. This category includes assets that will be used in the business for more than a year, such as cars, land, buildings, office equipment and computers. See Chapters 7 and 12 for more information about fixed assets. These sorts of assets are known as *tangible* fixed assets (*tangible* means you can physically touch them). Fixed assets can also be *intangible* (in other words, they're invisible) such as computer software and goodwill.
- » **Stock/inventory:** For a retail business that sells to the general public – like a clothes shop or a supermarket – any goods available for sale are included in its stock (sometimes called *inventory*). For a *manufacturing* company – a business that makes the items retailers sell – stock also includes the raw materials used to make those items. See Chapters 7 and 13 for more information about inventory.
- » **Trade debtors/receivables:** This account shows all the money that customers owe to a business for completed sales transactions. For example, Company A sells goods to Company B with the agreement that B pays for the goods within 30 business days. Business A includes the amount of the transaction in its trade debtors figure.
- » **Prepayments:** *Prepayments* are expenses that the business pays for in advance, such as rent, insurance or annual subscriptions.
- » **Other debtors/receivables:** Any other resources owned by the company go into this catch-all category. Rent deposits are a good example of other assets. Say the company rents an office building, and as part of the lease agreement (see Chapter 19) it pays a £1,000 deposit to the landlord. That £1,000 deposit appears in the 'Other debtors/receivables' section of the balance sheet until the landlord refunds the business at the end of the lease.
- » **Cash:** Cash includes accounts such as the company's bank account, which the business uses to receive customer payments and pay business expenses, as well as the company's cash in hand balance, which it uses for petty cash expenses.



TIP

Petty cash refers to money the company keeps handy for insignificant daily expenses. For example, the business runs out of milk in the staff canteen and sends an employee to the shop down the road to buy some more. Although nowadays, such sundry expenditure is often paid for using a debit or credit card as cash is becoming less prevalent.

Liabilities

Liabilities are amounts that a company owes to third parties. For example, money can be owed to a third party, such as a bank, or to employees for wages earned but not yet paid. Some examples of liabilities are trade creditors/payables, payroll liabilities payable and bank loans. I discuss each of these liabilities in detail in Chapter 8. For now, here's a brief description of each:

» **Trade creditors/payables:** This is a current liability (in other words, a liability that will fall due to be paid within 12 months from the period- or year-end) reflecting the amount of money the company owes to its suppliers. This category is the flip side of trade debtors/receivables because a trade receivable on one company's balance sheet appears as a trade payable on the other company's balance sheet.

» **Payroll liabilities:** Most companies *accrue* payroll and related payroll taxes (such as pay as you earn [PAYE] and national insurance contributions [NICs]); the word 'accrue' means a company owes its employees money but has not yet paid them. This process is easy to understand if you think about the way you've been paid by an employer in the past. Most companies will pay their employees in arrears, which means you may have to work, say, a week and then get paid for that week's work in the next week.

In addition to recording unpaid wages in this account, the company also has to add in any PAYE, Student Loans and NICs that will be deducted from the employee's wages.

» **Bank loans due within one year:** Bank loans payable that are due in full less than 12 months after the balance sheet date are short term ('short term' also means 'current') – or may be the short-term portion of a long-term bank loan. Chapter 8 looks at loans in more detail.

» **Long-term bank loans:** If a short-term bank loan must be paid back within 12 months after the balance sheet date, you've probably guessed that a long-term loan is paid back after that 12-month period! A good example of a long-term loan is a mortgage. *Mortgages* are used to finance the purchase of property (see Chapter 12).

Equity

Equity shows the owners' (the shareholders') total investment in the business. As such, equity shows the difference between assets and liabilities. It's also known as *net assets* or *net worth*. Examples of equity are retained earnings (accumulated profits a company has made since it started in business on day one) and paid-up

share capital (shares in a company that have been paid for by the shareholders). I discuss both equity accounts in detail in Chapter 9. For now, here's a brief description of each:

» **Retained earnings:** This account shows the result of income and dividend transactions (dividends are sums of money paid to shareholders out of profits that have been taxed as a return on their investment). For example, the business opens on 1 January 2026 with a 31 December 2026 year-end. In the year to 31 December 2026, it made a net profit of £50,000 (wow!) but has also paid £10,000 in dividends to shareholders. The retained earnings for the year ended 31 December 2026 are £40,000 (£50,000 – £10,000).

Retained earnings accumulate year after year – hence the word 'retained'. So if in 2027 the same business makes £20,000 and pays no dividends, the retained earnings as at 31 December 2027 are £60,000 (£40,000 + £20,000).

» **Paid-up share capital:** This element of equity reflects the shares the company has issued to its shareholders and which the shareholders have paid for (hence the words 'paid up'). A company will sell shares at *par value*, which is the face value of the shares; so, for example, if Sue decides to buy 100 £1 shares in Breary's Bricks Limited, she will pay £100 for the shares.

Sometimes, however, it may be that the company wants to raise money by issuing more shares for more than *par value* (in other words, at a premium). What happens in this situation is that a company will have an increase in its share capital figure, but will also have a 'Share premium' account to take the excess over par value. Let me take you through how this works with an example.



EXAMPLE

Sue decides to subscribe for £100 worth of £1 shares (£1 is the par value) in Breary's Bricks Limited on 1 January 2026. The balance sheet of Breary's Bricks Limited as at that date will be as follows:

Current Assets	
Cash at bank	<u>£100</u>
Equity	
Share capital	<u>£100</u>

On 30 June 2026, Breary's Bricks decides it needs to raise finance so it issues a further 100 shares at a value of £1.50 per share. Here you can see that the par value is £1, but the company has issued further shares for £1.50 (in other words, at a price higher than par value). The share capital figure will increase by the par

value, but the excess is recorded in a 'Share premium' account. So this is the effect on Breary's Bricks' balance sheet following the additional share issue:

Current Assets	
Cash at bank (Cash balance of £100 + additional 100 shares × £1.50)	<u>£250</u>
Equity	
Share capital (100 shares at £1 + additional 100 shares × £1.00)	£200
Share premium (100 shares at £0.50)	£50
Total equity	<u>£250</u>

Looking at an example of a balance sheet

A balance sheet groups together similar accounts so the financial statement user has an easier time reading it. In Chapter 7, I show you a full-blown balance sheet that is structured in accordance with generally accepted accounting practice (GAAP; see Chapter 4). In Figure 3-1, I give you a very simplified version of what a balance sheet looks like.

Lucas Lighting Limited Balance Sheet As at 31 March 2026

Assets	£
Tangible fixed assets	175,000
Current assets	<u>14,125</u>
Total assets	<u>189,125</u>
Liabilities	
Current liabilities	2,300
Long-term liabilities	<u>90,525</u>
Total liabilities	<u>92,825</u>
NET ASSETS (assets minus liabilities)	<u>96,300</u>
Equity	
Called up share capital	6,000
Retained earnings	<u>90,300</u>
Total equity	<u>96,300</u>

FIGURE 3-1:
A simplified
balance sheet.

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Summing Up Profit or Loss: The Income Statement/Profit and Loss Account

Next up in your exciting walkthrough of the three financial statements is (drum roll, please) . . . the *income statement* (more commonly known as the *profit and loss account* or *P and L*), which shows income, expenses, gains and losses.

Here, I provide only a brief introduction to the income statement. For the complete lowdown on the income statement, the accounts it contains and how to prepare one, have a nose at Chapter 10.

Delving into the income statement components

The income statement shows financial results for the accounting period it represents (in other words, the financial performance of the business for the period or for the year). It lets the user know how the business is doing in the short term. And please bear in mind that the company's performance is not just a question of whether it made or lost money during the financial period. The issue at hand is more a matter of the relationship among the different accounts in the income statement.

For example, maybe you see that a company's *gross profit*, which is the difference between sales and cost of sales, is £500,000. (Not sure what cost of sales is? Don't panic – you find out in the next section of this chapter!) Based on the amount of sales or historical trends, you may expect gross profit to be £700,000. Well, your expectation is actually £200,000 short – not good. And if you're a member of company management or the business owner, you need to find out why, because you can be losing cash.



TECHNICAL
STUFF

Historical trends, which I discuss in Chapter 14, refer to a company's performance measured in many different ways tracked over a period of time – usually in years rather than in months.

Perhaps you're thinking, 'Hang on – what about the equity section of the balance sheet? Doesn't that provide a benchmark too?' Well, look back to my definition of retained earnings earlier in this chapter: *retained earnings* is the accumulated total of net income or loss from the first day the company is in business, all the way to the date of the balance sheet (less dividends and other items that I discuss in Chapter 9). Retained earnings does provide valuable information, but because it's an *accumulation* of profit or loss that you can't pin down to any specific financial

period, and because it can potentially be reduced by other accounting transactions such as dividends, it doesn't really provide a benchmark like the income statement can.

Textbooks on financial accounting will focus on the main areas of an income statement such as revenue, cost of sales, operating expenses and other gains and losses. In this section, I give you just the basics on each. For a more comprehensive explanation of all the income statement accounts, make sure you read Chapter 10.

To kick off, let's talk about everyone's favourite topic: revenue!

Revenue

Revenue is the income arising in the course of the business's day-to-day activities (such as selling products or rendering services). In other words, revenue is the amount of money the company is due to bring in doing whatever it's in the business of doing.

The revenue account shows up in the income statement as *revenue* or *turnover*. Both names mean the same thing: revenue before reporting any deductions from revenue. Deductions from revenue can be *sales discounts*, which reflect any discount a business gives to a customer who pays early or because they've ordered a lot of goods, or *sales returns*, which reflect all products customers return to the company after the sale is complete.

Cost of sales

Cost of sales (sometimes referred to as *direct costs*) reflects all costs directly associated with any product a company makes or sells, whether the company is a retailer or a manufacturing company.

If a company is a *retailer* (it buys products from a manufacturer and sells them to the general public), the cost of sales is calculated by working out how much it costs to buy the items the company holds for resale. Keep in mind that to accurately calculate this amount, you have to understand how to value *closing stock/inventory*, which is the inventory remaining on the shelves at the end of the financial period, an issue I discuss in Chapter 13.

Because a manufacturer makes products, its cost of sales consists of raw material costs plus the labour costs directly related to making any products that the

manufacturer offers for sale to the retailer. Cost of sales also includes factory overheads (such as electricity), which consists of all other costs incurred while making the products.



A service company, such as an accountancy firm or a solicitor's practice, will not have any cost of sales because it does not sell a tangible product. Some businesses may also include staff costs in cost of sales.

Operating expenses

Operating expenses are expenses a company incurs that relate to its activity and aren't directly tied to cost of sales. Two key categories of operating expenses exist:

- » **Distribution costs:** Any expenses a company incurs to sell its goods or services to customers. Some examples are transportation costs and packaging costs.
- » **Administrative expenses:** All expenses a company incurs to keep up the normal business activities. Some examples are office supplies, administrative staff costs, advertising expenses, office rents and utilities and legal and professional costs (such as accountancy fees and lawyers' bills).

Other income and expense

You classify all other income the company brings in peripherally as *sundry income* or *other income*; either description is fine. This category includes any bank interest received on savings or current accounts or rental income. In other words, it's any income that the company earns from sources other than its normal business operations.

Other expenses (being the flip of other income) are expenses the company incurs that aren't associated with normal operations. Here are two types of expenses you typically see:

- » **Interest expense:** The cost of using borrowed funds for business operations, expansion and cash flow (such as a bank loan).
- » **Loss on disposal of a fixed (non-current) asset:** If the company loses money on the sale of an asset, you report the loss in this section of the income statement.

Looking at an example of an income statement

I show you a full-blown income statement prepared in accordance with GAAP in Chapter 10. In Figure 3-2, I give you a very simplified version of what an income statement looks like.

Gabriella Gardening Limited
Income Statement
For the year ended 31 March 2026

FIGURE 3-2:
A simplified
income
statement.

	£
Revenue	45,000
Cost of sales	<u>(20,000)</u>
Gross profit	25,000
Operating expenses	<u>(10,000)</u>
Operating profit	15,000
Other expenses	<u>(5,000)</u>
Profit before tax	<u>10,000</u>

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Showing Us the Money: The Statement of Cash Flows

This section offers a brief overview of the statement of cash flows (sometimes called the *cash flow statement*). You prepare the statement of cash flows using certain components of both the income statement and the balance sheet. The purpose of the statement of cash flows is to show how the company has made money and what it has spent that money on. This information is used by investors and potential creditors to gauge whether the business may have sufficient cash flow to pay dividends or repay loans as well as to see how efficiently the company is managing its cash flow.



REMEMBER

The statement of cash flows is very important for financial accounting because generally accepted accounting practice (see Chapter 4) requires you to use the accrual method of accounting. This means that you record revenue when it is earned (regardless of when money changes hands), and you record expenses when they are incurred (regardless of when they are paid). On the flip side, when using the cash basis of accounting, a transaction isn't recorded until money changes

hands. The cash basis of accounting is not an acceptable basis under UK and Ireland GAAP but you may come across it in some instances (such as for a very small charity). The statement of cash flows gives the financial statement user a basis for understanding how non-cash transactions showing up on the balance sheet and income statement affect the amount of cash the company has at its disposal.



REMEMBER

Businesses that are classed as small or micro (see Chapter 4) are not required to include a statement of cash flows in their annual financial statements. Only medium and large businesses need to do this, so don't be too surprised if you don't see a statement of cash flows in every set of financial statements you may come across.

Exploring how companies generate and spend cash

If I could choose only one of the three primary financial statements to evaluate a company's ability to pay dividends and meet its short-term obligations (both of which indicate a healthy business), I would pick the statement of cash flows. That's because even though the income statement shows eventual sources and uses of cash, the statement of cash flows gives you a better idea of exactly how a business is managing its cash resources.

As a general rule, a business presents itself in a better light if its costs are being covered by the cash it brings in from the day-to-day running of the business rather than from borrowed funds. As a potential investor or lender, I want to see that the cash the company brings in through operations exceeds any cash brought in by selling assets or borrowing money. This is because selling assets and borrowing money can never be viewed as a business 'strategy' the way bringing in cash from selling goods or services can be. If the company has to keep borrowing funds or selling assets to raise funds, there's a problem somewhere down the line!



REMEMBER

Financial accounting, which is done on the accruals basis (see Chapter 6), does not show the cash ins and outs of business operations. The statement of cash flows gives the user of the financial statements a better idea of cash payments and receipts during the year in two ways:

- » By removing the effect of increases and decreases in trade receivables, trade payables and other current assets and current liabilities (these are often referred to as *working capital*).

- » By showing cash brought in by means other than the operations of the business and cash paid out for items outside the scope of the company's operations – for example, for the purchase of fixed (non-current) assets.

Taking a look at each section of the statement of cash flows

A statement of cash flows has three sections: operating activities, investing activities and financing activities, which I will look at as follows:

- » **Operating activities:** This section shows items that are included in the income statement. The three big differences between the cash and accruals bases of accounting (see Chapter 6) are *trade receivables*, which is money owed to the company by its customers, *trade payables*, which is money the company owes to its suppliers, and *inventory*, which are goods held by the business for resale to customers.
- » **Investing activities:** This section usually shows the sale and purchase of long-term assets such as property, plant, equipment and long-term investments. The purchase of long-term assets is reflected on the balance sheet (see Chapter 7). The sale of long-term assets is reflected both on the balance sheet and in the income statement (see Chapter 10). It is reflected on the balance sheet as a reduction of the amount of assets the company owns, and in the income statement as a gain or loss from disposing of the asset.
- » **Financing activities:** This section shows the cash effects of long-term liability items (paying or taking out loans beyond a period of 12 months from the balance sheet date) and equity items (such as the cash received from selling shares in the business).

Looking at an example of a statement of cash flows

I show you a full-blown statement of cash flows prepared in accordance with GAAP in Chapter 11. In Figure 3-3, I give you a very simplified version of what a statement of cash flows looks like.

FIGURE 3-3:
A simplified
statement of
cash flows.

	£
Net cash inflow from operating activities	5,000
Net cash outflow from investing activities	(10,000)
Net cash outflow from financing activities	(200)
Increase (decrease) in cash and cash equivalents	(5,200)
Cash and cash equivalents at start of year	5,672
Cash and cash equivalents at the end of the year	<u>472</u>

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TIP

You can prepare a statement of cash flows in two different ways: the direct method and the indirect method. I show you how to prepare a statement of cash flows using each method in Chapter 11. For now, here's what to remember:

- » The direct method reports major classes of gross cash receipts and payments. In other words, it takes these 'major' classes of gross receipts and payments direct from the cash book (the ledger that records cash in and cash out).
- » The indirect method starts with net profit (or *operating profit*) from the income statement and adjusts for non-cash items reflecting in the income statement such as *depreciation*, which is allocating the cost of non-current assets (things like cars, property and machinery) over their useful life. (See Chapter 12 for more info about depreciation.) This is the more popular method in the UK.

- » Meeting the accountancy regulatory bodies
- » Finding out about regulatory issues
- » Exploring generally accepted accounting practice (GAAP) and IFRS Accounting Standards

Chapter 4

Acronym Alert! Setting the Standards for Financial Accounting

If you're the kind of person who thrives in a structured work environment, you've come to the right profession! The work of an accountant is carefully guided by the standards, rules and regulations that I introduce in this chapter.

I give you an insight into the code of professional conduct, which is primarily set by the International Ethics Standards Board for Accountants (IESBA) and is adopted by many professional bodies in the UK and other countries. These standards provide a roadmap to follow in your dealings with clients or your employer and how to handle various situations arising during day-to-day business operations.

Next, you meet the financial accounting standard-setting bodies and find out why *publicly owned* companies (those whose shares are traded on a public stock exchange, such as the London Stock Exchange) abide by different accounting standards to privately owned companies.



REMEMBER

Throughout this book, I refer to the acronym GAAP or UK and Ireland GAAP. ‘GAAP’ stands for *generally accepted accounting practice*. In this chapter, I explain that GAAP provides the acceptable practices reporting entities must adopt in the preparation of financial statements in the UK and Republic of Ireland. Many countries use their own national standards, but in the last 20 years, we’ve seen an increase in the adoption of International Financial Reporting Standards (officially referred to as *IFRS Accounting Standards*), which is why this book frequently refers to IFRS Accounting Standards.

Understanding the Role of the Professional Bodies

Professional accountants *must* maintain the highest level of ethical behaviour and conduct themselves in accordance with a code of conduct. This means that accountants must always act ethically and do the right thing – regardless of whether doing the right thing at that particular moment is the best choice for the accountant personally.



REMEMBER

Why is the accountant’s ethical behaviour so crucial? The reports that financial accountants prepare are used by individuals to make important decisions (often investment decisions) that can have a huge future effect on the user’s hard-earned cash. The users of the financial reports must be given accurate, comparable financial statements so they can make educated decisions about how to invest their money. Professional accountants are placed in a significant position of trust.



TIP

You may be surprised to find out that in the UK, anyone can call themselves an accountant. You don’t have to be professionally qualified to operate as an accountant, and many accountants are *qualified by experience*, which means they’ve worked in the job for so long that they’re on the same level as a professionally-qualified accountant who’s worked in the profession for the same length of time. However, many accountants belong to a professional body, and the UK has several of them: the Institute of Chartered Accountants in England and Wales (ICAEW, www.icaew.org.uk), the Association of Chartered Certified Accountants (ACCA, www.accaglobal.com), the Association of Accounting Technicians (AAT, www.aat.org.uk) and the Chartered Institute of Management Accountants (CIMA, www.aicpa-cima.com), to name but a few. Whilst being a member of a professional body isn’t a pre-requisite for working as an accountant in the UK, it is mandatory for an auditor to be a member of one of the Consultative Committee of Accountancy Bodies (CCAB) because audit is a regulated profession in the UK. Check out CCAB’s website (www.ccab.org.uk) to identify the relevant bodies.

So what exactly do the professional bodies do? Well, among other things, they influence the accountancy profession by being involved in advising standard-setters and other regulatory bodies as to how accounting standards, tax legislation and company law should work. They also impose strict ethical rules on their members and regulate them by making sure they undertake continuing professional development (CPD), which means keeping abreast of changes and developments within the profession. They also monitor accountancy practices to ensure work of a high standard. Professional bodies, therefore, reassure the public that an accountant is properly regulated, required to work to certain standards and technically capable of doing the job. An accountancy practice undertakes a variety of work for the general public.



REMEMBER

Here are definitions of three key terms you'll encounter in relation to an accountancy practice:

- » The purpose of financial statement *auditing* is to gather enough evidence about a company's transactions, events and disclosures to be able to issue an opinion on whether the financial statements are free of material (significant) misstatements.
- » A financial accountant provides an *attestation* service when they issue a report on a subject that's the responsibility of another person or business. For example, a company can hire you to calculate the rate of return on the company's investments (see Chapter 14), making sure your figures match the company's report on the same topic.
- » *Private* companies are close companies (meaning privately owned). Their shares aren't traded on any open-to-the-public stock exchange. For example, if you start a company, you aren't required to sell any of your shares unless you want to. In contrast, a *publicly traded* company's shares are available for purchase in stock exchanges such as the London Stock Exchange.

Getting to grips with the Financial Reporting Council (Audit, Reporting and Governance Authority)

One of the main jobs of this professional body is to develop and maintain accounting standards for use by private entities in the UK and Republic of Ireland. A *private* entity is one that is privately owned and that does not trade its shares on a recognised stock exchange.



The Financial Reporting Council (FRC) is expected to be rebranded at some point in the future. It will eventually be known as the *Audit, Reporting and Governance Authority* (ARGA). This new regulator will carry out pretty much the same duties as it does now (regulating the accounting, auditing and actuarial professions), but it will have more powers to hold more people to account when things go badly wrong.



The standards which the FRC/ARGA maintain are known collectively as *UK and Ireland GAAP* and are referred to as *Financial Reporting Standards* (FRSs). FRSs are UK and Ireland specific and are separate from IFRS Accounting Standards. UK and Ireland FRSs consist of the following:

» **FRS 100: Application of Financial Reporting Requirements.** FRS 100 tells preparers which types of organisations can use which FRS. For example, it says that a micro-entity can use FRS 105. Listed companies in the UK (those which sell their shares on a stock market, such as the London Stock Exchange) must use UK-adopted IFRS, whereas listed companies in the Republic of Ireland must use EU-adopted IFRS.

» **FRS 101: Reduced Disclosure Framework.** FRS 101 allows qualifying subsidiaries and intermediate parents to apply reduced disclosures in their individual financial statements. The qualifying subsidiary or intermediate parent must apply IFRS Accounting Standards in the preparation of its own individual financial statements, and the idea is that certain disclosures need not be made if those financial statements are then consolidated with a parent company that prepares group financial statements that give a true and fair view.

FRS 101 is reviewed on an annual basis by the FRC/ARGA to ensure that all the disclosure exemptions keep track of developments in IFRS Standards (which move at a fast pace).

» **FRS 102: The Financial Reporting Standard applicable in the UK and Republic of Ireland.** This is the main accounting standard applied in the UK and Republic of Ireland. This standard provides the recognition, measurement and disclosure rules that entities must follow when preparing financial statements in addition to the requirements of applicable law.

» **FRS 103: Insurance Contracts.** This is an industry-specific standard that deals with entities that write insurance contracts or reinsurance contracts and prepare financial statements under FRS 102 (see the previous bullet point). Because this standard is so specialised, I don't go into any further detail about it in this book. If you want to find out more about FRS 103, check out the FRC's website (www.frc.org.uk).

» **FRS 104: Interim Financial Reporting.** Interim financial reports are not mandatory for private companies, but they are for listed companies (those that trade their shares on the stock market). So this FRS is not widely used but

is applied by private entities that do prepare interim financial reports for issuance to shareholders and stakeholders and provides a framework as to how the interim financial statements should be presented.

» **FRS 105: The Financial Reporting Standard applicable to the Micro-entities Regime.** FRS 105 is a standard used by micro-entities, which are defined as a subset of the small companies' regime. Micro-entities are the smallest types of business in the UK and Republic of Ireland. This standard provides a simpler approach to preparing financial statements. The next section discusses the size of companies in more detail.



WARNING

Only certain types of micro-entity can use FRS 105. Micro-entities whose accounts are subsequently consolidated with those of a parent cannot use FRS 105 because the standard does not deal with groups. In addition, charities cannot use FRS 105, nor can financial institutions. It's therefore advisable to consider at the outset whether the micro-entity's day-to-day activities allow it to use FRS 105 before preparing financial statements under that standard. If the micro-entity cannot use FRS 105, it will need to use FRS 102 as a minimum.

ENOUGH WAS ENOUGH: INTRODUCING ARGA

In the last few years, there have been some high-profile corporate collapses. For example, Carillion, Patisserie Valerie and Thomas Cook, to name just three. These collapses happened because of dodgy accounting stuff which the auditors did not highlight. When something like this happens, the FRC is quickly on the case and will open an investigation into the audit to see what (if anything) has gone wrong with it. Sometimes it's the case that many things have gone wrong with the audit which contributed to the collapse of a big company.

Given the aftershocks that tend to happen following a large company going bust, the Government decided enough was enough. In 2018, the Government commissioned an independent investigation into the FRC, led by Sir John Kingman, who was quite critical of it – in fact some of his comments about the regulator were far from complimentary. However, what must be borne in mind is that to some extent, the FRC had their hands tied as to what they can do about unorthodox practices by directors of public interest companies because it simply doesn't have the powers to hold directors who are not accountants to account. Well, that's until ARGAs come onto the scene . . .

(continued)

(continued)

It was never going to be an overnight job rebranding a public body such as the FRC. Lots of Parliamentary protocol must be completed, such as issuing various *Statutory Instruments* (an act of law) to give the new regulator the powers it needs to hold directors and accountants to account. This takes time, and in July 2025 the Government announced a further delay in getting ARGa up and running, so it's a case of waiting and seeing when it happens. But when it does happen, ARGa will have more powers than the FRC currently has.

Determining the size of a company

In the preceding section, I mention 'micro-entities' a few times as well as 'small companies'. But how do you know what a micro-entity is and what a small company is? Well, the size of a company is determined by what's known as the *company size thresholds*. These are determined by the government and are based on three thresholds:

- » The level of the organisation's turnover
- » The value of the organisation's total assets (fixed assets plus current assets – see Chapter 7)
- » The average number of staff employed by the business during the period

Table 4-1 shows the thresholds that apply for accounting years commencing on or after 6 April 2025.

TABLE 4-1 UK company size thresholds

2 out of 3 of:	Micro	Small	Medium	Large
Annual turnover (£)	≤1m	≤15m	≤54m	>54m
Balance sheet total (£)	≤500k	≤7.5m	≤27m	>27m
Average number of employees	≤10	≤50	≤250	>250



REMEMBER

In Table 4-1, the turnover threshold is pro-rata'd if you have a short accounting period. So, if a business has only been trading for nine months, the turnover figure is pro-rata'd by nine-twelfths, so it becomes £750,000 (£1m × 9/12). Also, don't forget that *balance sheet total* is fixed assets plus current assets (see Chapter 7). And for employees, it's the *average* number during the year, not the actual number employed by the business at the reporting date.

Looking at how accounting standards have changed

The world of financial accounting does not stand still. No sooner has one standard been introduced, changed or withdrawn, another standard is introduced, changed or withdrawn soon after. This is because the world of business moves at a fast pace.

The FRC/ARGA is required to carry out comprehensive reviews of UK and Ireland accounting standards at least every five years. The latest comprehensive review (known as the *periodic review*) was completed on 27 March 2024. Amendments arising from this periodic review become mandatorily effective for accounting periods commencing on or after 1 January 2026. An organisation can decide to early adopt the amendments if it wishes, but it must adopt all the amendments at the same time. In other words, it cannot cherry-pick which amendments it would like to early adopt and which it doesn't.

In between periodic reviews, the FRC/ARGA may carry out ad-hoc projects that can also result in changes. For example, the standard setters may decide that an issue which has come to their attention may cause different accounting treatments to be applied across various companies (this is known as *divergent practice*). The FRC/ARGA may then issue an amendment to a standard that clarifies what the treatment should be so that there is no difference in accounting or disclosure.



TECHNICAL
STUFF

At the time of writing, the latest updates of UK and Ireland accounting standards are the September 2024 editions. Soon after these were issued, further changes were made to those standards to cater for a change in legislation (the increase in the company size thresholds, see 'Determining the size of a company' elsewhere in this chapter).

Taking a look at the UK Endorsement Board

International Financial Reporting Standards (IFRSs) are set by the International Accounting Standards Board (IASB). Since 2021, the UK Endorsement Board has been responsible for endorsing IFRS Accounting Standards for use in the UK. Prior to this, the UK applied EU-adopted IFRS Accounting Standards but since the UK left the EU in December 2020, the use of EU-adopted IFRS Accounting Standards is no longer permitted.



REMEMBER

The Republic of Ireland is still a member of the EU, so public companies (for example, those which trade their shares on a recognised stock market) must continue to use EU-adopted IFRS Accounting Standards when preparing their financial statements.

The UK Endorsement Board is responsible for influencing the development of IFRS Accounting Standards and deciding which of these standards will be used in the UK. The FRC/ARGA has oversight responsibility for the UK Endorsement Board's performance of its governance and due process.

Perusing the Code of Ethics for Professional Accountants

The Code of Ethics for Professional Accountants of the International Ethics Standards Board of Accountants (IESBA) contains five principles of professional conduct by which its members must abide: integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Most of the UK's professional bodies apply the IESBA's Code in the development of their own Codes.

Here's a brief explanation of each of the five principles:

- » **Integrity:** This characteristic means you're honest when dealing with others. In the world of financial accounting, integrity means that you serve the company for whom you are preparing the financial statements to the best of your ability, keeping in mind that this may not be the same thing as completely agreeing with the way the company wants its financial statements prepared. You can't be concerned that management will be mad at you or fire you if you disagree with them.
- » **Objectivity:** When you're objective, you're neutral and unbiased in all decision-making processes. You base your opinions only on facts and not on any preconceived notions you may have. You interpret rules and policies, such as GAAP, in a truthful and sincere manner – staying true to both the form and spirit of the particular principle or regulatory issue.

Professional accountants who provide auditing and other attestation services must be independent in both mind and appearance. Being *independent* means you have no special relationship to or financial interest in the company that would cause you to disregard evidence and facts when evaluating them. For example, preparing the financial statements for a business owned by a close relative can justifiably cause those viewing your report to doubt its veracity or your objectivity.
- » **Professional competence and due care:** In a nutshell, this principle means you have the technical skills, ability and experience to perform the work at hand, and crucially, you keep updating your knowledge. You must be both competent and practise diligence. In addition, due care means you plan and supervise adequately any professional activity for which you're responsible



» **Confidentiality:** Professional accountants have a duty to ensure that confidentiality is observed at all times. A professional accountant cannot disclose information to any third party without proper and specific authority, unless a legal or professional right or duty to disclose exists (if the client is involved in illegal acts, for example). Professional accountants also cannot use confidential information acquired during their work for their personal advantage or to the advantage of third parties.

» **Professional behaviour:** Professional accountants must comply with relevant laws and regulations and avoid all action that may discredit the profession. Professional accountants must be seen to be behaving in a professional manner at all times, including the professional accountant's marketing or advertising.

With the increased use of social media platforms, professional accountants must be careful in how they conduct themselves on such platforms. Any abusive, threatening or defamatory comments (even if nothing to do with accountancy) can result in the accountant facing disciplinary action from their professional body for bringing the profession into disrepute.

Following Regulatory Issues

In addition to the various professional bodies such as ACCA, ICAEW, CIMA, Chartered Institute of Public Finance and Accountancy (CIPFA), AAT, and so on, other organisations provide official guidance on how to prepare financial statements. Public and private companies have different bodies monitoring them and keeping them on the right track.

In this section, I discuss the London Stock Exchange. It was charged with regulating the stock market and preventing corporate abuses relating to the offering and sale of shares and securities and corporate reporting. Also in this section, I explain how accountancy firms are regulated in the UK and by whom and some of the consequences that can occur when an accountancy practice fails to work to the required standards expected of a professional firm.

Introducing the London Stock Exchange

The London Stock Exchange's main role is to allow companies that are listed on it to raise finance, increase their profile and obtain a market valuation through a variety of routes.



The London Stock Exchange was opened by Elizabeth I in 1571 as the Royal Exchange. Over the centuries, it's experienced some turbulent events, the most dramatic of which was probably the 'big bang' of the 1980s. The big bang refers to the major modernisation of the stock exchange during which the distinction between *jobbers* (someone who makes sure brokers have someone to buy or sell shares from or to for a client) and *brokers* (someone who carries out transactions for the investors who hire them) was abolished, and the exchange's operations were computerised. Fixed commission charges were also abolished during the Big Bang.

A *premium listing* is a prestigious listing that can only be obtained by companies that meet the strict criteria of the UK 'super-equivalent' listing rules, which are higher than the EU minimum requirements. A company that obtains a premium listing is expected to meet the UK's highest standards of regulation and corporate governance. A *standard listing* allows companies to access the Main Market by meeting minimised standards in UK law rules rather than the UK's 'super-equivalent' requirements.

The London Stock Exchange has a choice of markets, which enables companies in the UK and international companies to access one of the world's deepest pools of investment capital through the:

- » **Main Market:** This is the Exchange's flagship market for larger, more established companies.
- » **Alternative Investment Market (AIM):** This is the world's leading growth market for the smaller, more ambitious company.
- » **Professional Securities Market:** This is the Exchange's regulated market for listed debt and depositary receipts.
- » **Specialist Fund Market:** This market is specifically designed for issuers of specialist funds.

Many successful companies eventually may decide to list on a stock exchange (the company is *float*). It's fair to say that a stock market listing increases the company's external and internal profile and enhances how it's viewed by stakeholders, potential investors and shareholders.



The decision to float is a major one and cannot be taken on a whim. Detailed management consultation and the advice of professionals is necessary to ensure the decision is right not only for the company, but also for those who may be directly affected by the decision to float.

The *London Stock Exchange Admission and Disclosure Standards*, published by the London Stock Exchange, sets out the rules and responsibilities relating to a

company that's admitted to trade on it. It also outlines disclosure obligations for those companies seeking admission, or already admitted to trade on the Exchange. For more information, visit www.londonstockexchange.com.



REMEMBER

As a financial accountant, your exposure to the London Stock Exchange will be limited unless you work for a company whose shares are publicly traded or you work for an accountancy firm conducting financial statement audits for publicly traded companies.

Monitoring accountancy firms in the UK

The Big 4 accountancy firms (PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG) are all monitored by the Financial Reporting Council (FRC), which will eventually become ARGA (see earlier in this chapter). By *monitored*, I mean that the FRC regularly checks out the Big 4 to make sure their work complies with all requisite standards (such as UK and Ireland GAAP and IFRS Standards, as well as auditing standards), regulations and legislation. The FRC also monitors some mid-sized firms to make sure they're applying the rules as they should. This is particularly the case for audit work because audit is a regulated profession in the UK.

All professional accountancy firms that are regulated by a professional body (such as ICAEW or ACCA), particularly those carrying out statutory audit work, are monitored on a periodic basis. Usually this can be anything from a three- to six-year cycle, depending on the findings of the professional body. If an accountancy practice is found to be complying with the applicable standards, regulations and legislation, it will usually not be inspected for another six years. Some professional bodies' policies and procedures may involve shorter or longer timescales for re-inspection, however.

If the firm is found to be falling short of the mark, the professional body may make additional visits to make sure that any recommendations and improvements are actually undertaken. Sometimes the professional body will require the firm to have an external review by an unconnected and independent file reviewer, and to submit the report to demonstrate improvement in its work.

Some professional bodies make it a mandatory requirement for member firms to send the results of at least one file review to the professional body on an annual basis so that the professional body can see if standards are being maintained, even though no inspection has taken place. In any event, having at least one file review per year (even if your professional body doesn't make it a mandatory requirement) is a good idea because it either provides reassurance that you're doing things right or flags up areas where the practice needs to improve.



WARNING

In some serious cases, if an inspection reveals substantial failings, the punishments become more severe. The firm can be fined for failing to apply the required standards and, in some particularly serious cases, the professional body may even revoke the firm's audit licence.

Professional bodies will inspect other areas of the firm's work and look at its internal procedures, such as staff recruitment policies, staff induction, anti-money laundering regulations administration, bookkeeping and accountancy processes, staff training and CPD, as well as other practice management issues. The professional bodies do this to make sure that the member firm is applying the standards expected of a professional accountancy firm. This is a vital tool, and one which benefits accountancy firms, because being a member of a professional body assures the public that you're mandated to comply with certain professional standards.

Recognising Big Brother: The Financial Reporting Council

Earlier in this chapter, I discuss the Financial Reporting Council (FRC). The FRC is an independent regulator, which focuses its attention on promoting high levels of audit quality, corporate reporting and governance.

One of the FRC's jobs is to review audited accounts for large private companies, companies listed on the Alternative Investment Market (AIM) and companies listed on the full stock exchange (PLCs). Each year the Financial Reporting Review Panel (FRRP) reviews many accounts for companies. It has the power to request a company to make changes to its accounts where it finds errors or omissions, or where information is deemed to be inadequate. In rare cases, the FRC also has the power to obtain a court order to require a company's financial statements to be amended.

The FRC's FRRP prepares an *Annual Review of Corporate Reporting*, which details its findings. These reports can provide valuable insight into common deficiencies and how to avoid them (even for smaller companies).

Understanding Generally Accepted Accounting Practice (GAAP)

For companies GAAP, along with company law, defines for financial accountants the acceptable practices in the preparation of financial statements in the UK. The importance of the information I provide in Parts III, IV and V of this book directly

ties back to GAAP. Specifically, GAAPs tell financial accountants exactly how financial data must be presented in the statement of profit or loss/income statement (profit and loss account), statement of financial position (balance sheet) and statement of cash flows (cash flow statement).

For example, GAAP states that assets, liabilities and equity go on the balance sheet and not in the income statement. GAAP is also particular about how these accounts are arranged on the balance sheet (see Part 3). In addition, GAAP gives specific rules for separating operating revenue (which is related to the business activity) from non-operating revenue (non-business-related revenue, such as profit from selling a company asset), which I explain in Chapter 7.



REMEMBER

In the UK and Republic of Ireland, GAAP consists of UK and Ireland GAAP, which are UK and Ireland accounting standards (FRS 100 to FRS 105 shown earlier in the chapter). These standards are applied by private companies as well as other types of entities, such as charities and Limited Liability Partnerships. So, when you see the phrase 'UK GAAP' or 'UK and Ireland GAAP' (the latter is the more technically correct phrase) it means FRS 100 to FRS 105.

Public interest entities (those which have significant public relevance and/or have shares traded on a stock market) and *listed entities* (those whose shares are traded on a stock exchange, including those on the Alternative Investment Market) in the UK must prepare financial statements under UK-adopted IFRS Accounting Standards. UK-adopted IFRS Accounting Standards are endorsed by the UK Endorsement Board.



REMEMBER

Changes in the FRC's structure, which are expected in the future when it transitions to ARGA, won't impact your day-to-day working life in the world of accountancy as such, so don't panic!

Looking at UK-adopted IFRS Accounting Standards

In the preceding section, I mention that two financial reporting frameworks exist in the UK: UK and Ireland GAAP and UK-adopted IFRS Accounting Standards. Listed companies (PLCs) in the UK had to adopt EU-IFRS Accounting Standards in 2005, and AIM-listed companies had to do so in 2007. Since Brexit in 2020, the UK can no longer use EU-adopted IFRS Accounting Standards and must use UK-adopted IFRS Accounting Standards instead.

So why do we have these different frameworks? Well, those responsible for standard-setting in the UK always intended to move to an international-based framework eventually, which is why UK and Ireland GAAP (FRS 100 to FRS 105) are written from an international perspective. When you work with UK and Ireland GAAP on a daily basis, you'll see there are many similarities with IFRS Accounting Standards (although UK and Ireland GAAP is not a mirror image of IFRS Accounting Standards).



TECHNICAL
STUFF

IFRS Accounting Standards date back as far as the early 1970s, and more than 140 countries around the globe are reported to be allowing, or mandating, the use of these standards. 'Why?' I hear you ask. Well, many countries adopt IFRS Accounting Standards because they want consistency in financial reporting and believe that following IFRS Accounting Standards grants access to more sources of capital because investors, creditors, financial analysts and other users of the financial statements welcome standards that require high-quality, transparent and comparable information. Without common standards, comparing financial information prepared by companies located in different parts of the world is inherently difficult, particularly in an increasingly global economy.

2

Looking at Some Accounting Basics

IN THIS PART . . .

Understand how the double-entry system of debits and credits works as well as how to prepare journal entries and bring everything together into a ledger.

Discover the different types of financial reporting frameworks used in financial accounting.

- » Defining bookkeeping
- » Bonding with the fundamental accounting equation
- » Becoming familiar with journals and ledgers

Chapter 5

Doing the Books: The Process behind Financial Accounting

In this chapter, I discuss the nuts and bolts of collecting, sifting through and entering accounting info into an accounting system. Accountants call the process of recording accounting transactions *bookkeeping*.

Some bookkeeping tasks involve basic data entry done by clerks. Others, such as preparing journal entries, are mostly done by junior accountants or bookkeepers. ‘What are *journal entries*?’ I hear you ask. Well, they’re one of the ways in which accountants enter transactions into the accounting system. I discuss journal entries in detail later in this chapter, ‘Getting to Grips with Journals’.

Will you need to deal with journal entries during your accounting career? More than likely. If you work for a small company in a one- or two-person finance department, you can very well be the *financial controller* (the big chief in charge of the company’s purse strings) and carry out journal entries yourself. If, instead, you work for a large firm of accountants that provides external auditing services to clients, the chances are you will request certain journal entries to correct

identified errors but won't necessarily process the journal entries yourself. However, you'll most certainly review journal entries while auditing the company's financial statements.

No matter where your accounting career takes you, you need to know what bookkeeping involves, and this chapter is here to help!

Shedding Some Light on Computerised Bookkeeping

Most people who aren't familiar with accountancy think in stereotypes when the word 'bookkeeping' comes up. They conjure up images of someone who looks like Bob Cratchit from *A Christmas Carol* – an overworked and underpaid clerk doing the boring, mundane task of writing up the books and making sure they balance. In the broadest sense possible, this analogy does relate to modern financial accounting. Bookkeeping involves recording daily transactions in the accounting system, such as entering customer invoices and paying supplier bills. *Bookkeepers* (the name for the employees doing the 'keeping') may also carry out routine tasks such as running payroll and doing the *bank reconciliation*: making sure the cash in the company's bank account equals the cash reflected by the cashbook.



REMEMBER

Most bookkeeping systems are now computerised and there are lots of well-known off-the-shelf systems, such as XERO (www.xero.com), SAGE (www.sage.com) and QuickBooks (www.quickbooks.intuit.com). They all do the same job (which is to keep a track of the business's accounts) albeit indifferent ways. Very rarely do you still see a manual bookkeeping system in operation because technology has taken over.

Depending on the depth of their knowledge, bookkeepers may also prepare the company's initial financial statements, which are then reviewed and adjusted by the external accountants. So, a bookkeeper can be a jack-of-all-trades. But bookkeepers are not *usually* qualified accountants (such as Chartered or Chartered Certified accountants).



TECHNICAL
STUFF

A bookkeeper may not have any specific education, experience or professional accountancy qualifications. Many bookkeepers learn accounting by doing: starting at a business in the purchase ledger department or credit control department, and then perhaps filling in the gaps in their accounting knowledge by undertaking an accounting-related course (such as a bookkeeping course).

Analysing the Effect of Business Transactions

This section walks you through the basics of bookkeeping, including the rule of debits and credits (debts and credits are known as the *double-entry* principle, which is discussed below) and why accurate bookkeeping keeps the financial statements in balance. You also discover the five steps for entering transactions into the accounting records.



REMEMBER

Modern accounting systems use the *double-entry* system: double entry means that for every entry into the company accounting records, an opposite and equal entry is necessary. In other words, debits must always equal credits. (Financial accounting has quite a bit in common with Newton's third law of motion – the one about every action having an equal and opposite reaction.) Technology certainly helps here: no accounting software package worth its salt will let you enter a single-sided transaction into the books.



TIP

Computerised bookkeeping systems always operate on a double-entry system. However, it's always worthwhile getting a sound understanding of how debits and credits work. This helps the bookkeeper or accountant when things go a bit wrong in the system. Knowing how the underpinning system works makes finding errors easier. Sometimes the books may 'balance' but hidden underneath this fake balancing may be a multitude of errors.

Understanding how debits and credits work may feel like a painstaking process when you're initially learning how they work. Believe me, it took me a long time to get my own head around the system. But once it clicks, it's like riding a bike – you never forget.

Seeing how the fundamental accounting equation works



REMEMBER

The *fundamental accounting equation* (also known as the *accounting equation* or the *balance sheet equation*) proves that all transactions are equal and opposite. It demands that

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

A truncated version of this equation states

$$\text{Net assets} = \text{Owners' equity}$$

This version of the equation just moves liabilities over to the other side of the equal sign; *net assets* are all assets minus all liabilities. Before I go any further, I need to clarify what is meant by assets, liabilities and owners' equity:

- » **Assets** are things a company owns (and controls). Chapter 7 discusses all the typical types of business assets. Some examples are cash, equipment and cars.
- » **Liabilities** are debts the company owes to others. See Chapter 8 for the complete lowdown on liabilities. The main sorts of liabilities you are likely to come across as you embark on your accountancy career are trade creditors (sometimes called *trade payables*) and loans.
- » **Owners' equity** is what the owner puts into the business when they set it up and also what's left over in the business at the end of the day – a company's assets minus its debts. Many financial accounting textbooks call owners' equity *shareholders' funds*, but it all amounts to the same thing. Chapter 8 discusses the different components of owners' equity.

Here's a simple example of the fundamental accounting equation at work:

Assets = Liabilities + Owners' equity

£100 = £40 + £60

Or

Net assets = Owners' equity

£60 = £60

Getting familiar with accounts

As an accountant within a business, you'll summarise transactions into accounts that you use to create financial reports. Each and every account your company uses is annotated in a list called the *chart of accounts*. The business uses that chart of accounts to record transactions in its general ledger (often referred to as the *nominal ledger*). The *general ledger* is a record of all financial transactions within the company during a particular accounting period. You find out everything you need to know about the general ledger at the end of this chapter.



REMEMBER

The chart of accounts is not a financial report. It's merely a list of all accounts you've previously set up to handle the company transactions. In most computerised accounting systems, the chart of accounts is already set up but can be changed to suit the organisation's requirements. You will need to know what you're doing

though when changing a chart of accounts because if you get something wrong, it can be a painstaking process putting it right.

When you're 'doing the books', as the saying goes, you record your normal business transactions using accounts you set up in the chart of accounts. Each account in the chart of accounts has a unique account number. Regardless of what accounting software package your company uses, the numbering sequence is pretty much set in stone to ensure consistency among companies and among their financial reports.

The number of accounts you can set up in the chart of accounts is virtually unlimited, so you can customise it to fit your business perfectly. Here's an example of a numbering sequence that can be used in a company's charts of accounts:

Number Sequence	Account Type
1000 to 1999	Assets
2000 to 2999	Liabilities
3000 to 3999	Equity
4000 to 4999	Income
5000 to 5999	Cost of sales
6000 to 7999	Operating, general and administrative expenses
8000 to 9999	Non-business-related items of income and expense



REMEMBER

Instead of using a four-digit numbering sequence, some software programs use a three-digit numbering sequence. For example, instead of 1000 to 1999 for assets, some software programs may use 100 to 199 but the actual structure of a chart of accounts is pretty much standard.

In the previous section, I define assets, liabilities and equity. And the income accounts (numbers 4000 to 4999) are pretty easy to understand; they represent any money the business received or is due to be received for the products or services it sells or renders. Here's a brief explanation of the accounts in the 5000–9999 numbering sequence:

- » **Cost of sales:** Cost of sales is the cost of the product that a company sells (sometimes called *direct costs*). The company can either make the product that it sells or buy it from someone else and then resell it. I talk much more about cost of sales in Chapters 10 and 13.

» **Operating, general and administrative expenses:** These accounts reflect all expenses a business incurs while performing its activities that do *not* directly relate to making or selling a product – in other words, any expense that's not a cost of sales (you may see these costs called *overheads*). Some examples are telephone and postage expenses. You can find out more about these types of expenses in Chapter 10.

» **Non-business-related items of income and expense:** A company may bring money in or spend money that generally accepted accounting practice (GAAP) may classify as *non-business-related*. For example, a business treats interest it earns on investments as non-business income. If a company sells a non-current (fixed) asset (a long-term asset that it owns, such as a car or a building) at a loss, that's an example of a non-business expense. Chapter 10 has more info about this topic as well.

Keep in mind that, if a company is in the business of lending money, interest earned on these loans *is* considered business income. Likewise, a car dealership must report losses on sales of vehicles as business expenses.



REMEMBER

Defining debits and credits

Now that you understand the basics of accounts and the chart of accounts, it's time to learn about *journal entries*, which you use to enter certain information into the company's accounting system.

Preparing journal entries is a major area of concern for trainee accountants and small business owners. The logistics of presenting the journal entry don't cause the concern; instead, the worry is how to figure out which account is debited and which is credited (the double-entry principles).



REMEMBER

Here's one of the immutable laws of accounting: assets and expenses are *always* debited to add to them and credited to subtract from them. Liability, revenue and equity accounts are just the opposite: these accounts are *always* credited to add to them and debited to subtract from them. Always, always, always – no exception to this rule exists – ever!



WARNING

A common pitfall is to mix up debits and credits where a bank account is concerned. Think about your own personal bank account. When your bank account is in *credit* it means you have money in the account (known as being *in the black*). On the flip side, when your bank account is in *debit* it means you're overdrawn (known as being in the *red* – boo!). Be careful not to mix these types of debits and credits up. A bank account in *credit* means the bank owes you the money in the account,

whereas you owe the bank account if your account is in debit. You're looking at it from the bank's point of view. When you're doing the bookkeeping, if you *debit* the bank account in the accounting system, you're putting money *in* the account. When you *credit* the bank account, you're paying money *out*. This is because you're recording the transactions from the point of view of the company and not the bank.

Seeing how debits and credits work in a computerised system

Before you enter a transaction into an accounting system, you must consider the *transaction methodology*, a five-step process for deciding the appropriateness of whatever entry you're preparing. After you get into the financial accounting rhythm, following this process becomes as natural as breathing. Here are your five considerations:

- » **What's going on?** This question addresses the need for the entry into the books. For example, did the company buy a new piece of business equipment or sell something to a customer?
- » **Which accounts does this transaction affect?** Is the account an asset, a liability, owners' equity, a revenue or an expense? Assets would definitely be affected by the purchase of business equipment, and revenue would be affected by a customer sale.
- » **How are the accounts affected – by a debit or credit?** Looking back to the rules of debits and credits, buying assets adds to the account so it's a debit. Making a sale adds to a revenue account so it's a credit.
- » **Do all debits for an entry equal all credits for the same entry?** Think about the fundamental accounting equation, which I discuss earlier in this chapter. For every debit there has to be an equal credit (double entry). In a computerised accounting system, this is likely to always be the case unless something has gone very wrong or the system is corrupted.
- » **Does the entry make sense?** Do the actions you take match the facts and circumstances of the business event? For example, although the net effect on the books is the same, you can't credit an expense account to record revenue (in other words, offsetting is generally a no-no).

In the next section, I look at the different types of journals available to you to record transactions. I also give you plenty of examples of journal entries so you can see the concept brought to life.

Getting to Grips with Journals

Journals are a lot like the diary you may have kept as a child (or maybe still keep). They're a day-to-day recording of events. But journals record business transactions taking place within a company's accounts department.

A business can have many different types of journals. In this section, you find out about the most common ones you're likely to experience throughout your career, which are tailored to handle cash, accruals or special transactions. Want to find out more? I discuss cash journals first.

Using journals to record cash transactions

All transactions affecting cash go into the cash receipts or cash payments journal.

Cash receipts journal

Let's talk about the most popular cash journal first: the cash receipts journal. After all, everyone loves to receive a bit of dosh!



REMEMBER

When accountants use the word *cash*, it doesn't just mean paper money and coinage; it includes cheques (which are now few and far between), debit and credit card transactions and electronic money (such as BACS or CHAPS transfers). In accounting, *cash* is a generic term for any payment method that is assumed to be automatic. When you arrange a BACS transfer to pay your suppliers, part of your implicit understanding is that the funds are immediately available so the payment clears. Ditto paying with a credit card, which represents an immediate satisfaction of your debt with the supplier. (Never mind the fact that there's sometimes a lag between the time the payment is processed and when the money hits the supplier's bank account.)

Here are examples of some cash events that require posting to the cash receipts journal:

- » **Customer sales made for paper money and coinage:** Many types of businesses still have booming cash sales involving the exchange of paper money and coins. Some examples are supermarkets, retail shops and some service providers such as hair salons.
- » **Customers making payments on their accounts:** I talk about *accounts receivable* (commonly referred to as *debtors*), which is money customers owe a business, in the 'Recording credit transactions' section later in this chapter. For now, just remember that any payment a customer makes for goods or services previously billed goes in the cash receipts journal.

- » **Interest or dividend income:** When a bank or investment pays a business for the use of its money in the form of interest or dividends, the payment is considered a cash receipt.
- » **Asset sales:** Selling a business asset like a car or office furniture can also result in a cash transaction. An example may be where a company has bought a new van and sells its old van to a third party that may pay via bank transfer into the company's bank account.

Keep in mind that this list isn't exhaustive; these are just a few of the many instances that can necessitate recording a transaction in the cash receipts journal.



TIP

Various types of cash receipts receive different treatment in a company's profit and loss account (or income statement). For example, cash sales are treated one way, and interest income and dividends are treated another way. I give you the details in Chapter 10.

When you run a computerised bank account general ledger report, it will usually detail the following information:

- » The name of the party who has paid the company or who the company has paid
- » A debit column, which usually indicates cash received
- » A credit column, which usually indicates cash paid
- » A VAT/sales tax column dealing with any Value Added Tax (VAT) that may be chargeable or claimable on the transaction



REMEMBER

A business needs to be registered for VAT if it expects to sell enough goods or render enough services to take it over the VAT thresholds (£90,000 at the time of writing). Not all sales are subject to VAT. HM Revenue and Customs (HMRC) determines what types of transactions are VATable and which aren't. For example, certain items of food and drink are zero-rated (VAT is charged at 0 per cent), as are lottery tickets. Cars, by contrast, are charged VAT at the standard rate (currently 20 per cent). Check out HMRC's website at www.hmrc.gov.uk for more on what is and what's not VATable.

In addition to the debit and credit columns, you may see other information in the report that doesn't have anything to do with debits or credits:

- » The date the transaction occurs
- » The name of the account affected by the transaction

Depending on the company or accounting system, additional columns may be used as well.

Figure 5-1 shows an example of a portion of a cash receipts journal.

Date	Account	Receipt total Debit	VAT Credit	Sales Credit	Sundry income Credit	Other Credit
		£	£	£	£	£
12.01.2026	Interest received	32.50			32.50	
16.01.2026	Sunnie's Sunbed Salons	1,000.00	166.67		833.33	
17.01.2026	Cash sales	680.00	113.33	566.67		
22.01.2026	VAT refund	290.00				290.00
		<u>2,002.50</u>	<u>280.00</u>	<u>566.67</u>	<u>865.83</u>	<u>290.00</u>

The journal is as follows:

		Debit	Credit
		£	£
Bank current account	Balance sheet	2,002.50	
Output VAT	Balance sheet		280.00
Sales	P&L		566.67
Bank interest received	P&L		32.50
Other income	P&L		833.33
VAT refund	Balance sheet		290.00
		<u>2,002.50</u>	<u>2,002.50</u>

FIGURE 5-1:
A partial cash
receipts journal.

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Cash payments journal

On the flip side, certain payments that the business makes to third parties are recorded as bank payments. Here are a few examples of transactions you may see in a cash payments journal:

- » **Staff wages or salaries:** When a business pays its employees, the payments made to the employees and HMRC (for pay as you earn or PAYE, and National Insurance Contributions or NIC) are recorded in the cash payments journal.
- » **Payments the company is making for sundry items:** This includes bank charges which the bank may levy for maintaining the company's bank account or one-off payments to a third party that the company isn't expecting to pay again.
- » **Payments for taxes payable:** A company pays corporation tax on its profits to HMRC or will need to pay HMRC in respect of any VAT owed once the VAT return has been completed.

The cash payments journal normally has two columns for debits and two for credits:

- » **Credit columns:** Because all transactions in the cash payments journal involve the payment of cash, one of your credit columns is for cash. The other is for *discounts received*, which are reductions in the amount a company has to pay the supplier for any purchases on account. For example, a business offers customers a certain discount amount if they pay their bills within a certain number of days (sometimes referred to as a *settlement discount*).
- » **Debit columns:** To balance these credits, the debit columns in a cash payments journal are trade payables (or trade creditors) and *miscellaneous* (a catch-all column where you record all other cash payments for transactions, such as the payment of operating expenses).

A cash payments journal also contains at least three other columns that don't have anything to do with double-entry principles:

- » The date the transaction occurs
- » The name of the account affected by the transaction
- » The name of the company that supplied the goods/services (which means who the payment is made to)

Depending on the company or accounting system used, more columns can be used as well. Figure 5-2 shows an example of a partial cash disbursements journal.

Date	Internal Payment ref	Payee	Payment total Credit	VAT Debit	Bank charge Debit	HMRC VAT Debit	Net wages Debit	Repairs Debit
			£	£	£	£	£	£
07.03.2026	HMRC	VAT return - Qtr 31.01.2026	196.44			196.44		
16.03.2026	DD	FarWest Bank Ltd	35.00		35.00			
18.03.2026	BACS	February 2026 salaries	8,743.00				8,743.00	
19.03.2026	D Joiner	D Joiner - repairs to property	750.00	125.00				625.00
			<u>9,724.44</u>	<u>125.00</u>	<u>35.00</u>	<u>196.44</u>	<u>8,743.00</u>	<u>625.00</u>

The journal is as follows:

		Debit	Credit
		£	£
Bank current account	Balance sheet		9,724.44
Input VAT	Balance sheet	125.00	
Bank charges	P&L	35.00	
VAT control account	Balance sheet	196.44	
Net wages control account	Balance sheet	8,743.00	
Repairs and renewals	P&L	625.00	
		<u>9,724.44</u>	<u>9,724.44</u>

FIGURE 5-2:
A partial cash
payments journal.

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Recording credit transactions

Credit transactions take place whenever cash doesn't change hands immediately. For example, a customer makes a purchase with a promise to pay within 30 days. These transactions are accounted for under the 'accruals' method of accounting (which means transactions are recognised in the accounts when they arise, not when they are paid or settled). See Chapter 6 for more details.

For trainee accountants or those new to the world of accountancy, dealing with all the different types of credit transactions can seem rather daunting but don't worry, I take you through all of the ones you're likely to come across as you begin your accountancy journey and give you a complete explanation of each. And, before you finish this section of the book, I'll outline some typical credit transactions.

Following is information about the two main types of credit journals. The first applies when goods/services are sold to customers on credit – the *sales journal*. The second applies when goods/services are received on credit from a supplier – the *purchases journal*. I discuss other accrual-type journals in the upcoming section 'Finding out about other journals'.

Sales journal

The sales journal records all sales that a business makes to customers *on credit* (or 'on account'), which means no money changes hands between the company and its customer at the time of the sale. A sales journal affects two different accounts: trade receivables (also known as *trade debtors*) and sales. The sales journal is often referred to as the *sales day book*.



REMEMBER

Sales made to customers on credit are usually recorded by way of a sales invoice in a computerised accounting system. When the sales invoice has been raised, the double entry is automatically carried out. However, accountants need to have an awareness of what those journals are to resolve any posting issues if they arise.

Where the business is registered for VAT (meaning it must charge VAT on any sales it makes to a customer that are within the scope of VAT), the VAT element is also dealt with in a computerised accounting system.

Figure 5-3 presents an example of a sales journal.



TIP

When you record credit sales in your sales journal, you follow up by posting the transactions to each customer's listing in the trade receivable ledger. (See the 'Bringing It All Together in the Ledger' section of this chapter.)

Date	Invoice ref	Customer	Trade debtors Debit	VAT Credit	Sales/revenue Credit
			£	£	£
17.06.2026	3254	Selwood Industries Ltd	3,000.00	500.00	2,500.00
20.06.2026	3255	Bauer Enterprises Ltd	1,275.00	212.50	1,062.50
22.06.2026	3256	Olive Workwear Ltd	4,250.00	708.33	3,541.67
			<u>8,525.00</u>	<u>1,420.83</u>	<u>7,104.17</u>

These items are recorded in the accounts as follows:

		Debit	Credit
		£	£
Trade debtors	Balance sheet	8,525.00	
VAT control account	Balance sheet		1,420.83
Sales	P&L		7,104.17
		<u>8,525.00</u>	<u>8,525.00</u>

FIGURE 5-3:
A partial
sales journal.

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REMEMBER

Use the sales journal only for recording credit sales. Sales returns, which reflect all products the customers return to the company after the sales are done, do not get recorded in the sales journal. Instead, you record them in the general journal, which I discuss later in this section.

Purchases journal

Any time a business buys using credit (*on account*), it records the transaction in its purchases journal. The purchases journal is also known as the *purchases day book*. The purchases journal typically has a column for date, number and amount. It also has the following columns:

- » **Trade payables (trade creditors):** Because the company is purchasing on account, the current liability account called 'trade payables/trade creditors' is always affected.
- » **Terms:** This column shows any discount terms the company may have with the supplier. For example, *2/10, n/30* means the company gets a 2 per cent discount if it pays within ten days; otherwise, the full amount is due in 30 days. (The *n* in this abbreviation stands for 'net'.)
- » **Name:** The company records the name of the supplier from whom the purchase is made.
- » **Account:** This column shows to which financial statement account(s) the purchase is posted to.

In the example shown in Figure 5-4, three accounts exist: trade payable (T/P), VAT and purchases.

Date	Ref number	Supplier	Trade	VAT	Purchases
			creditors	Debit	Debit
			Credit		
			£	£	£
13.07.2026	1993	Philbin Supplies Ltd	125.63	20.94	104.69
20.07.2026	2357	Ratchford Roofing Supplies Ltd	2,587.00	431.17	2,155.83
31.07.2026	1485	McSharry Manufacturing Ltd	5,000.00	833.33	4,166.67
			<u>7,712.63</u>	<u>1,285.44</u>	<u>6,427.19</u>

These items are recorded in the accounts as follows:

		Debit	Credit
		£	£
Purchases	P&L	6,427.19	
VAT control account	Balance sheet	1,285.44	
Trade creditors (payables)	Balance sheet		7,712.63
		<u>7,712.63</u>	<u>7,712.63</u>

FIGURE 5-4:
A partial
purchases
journal.

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Finding out about other journals

The discussion of journals wouldn't be complete without a brief rundown of other types of journals you'll stumble upon in your dealings with financial accounting, as well as the general journal. I cover both issues in this section.

Special journals

Here are three additional journals you'll encounter:

- » **Payroll journal:** This journal records all payroll transactions such as gross wages, PAYE tax and other deductions (such as NIC paid by the employee and employer) and *net pay*, which is the amount paid to the employee.
- » **Purchases return and allowances journal:** This journal shows all subtractions from gross purchases because of products a company returns to the supplier or discounts given to the company by the supplier.
- » **Sales returns and allowances journal:** This journal shows all subtractions from gross sales because of products customers return or discounts given to the customers.



REMEMBER

This list isn't exhaustive; some companies may have other journals, and some smaller companies may not use all of these. However, if you understand the basic methodology of all the journals I discuss in this chapter, you'll be well on your way to handling the major types of journals a business will process in its accounts.

Sometimes a bookkeeper may not fully understand a transaction or may need to undertake some additional investigation work. For example, there may be an amount of money paid into the bank account by BACS for which there is no meaningful reference on the bank statement. The bookkeeper cannot just ignore this deposit into the bank account because the bank reconciliation will not balance. While the bookkeeper investigates this amount of money, it can be posted to an account called a *suspense account*. A suspense account is a temporary account that holds transactions that need to be investigated further. At the accounting period end, the suspense account must be cleared out to nil.

General journal

The *general journal* is a catch-all type of journal where transactions that don't appropriately belong in any other journal get posted. Many companies record interest income and dividends in the general journal.

This journal is also used for adjusting and closing journal entries:

» **Adjusting journal entries:** One key reason you'd adjust journal entries is to make sure the books are recording transactions under the accruals basis of accounting. For example, on 30 April 2026, employees have earned but not yet been paid £5,000 in gross wages (the next payroll run is on 2 May 2026). So, to make sure that your company's payroll expense for the period is complete, you post an adjusting journal entry debiting 'payroll costs' in the profit and loss account for £5,000 and crediting 'wages payable' in the balance sheet as a liability for £5,000 plus the employer's NIC on that £5,000.

You also adjust journal entries to *reclassify* transactions when the way in which a transaction was originally recorded is correct, but circumstances change after the fact, and the transaction needs to be adjusted. For example, your company buys £1,000 of supplies on 1 April 2026, and the transaction is originally posted as stock. On 30 April 2026, a stock take is carried out. Only £800 of the stock remains as you've sold £200 worth, so you have to debit your 'purchases expense' account in the profit and loss account for £200 and credit 'stock' in the balance sheet also with £200.

» **Closing journal entries:** You use this type of entry to clear out all *profit and loss accounts*, which reflect all the revenue and expenses for a certain time period. You then transfer the net amounts to the balance sheet as 'profit and loss account reserves' (sometimes called 'retained earnings'). You take this step to set the profit and loss account figures to zero, so you know exactly how much revenue and expense are recorded during a certain time period.

(See Chapter 10 for information about the profit and loss account.) Four closing journal entries are necessary:

- You debit all revenue accounts and miscellaneous income accounts.
- You credit all cost of sales and expenses accounts with the same amounts as they have been originally debited with.
- You post the difference between the debits and credits in steps 1 and 2 – which is the net profit for the period – to profit and loss account reserves in the equity section of the balance sheet (sometimes called ‘retained earnings’).

Here’s an example. If in step 1 you debit income by £5,000 (to reduce income to zero) and in step 2 you credit expenses with £3,000 (to reduce expenses to zero), you now have a balance left over of £2,000, which is profit (income is more than expense by £2,000). This remaining credit is posted to profit and loss account reserves (retained earnings). And crediting retained earnings is a good thing!

- Finally, if the owners have paid themselves any dividends during the period, you credit the dividend account, reducing it to zero and debit retained earnings.



TIP

Honestly, the chances are you may never have to prepare the first three closing entries yourself because all accounting software systems do this task for you automatically. However, you do need to understand what goes on with the debits and credits when the books close, in case there are any errors that need investigating.



TECHNICAL
STUFF

You clear out only profit and loss accounts with closing journal entries. Balance sheet accounts are permanent accounts. Until you cease using the account (for example, you close a bank account), no balance sheet accounts are zeroed out at the year- or period-end. Part 3 of this book provides lots more info about balance sheet accounts.

Exploring examples of common journal entries

It’s time for you to review a few journal entries so the concepts I discuss earlier in the chapter really come to life. First, keep in mind the general format of a journal entry, which is shown in Figure 5-5:

- » The date of the entry is recorded in the left-hand column.
- » The account debited or credited is in the middle column.
- » The amounts are shown in the right-hand column.

FIGURE 5-5:
The standard
journal
entry format.

Date	Account name and narrative	Debit	Credit
		£	£
31.07.2026	Bank current account	45.00	
31.07.2026	Bank interest received		45.00
	<i>Being interest received on bank current account</i>		

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Journal entries always tend to list debits first and credits afterwards.



REMEMBER

Journal entries can have more than one debit and one credit. And the number of accounts debited and credited doesn't have to be the same. For example, you can have five accounts debited and one account credited. However, the final monetary amount of the debits and credits has to match.



EXAMPLE

Let's prepare the journal entry for service income, which records cash and accrued income. You provide a service to your client, Mr Jones, on 15 May 2026, giving him invoice number 200 in the amount of £700 for services rendered. Before he leaves your office, he pays you £200 via Apple Pay, and it has been agreed that he will pay the remaining balance of £500 next month when he receives payment from one of his customers. The journal entry to record this transaction is shown in Figure 5-6. (Note, I have ignored VAT in this figure.)

FIGURE 5-6:
Recording
service income.

Date	Account name and narrative	Debit	Credit
		£	£
15.05.2026	Bank current account	200.00	
	Trade debtors (receivables)	500.00	
	Service income		700.00
	<i>To record invoice number 200</i>		

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REMEMBER

Under the accruals method of accounting (see Chapter 6), both the cash receipts and the agreement to pay the remaining balance must be reported at the time the transaction takes place because the service has been rendered and the income has been earned.



TIP

Every journal entry should have a brief explanation (called a *narrative*). It doesn't have to be extremely detailed but should be long enough that you or anyone else reviewing the journal entry can understand why you made the journal entry. The description for the journal entry in Figure 5-6 ('To record invoice number 200') is brief but completely understandable.



EXAMPLE

Let's do one more journal entry before moving onto the last section in this chapter. Say you borrow £5,000 from a friend on 1 July 2026. The terms of the loan are that you have to pay £200 worth of interest on 31 July 2026 and pay the loan back in full, plus another £200 in interest on 31 August 2026. Figure 5-7 shows how your journal entries look from start to finish.

Date	Account name and narrative	Debit	Credit
		£	£
01.07.2026	Bank current account	5,000.00	
	Loan account		5,000.00
	<i>Being working capital loan received</i>		
31.07.2026	Interest expense	200.00	
	Bank current account		200.00
	<i>Being interest payment on loan</i>		
31.08.2026	Loan account	5,000.00	
	Interest expense	200.00	
	Bank current account		5,200.00
	<i>Being redemption of loan and payment of interest</i>		

FIGURE 5-7:
Journalising a
loan transaction.

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Bringing It All Together in the Ledger

At this point you may be thinking, 'Okay, I understand how journals are posted and what they do, but how do these entries affect the financial statements?' That's the subject of this section. The accounts and amounts debited or credited affect the company's ledgers, which I define next.

Understanding what a ledger is

The term 'ledger' is quite an old term and the term itself originates from a book that lies permanently in some specified place that records various transactions. Even though everything accounting-related is now computerized, we still refer to ledgers in the workplace.

A *ledger* records transactions taking place in a company during a particular accounting period. Picture a very big book. Every page of the book has a title that corresponds with an account from the chart of accounts. For instance, page 1 may be titled '1001 Cash at Bank'. On this page, you'd list the total of the monies you paid into your company bank account, as well as the total of all the withdrawals from the bank account for a given period – say, for a month.

WALKING THROUGH THE BASIC ACCOUNTING PERIOD

In most businesses, the accounting period is based on a calendar month. Using January as an example, during that month's accounting period, transactions are entered into an organisation's accounting system up to 31 January. For example, the business receives an invoice from a stock supplier for purchases made on 12 January, and the invoice will be paid when the supplier statement arrives showing all purchases the company makes during January. (See Chapter 8 for more information about purchases and payables.) The purchase ledger clerk posts this invoice into the purchase ledger, which increases stock and trade payables. Both actions affect the balance sheet (see Part 3 of this book). However, by doing a stock count, the company accountant reclassifies some of this purchase to cost of sales – a profit and loss account – via a journal entry.

Also, during each accounting period, the cost of using any non-current (fixed) assets such as property, plant and equipment (see Chapter 7) must be reclassified from the balance sheet to the profit and loss account. This is done by preparing a journal entry to record the depreciation expense (see Chapter 12).

A company enters accounting transactions contemporaneously during the accounting period. However, preparation of the financial statements takes place after all transactions and journal entries have been completed. How quickly the financial statements are prepared varies by company. Some companies have very tight deadlines after the year/period end to prepare the financial statements; others may not.

A business has one big ledger: the general ledger. The *general ledger* lists all transactions taking place in all the accounts during the accounting period. You may also see subsidiary ledgers (often referred to as *memorandum accounts*) that list in detail transactions happening only in specific accounting circumstances. For example, the *payroll subsidiary ledger* lists all payroll transactions. The *trade receivables subsidiary ledger* lists all customers owing your company money and the amount of their current outstanding balance.

Posting transactions to the ledgers

When you *post to the ledgers*, you simply take accounts and numbers from transactions you enter in the journals and record them in the correct ledger. If a subsidiary ledger is the first point of recording, the transaction eventually flows through the subsidiary ledger to the general ledger. For example, a customer sale on credit first gets posted to the sales journal and then is reported in the trade receivables subsidiary ledger under the customer's name.

Then, that amount flows from the trade receivables subsidiary ledger to the trade receivables listing in the general ledger, combining with all other customers owing the business money to show a grand total of trade receivables. Following on with the same transaction, the combined total of all the transactions in the sales journal also posts to the sales day book in the general ledger.

Until modern accounting software arrived, posting to the ledgers was a laborious process requiring the use of an A3 analysis pad with about 14 columns. Luckily, this practice has pretty much become a thing of the past because off-the-shelf accounting software packages have become so cheap and easy to use.



TIP

With most accounting software programs, no formal procedure to post to the ledgers exists, so the above process is unlikely to happen in real life. Every time you enter a transaction in a journal, it automatically posts to the correct ledger. However, bespoke accounting software may require the user to actively select the posting command.

Viewing an example of a general ledger

While the theory of a general ledger is the same in every instance, general ledgers from one company to another using different types of accounting software will look slightly different. Figure 5-8 shows a very simple partial general ledger for a small services company. It starts with a revenue account, 'consultancy fees', and ends with an operating expense account, 'bank charge'.

The debit, credit and balance columns in Figure 5-8 should be self-explanatory. Here's what some of the other columns mean:

- » **Type:** The original nature of the transaction.
- » **Date:** The day the transaction took place.
- » **No.:** The identifying number from the journal of original entry. For example, BAC1008 is the internal BACS reference number used to pay Isabelle Byrne.
- » **Narrative:** Any explanation for the transaction that you put in the original entry.

Breary Bricks Ltd
General ledger (extract)

	Type	Date	Internal ref	Narrative	Debit	Credit	Balance
					£	£	£
4050 - Consultancy fees							
	Sale	03.01.2026	BB1025	Bamber-Ashton project		55,000.00	55,000.00
	Sale	26.03.2026	BB1172	Sunnie Interiors		500.00	55,500.00
	Sale	27.03.2026	BB1183	Greaves Industries project		15,000.00	70,500.00
	Credit note	27.03.2026	BB1183CR	Greaves Industries overcharge	500.00		70,000.00
	Sale	31.03.2026	BB1185	Sunnie Interiors - renovation		12,000.00	82,000.00
	Total 4050 - Consultancy fees				500.00	82,500.00	333,000.00
5300 - Wages							
	Payment	29.03.2026	1008	Isabelle Byrne - gross pay	800.00		800.00
	Payment	29.03.2026	1009	Megan Breary - gross pay	1,000.00		1,000.00
	Payment	31.03.2026	1010	Alex Leavitt - gross pay	1,500.00		1,500.00
	Total 5300 - Wages				3,300.00	0.00	3,300.00
5400 - Subcontract labour							
	Payment	31.03.2026	BAC1011	Lisa Weaver - consultancy	1,500.00		1,500.00
	Total 5400 - Subcontract labour				1,500.00	0.00	1,500.00
5500 - Bank charges							
	Payment	31.03.2026	Direct debit	Farwest Bank PLC	15.00		15.00
	Total 5500 - Bank charges				15.00	0.00	15.00

FIGURE 5-8:
A partial
general ledger.

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Summing up the purpose of the trial balance

The *trial balance* is a listing of all the accounts in the general ledger and the balance they hold as at the date of the report. The purpose of the trial balance is to make sure all debits equal all credits. Accountants also use it as a front-line tool to review the accuracy of the financial statements.

For example, you run the trial balance, quickly scan it and see that the postage and stationery expense account seems too high based on your professional judgement and knowledge of the company. You check the general ledger and see that a rent payment to the business landlord for £5,000 was posted to postage and stationery by mistake.

Figure 5-9 shows an example of a partial trial balance.



WARNING

Accounting software should not allow a user to enter a transaction that's out of balance, so technically, the trial balance should always be in balance. If the accounting system allows an out-of-balance transaction to occur, the software has a serious flaw and shouldn't be used.

Breary Bricks Ltd
Trial Balance as at 31 March 2026

Account no.	Account name	Debit £	Credit £
0001	Delivery van	35,000.00	
0002	Delivery van depreciation		5,000.00
1001	Stock and work in progress	27,488.50	
1002	Trade debtors	13,194.56	
1003	Petty cash	50.00	
1004	Bank current account	17,113.25	
1100	Trade creditors		2,500.00
1101	VAT liability		265.31
1102	Credit card		1,645.22
1103	PAYE/NIC payable to HMRC		2,211.00
1104	Bank loan		5,411.00
1105	Director's current account		1,000.00
1200	Ordinary shares		100.00
1300	Retained earnings		3,996.00
4000	Sales		135,117.62
5000	Cost of sales	41,091.55	
6000	Gross wages	10,001.22	
6005	Employer's National Insurance	4,189.65	
7000	Heat and light	3,266.98	
7100	Insurance	2,150.44	
7200	Rent	2,000.00	
8000	Accountancy	1,700.00	
		157,246.15	157,246.15

FIGURE 5-9:
A partial
trial balance.

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- » Getting to grips with the cash and accruals methods of accounting
- » Walking through other types of accounting besides financial
- » Discovering the *Concepts and Pervasive Principles*

Chapter 6

Exploring Accounting Methods Under UK and Ireland GAAP and UK-adopted IFRS

If you're coming round to the way of thinking that accounting isn't that bad, this chapter gives you some information about other types of accounting besides financial that you may be interested in. And the good news is that the basic accounting facts you learn in your studies apply to just about any accounting specialism.



TECHNICAL
STUFF

Before I discuss other types of accounting, I explain the difference between the cash and accruals methods of accounting. Accountancy courses are primarily concerned with the accruals method because it's the only method allowed under UK and Ireland generally accepted accounting practice (UK and Ireland GAAP, which I explain in Chapter 4). However, to truly understand the accruals method, you must understand how it differs from the cash method.

In addition, you get an introduction to the *Concepts and Pervasive Principles*. I walk you through these concepts, tying them into material you encounter in Parts 3 and 4 of this book and throughout your financial accounting class.

Understanding Different Accounting Methods

This book is about financial accounting, which means operating on the accruals method of accounting according to GAAP. (If you struggle with the accruals method and GAAP, don't worry – I cover both in the upcoming 'The accruals basis' section.)

However, another method of accounting exists besides the accruals basis: the cash method. This section gives you an expanded version of what you'll potentially come across when this method is appropriate.



REMEMBER

Going through this information is important for a few different reasons. First, to really understand a topic, you often have to understand why it differs from the alternatives. Second, if after finishing your accountancy studies you find you have a passion for the whole debiting and crediting extravaganza, you'll need to know what other accounting specialisms are available. Finally, to be a well-rounded financial accountant, you must have at least a basic understanding of the other methods and types of accounting – not only to know the differences, but also to be able to explain to individuals who may not be as savvy on accountancy about the different methods and the method that is appropriate in a given situation. In addition, financial accountants may well have to refer to management accounting records used in the production of internal management accounts in order to produce the financial accounts.

The cash basis

Using the cash basis of accounting couldn't be easier. You record income when cash is received, not when an invoice is raised; and you record expenses when they're paid – not when they're incurred. However, the ease of using the cash method is more than offset by the fact that the cash basis fails to match revenue to the expenses the company incurs to earn that revenue. Because of this failure, cash basis financial statements do not present as accurate a picture of how the business is performing as the accruals basis of preparing financial statements does. Certainly in the UK, financial statements must be prepared that give a *true and fair view*. Financial statements prepared using the cash basis would hardly

give a true and fair view if the company buys and sells goods on credit because the company's trade receivables and trade payables wouldn't be included. That can seriously mislead a user of the financial statements, who may come to the completely wrong conclusion about the financial health of the business.



EXAMPLE

Leslie's Lilos Limited has revenue of £40,000 and expenses totalling £15,000, which are directly associated with revenue (known as *cost of sales*) in April. £20,000 of the revenue was received in cash, and the rest is on account. Leslie's Lilos paid cash for the entire £15,000 of expenses.

Using the cash method, Leslie's Lilos net profit for April is £5,000 (£20,000 cash revenue less £15,000 cash expenses). But that £5,000 of net profit grossly underrepresents the volume of activity the company had during the month. The figures can be just as wildly inaccurate if the company didn't pay any of its expenses and had cash sales of £30,000 – or for any other scenario involving using cash changing hands as a criterion for recording net income. So, you can see why a user of cash-based accounts can be seriously misled and end up drawing the wrong conclusions about the business.



REMEMBER

Some small sole trader businesses use the cash method because they have little activity in the way of trade debtors/receivables or trade creditors/payables. This is acceptable for tax purposes. But the vast majority of businesses use the accruals basis, which I explain next.

AN 'EARNED AND REALISABLE' EXAMPLE

If you're at all confused about how a transaction becomes earned and realisable (*realisable* means 'in or able to be converted into cash'), here's an example to bring the concept into focus:

A florist customer's wedding is taking place in a couple of days, and the customer has just paid the florist in full using a debit card for the reception table arrangements. Is this income earned? No, the florist has not earned the revenue from the wedding job until all floral arrangements are present and correct on the reception tables.

At face value, because the florist has received the customer's money in the bank, you may be tempted to say that this revenue is realisable even though the flowers haven't been delivered yet. But hang fire: a couple of days after the wedding, the florist finds out the customer's debit card payment has been reversed by the bank because the customer had insufficient funds. The florist calls the customer's mobile, but it's switched off. The florist subsequently finds out that the customer has also moved, leaving no forwarding address.

(continued)

(continued)

Is the revenue from this job now earned and realisable? Earned, yes – the florist delivered on their end of the contract. Realisable, no, because the florist has no realistic expectation of ever being paid. Under the accruals method of accounting, this transaction is not recorded as revenue. (And under the cash method of accounting, it's not recognised because money did not change hands.)

The accruals basis

This is the main basis on which financial statements are prepared. Using the accruals method of accounting, you record revenue when it's earned and realisable (by *realisable*, I mean turned into cash), and you record expenses when they're incurred, regardless of whether they have been paid. Wondering what the criteria are for revenue to be *earned* and *realisable*? The earned criterion is satisfied when the supplier satisfactorily fulfills its contractual obligations with the customer. *Realisable* means that there is an actual expectation of collecting the money for the job from the customer.

The accruals method takes cash out of the equation, because money changing hands doesn't determine whether you recognise a transaction. As a result, a company using the accruals method will have a *trade receivable* (also known as a *trade debtor*), which is money owed to the business by customers, and a *trade payable* (also known as a *trade creditor*), which is money a company owes to its suppliers.



TIP

The statement of cash flows, which I discuss briefly at the end of this chapter and explain in detail in Chapter 11, is the 'bridge' between the cash and accruals methods of accounting. That's because the statement of cash flows shows how a company has generated cash and what it has spent that cash on – an aspect missing from the accruals method. Therefore, it gives the users of the financial statements a chance to look beyond the accruals-based numbers.

Sifting through Standards for Other Types of Accounting

The accountancy profession is vast, and there are lots and lots of specialisms within it. While many chartered and chartered certified accountants work in financial accounting, other fields also exist in which accountants can pursue

employment. In this section, I discuss four accounting fields: management accounting, not-for-profit, governmental and international. (For an insight into life as an accountant, be sure to check out Chapter 2.) The basic accounting concepts you learn in your financial accounting studies remain the same in these fields, but some important differences exist between these four and financial accounting.

For example, if you work in an accounting field other than financial accounting, you have to follow standards different from (or in addition to) those I discuss in Chapter 4. Other organisations besides the financial accounting standard-setters give official guidance on how to prepare financial statements and reports. For example, in the UK, charitable organisations follow the Statement of Recommended Practice (SoRP) on charity accounting.

But wait, I don't want to get ahead of myself! Read on, because in the next few sections, I give you the lowdown on these four types of accounting and note who provides guidance to accountants in these fields.

Management accounting

Management accountants provide economic and financial information for the internal users of financial statements, such as a company's directors, management and human resources department. For example, human resources personnel use managerial accounting reports to make sure they have the right mix of employees to keep the business running smoothly. Additionally, management accounting reports measure quality, performance and how close each department or business unit comes to meeting its goals. They also measure managerial effectiveness and efficiency – a topic I touch on in Chapter 1.

In order to be useful, management reports are issued frequently – sometimes daily. There's no messing around! Other times, the finance department may prepare and distribute the reports the day after a reporting period ends. Management accounts usually follow a company's own 'house style' rather than specified formats, but are reliable enough for management to make informed decisions.



REMEMBER

Because these reports are only used internally, no regulatory bodies or other external authority tell the management accountant how they should do their job. However, accountants are all bound by ethical standards issued by their professional bodies, and even if the management accountant is not professionally qualified, they're still expected to undertake their job to the best of their ability.

Not-for-profit accounting

As I explain in Chapter 2, not-for-profit businesses are run for the benefit of the public good – not because of any profit motive. These types of organisations include hospitals, schools, religious organisations and charitable organisations.



TECHNICAL
STUFF

Obtaining ‘not-for-profit’ status involves having to meet certain strict criteria (you can’t just set up a charity on a whim). For example, a charity must be able to demonstrate its purpose and its objectives and is generally not able to pay its trustees for their services. In the UK, many not-for-profit companies operate as a *company limited by guarantee*, which means that the company does not have shares or shareholders but still has the benefit of corporate status. Since the introduction of the Companies Act 2006, the number of *Community Interest Companies* (CICs) has increased. These are companies that are limited by guarantee, or companies limited by shares (a *company limited by shares* means the company issues shares to shareholders and in the event of the company being wound up the shareholders liability is only limited to the amount they have invested), but with special conditions applied to make sure that the companies’ profits and assets are used for the benefit of the public.

The not-for-profit accountant’s job has two additional components (in addition to the typical accounting duties): preparing budgets and preparing the financial information for grant applications. Budgets are crucial because the organisation needs to be able to predict the amount of money that must be obtained through grants, donations and fundraising efforts in order to serve the organisation’s purpose.



REMEMBER

One difference in keeping the books for profit-seeking versus not-for-profit organisations is that not-for-profits use *fund accounting*, which groups transactions together into funds or accounts that share a similar purpose. This way, the organisation has a better idea of what resources it has available for each specific function.



TIP

If not-for-profit accounting interests you, check out *Nonprofit Bookkeeping & Accounting For Dummies Second Edition* by Maire Loughran and Sharon Farris (John Wiley & Sons, Inc., 2023) for much more information about this field.

Government accounting

At the local and national government level, cash comes in from sources such as council taxes; funding from the central government, such as for schools and roads; interdepartmental government transfers; fines; value added tax; licences and permits; and issuances of bonds. Funds are then dished out to cover costs.

Government accountants also prepare financial statements that are open to the general public. The financial statements must show accountability to the general public while pursuing the goals of efficiency and effectiveness. The financial statements are also used by external users (see Chapter 1) to decide whether to invest in government bonds.

In the UK, government accountants are mainly qualified with the Chartered Institute of Public Financial Accountants (CIPFA). CIPFA is the only professional accountancy body dedicated to public finance.

International accounting (IFRS)

An accountant may work for multinational businesses performing financial and management accounting, preparation of corporate tax returns and auditing for businesses operating around the world. (Remember that *auditing* is the process of investigating financial information prepared by someone else to see if it is fairly stated.) They should be familiar with the legal regulations and standards of the countries with which their employer conducts business.

Accountants have to deal with foreign currency translations, such as how many UK pounds equal how many euros (EUR), and then incorporate this translation into the company's financial statements in its presentation currency (the currency in which the financial statements are prepared).



REMEMBER

An important organisation for international accountants is the International Accounting Standards Board or IASB (www.ifrs.org). The IASB is active in making its accounting standards (International Financial Reporting Standards) global, and many countries have adopted the use of IFRSs as their financial reporting framework. This process is referred to as *harmonisation*, and the purpose is to develop a single set of global accounting standards that will provide high-quality, transparent and comparable financial statement reporting. In the UK, some large businesses, including those that sell their shares on the London Stock Exchange, prepare their accounts under UK-adopted IFRS. Even though the IASB develop IFRS Accounting Standards, they are issued for use in the UK by the UK Endorsement Board.

Many professional courses on accountancy will examine IFRSs because of their global domination, so if you're pondering the thought of becoming an accountant, the chances are you won't escape IFRSs!

Considering the *Concepts and Pervasive Principles*

Accountancy dates back to the Stone Age as a way of working out the supply and demand of commerce. Long before we had shops and cash registers, people had to have some way of making sure an adequate trade goods for goods or goods for services existed. Also, accountancy was put to use as far back as the Holy Roman Empire (and probably even earlier) to make sure that all subjects to the empire were paying their share of taxes. Note I didn't say their *fair* share of taxes, which is always a lively subject for debate! As I say in Chapter 4, standard setting wasn't prevalent in the olden days, and it wasn't until the early 1970s that the (then) International Accounting Standards Committee started to issue accounting standards. In the UK, things started a little later when the (then) Accounting Standards Board started to issue standards in 1982.



REMEMBER

The *Concepts and Pervasive Principles* is found in FRS 102, Section 2 *Concepts and Pervasive Principles* and in FRS 105, Section 2 *Concepts and Pervasive Principles*. They set out the concepts and basic principles which underpin the preparation of financial statements as well as the objective of financial reporting.



TECHNICAL
STUFF

The *Concepts and Pervasive Principles* in FRS 105 is much shorter than the *Concepts and Pervasive Principles* in FRS 102 because FRS 105 is prescriptive in how a micro-entity must deal with items in its accounts, whereas FRS 102 offers much more choice.

The International Accounting Standards Board (IASB) that issues IFRS Accounting Standards has a *Conceptual Framework for Financial Reporting* which provides a theoretical framework for issuing new, and amending existing, IFRSs and IASs. The *Concepts and Pervasive Principles* found in FRS 102 and FRS 105 are both similar and have recently been aligned so that they are more consistent with the IASB's *Conceptual Framework for Financial Reporting*.

The objective of financial reporting



REMEMBER

What is the purpose of financial accounting? It's the process of classifying and recording all accounting events taking place during the normal course of a company's business. These events include earning revenue, paying bills, making gains and incurring losses.

The results of all these events are arranged into the correct financial statement (the balance sheet, income statement and/or statement of cash flows) and reported to the external users of the financial statements (often called the *stakeholders*).

External users include investors, creditors, banks and regulatory agencies such as HM Revenue and Customs (HMRC) and the London Stock Exchange. Want to know more? I discuss this topic in Chapter 1.

The fundamental and enhancing characteristics of financial statement information

Besides organising accounting events into financial statements, how do financial accountants serve the needs of the external users? Well, just like adding salt instead of sugar to a cake mix is going to make your end result seriously out of whack, adding the wrong ingredients to your financial statements is going to give your users the equivalent of an inedible cake.

What sorts of characteristics must be present so you can make sure the financial statements totally serve the needs of your users? Well, the *Concepts and Pervasive Principles* split the characteristics into two parts: fundamental qualitative characteristics and enhancing qualitative characteristics. These characteristics are then broken down into sub-components, as follows:

» **Fundamental qualitative characteristics:** Financial information is:

- **Relevant:** The information is capable of making a difference in the decisions made by users.
- **Faithful in what it represents (faithful representation):** The information is complete, neutral (meaning free from bias) and free from error.

» **Enhancing qualitative characteristics:** The enhancing qualitative characteristics are:

- **Comparability:** Financial statements should be prepared so that the user can compare the information with another entity in the same industry/ service sector or compare financial information from one accounting period to the next.
- **Verifiability:** financial information should be verifiable; that is, information is available to back up the financial statements.
- **Timeliness:** Financial information should be prepared on a timely basis because the longer it takes to prepare financial statements after the accounting period has ended, the less meaningful it is. However, on the flip side, it may be that a certain amount of time must pass so as to assess seasonal fluctuations or obtain some other information that may not be available until some time after the accounting period has ended.

- **Understandability:** The information in the financial statement must be understandable to people not privy to the internal operations of the business. Of course, being understandable is a relative concept. Basically, this characteristic means the financial information must be laid out in a fashion so that users with a reasonable understanding of the business world (and a willingness to do research on specific topics as needed) can understand the important issues in the financial statements. However, the need for understandability does not allow for complex information to be omitted on the basis that it may be too difficult for users to understand.

The *Concepts and Pervasive Principles* also includes materiality as a sub-section of relevance. An item is *material* if its omission, misstatement or obscurement may cause the user of the financial statements to arrive at the wrong conclusion.



WARNING

Where materiality is concerned, be especially careful. Sometimes (particularly in auditing), you can calculate materiality using a variety of methods. Something that may be immaterial in numerical terms may become material in nature – for example, if it turned a profit into a loss.

Going concern

The term *going concern* refers to a business's ability to continue operating for the foreseeable future. The *foreseeable future* is usually a period of at least 12 months from the date on which the year-end accounts are approved.

Accounts are usually prepared on a going concern basis. However, this won't be the case if management intends to liquidate the business or cease trading (meaning if it closes down), or they have no realistic alternative but to do so. This is usually a drastic decision and one that won't be taken lightly. This will usually happen if the business runs out of cash and can't source additional funding – for example, because the bank has refused support, and the directors and/or shareholders can't raise the funds the business needs to survive.

If the accounts are not prepared on a going concern basis, the accounts will need to describe the basis that has been used. This will be a basis other than the going concern basis (that is, a 'non-going concern basis') meaning the company is not expected to continue trading for the foreseeable future.

Elements of the financial statements

Financial statements must be prepared in such a way that the user can understand what's going on in the business. It would be pretty pointless if this were not the case, as financial statement information would be all over the place – not to mention against the law in most jurisdictions.



REMEMBER

The *elements* of the financial statements are:

- » Assets (see Chapter 7)
- » Liabilities (see Chapter 8)
- » Equity (see Chapter 9)
- » Income (see Chapter 10)
- » Expenses (see Chapter 10)

Recognition and derecognition

Recognition means bringing something onto the balance sheet (or in the income statement). No prizes for guessing what *derecognition* means . . . it means removing an item from the balance sheet. The *Concepts and Pervasive Principles* only allows an item to be recognised on the balance sheet when it meets the definitions of an asset (see Chapter 7), or a liability (see Chapter 8) or equity (see Chapter 9). Hence, you may hear a financial accountant say, “We need to *recognise* that motor vehicle on the balance sheet as it is a fixed asset.”

Similarly, only items that meet the definitions of *income* or *expense* (see Chapter 10) can be recognised in the profit and loss account.

Financial statement measurements

Communicating with parties interested in the business via the financial statements requires the measurement of all accounting transactions. *Measurement* refers to the fact that every accounting event must have a cost or a value in order to be recognised in the financial statements. You may be confused about the difference between cost and value. Well, you’re not alone. This issue can be thorny even among seasoned financial accountants.

Depending on their nature, accounting transactions may be recorded in different ways. If a transaction is recorded at *historic cost*, it shows how much the company paid in cash or how much the company was owed, or was paid, during the transaction. *Net realisable value* (NRV) can also be used, which is the amount of cash a business anticipates receiving from an asset in the normal course of business – after factoring in any related costs. You find all sorts of good information about historic cost and NRV in Chapter 7.

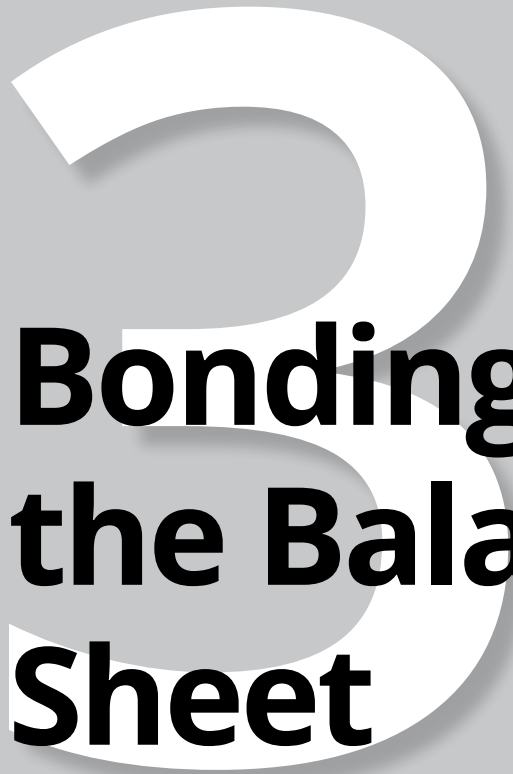
Presentation and disclosure



REMEMBER

The *Concepts and Pervasive Principles* set out the way that items in the financial statements should be presented and disclosed as follows:

- » **Classification:** This means the sorting of assets, liabilities, income or expenses based on shared characteristics.
- » **Offsetting:** This refers to the business recognising and measuring both an asset and a liability as separate items but then grouping them together into a single figure on the balance sheet. Generally, offsetting is a no-no unless it is specifically allowed by an accounting standard.
- » **Classification of equity:** The *Concepts and Pervasive Principles* singles out classification of equity separately because it is sometimes necessary to classify equity according to legal requirements. For example, if a company issues shares (see Chapter 9) at more than their par value, the value of the share issue must be split between the amount attributable to the par value of the share, and the excess over par value must be recognised in a share premium account.



Bonding with the Balance Sheet

IN THIS PART . . .

Stack up the different types of assets a company has on its balance sheet.

Discover how companies must record short-term and long-term liabilities.

Come to grips with the importance of equity.

- » Sticking with historic cost
- » Distinguishing between tangible and intangible assets
- » Listing common current assets
- » Preparing the assets section of a balance sheet

Chapter 7

Looking at Assets

Part 3 of this book is all about the financial statement called the *balance sheet* (also known as the *statement of financial position*), which reports a company's assets (the things a company owns and *controls*. *Control* means the company can control access to the benefits such assets bring to the business, for example, revenues and controlling when the company decides to dispose of an asset, liabilities (the amounts a company owes) and equity (the bit left over that belongs to the shareholders). In Chapter 8, I take you through the liabilities part of the balance sheet, and Chapter 9 is all about the equity part of the balance sheet. This chapter gets the party started by focusing on assets.

Assets are resources a company owns – stuff like property, plant, equipment and cash. Businesses have many different types of assets, which are classified as either *current* or *non-current*. Current assets (such as stock/inventory, trade debtors/receivables, bank and cash accounts) are *liquid*, which means they either are cash or can quickly be turned into cash. You'll often see current assets listed on the balance sheet in the *order of liquidity*; this means that they're listed from the least to the most liquid, starting with inventory, which then gets sold and turns into a receivable, which then pays the company, and then turns into cash.

Non-current (sometimes referred to as *fixed*) assets are not liquid; converting them to cash may take time. Examples of non-current assets often include *tangible* assets (assets you can touch) such as a company's cars, computers or buildings. But not every non-current asset is tangible. For example, consider a company's patents and trademarks, as well as certain types of computer

software – these are all *intangible* assets (intangible assets are those assets that don't have a physical form; in other words, you can't kick them!).

Most types of leased equipment are considered assets too, which may seem strange because the company doesn't legally own them outright. I devote Chapter 19 to accounting for leases.

Current? Non-current? Tangible? Intangible? The topic of assets may seem a little overwhelming at first because so many kinds of assets exist. But in this chapter, I give you a straightforward, easy-to-understand lowdown on the different types of assets a company may own. By the end of it, things may not seem as daunting as you first thought!

Homing in on the Historical Cost Convention

Before I start identifying and explaining typical business assets, I want to explain how the values of most assets are normally shown on the balance sheet. Regardless of their *market value* (sometimes called *fair value*), which is what a knowledgeable, willing person will pay for the asset in an arm's length deal (by *arm's length*, I mean unbiased and uninfluenced), most assets go on the balance sheet at their original historic cost.

Here's an example to explain what I mean.



EXAMPLE

Woodward's Windows Limited buys a building for £200,000 in 2012. In 2026, the market value of that building is £400,000, but the cost of the building stays on the balance sheet at £200,000. This value is also known as the building's *book value*. If the asset is subject to depreciation (writing off the cost of the building over its estimated useful life, a topic I cover in Chapter 12), the historic cost (£200,000) minus the depreciation charged to date is known as the asset's *net book value*.

Keeping Track of Non-Current (Fixed) Assets

You classify an asset as *non-current* or *long-term* if the asset will be used in the business for more than 12 months after the date of the balance sheet. In addition, a non-current asset must also meet the *recognition criteria* required by UK and

Ireland generally accepted accounting practice (GAAP) to be brought onto the balance sheet. The recognition criteria are as follows:

- » The asset will generate future economic benefits (meaning sales or other forms of assets) for the business; and
- » The asset's cost can be measured reliably.

In this section, I focus on the most common types of non-current assets you'll encounter both in your accountancy studies and in the real world. I start with tangible assets (those you can touch) and then discuss intangibles (those you can't touch).

Meeting the tangibles: Property, plant, and equipment (PP&E)

In this section, I introduce you to a company's tangible assets. *Tangible* assets, also called *fixed* assets, include 'property, plant and equipment' (PP&E) – a category that includes land, buildings, equipment, furniture, and fixtures and fittings.



TIP

I devote an entire chapter to an account directly related to PP&E – that of depreciation. *Depreciation* is the method of writing off the cost of an item of PP&E over its estimated useful life to the income statement (or profit and loss account) (see Chapter 10). To get the complete lowdown on depreciation, check out Chapter 12.

Land

Land is the earth on which the company's office buildings or manufacturing facilities stand. The cost of the land plus any improvements the company has made to the land to use it for business operations are recorded on the balance sheet at historic cost.

Three types of costs relate to the purchase of land:

- » **Purchase price:** The price paid for the land.
- » **Directly attributable costs:** Legal fees incurred when the buyer purchases it from the seller.
- » **Land improvements:** Expenses the company incurs to get the land ready for use, which include the cost of clearing the land if necessary to build the manufacturing plant or adding alleyways and fences to an existing property. In addition, an initial estimate of the costs of dismantling, removing and restoring the site to its original condition are also costs that relate to the purchase of land.



REMEMBER

Because it's not considered to be 'used up' in the way that other PP&E is, land is never depreciated (written off to the income statement over its estimated useful life). Land also has an indefinite life, so that's another reason why it isn't depreciated.

Buildings

This category covers the company-owned structures in which the company conducts its business operations. It includes office buildings, manufacturing facilities, warehouses and off-site storage facilities.



TIP

Unlike land, buildings are depreciable (see Chapter 12). Always keep in mind that while land and buildings may be acquired together, they must be separately accounted for under UK and Ireland accounting standards. This is because land does not depreciate, but buildings do. If you want the source of the authority, check out paragraph 17.8 of FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (see Chapter 1 for more about FRS 102).



TIP

In real-life accountants use valuations for the land element and the buildings element to include on the balance sheet for land and buildings. Or, if the business purchases a piece of raw land and constructs its own building, calculating the cost of each is simple because you have the purchase agreement for the land and all related expenses to construct the building already separated out for you. You won't have to undertake any complex calculations – feel free to breathe a deep sigh of relief!

Equipment

This category is quite broad, encompassing any equipment a company uses to make the products it sells to customers. For example, a manufacturing company such as a bakery includes all the mixers, ovens and packaging machines it uses to turn the yeast and flour into loaves of bread ready to ship to the supermarkets.

A retailer, such as a department store, (which doesn't make any products) includes in this category any office computer equipment it owns, plus forklifts or ladders to move its stock/inventory around. Retail shops also usually categorise their cash registers as equipment.

Furniture and fixtures

Last up in our parade of PP&E are furniture and fixtures, which include desks, chairs and filing cabinets. Next time you're in the office, take a look around; chances are that any new items of furniture are capitalised in the company's balance sheet as furniture and fixtures.

A retailer such as a clothes shop has fixtures to display clothes for sale such as floor or wall display racks. Mannequins are also considered fixtures and, depending on their quality, can be quite sizeable in terms of monetary amounts on the balance sheet.



REMEMBER

If the company leases any of its PP&E, the leased items are usually recognised as PP&E. However, there are some leased items that may not be included as PP&E (such as leases of assets of low-value and leases of assets that are short-term – 12 months or less from the commencement date). I discuss these in more detail in Chapter 19.

Investigating intangible assets

The big difference between tangible and intangible assets is that *intangible assets* don't have a physical presence. When you really scratch the surface of this subject, you'll probably find intangibles a lot more interesting than desks and machinery!

Differentiating the two types of intangibles

Two types of intangible assets exist. The first type, which is the most common, includes intangible assets with long lives such as patents, copyrights and trademarks:

- » **Patents:** Patents provide licensing for inventions or other unique processes and designs. Items that can be protected by patents can be anything from a new drug to a new designer clothing logo.
- » **Copyrights:** Securing a copyright means that someone can't use the company's printed work (such as books or articles) or recorded work (such as music or films) without permission. Any original piece of work is automatically copyrighted.
- » **Trademarks:** These are unique signs, symbols or names the company can use to create a brand or image. When a company has a trademarked name or symbol, no other company can use it.

The second category of intangibles is *goodwill*. Goodwill arises when one business purchases another business (or a share in another business) for a price greater than the *fair value* (the price knowledgeable, willing parties will pay in an arm's length transaction) of the net assets acquired in the sale. (*Net assets* are total assets less total liabilities.)



EXAMPLE

Alexander Business Attire Limited buys Alicia's Funky Fashions Ltd for £250,000. The fair value of Alicia's Funky Fashions net assets is £175,000. Alexander Business Attire acquires £75,000 ($£250,000 - £175,000$) of goodwill in the transaction.

Writing intangibles off using amortisation

Amortisation is similar to depreciation (see Chapter 12) but is applied to intangible assets and is used to move the cost of intangible assets from the balance sheet to the income statement over the intangible asset's useful economic life.



REMEMBER

Under UK and Ireland accounting standards, all intangible assets must be amortised on a systematic basis over their useful lives. There is no option to assign an indefinite useful life to any intangible assets (including goodwill). If the management team of a business are struggling to come up with a reliable estimate of a useful economic life for an intangible asset, the maximum they can write off the cost of that intangible asset over (by way of amortisation) is ten years. It can be shorter, but not longer.



REMEMBER

Some GAAPs (see Chapter 4), such as UK-adopted IFRS 3 *Business Combinations* (see Chapter 4 for more on UK-adopted IFRS) don't allow goodwill to be amortised (meaning that it's treated as if it has an indefinite useful life). Instead, a business must review goodwill annually to see if there are any indicators of *impairment* (checking to see if the amount of goodwill is overstated). This is quite a complex area, so it's always best to consult a specialist.



WARNING

Internally generated goodwill must never be recognised on the balance sheet. This is because there is no reliable measure of cost attached to such goodwill. Only goodwill that has been acquired for *valuable consideration* (paid for in cash or other assets) can be recognised. This will generally only ever arise when one business (the acquirer) buys another business (the subsidiary) and pays more for the business than its fair value.

Learning about Current Assets

Current assets include cash and any asset that a company anticipates converting to cash within a 12-month period from the date of the balance sheet. On the balance sheet, you list current assets in *order of liquidity* (starting from the hardest to turn into cash and ending with the easiest to turn into cash and cash itself). Because stock is the least liquid, it shows up on the balance sheet first. Other common current assets are trade receivables, loans receivable, prepaid expenses and cash (cash being the most liquid because it's already cash!). Here, I cover each type in turn.

Short-term investments

Short-term investments can be equity (stocks and shares) and debt (loan notes) investments that a company invests in to put any surplus cash to work making money. (I discuss loans in Chapter 8, and stocks and shares in Chapter 9.) Just to be clear: the company is not recording its *own* equity and debt as investments here. Instead, the company is recording stocks and shares in *other* companies it purchases as investments.

To be able to classify these investments as short term (in other words, *current*) on the balance sheet, the company must be planning to sell them within 12 months of the balance sheet date.

Some companies make short-term investments in *listed* entities (a listed entity is a company that is registered on the London Stock Exchange). At each balance sheet date, the company will get a value of its investment and any changes in that investment will be recorded through the income statement.



EXAMPLE

Judith's Jumpers Ltd makes an investment in a company listed on the London Stock Exchange for £10,000 which is recorded as a current asset investment as the company will only hold the investment for six months. At the balance sheet date, the fair value of the investment increases to £11,000.

As the investment is a listed investment and a fair value of the investment at the balance sheet date can be reliably obtained from the London Stock Exchange, the investment is adjusted to reflect its fair value at the balance sheet date as follows:

Debit: Current asset investment	£1,000
Credit: Income statement	£1,000



REMEMBER

If the business is preparing its accounts under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, it must not record the fair value adjustment. Instead, it must keep the investment recorded at its original historic cost because FRS 105 does not allow any fair value accounting. This means the business must consider whether the investment is showing indicators of *impairment* (meaning that it's performing worse than expected). I explain impairment in the following example.



EXAMPLE

Connor's Concrete Ltd makes an investment in a private company (a company that is *not* listed on a stock exchange) for £10,000. This investment is recorded at cost. As there is no reliable measure of fair value available for this investment, the company keeps the investment recorded at its cost of £10,000. However, the directors must then consider whether the investment is showing any indicators of

impairment (has the investment performed better or worse than expected?) If worse, then it's impaired and the directors then need to work out how much the investment is realistically worth (its *recoverable amount*) and write the current asset investment down to that recoverable amount. So, let's assume the investment's recoverable amount is deemed to be £9,000, the write-down is recorded as follows:

Debit: Income statement impairment expense	£1,000
Credit: Current asset investment	£1,000



TIP

All assets measured at historic cost must be reviewed at each balance sheet date to see if they are showing indicators of impairment. If they're not, leave them as they are; if they are, then they'll need writing down to the recoverable amount by way of an impairment loss.

Inventory and work in progress

When you're starting out on your accountancy journey, you'll need to get to grips with two different types of inventories. The first type consists of products that are bought from a manufacturer and are available for sale in shops and supermarkets. The second type of inventory are the stuff used by manufacturers to make products that are then sold to customers, which includes direct materials, work in progress and finished goods.

I devote an entire chapter to inventory – Chapter 13. Here, I just give you brief snippets and examples of inventory terminology.

Retail inventory

Accounting for retail inventory is easier than accounting for manufacturing inventory because a company, such as a retail outlet, has only one class of inventory to keep track of: goods the business purchases from various manufacturers for resale on to its customers.

Here's an example of how a retailer handles an inventory purchase. The buyer in charge of outdoor gardening inventory at a major home improvement store sees that their department is running low on a certain type of lawnmower. The buyer follows the purchasing process, and the end result is that the department receives a shipment of mowers from its supplier.

This transaction is a purchase (a cost), but it's not an expense until the store sells the mowers to customers. So the business records the entire shipment of mowers

on the balance sheet as an addition to both inventory (see Chapter 13) and trade creditors/payables (see Chapter 8). I use *trade payables* instead of *cash* because the department store has payment terms with this supplier, and money has yet to change hands during this transaction (known as buying goods on *credit*).

Manufacturing inventory

Because a manufacturing company doesn't simply buy finished goods for resale to customers, its inventory is a bit more complex, as it generally has three major components:

- » **Raw materials inventory:** This inventory reflects all materials the company owns that it will use to make a certain product. For example, for the lawnmower manufacturer, this includes the steel to form the body, leather or fabric for the seat, and all the other bits and pieces that make the mower work. In essence, any materials that you can directly trace back to making the mower are raw materials inventory.
- » **Work in progress:** At any point in time during the manufacturing process, the company probably has items that are in the process of being made but aren't yet complete; these are called *work in progress* or *WIP*. For a lawnmower manufacturer, this will include any mowers that aren't completely put together and ready to give a lawn a haircut at the end of the accounting period. The company values its work in progress based on how complete each mower is in the manufacturing process.
- » **Finished goods:** These are costs you associate with goods that are completely ready for sale to customers but haven't yet been sold. For the lawnmower manufacturer, this category consists of mowers not yet sold to retail home improvement shops.



TIP

Companies can use many different methods to place a value on closing inventory. I discuss everything you need to know on this topic in Chapter 13.

Trade receivables/debtors

Trade receivables (often referred to as *trade debtors*) is the amount of money that customers owe a business for goods they've purchased from the company or services the company has rendered to them. Just about all types of businesses can and probably do have trade receivables.

For example, I prepare the financial statements for one of my small joinery clients. We review the financial statements together and approve them. I then send the client an invoice for £900 for accountancy and tax services provided. A couple

of weeks later, my client sends me a bank transfer for payment in full. In that two-week period between signing off the financial statements and receiving the payment, that £900 is on my books as a trade receivable.

Now, it's a sad fact of life that businesses providing credit to their customers almost always have some customers who don't pay their bills. Under GAAP, you have to make a provision for any amounts that may become bad debts. You may be asked to make a provision for bad debts (sometimes called an *allowance for doubtful debts*) in your accountancy studies and you're also likely to come across such provisions in your day-to-day work in accountancy. To make sure you're fully prepared, I want to show you how to account for bad debt.



REMEMBER

UK and Ireland GAAP does not let companies overstate their assets to present a better position than what is really the case. This is clearly so the financial statements aren't misleading. To comply with that principle, a business must look at who owes the company money at each balance sheet date and then consider whether there are any debts that may not be paid. If there are any debts that may not be paid, a provision is made against that debt to reduce the value of trade receivables to the amount the company does expect to receive.



EXAMPLE

Norah's Nightwear Ltd has outstanding trade receivables on 31 December 2026 amounting to £30,000. One of its customers owes £750, and Norah has heard on the grapevine that this company is about to go bust and doesn't think she'll get the money in. Norah decides to make a provision for this debt in her accounts as follows:

Debit: Bad debt expense (income statement)	£750
Credit: Provision for bad debts	£750

This example ignores any VAT issues.



WARNING

Historically, many companies used to make a blanket provision for potential bad debts. By *blanket* I mean they usually look at the value of outstanding receivables at each reporting date and then come up with a historic percentage of receivables they think may not pay. For example, a company with £70,000 worth of trade receivables outstanding may make a rudimentary provision equalling 5 per cent of total trade receivables (i.e. $£70,000 \times 5 \text{ per cent} = £3,500$, which they don't think will be collectible). This sort of blanket provision (known as a *general bad debt provision*) is not allowed under UK and Ireland accounting standards. Only bad debt provisions against specific receivables can be made (these are called *specific bad debt provisions*).

A *contra account* carries a balance opposite to the account's normal balance. Because the normal balance for an asset is a debit, the normal balance for a contra-asset account, such as 'allowance for doubtful debts', is a credit. 'Allowance for doubtful debts' is also known as a *provision for doubtful debts*, which is an offset against the main account. That's because, while the trade receivables account itself is carried at the actual amount that the customers owe, the allowance for doubtful debts contra-asset account serves to reduce trade receivables to the amount estimated to be collected, or what's called *net receivables*.



EXAMPLE

Wrench's Windows owes you £1,000 (ignoring any VAT issues). You send the company a letter stating that the account is now overdue, and Royal Mail returns the letter as 'return to sender', with no forwarding address. You are unable to locate anyone from Wrench's Windows. You must make a journal entry to debit 'bad debts' in the income statement for £1,000 and credit 'trade receivables – Wrench's Windows' for £1,000.

Now, what if, out of the blue, the owner of Wrench's Windows sends you a bank transfer for the £1,000 after you've written off the balance owed? You would need to credit 'bad debts expense' in the income statement for £1,000 (because the original debit went there when the debt was first written off) and then debit the bank account with £1,000. The entry would not need to touch trade receivables.

Loans receivable

A *loan receivable* is a short-term debt that someone owes you, meaning it becomes due for payment within 12 months of the balance sheet date. A company will sometimes make a loan to a third party – for example, to one of its employees to help them out with short-term cash flow problems. Generally, a short-term loan has three major components:

- » **Principal (sometimes called *capital*):** The amount owed to the company by the debtor.
- » **Rate:** The calculation that will be used to determine the amount of interest the debtor pays on the principal. Some loans may be interest-free.
- » **Time:** The period within which the debtor must pay back the loan.

Prepaid expenses

Prepaid expenses are expenses the business pays upfront. Many companies pay a year's worth of business insurance at once. Subscriptions are another common expense that a business will pay upfront.



EXAMPLE

Stella pays an invoice for £1,200 that covers 12 months of car insurance for the company vehicle. You originally post this amount as an increase to prepaid expenses. Then, as each month passes, you move the portion of the insurance the company has used off the balance sheet into the income statement by debiting insurance expense for £100 (£1,200/12 months) and crediting prepaid expenses for the same amount.

Cash and bank

Before we start talking about cash, I want to emphasise that the definition of cash goes beyond actual notes and coinage. Any sort of account that's backed by cash is deemed to be a cash account. For example, when you go to the supermarket and pay the bill using your debit or credit card, that card payment is the same as cash. That's because when you enter your PIN or use contactless payment, you attest to the fact that there are funds in your bank account, allowing this card payment to immediately clear – that is, funds can be withdrawn on demand.

Depending on the size of the business, it may organise and manage the way it brings in money and pays its bills in one or more types of cash accounts. A large service business may have a separate bank account for day-to-day transactions and a foreign currency bank account. Some companies have bank accounts for which they earn interest income (sometimes called *deposit accounts* or *savings accounts*).



REMEMBER

You may be wondering why a company complicates its bookkeeping with different bank accounts to pay expenses and bring in dosh. In some cases, having different bank accounts creates a safer business environment. For example, having a dedicated purchase ledger bank account allows purchase ledger clerks to do their job (process cheques to pay suppliers and perform electronic transfers) while having access to a limited, defined amount of cash.

But when it comes to cash accounts, it's really the Wild West out there in the business world. Some small businesses may have several bank accounts – many more than they actually need – and some large businesses may only have one.

Accountancy textbooks often concern themselves with making sure you understand that cash accounts are included in the *current assets* section of the balance sheet. Don't worry, I provide a full-blown assets section of a balance sheet at the end of this chapter so you can see this theory at work. However, it's also important that you understand the business purpose for different types of bank accounts – so here they are, with brief descriptions:

- » **General bank account (or bank current account):** A business usually earmarks a particular bank account, which it calls its *general* or *current* account, to handle business activities such as depositing cash and paying bills.
- » **Payroll account:** Many mid-sized and large companies (and some small ones, too) have a bank account that's used only to pay employees. What the company does is work out the total amount of bank transfers it needs to pay employees and transfers that amount from its general account to cover the payroll payments.
- » **Merchant account:** If a business allows customers to pay by credit card, it probably has a dedicated merchant account into which the only deposits will be from its *merchant provider*: the company that helps it process customer credit cards. Normally, withdrawals from this account go to the general bank account to cover withdrawals.
- » **Sweep account:** A sweep account is a way for the company to automatically earn investment income (interest). The way it works is that each evening, any extra cash in the company's general account is gathered up and transferred (swept) into investment (or deposit) accounts.

Money from many different companies is pooled into a bigger pot, thereby providing the advantage of a higher rate of return. Then as the company needs the money in order to meet withdrawals, the money is swept back into the general account.

Studying the Assets Section of the Balance Sheet

To wrap up this chapter, I show you in Figure 7-1 what the assets section of the balance sheet looks like. Liabilities and equity are each merely a line item in Figure 7-1. Check out Chapter 8 to see the liability section and Chapter 9 to see the equity section of a balance sheet fully developed.

The company's property, plant and equipment (tangible fixed assets) are listed first, net of depreciation charges (the method of writing off the cost of tangible non-current assets over their expected useful lives). Then intangible assets (those without a physical substance) are shown – usually *net of amortisation*, which means that amortisation is subtracted before listing the values of the intangibles on the balance sheet (this net value is known as *net book value*). Current assets are always shown after non-current (fixed) assets, in order of liquidity. If you're a student accountant, the only long-term current asset you're likely to come across is a loan that falls due after more than 12 months from the balance sheet date.

Fixed assets	£
Tangible fixed assets	52,655
Intangible fixed assets	<u>1,330</u>
	53,985
Current assets	
Stock and work in progress	4,300
Trade debtors	7,800
Other debtors	3,500
Short-term investments	1,600
Prepayments	500
Cash at bank and in hand	<u>3,560</u>
	21,260
Total assets	<u><u>75,245</u></u>
Total equity and liabilities	<u><u>75,245</u></u>

FIGURE 7-1:
The assets
section of a
balance sheet.

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- » Discovering how a company raises cash
- » Identifying current liabilities
- » Coming to grips with long-term debt
- » Accounting for loans

Chapter 8

Grappling with Liabilities

Part 3 of this book is all about the financial statement called the balance sheet (otherwise known as the *statement of financial position*), which presents the financial position of a company (how financially stable it is). The *balance sheet* reports a company's assets and the claims against those assets. In Chapter 7, I take you through the assets part of the accounting equation. This chapter is all about the claims, or debts, which in accounting lingo are called *liabilities*.

Nobody likes debt, but it's an inevitable part of a company keeping its doors open for business. In this chapter, I cover both current and long-term debt. You find out what types of current liabilities help a business manage its day-to-day operations, and you learn about long-term debt obligations that businesses often take out. I cover basic long-term debt such as mortgages, and I also discuss a method many companies use to raise finance – loans – focusing on the correct accounting treatment for these. Another type of liability – contingent liabilities – also gets a mention in this chapter. These liabilities aren't included in the income statement and balance sheet (see Chapter 3), so I give you the lowdown on when and how to include them.

Seeing How Businesses Record Liabilities in the Balance Sheet

Liabilities are amounts owed by a business to third parties. Examples include:

- » **Trade payables (often called trade creditors):** Money a company owes to its suppliers for services rendered and products it has purchased.
- » **Deferred income:** Money received upfront from customers that pay the business for goods or services they haven't yet received – such as advance payments for subscriptions.
- » **Salaries payable:** Salaries the company owes to employees.



REMEMBER

Generally accepted accounting practice (GAAP, which I discuss in Chapter 4) dictates that when you prepare the liability section of the balance sheet, these liabilities must be broken down between *current* and *long-term* obligations. The dividing line between the two is the one-year mark: all liabilities that are due within one year of the date of the financial statements (meaning the date of the balance sheet) are considered current. All others are considered long term.

In Chapter 5, I introduce the fundamental accounting equation, which under UK and Ireland GAAP is this:

$$\text{Assets} = \text{Liabilities} + \text{Owners' equity}$$

Based on the order of elements in this equation, liabilities show up on the balance sheet after total assets but before equity accounts. Current liabilities are shown first, followed by long-term liabilities.

The equation above is based on UK and Ireland GAAP. However, financial statements prepared under UK-adopted International Financial Reporting Standards (referred to as IFRS Accounting Standards) are often presented slightly differently, meaning the liabilities section might be shown *after* equity, hence the equation under UK-adopted IFRS becomes:

$$\text{Assets} = \text{Owners' equity} + \text{Liabilities}$$



REMEMBER

Under the accruals method of accounting (which I explain in Chapter 6), all revenue is matched with all expenses incurred during the generation of that revenue. So if a company incurs costs but money hasn't changed hands by the year- or period-end, a liability shows up on the balance sheet to reflect the amount that eventually has to be paid. For example, the company may buy goods from a

supplier and have received the supplier's invoice, but not yet paid it (in other words, the business purchases the goods on credit); the value of those goods (including any Value Added Tax, or VAT) appears in trade payables, which is a current liability. If an invoice hasn't been received by the balance sheet date, the amount is included in accruals (another current liability) without VAT.

Figure 8-1 shows a very simple liability section of the balance sheet, with all asset and equity accounts consolidated in a single line item each (the two shaded lines). Check out Chapter 3 for a more formal presentation of all sections of the balance sheet.

Creditors: Amounts falling due within one year		£
Bank loan		1,366
Trade payables		34,203
Leases		4,564
Other creditors		1,647
Accrued expenses		<u>1,750</u>
		<u>43,530</u>

FIGURE 8-1:
The liability
section of a
balance sheet.

Creditors: Amounts falling due after more than one year		
Bank loan		6,750
Leases		<u>10,650</u>
		<u>17,400</u>

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Keeping Control of Current Liabilities

In this section, I cover some of the more common types of current liability that a company incurs, so by the end, you'll be a whizz! To help you further, I throw in some journal entries so you can see how the transactions get into the accounting records (see Chapter 5).

But before you start, I want to make sure you understand why it's so important to separate out current and long-term liabilities. Both company law (Companies Act 2006) and GAAP requires the separation so the user of the financial statements can easily glean the information necessary to work out a company's liquidity and solvency figures such as *working capital*, which is current assets minus current liabilities, or the *current ratio*, which is current assets divided by current liabilities. (A reminder: *users* of financial reports may be investors, banks or anyone else with an interest in the company's financial health; see Chapter 1.)

These financial ratios and tools (which I spell out in Chapter 14) give the user specific information to help them decide how well the company is performing. For example, a bank thinking about making a loan to a business wants to gauge the expectation of being paid back on time, as well as ensuring the business can afford the interest on the loan. The viability of a company's working capital is a very important aspect here.



WARNING

For this reason (among others), it's hardly ever appropriate to offset current assets with current liabilities under GAAP (and accounting standards usually prevent the business from doing this anyway). To do so would eliminate the ability to use any sort of ratio analysis involving current asset or liability accounts.

Trade payables/creditors

Trade payables (commonly referred to as *trade creditors* in UK and Ireland GAAP) generally relate to money a company owes its suppliers for services and products that it's purchased in the normal course of business and anticipates paying for in the short term in accordance with agreed credit terms. For example, the company purchases inventory from a manufacturer who has agreed to accept payment in 30 days. Once the invoice is received, it is posted into the accounting system. Assuming the accounting system is computerised, the entry is recorded in the accounts like this (ignoring any VAT):

Debit: Purchases (in cost of sales)	£X
Credit: Trade payables (balance sheet)	£X

Trade payables are always assumed to be a current liability.



TECHNICAL
STUFF

Note that the terms *trade payables* and *trade creditors* are often used synonymously. But technically, *trade payables* generally refer to amounts owed to suppliers from which a company buys business supplies and *direct materials*: items it uses to manufacture products for sale (see Chapter 10). Some suppliers selling on credit give a discount to customers who pay their outstanding invoices early (this is known as a *settlement discount*). For example, the terms of the purchase may require full payment in 30 days but a discount of 2 per cent if the customer pays the bill within 10 days. Figure 8-2 shows the debiting and crediting for £1,000 of materials purchased on credit with discount terms of 2 per cent if the bill is paid within 30 days and the subsequent payment.

FIGURE 8-2:
Materials
purchased on
credit
and payment
made within
discount period.

1. To record the purchase made on 21 May 2026	
Debit: Cost of sales	1,000
Credit: Trade payables	1,000
2. To record the payment made on 1 June 2026	
Debit: Trade payables	1,000
Credit: Cash at bank	980
Credit: Discount received	20

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Sundry creditors

Companies often have *sundry creditors* within their balance sheet, which are other types of liabilities that don't generally fall under the umbrella of trade payables, taxation or other main headings. Sundry creditors can include one-off transactions, such as small, infrequent supplies that aren't assigned an individual purchase ledger account. Or they can include things like amounts owed to employees, such as net wages that are paid after the balance sheet date.

Payroll and employment taxes

The nature of the beast is that most companies *accrue* payroll and related payroll taxes (such as pay as you earn [PAYE], student loan deductions and National Insurance contributions [NICs]), which means the company owes them but has not yet paid them over to the tax authority (HM Revenue and Customs). This concept is easy to understand if you think about the way you've been paid by your employer in the past.

Most companies have a built-in time lag between when employees earn their wages and when they are paid.



EXAMPLE

Stella's Stylish Shoes pays its employees on the 1st and 15th of every month with 15 days of wages in arrears. This means that when the employees get their pay slips on 15 July, the payments relate to work they did from 16 June to 30 June.

To match expenses to revenue when preparing financial statements for the one-month period ending 30 June, the gross wages earned but not yet paid as at 30 June must be added to the balance sheet as a current liability.

Not only that, but you also must account for any payroll taxes and NICs that will be deducted from the employee's wages when the wages are finally paid. Here are

examples of employee payroll-related accruals that are often accrued in a company's financial statements:

- » **National insurance contributions (NICs):** NICs fund certain state benefits, including the state pension. NICs are payable on a percentage basis on wages up to a certain amount. Employers also have to pay *employer NICs*, which are 15 per cent of an employee's gross pay at the time of writing.
- » **Pay As You Earn (PAYE):** This is income tax on the employee's salary, and the company calculates this tax using the basic rate of income tax, which is 20 per cent at the time of writing. There are currently three rates of PAYE: a basic rate, a higher rate and an additional rate. These rates change from time to time.
- » **Health care or other insurance premiums:** An employer may pay only a portion of the health insurance premium for an employee and their family. The additional amount for health and other insurance, such as life insurance, is a deduction as well if the employee authorises it.
- » **Pension deductions:** Many employers have pension plans that allow employees to make contributions into a pension scheme. The law requires employers to offer a pension plan, and the employer must also pay a contribution into the employee's pension pot.
- » **Employer benefits:** Additionally, the employer must pay NIC on the value of any benefits that the company provides to employees (in the UK, this is known as *Class 1A National Insurance*). Employee benefits can include all sorts of different things, but the most common are: company cars and vans; health care; and accommodation.



TIP

Class 1A NICs that an employer must pay are set at 15 per cent at the time of writing. This rate can be changed, however, so keep your eyes peeled. To check out rates and allowances, go to www.hmrc.gov.uk.



EXAMPLE

So that you can better understand this class of current liabilities, here's a payroll scenario that's similar to what you'll come across in either your accountancy studies or the workplace.

Greavesey's Gardening Supplies Limited has a year-end of 31 December 2026. On 29 December 2026, Lisa, the company's payroll clerk, ran the company's payroll. These wages will not be paid until 3 January 2027, and details of the payroll are as follows:

Gross pay:	£50,000
PAYE:	£7,500
Employee NIC:	£3,500
Pension deductions:	£1,500
Net wages paid:	£37,500
Employer NIC:	£7,500

The question is, how does Lisa record gross wages, PAYE and other deductions made from the employees' wages as short-term liabilities? Additionally, how does she record the related payroll tax expense? For the purposes of this scenario, you can assume that Greavesey's Gardening Supplies has no employer benefit expense.

Wondering how to answer this question via journal entries? I show you how in Figure 8-3.

FIGURE 8-3:
Journal entry to
record accrued
payroll and taxes.

To record accrued payroll	Debit	Credit
	£	£
Payroll expense (income statement)	50,000	
Employer NIC (income statement)	7,500	
PAYE (current liability - balance sheet)		17,000
Gross NIC (employee + employer NIC as current liability)		11,000
Pension deductions (current liability – balance sheet)		1,500
Net wages account (current liability – balance sheet)		28,000
	<u>57,500</u>	<u>57,500</u>

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When Lisa finally makes the payments on 3 January 2027, she will credit the cash at bank account with £28,000 and debit the net wages account with £28,000. Doing so will clear the current liability back down to £nil. When she makes the payment to HM Revenue and Customs (HMRC) in respect of the PAYE and total national insurance deductions, she'll also credit the bank account with £28,000, and debit the PAYE current liability account with £17,000 and the gross NICs current liability account with £11,000, which will clear out those liabilities. When the company makes the payment to the pension scheme for the employee contributions, Lisa will credit the bank account with £1,500 and debit the pension deductions current liability account.

Deferred income

Another common short-term liability is that of *deferred income*. This current liability occurs when a company receives payment for goods or services rendered before it actually provides those goods or services. Because the business has an obligation to fulfil its end of the contract, the deferred income is a current liability until the company completes its contractual obligations.



REMEMBER

To record revenue, it must be earned and realisable (*realisable* means the transaction will eventually turn to cash). However, in this situation, the revenue is not yet earned because the business still has some stuff to do to fulfil its obligations.

It's easier to bring this scenario to life using a typical illustration. Let's say you pay £120 for an annual subscription to a magazine, consisting of 12 issues. Until the magazine publisher sends the twelfth issue to you, your payment is not 100 per cent earned revenue for the publisher. This is because the publisher still 'owes' you one magazine.

The way this scenario works at the publisher's end is that it debits cash and credits unearned revenue for your payment of £120. Then each month after it sends you an issue, it records earning that portion by debiting unearned revenue and crediting gross sales for £10 (£120/12).

Other short-term liabilities

Other short-term liabilities include items such as loan payments that are payable within 12 months. Current liabilities can originate as short-term bank loans, or they can be the portion of a long-term debt that's due within the next 12 months from the balance sheet date.

Here's more information on short-term bank loans, current portion of long-term debt and estimated warranty expense:

» **Short-term bank loans:** When a company takes out a loan, it doesn't always have to be for an extensive period (such as a 30-year mortgage). In many cases, a company anticipates getting paid for a job it's performed and just needs a brief influx of cash to pay day-to-day expenses such as payroll.

A good example of this situation is a *working capital loan*, which a bank makes with the expectation that the loan will be paid back from collection of trade receivables. As long as the loan is due in full within 12 months after the balance sheet date, you classify these borrowed funds as current liabilities.



TIP

It's important to examine short-term debt when determining the financial health of a company because it indicates whether a cash flow issue (see Chapter 11) can arise in the immediate future. If short-term debt is unreasonably high, the company may not have the cash available to make the loan payments. This is a warning sign that cash flow difficulties may be on the horizon.



REMEMBER

A company can also have a *revolving line of credit*, which is a loan with a pre-set limit on how much the company can withdraw at any one time, reflecting as current debt. This sort of current debt is much more flexible than a loan because the company borrows against it only when necessary.

» **Current portion of long-term debt:** Say that a company has a mortgage on its land and building spanning 30 years, and it's in the third year of paying off the loan. To properly reflect this mortgage on the balance sheet, the principal amount (sometimes called the *capital amount*) the company owes in the next 12 months must be shown as a current liability. The rest of the mortgage payable is classified as a long-term liability, a subject I discuss in the next section.

» **Estimated warranty liability:** Warranties on products may be an assumed part of the purchase price or something the purchaser elects to buy – usually at the time of purchase. A good example is the warranty purchased for a computer from a PC shop. The computer comes with a six-month warranty from the manufacturer covering numerous performance and repair issues. Assume that if the computer breaks down within the six-month warranty period, the purchaser can send it back to be fixed, free of charge. The company has to calculate and record an estimate of how much it costs the company to fulfil the terms of the warranty.

A popular way to estimate warranty expense is to use a percentage of sales. This percentage is normally based on historical sales returns information. If in the past the company has incurred an actual warranty expense of 4 per cent, that same percentage can be the current year's estimate until the facts change. Below is an example of how to deal with warranty calculations.



EXAMPLE

Computers R Us sells laptop and desktop computers nationwide through 20 stores across the country. In the month of September, it sold £500,000 worth of computers. Historical warranty expense is 4 per cent of sales. So, the estimated warranty liability is £20,000 (£500,000 multiplied by 4 per cent).

Also, during September, Computers R Us has actual expenses of £2,000 for labour and £3,000 (total of £5,000) for materials to fulfil warranty claims. Keep in mind that the £5,000 includes warranty costs not only for September purchases but also for purchases going back six months.

Ready to see how to get these transactions in the books by way of journal entry? Figure 8-4 gives you the lowdown on the entry to record the estimate and record actual warranty expense.

	Debit	Credit
	£	£
Warranty expense (income statement)	20,000	
Warranty liability (balance sheet)		20,000
<i>To record estimated warranty expense for September</i>		
Warranty liability	5,000	
Labour (income statement)		2,000
Materials (income statement)		3,000
<i>To record actual warranty cost for the month of September</i>		

FIGURE 8-4:
Recording
accrued and
actual warranty
expense.

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Planning for Long-Term Obligations

If you've bought a car on finance or have a mortgage, you're already familiar with *long-term debt*: loans that won't be paid off by the end of the next 12-month period. Companies have long-term debt, too. While a company usually uses current debt as a vehicle to meet short-term obligations, it may take on long-term debt for the financing of company assets.

Managing long-term debt

If a company needs to raise cash and decides to do so by taking out debt, the most common types are mortgages, loans and leases. Following is your financial accounting guide to the first three of these categories of long-term debt. The accounting treatment of a loan can become complex, so the section 'Accounting for market rate loans' later in this chapter is devoted to that topic.



REMEMBER

Any type of debt instrument between a lender and a borrower specifies *principal* (the amount borrowed), *rate* (how much interest the company pays to borrow the money) and *time* (the length of the loan). The accounting treatment isn't quite as straightforward because the accounts recognise an *effective* interest rate rather than the interest that is physically paid to the loan provider, but I tackle that later in this chapter.

Mortgages

Mortgages are used to finance the purchase of land and buildings. The property *collateralises* the mortgage, which means the property is held as security on the mortgage. If the company defaults on the mortgage, the bank/finance company can seize (or *repossess*) the property and sell it in an attempt to pay off the loan.

If you own a house or flat, the chances are you purchased it by getting a mortgage from a bank. The paperwork involved in this transaction is quite significant, and it's a similar beast when a company purchases a property, with a whole host of documentation being transferred back and forth among the buyer, seller, lawyers and the bank itself.

Loan agreements

Loan agreements are formal written documents that spell out how money is being borrowed. In the earlier section 'Other short-term liabilities', I explain that the part of a loan that's going to be paid off within the 12 months following the financial report release is classified as short-term debt (a *current liability*). The remainder of the loan is considered a long-term debt (a *non-current liability*, or in UK and Ireland GAAP lingo, *creditors falling due after more than one year*).

FINANCING ASSET PURCHASES WITH DEBT VERSUS EQUITY

Companies raise money to purchase assets in one of two ways: debt or equity. *Debt* means the company borrows money with an obligation to pay the borrowed funds back. *Equity* means the company issues shares to investors and the money from this share issue is then used towards financing the cost of the asset(s).

What makes equity investing appealing is that the company is not under any obligation to buy back the shares from the investors (unless they are redeemable shares). However, where the shares are issued to more investors it also means that more voices are heard regarding how the business is run, especially in smaller companies – something that shareholders who also handle the day-to-day operations may not be all that eager to put up with.

Oddly enough, debt can end up making a company money. This situation is called *financial leverage*, and it happens when the borrowed money is expected to earn a higher return than the cost of interest payable on the debt.

(continued)

(continued)

The interest expense on debt is calculated using an *effective interest rate* which I talk about in more detail later in this chapter, in the section 'Learning about the effective interest rate'. This type of expense is tax deductible (which means the expense is allowed for tax purposes in working out the profit on which corporation tax is paid) while dividends payable to investors (the shareholders) are not. Based on many factors, the company using debt to finance its asset purchases can also end up in a better position due to the decrease in corporation tax payable.

Here's an example: let's say you take out a student loan at 2 per cent interest to pay for your university accommodation. Your family wants to lend a helping hand and gives you a gift of £2,000 to put toward your living expenses. Because that gift frees up £2,000 of your student loan, you decide to invest this amount in a savings account paying 3 per cent. You've just made 1 per cent using someone else's money. Woohoo!

Leases

Another type of long-term debt involves *leases*. A company doesn't always buy its fixed assets (see Chapter 7); sometimes it leases them. Doing so makes sense for any fixed asset that needs to be frequently replaced. For example, leasing computers makes sense for businesses that need to stay up to date with computer technology.

Leases have characteristics of ownership, which means the cost of the leased asset goes on the balance sheet as a depreciable asset (although there are some leases that don't require this treatment). I offer a full discussion of accounting for leases in Chapter 19.

Anticipating contingent liabilities

A *contingent liability* arises when a company has a possible obligation as at the date of the financial statements that may cause a future loss depending on events that have not yet happened (and indeed may never happen). Here are two examples of common contingent liabilities:

- » **Pending litigation:** This means the company is actively involved in a lawsuit that is not yet settled.
- » **Guarantee of obligations:** This circumstance occurs when a business agrees to step in and satisfy the debt of another company if need be (the company agreeing to step in, if need be, is often referred to as the *guarantor*).



REMEMBER

Contingent liabilities aren't provided for in the financial statements (see Chapter 15) because they don't satisfy the recognition criteria for a liability. Instead, such contingent liabilities are disclosed in the notes to the financial statements to comply with FRS 102, Section 20 *Provisions and Contingencies* or FRS 105, Section 16 *Provisions and Contingencies*. Here are the three criteria that must be met before a contingent liability becomes an actual liability:

- » The company has a present obligation (legal or constructive) as a result of a past event(s).

A *legal obligation* results when a solicitor or court says that you're going to have to cough up some cash, or give up another form of asset, to settle the liability. A *constructive obligation* is one that arises because of the company's actions, such as a pattern of past practice (for example, a long history of paying bonuses based on pre-tax profits using a specified formula), or because it creates a valid expectation in the minds of those parties (for example, announcing a programme of redundancies as the result of a division closing down or ceasing to trade).

- » It's probable that an outflow of resources embodying economic benefits (in other words, cash or other assets) is required to settle the obligation. The term 'probable' means 'more likely than not'.
- » A reliable estimate of the obligation can be made.

If the contingency meets these three criteria for recognition of a liability, a provision is made in the accounts. The journal entry involves a debit to a relevant expense account in the income statement (see Chapter 10) and a credit to a provision account.

Accounting for Bank and Other Loans

Well, I saved the best for last! I say that tongue-in-cheek because bank loans (which are essentially *financial instruments*) are a somewhat thorny financial accounting issue. However, if you can get the gist of this section, you'll have no trouble dealing with this minefield in your work or in your accountancy studies.

Understanding the basics

Financial instruments are a way of raising finance. The way to look at a financial instrument is to consider that when a company raises finance (meaning it incurs a *liability*), another third party is providing that finance (which creates an *asset* for

the lending party). Financial instruments are basically things like loans, trade payables, shares and mortgages – anything the company uses as a means of finance.



REMEMBER

In order to meet the (very long-winded) definition of a financial asset or a financial liability, there must be a *contractual right* for the party lending the money to receive cash or another asset in settlement of the debt. Conversely, there must be a *contractual obligation* for the borrower to pay cash or transfer another asset to the lender to settle the debt. Hence, there must be a *contract* in place. Without a contract, a contractual right and a contractual obligation, a financial instrument doesn't arise. Let's have a quick look at an example to bring this to life:



EXAMPLE

Sunnie Enterprises Ltd employs 100 people. Last week, one of the employees, Alex, asked the finance director for a short-term loan to buy a car. The company agreed to provide Alex with this loan and the loan repayments will be taken out of Alex's salary each month over a two-year period. If Alex leaves Sunnie Enterprises before he has paid this loan back, the company can require immediate repayment of the balance. Both Alex and the finance director have signed an agreement to this effect.

The signing of this agreement creates a *financial asset* for Sunnie Enterprises. The loan is shown as a receivable (a debtor) in the company's balance sheet, and the monthly repayments will go to reduce this loan balance. It also creates a *financial liability* for Alex because he is obliged to make these loan repayments on a monthly basis through his salary until such time that the debt is paid off.

This example shows how a *financial instrument* is created. Some transactions might, on the face of it, look like a financial instrument but they aren't. For example, consider a company's corporation *tax liability*, which is the tax the company pays on the profits it generates. The cash it pays to the tax authority to settle its tax liability can be viewed as a financial instrument because it involves an *outflow* of money. However, there is no contract in place between the company and the tax authority to pay this liability because taxation arises through legislative requirements rather than contractual obligations. Therefore, payments or receipts of tax aren't classed as financial instruments.



TIP

Think 'contract', 'contractual right' and 'contractual obligation' where financial instruments are concerned and you shouldn't go too far wrong.

Accounting for market rate loans

When something is *market rate*, this refers to the usual price someone pays for something in an arm's length transaction (meaning not at mates' rates!). This applies to straightforward bank loans. If you've ever taken out a bank loan, very

rarely will the bank give you a mate's rate of interest. It will always be a market rate of interest.



WARNING

Under FRS 102, you would think this would be quite straightforward to deal with, right? Surely you simply split the payments between the amount that is the *principal* amount (the capital portion of the payment) and the interest? Well, I'm afraid this is accounting and life's never really that straightforward.

When a company takes out a bank loan, it accounts for that loan using the *amortised cost method*. 'The what?' I hear you say . . . Let me explain: the phrase *amortised cost* refers to the value of a financial instrument over its lifetime. It's the value of a financial asset or a financial liability at a specific point in time (usually the balance sheet date) which has been adjusted for repayments of the principal amount and the recognition of interest over the life of the instrument. Don't worry too much if all this seems a bit overwhelming – I run through an example of this using numbers in the next section.

Learning about the effective interest rate

The amortised cost method of accounting for a financial instrument uses an effective interest rate. It is the actual rate of interest paid on a loan (or earned on an investment) and takes into account the effects of *compounding* (the amount of interest on interest). This method provides the company with a true cost of borrowing or the true return on a financial asset.



REMEMBER

When it comes to recording the interest in the company's accounts under FRS 102, it's the effective interest that is recognised and not the actual amount of interest paid over to the bank. However, if the company is a micro-entity preparing its accounts under the simplified standard, FRS 105, then it does just record the actual amount of interest paid over to the bank. This is because the amortised cost and effective interest methods are viewed as being too onerous for micro-entities.

Let's plug all this technical jargon into a worked example to bring this theory to life.



EXAMPLE

Bauer Industries Ltd makes electronic goods for sale to the general public. Demand for its products has increased massively over the last couple of years so it decides to invest in new machinery to speed up the production process. The cost of this new machinery is £600,000. The company's bank has agreed to provide it with a loan for £600,000 which is repayable over five years at £11,166 per month or £134,000 a year. For simplicity, I'm going to use the annual repayments but in real-life, you'd deal with these repayments on a monthly basis. I've also assumed that the bank has been really generous and not charged any loan arrangement fees.

Step 1: Profile the loan repayments

We can use a spreadsheet to do this. This involves analysing the payments in the loan over its life as follows:

Year	Opening balance	Repayments	Interest	Closing balance
	£	£	£	£
1	600,000	(134,000)		466,000
2	466,000	(134,000)		332,000
3	332,000	(134,000)		198,000
4	198,000	(134,000)		64,000
5	64,000	(134,000)		(70,000)

You're probably wondering why in year 5 the loan balance is showing as a debit balance of (£70,000). Don't worry about that for now – it's because we've not dealt with the interest side of things.

So, here we've started with the £600,000 loan which has been brought into the accounts by debiting the cash coming in from the loan proceeds and crediting the loan liability account. Each month we're paying the bank £11,166 a month, so that equals £134,000 a year ($£11,166 \times 12$ months), give or take a little rounding. The journals to record these payments are:

Debit: Loan liability	£134,000
Credit: Bank account	£134,000

The next thing we need to do is deal with the interest using the *effective interest rate*. To do this, I'm going to use the *Goal Seek* function in Microsoft Excel. I'll provide the screenshots of the Excel spreadsheet later on for you so you can see the formulae and how the numbers are calculated (see Figures 8-5 and 8-6).

Step 2: Calculate the interest

Using the Goal Seek function, the interest is calculated as follows:

Year	Opening balance	Repayments	Interest	Closing balance
	£	£	£	£
1	600,000	(134,000)	22,768	488,768
2	488,768	(134,000)	18,547	373,315

3	373,315	(134,000)	14,166	253,481
4	253,481	(134,000)	9,619	129,100
5	129,100	(134,000)	4,900	-

Step 3: Record the interest in the accounts

The table above shows us that the amount of interest in year 1 of the loan at the effective interest rate is £22,768. This is recorded in the accounts as follows:

Debit: Interest expense (income statement)	£22,768
Credit: Loan account (balance sheet)	£22,768

Once we've allocated the interest, we can check that the loan balance is correct by looking at the trial balance, which shows a loan liability account of £488,768. Which it does (hooray!).

Step 4: Split the current and long-term liability portion of the loan

In the earlier section 'Planning for Long-Term Obligations', I said that these sorts of liabilities had to be split between their current portion and their long-term portion. Well, this is how we do it for this loan.

We know from the table in Step 2 that the loan balance at the end of year 1 is £488,768. If we were to leave all this in current liabilities, it would present a seriously misleading picture of the loan because not all this loan is repayable within 12 months (only part of it is). Therefore, we split the liability between its current portion and its non-current portion as follows:

Current element of loan (£488,768 less £373,315)	£115,453
Long-term element of loan	£373,315

The £373,315 figure is the closing balance of the loan shown in the table in Step 2.

These two totals added together come back to the loan liability of £488,768. The loan balance of £115,453 is presented within *creditors: amounts falling due within one year*. The loan balance of £373,315 is presented within *creditors: amounts falling due after more than one year*.

So you can see that having £115,453 showing as falling due within one year will present a much more accurate picture than having it all shown as current or long-term (and this will help the users make better informed decisions as well about the financial position of the business).

We can use Microsoft Excel to do this for us as well rather than doing it manually. Figure 8-5 shows the above table in an Excel spreadsheet.

FIGURE 8-5:
Loan liability
profiled in an
Excel
spreadsheet.

A	B	C	D	E	F	G
Year	Opening balance £	Repayments £	Interest £	Closing balance £		3.79%
1	600,000	(134,000)	22,768	488,768		
2	488,768	(134,000)	18,547	373,316		
3	373,316	(134,000)	14,166	253,482		
4	253,482	(134,000)	9,619	129,101		
5	129,101	(134,000)	4,899	-		

The highlighted cell under column G shows the effective interest rate that the Goal Seek function has calculated.

Figure 8-6 shows the formulae used in Figure 8-5's spreadsheet.

FIGURE 8-6:
Formulae used in
the amortised
cost table.

A	B	C	D	E
Year	Opening balance £	Repayments £	Interest £	Closing balance £
1	600000	-134000	=G1*B3	=B3+C3+D3
2	=E3	-134000	=G1*B4	=B4+C4+D4
3	=E4	-134000	=G1*B5	=B5+C5+D5
4	=E5	-134000	=G1*B6	=B6+C6+D6
5	=E6	-134000	=G1*B7	-



REMEMBER

If the company is preparing micro-entity accounts under FRS 105, it doesn't use the amortised cost method. The financial accountant simply splits the monthly payment made to the bank between the amount of capital and the amount of interest. In other words, use the *real* interest rate paid to the bank under FRS 105 and not an effective interest rate.

Addressing non-market rate loans

Not every loan you come across will be at a market rate. For example, say you've just set up in business as a bakery selling hot and cold food. To get you off the ground, your family provide you with a start-up loan of £20,000 but decide not to

charge you interest because they're very kind. This would be classed as a non-market rate loan because the bank wouldn't be as kind as your family – the bank would want to charge a market rate of interest.

When you have a loan that isn't market rate, you first need to check whether the loan is covered by any agreement. Sometimes, family members may provide a loan and not bother having any agreed upon terms in writing. When looking at this arrangement from an accounting perspective, the loan is deemed to be *repayable on demand*. This means that the entire loan balance is presented as a current liability, regardless of when you've either agreed to pay it back or decide to pay it back. This is because the company doesn't have anything in writing to say it is entitled to defer settlement beyond a 12-month period from the balance sheet date.

If there are written terms in place and the loan isn't at market rate, you would need to *impute* (assign a value) a market rate of interest and then record the loan in the accounts using that market rate of interest (in the same way as we did in the example of Bauer Industries in the previous section).

IN THIS CHAPTER

- » Meeting the three types of business structures
- » Comprehending paid-up share capital and retained earnings
- » Understanding how companies pay their investors
- » Preparing the equity section of the balance sheet

Chapter 9

Examining the Equity Section

Part 3 of this book is all about the financial statement called the *balance sheet* (also known as the *statement of financial position*), which reports a company's *assets* (the things a company owns), its *liabilities* (the stuff it owes) and owners' equity. In Chapter 7, I take you through the assets part of the balance sheet. Chapter 8 is all about the liabilities part.

This chapter gets into the nitty-gritty of how the owners' interest in the business is recorded on the balance sheet. *Equity* is the combined total of each and every owner's investment in the business. Another term for equity is *net assets* or *net worth*, which is the difference between total assets and total liabilities.

Depending on how a business is structured, its owners' equity can appear in a few different types of accounts on the balance sheet. The main types of business structures are sole traders, limited companies and partnerships. One other type of business structure exists in the UK: the limited liability partnership (LLP). LLPs are a bit of a halfway house between a partnership and a limited company but LLPs are protected by limited liability in company law (unlike a traditional partnership). Because most people are familiar with limited companies, I give them the most attention in this chapter. But I also share all you need to know about sole

traders and partnerships, so you can handle the different types of accounting for these business structures. A company's *equity* may consist of different types of shares and additional paid-up capital (known as *share premium*). In this chapter, I explain the differences between ordinary and preference shares and treasury shares. You also find out about dividends and how a company must handle them. Plus, I touch on some other sorts of transactions which involve equity, including bonus share issues and rights issues.

Wait, I'm not finished! You also receive a tutorial on *retained earnings*: the total profit generated by the business since it started that has not been paid out as dividends. Finally, you bring all this information together by going through the equity section of a sample balance sheet for a limited company. Ready, then? Here we go.

Identifying the Different Types of Business Structure

Forming a business can be super-simple or extremely complicated, depending on the type of business entity being created. Likewise, the owners' equity section of the balance sheet can range from bare-boned to quite elaborate – again, depending on the type of business entity.

Following are the basics of the three types of business entities and their unique components of equity. First, I give you a brief overview of sole traders and partnerships, which are very common throughout the world of financial accounting. Then I launch into a discussion of all you need to know about the most common type of business entity you'll come across, not only in your accountancy studies, but also in your day-to-day working life: the limited company.

Sole trader

Like the name implies, a *sole trader* has one and only one individual owner. This owner can't collectively own the business with anyone else – even with a spouse, another relative or friend. While only one owner can exist, the sole trader can hire as many employees as it needs, or even have family members working for the business.

Forming a sole trader entity couldn't be easier. Most jurisdictions don't require formal documentation to be filed at regulatory authorities for a sole trader (but be careful – HM Revenue and Customs [HMRC] will need to be informed when a sole trader business starts, and there will be a fine if they are not informed in a speedy

fashion). Instead, as soon as the business makes its first sale or incurs its first business expense, it's officially in business as a sole trader business.

The sole trader has two unique equity accounts: *capital introduced* (or *capital account*) and *drawings*. The capital introduced account shows cash and other contributions (such as equipment) that the owner makes to the business out of their own private funds. The drawings account shows money and other assets the owner takes from the business for personal use.

Figure 9-1 shows the owner's equity section of the sole proprietorship for Kai's Kayaks. Not too complicated, right?

**Kai's Kayaks
Capital Account**

As at 31 December 2027

	£
Capital account brought forward 1 January 2027	20,000
Net profit for the year ended 31 December 2027	<u>7,000</u>
	27,000
Less drawings	<u>(15,000)</u>
Capital account as at 31 December 2027	<u>12,000</u>

FIGURE 9-1:
A statement of
owner's equity for
a sole trader.

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Partnership

A partnership must have at least two partners holding any percentage of interest in the business. For example, one partner can have a 99 per cent interest and the other can have a 1 per cent interest, or each partner can have a 50 per cent interest. The division doesn't matter as long as the combined interest adds up to 100 per cent. Keep in mind that a partnership is not limited to two partners; there can be as many partners as the partnership wants to have, and in some cases, a partnership can involve as many as 100 (or more) individuals.

When a partnership is formed, the partnership agreement will set out how the partnership is to be comprised and how it will operate. This partnership agreement can be drawn up by the partners themselves, but many partnership agreements are drawn up by a solicitor. In the UK (and indeed in most other countries), certain conditions may govern a partnership:

- » *General partnerships*, in which all partners are personally liable for any legal action taken against the partnership and for any debts the partnership owes.

» *Limited liability partnerships*, in which your liability for partnership debt is limited to your investment in the partnership (for more on limited liability partnerships, see the next section 'Limited liability partnership').

Partnerships mimic sole traders in that the equity section on the balance sheet has a capital and a drawings account. Figure 9-2 shows the partners' equity section of the Double-Trouble Partnership, whose partners, Sue and Mark Double, each own 50 per cent of the business.

Double-Trouble Partnership
Statement of Partners' Equity
As at 31 December 2027

	Capital account: Mark Double £	Capital account: Sue Double £	Total capital £
Opening balance at 1 January 2027	10,000	7,000	17,000
Profit for the year ended 31 December 2027	12,000	12,000	24,000
	22,000	19,000	41,000
Partners' drawings to 31 December 2027	(10,000)	(2,000)	(12,000)
Closing balance at 31 December 2027	12,000	17,000	29,000

FIGURE 9-2:
A statement of
partners' equity.

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REMEMBER

The amount of drawings and income distributions a partner is allowed to take can differ from that person's partnership interest. So even though you have two equal partners, that doesn't mean they must take the same amount of drawings. Hence, the differences in opening and closing partners' capital accounts between partners in Figure 9-2.

Limited liability partnership

In the preceding section, I mention a limited liability partnership (LLP). An LLP is a sort of halfway house between a limited company and a traditional partnership. However, in the UK, an LLP has the same protection as that of a limited company (as described in the following section) in that its members are protected against the LLP's debts only to the amount of money they've invested. The fundamental difference is that, in the UK, LLPs have to file their accounts with Companies House (so they're on public record) and file annual *Confirmation Statements*, which include details of the LLP and a statement that the LLP's future activities will be lawful. The financial statements of an LLP also look different to those of the traditional partnership because they have to prepare accounts under a specific Statement of Recommended Practice (SoRP) on Accounting by Limited Liability Partnerships.



TIP

Further information on the SoRP for Accounting by Limited Liability Partnerships is available from the Consultative Committee of Accountancy Bodies' website at www.ccab.org.uk.

Limited companies

If a business wants to operate as a company, it must prepare and file a memorandum and articles of association with the Registrar of Companies (or Companies House). The memorandum and articles of association cover the basics about the company such as its name and address, the shares it issues (including the type and how many shares).



TIP

If you want more info on memorandum and articles of association then visit the Companies House website at www.companieshouse.gov.uk.

The type of information a particular jurisdiction requires for the creation of a company is a matter of law in that particular country and can be found by speaking to a *formation agent* (someone who prepares the necessary documentation to set up a company) or an accountant. Chapter 15 has more information about forming a company (also referred to as *incorporation*).

The balance sheet section called 'equity' or 'capital and reserves' or 'shareholders' funds' represents the claim shareholders of the company have to the company's net assets. Four common components to shareholders' equity exist: paid-up share capital, share premium, treasury shares and retained earnings. Paid-up share capital and share premium involve transactions dealing with share issues. Retained earnings shows profit and dividend transactions. In the sections that follow, I give a run-through of each of these components, starting with paid-up share capital and the share premium account, then retained earnings and finishing with treasury shares.

Sifting Through Share Capital

Paid-up share capital represents money the shareholders in a company invest in the business (contributed capital). It consists of purchases for preference shares (but see the first bullet point below for an important point on these), ordinary shares and premium paid on share capital. Here's a definition of each:

- » **Preference shares:** You have to be very, very careful with preference shares because they only show in the equity section of the balance sheet if (and only if) they do not entitle the holder of the preference shares to cash (either by

way of redemption of the shares or by way of dividends (note: dividends paid on preference shares are *interest charges in the paying company's financial statements*). Where preference shares do not contain such redemption features, and are rightly classified as equity, they're at the top of the pecking order. What this means is if a company sells its assets and closes its doors, preference shareholders get back the money they invested in the company plus any *dividends* owed to them (money paid to the shareholders based on their proportionate ownership of the shares) before the ordinary shareholders get their cut. For more information on dividends, see the 'Paying dividends' section later in this chapter.



WARNING

In almost all cases, preference shares will entitle the holder of those shares to cash – either by way of redemption at some point in the future, or by way of periodic interest payments (dividends). Where this is the case, the preference shares aren't shown in equity, but are instead shown as a liability (see Chapter 8 for more on liabilities). However, some countries that report under their own national accounting standards do still recognise preference shares in the equity section of the balance sheet, but for those companies reporting under UK and Ireland generally accepted accounting practice (GAAP) and UK-adopted International Financial Reporting Standards (UK-adopted IFRS Accounting Standards), this is not the case.

- » **Ordinary shares:** Ordinary shares are shares that aren't preference shares and don't carry automatic rights to dividends. Ordinary shares represent residual ownership in a company, and a share may allow the owner of that share to vote in matters put forward to the shareholders for approval in shareholders' meetings. Ordinary shareholders generally receive dividends at the discretion of the company (hence, there is no automatic right to a dividend if you're an ordinary shareholder).



REMEMBER

Ordinary shareholders elect the board of directors that oversees the running of the company. The board of directors will then appoint the management and senior management who will oversee the day-to-day operations of the business. In order to be a real company, at least one ordinary share must be issued.

- » **Share premium account:** This account represents the excess of what shareholders pay to buy the shares over the nominal value of the shares. *Nominal value* is what a share is worth (its *face value*). Wondering how par value is determined? Whoever was in charge of originally forming the company decided on the amount of nominal value. Most of the time, nominal value is an insignificant amount selected at random (usually £1 but it can be £100 or even 1 pence).

FOLLOWING THE RULES FOR ISSUING SHARES

A company's shares can be both *issued* and *outstanding* at any point in time. Here's how these terms are defined:

- *Issued*: A share is issued when the company sells it to an investor (the shareholder) and receives cash or some other benefit in return.
- *Outstanding*: After a share is issued, it's classified as outstanding for as long as it's in the hands of the shareholder. The company can buy back outstanding shares of shares, resulting in treasury shares. I fully explain treasury shares, which is issued but not outstanding, in the 'Buying back shares' section of this chapter.



EXAMPLE

Cahill Cars' ordinary shares have a nominal value of £10 per share. Liza comes along and is issued 20 shares for £15 a share. The addition to Cahill Cars' ordinary shares is £200 (20 shares at £10 nominal value). Additional paid-in capital (the *premium*) is £100, which is calculated by multiplying those 20 shares by the excess Liza paid for the shares over their nominal value (20 shares times £5).

Recording Retained Earnings

The *retained earnings* account (sometimes called *profit and loss reserves*) on the balance sheet shows the company's total net profit or loss from day one of trading to the date of the balance sheet. (See Chapter 10 for information on how to calculate net profit or loss.) While paid-up share capital is money contributed by the shareholders, retained earnings is *earned* capital.



REMEMBER

Keep in mind that retained earnings are reduced by *dividends*: earnings paid to shareholders based upon the number of shares they own. I discuss dividends in the next section.



EXAMPLE

Judith's Jumpers Ltd opens its doors on 1 January 2027. On 2 January 2027, retained earnings is £0 because the company didn't previously exist. From 2 January 2027 to 31 December 2027, Judith's Jumpers has a net profit, after tax, of £20,000 and pays out £5,000 in dividends to the shareholders. On 1 January 2028, the retained

earnings amount is £15,000 (£20,000 – £5,000). Then, to work out the retained earnings figure as at 1 January 2029, you start with £15,000 and add or subtract the amount of profit/loss after tax the company made or lost during 2028 (and subtract any dividends paid).

Spotting Reductions in Shareholders' Funds

During your accountancy studies, or your day-to-day working life, you'll come across two situations that reduce shareholders' funds (equity) other than when a company makes a net loss. These situations are when a company pays dividends to its shareholders or when the company buys back outstanding shares (treasury shares). Although both transactions reduce equity, they're completely different types of accounts. While you may be scratching your head, wondering what treasury shares are all about, you may be somewhat familiar with dividends. Don't worry! I thoroughly explain both in this section.



TIP

Corrections of accounting errors made in prior periods and discovered in the current period can also reduce equity. I discuss this topic in Chapter 20.



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THE TWO IMPORTANT DATES IN THE LIFE OF A DIVIDEND

The company's board of directors is in charge of deciding how much of a dividend to issue, and when. However, the board can't just wake up one morning and decide that today's the day to distribute some cash in the form of a dividend! The dividend cycle consists of two events:

- 1. Declaring the dividend:** This is the date on which the board of directors authorises the dividend. After a dividend is declared, the company has a legal responsibility to pay it.

The company records this legal responsibility by making a resolution in the board meeting and then reducing retained earnings and increasing a current liability: dividends payable. The amount by which retained earnings are reduced and the liability increased is the dividend per share multiplied by all shares outstanding. So if the company has 5,000 shares outstanding and declares a dividend of £2 per share, the amount is £10,000 (£2 × 5,000 shares).

2. Paying the dividend: The date on which the dividend is declared (see step 1 above) is not necessarily the date on which the dividend is paid. This is vitally important because tax legislation (as is the case in the UK) often says that any tax due on a dividend is payable when it's *receivable* and this date can be different to when it becomes *payable*. Paying cash dividends reduces both cash and dividends payable. For example, if the total dividends paid were £10,000, you debit dividends payable and credit cash for £10,000 each. Now, in the UK, for the purposes of tax if the dividend was declared on 31 March 2027, but not actually paid until 7 April 2027 (in the next tax year), the dividend would have to be put on the shareholder's self-assessment income tax return in the tax year ending 5 April 2027! This is because the dividend was *receivable* in the tax year to 5 April 2027. Boo!

Paying dividends

Dividends are distributions of company profits to the shareholders. An important point to emphasise where dividends are concerned is that they're *always* paid out of *after-tax* profits.



REMEMBER

Dividends are *not* an expense of doing business. They're a balance sheet transaction only, serving to reduce both cash (in the case of cash dividends) and retained earnings. This is why they're always paid out of post-tax profit (or paid out of retained earnings).

Nowadays, dividends are paid to shareholders generally by electronic bank transfer, based upon how many shares in the company they own. For a company to be able to pay dividends, two conditions must be met:

- » The company has positive retained earnings (otherwise the dividend would be unlawful).
- » The company has enough cash in the bank to pay the dividends.



EXAMPLE

Neil owns 1,500 ordinary shares in Leslie's Lilos Ltd. Leslie's Lilos has both a surplus of cash and positive retained earnings so the board of directors decides to pay a cash dividend of £12 per share. Neil's dividend is £18,000 (1,500 shares times £12). The reduction to retained earnings for a cash dividend is very straightforward. You record the transaction as follows:

Debit: Retained earnings	£18,000
Credit: Cash at bank	£18,000

Buying back shares

The term treasury shares sounds both very complicated and like something that the government would issue. However, *treasury shares* refer to shares that have previously been sold to investors and then bought back by the issuing company.

You record treasury shares on the balance sheet as a contra shareholders' equity account. *Contra accounts* carry a balance opposite to the normal account balance. Because equity accounts normally have a credit balance, a contra equity account weighs in with a debit balance.



WARNING

Under GAAP, it's not appropriate to record any sort of gain or loss on treasury share transactions.



REMEMBER

One reason a company may buy back shares of its own is to return money back to shareholders or to prevent a hostile takeover. The fewer shares trading in the open market, the smaller the chance that a controlling stake in the company can be purchased by another company.

Getting to grips with share splits

One other type of share transaction that doesn't reduce retained earnings is a share split. A *share split* increases the number of shares outstanding by issuing more shares to current shareholders proportionally by the amount they already own. Share splits are typically done when a company believes the trading price of its shares is too high; the split reduces the price per share.



EXAMPLE

Heaton Enterprises' shares are trading for £100, and the company thinks this high price affects the average investor's desire to purchase the shares. To get the price of the shares down to £25 per share, the company would issue a 4-for-1 split. Every outstanding share would now be equal to four shares.

Seeing Increases in Share Capital

Share capital can increase in one of two ways: via a bonus issue or a rights issue. These issues are offered by a company as a means of either holding on to existing cash or raising more cash. I explain each issue in turn below.

Learning about bonus issues

A bonus issue takes place when a company issues further shares to the shareholders in proportion to their existing shares (for example, a company may give a shareholder one additional share for every five shares they hold). The bonus issue is given to the shareholder free of charge. ‘Why on earth would a company give shares away for free?’ I hear you ask.

Well, a bonus issue means that the shareholder receives additional shares at no extra cost to them, and companies usually do this as an alternative to paying dividends. Dividends are usually paid out of the bank account (see the earlier section ‘Paying dividends’), so from the company’s point of view, making a bonus issue instead of paying dividends will preserve cash.

A company will also undertake a bonus issue if it’s *under-capitalised*, which means that it hasn’t got a lot of shares in issue. When a company is under-capitalised, the rate of dividend is higher, so a bonus issue lowers the rate of dividend, which preserves cash.

Rifling through a rights issue

A rights issue is a way for a company to raise cash by selling additional shares to existing shareholders in proportion to their current shareholding. As an incentive for the shareholder to take up a rights issue, the shares are usually sold at a discount (in other words, at a price set lower than the current share price), but this isn’t prescriptive and companies can offer a rights issue to existing shareholders at market value if they so choose.

If a shareholder does *not* take up an offer of a rights issue, their shareholding becomes diluted because the shares will go to other shareholders.

Exploring a Sample Equity Section of the Balance Sheet

Figure 9-3 shows you how to prepare the equity section of a balance sheet for a company. While assets and liabilities are merely a line item in Figure 9-3, you can go to Chapter 7 to see the asset section fully developed, and Chapter 8 shows the liability section in all its debt-filled glory!

First up is always the issuing of shares by a company. As you can see from the captions, the company has issued 250 ordinary shares and additional paid-up share capital of £5,000 means that investors paid £5,000 over par value (sometimes called *face value*) for shares purchased. The company also has a revaluation surplus from the revaluation of fixed assets of £1,500 (which means fixed assets have risen in value). Retained earnings tells us that the company has £21,029 of earned profit from the day it opened its doors to 31 December 2027.

		£
	Total assets	105,245
	Total liabilities	<u>(58,966)</u>
		<u>46,279</u>
	Shareholders' funds	
	Ordinary shares (250 shares x £75 per share)	18,750
	Share premium	5,000
	Revaluation reserve	1,500
	Retained earnings	<u>21,029</u>
		<u>46,279</u>

FIGURE 9-3:
The equity section of a balance sheet.

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4

Investigating Income and Cash Flow

IN THIS PART . . .

Explore the two different formats for the profit and loss account.

Discover how companies generate and spend cash by sifting through a cash flow statement.

Tackle depreciation and amortisation.

Find out how companies must value and account for inventory and work in progress in the financial statements.

IN THIS CHAPTER

- » Discovering ways to present an income statement (profit and loss account)
- » Classifying the three business types
- » Identifying the common income statement sections
- » Keeping an eye out for unusual income statement accounts
- » Preparing an income statement

Chapter 10

Understanding Profit and Loss

This chapter gives you an introduction to preparing an *income statement* (profit and loss account): the financial document that reflects a company's revenue and expenses (it's also known as the *statement of profit or loss* under UK-adopted International Financial Reporting Standards, or UK-adopted IFRS, which I discuss further in Chapter 4). The ultimate purpose of an income statement is to show how the company has performed during an accounting period.

In this chapter, you see the difference between a profit and loss account under the UK's format one (the most commonly used format) and format two methods. You also discover what an income statement prepared under UK-adopted IFRS looks like, including potential changes to the UK-adopted statement if the UK Endorsement Board (see Chapter 4) adopts the new IFRS 18 *Presentation and Disclosure in Financial Statements*.

I introduce each section commonly found in the income statement, and I discuss unusual items that sometimes show up. Finally, the income statement in all its glory is laid out on the table, from the start – revenue (or turnover) – to the end – net profit after tax.

Presenting the Profit and Loss Account in One of Two Ways

Before I get into the details of what you find in a profit and loss account, I want you to understand that not every profit and loss account looks exactly the same. That's because in the UK, you can prepare the basic profit and loss account in one of two ways: format one and format two. The format one method is most commonly used. Format one reports the classification of expenses by *function* (cost of sales, distribution costs and administrative expenses). Format two reports: the classification of expenses by *type* (raw materials and consumables, staff costs and depreciation).



REMEMBER

Under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, both format one and format two are permissible provided the business is consistent in which format it is using from one reporting period to the next. Under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, only format two is allowed.

In this section, I show you an example of each profit and loss format. Looking at them, you may think that even format one isn't all that informative – neither type of statement contains very many numbers. But as I show you later in the chapter in the section 'Examining Income Statement Sections', the income statement/profit and loss account is actually full to the brim with information.

Figuring out format one

In Figure 10-1, I provide an example of a profit and loss account prepared under format one. All the main players in the profit and loss account are present – notably turnover and net profit. I offer more details later in the chapter, but for now, just keep in mind that *turnover* is gross sales (without Value Added Tax, also known as VAT) less sales returns and discounts, and *net profit* is what the company has made at the end of the day after deducting all expenses.



REMEMBER

Completing the statement is the calculation for *basic earnings per share*, which shows net profit allocated to investors based on the number of shares they own. This bottom-line number is very important to the users of financial statements (see Chapter 1) because it tells them how well their investment in the shares of the company is performing.

Patton Patisserie Ltd
Profit and Loss Account
For the year ended 31 December 2027

	31.12.2027	31.12.2026
	£	£
Turnover	275,000	235,000
Cost of sales	(124,500)	(114,600)
Gross profit	150,500	120,400
Distribution costs	(38,103)	(30,140)
Administrative expenses	(65,790)	(63,110)
Operating profit	46,607	27,150
Interest receivable and similar income	2,697	2,403
Interest payable and similar expenses	(1,125)	(964)
Profit before tax	48,179	28,589
Tax on profit	(9,264)	(5,130)
Profit after tax	38,915	23,459

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FIGURE 10-1:
A format one
profit and
loss account.

Working through format two

Using the same facts and circumstances as in Figure 10-1, Figure 10-2 shows the profit and loss account prepared under format two. The big differences between format one and format two are the following:

- » Format one has a line item for gross profit. This information is very helpful when doing ratio analysis (see Chapter 14).
- » Format two breaks down operating costs in greater depth, allowing the user to see a more detailed make up of costs.
- » Format two profit and loss accounts also contain categories for 'Cost of raw materials and consumables' (which is shown directly underneath turnover). This figure is shown within cost of sales in format one profit and loss accounts.



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Because the UK's Companies Act permits these formats, it must seem that these differences are therefore insignificant. But they're worth noting from the start of our discussion because in your career, you'll probably come across both types of income statements.

Patton Patisserie Ltd
Profit and Loss Account
For the year ended 31 December 2027

FIGURE 10-2:
A profit and
loss account
prepared under
format two.

	31.12.2027	31.12.2026
	£	£
Turnover	275,000	235,000
Cost of raw materials and consumables	(124,500)	(114,600)
Staff costs	(38,603)	(31,250)
Depreciation and amortisation	(11,102)	(12,369)
Other charges	(52,616)	(48,192)
Profit before tax	48,179	28,589
Tax on profit	(9,264)	(5,130)
Profit after tax	<u>38,915</u>	<u>23,459</u>

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Looking at a UK-adopted IFRS income statement

The previous sections discuss the profit and loss accounts prepared under formats one and two. These two formats are very much UK-specific, but you also need to know how a profit and loss account prepared under UK-adopted IFRSs looks. A profit and loss account in international lingo is known as the *income statement* or *statement of comprehensive income* or (more recently) *statement of profit or loss*. For simplicity, I stick to using just the *income statement*.



REMEMBER

In 2024, a new IFRS Accounting Standard hit the streets in the form of IFRS 18 *Presentation and Disclosure in Financial Statements*. If the UK Endorsement Board (see Chapter 4) endorses IFRS 18 for use in the UK, it will change the way in which the income statement is presented. Specifically, it will introduce three defined categories for presenting income and expenses in the statement:

- » Operating
- » Investing
- » Financing

New subtotals will be needed, including a subtotal for operating profit as well.

Figure 10-3 provides an illustration of an income statement under IFRSs.

Patton Patisserie PLC
Profit and Loss Account
For the year ended 31 December 2027

	31.12.2027	31.12.2026
	£	£
Revenue	275,000	235,000
Cost of sales	(124,500)	(114,600)
Gross profit	150,500	120,400
Distribution costs	(38,103)	(30,140)
Administrative expenses	(65,790)	(63,110)
Operating profit	46,607	27,150
Finance income	2,697	2,403
Finance costs	(1,125)	(964)
Profit before tax	48,179	28,589
Tax on profit	(9,264)	(5,130)
Profit after tax	38,915	23,459
Basic earnings per share	31.5p	30.1p

FIGURE 10-3:
 An illustrative
 income
 statement.

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Defining Different Types of Businesses

Every business can be classed as one of three types: service, manufacturing and retail. It's important to realise which type you're working with when reviewing or creating any financial statement – including the income statement. That's because not every type of account (which I introduce in Chapter 5) shows up in the financial statements for every company.

Providing a service

When a company's income is from providing services rather than selling goods, that business is a *service* provider. Accountants, lawyers, doctors and hair stylists are examples of people who run service businesses.

Here's an example: as a chartered certified accountant working for an accountancy practice, I create reports that may be produced on paper (though nowadays many reports are produced electronically) and bound in folders for my clients. Each folder is a tangible product, but the client isn't paying me for the relatively small cost of the paper and ink; they're paying me for the intellectual product I provide on the paper.



TIP

One major giveaway that a company is a service provider is if it doesn't have any inventory (although it might have work in progress). Most service providers make purchases only for the job at hand, so they won't carry any inventory; the purchases are simply expensed to each job. If the company does retain

some purchases, the amount is inconsequential, especially when compared to a *retail* company (which sells products another company makes) or a *manufacturing* company (which makes the products it sells). I discuss these two types of companies next.

Selling goods to Joe Public

A *retailer* is a business such as your local supermarket or department store. The business purchases goods from a manufacturer (see the next section) and, in turn, sells them to the end user – a customer like you or me.

Unlike a service business, the retailer has inventory. The inventory consists of goods available for sale, which are ready to be put on the shelves of the shop. So, your local supermarket's inventory includes milk, fresh produce, tinned goods, baked goods, and so on. I show you how to account for retail-type inventory in Chapter 13.

Manufacturing a product

The finished goods sold by retailers have to come from somewhere, and that somewhere is the manufacturer. Because the manufacturer makes products from scratch, accounting for this type of inventory is much more complicated than accounting for products held by a retailer.

Manufacturers have three types of inventory:

- » **Raw materials:** This is the inventory the company purchases to make the products. For example, to make a dress, it purchases fabric, thread and buttons.
- » **Work in progress:** This inventory category includes all materials that have been partially but not completely made into finished products. A work-in-progress item can be a dress whose sleeves have not yet been sewn to the body of the dress.
- » **Finished goods:** Finished goods are all products that are completely assembled but not yet sold to a customer. So, our dresses are ready to leave the manufacturing plant as soon as a buyer puts in an order.

Discover how to account for manufacturing inventory in Chapter 13.

Examining Income Statement Sections

As you can see in Figures 10-1 and 10-2, income statements are broken down into different sections. The main reason that items of revenue and expense are separated and reported in distinct sections is so that the business owner can better use the income statement to make decisions and to isolate problems with the way the business is being run. (Fear not – this will make more sense after you review all the income statement parts in this section.)



TIP

Before getting into the nitty-gritty of all the different types of revenues and expenses, you have to know how to prepare a heading for a particular financial statement. The first line of the heading is always the name of the company. The second line identifies the type of report – in this case, Income Statement (or Profit and Loss Account). The third line in an income statement heading indicates the period covered by the statement; for example, 'For the year ended 31 December 2027'. (Note that the date on the report is *not* the date when the report itself was prepared; it's the last day of the financial period.)

Revenue and other income

In this section, I explain two revenue accounts that appear on an income statement: revenue from sales and other income.

Revenue from sales

The first line item in the income statement is always *revenue*, which is the amount of income the company generates by doing whatever it's in the business of doing. Some accountants refer to revenue as *turnover*. Both names mean the same thing.

Revenue is derived from a sale (whether a good or service), and a sale will start with an implicit or written contract between a company and its customer (and end with reporting the sale once it meets the revenue recognition criteria, which I discuss in a moment). The contract states that an agreed-upon good or service is to be provided for a set amount of money.

Here's an example of an implicit contract: I walk into a department store and buy a pair of trousers. It's implicitly understood that when I take the trousers to the checkout, I'll pay for the trousers using cash, card or another method such as Apple Pay.

An example of a written agreement is a contract for sale. Say that a department store signs a contract stating it wants to buy 500 pairs of trousers from the manufacturer. This contract states all the expenses and obligations on the part of both the seller and the purchaser.



REMEMBER

A company's sales revenue includes only transactions that relate to the purpose of the business. In the department store example, revenue includes the amount of products sold to customers. If that same company sells one of its company cars, you record the gain or loss on that transaction in the line called 'profit or loss on disposal of non-current assets', not within sales. That's because the company isn't in the used car sales business. Profit or loss unrelated to the business purpose isn't part of sales. Find out more about this subject in the upcoming 'Other income' section.

Financial accounting uses the accruals method of accounting (see Chapter 6) so a company can't record sales unless that money is earned and realisable. Here's what these terms mean:

- » For revenue to be *earned*, the job, whether it involves goods or services, has to be completed based upon the terms of the contract between the company and the customer. It must also meet the revenue recognition criteria in UK and Ireland accounting standards or UK-adopted IFRS.
- » For revenue to be *realisable*, it means an expectation exists that the company performing the service or providing the goods will be paid. When might revenue *not* be realisable? If, after the job is complete (but before the company is paid), a customer closes its doors and disappears or becomes bankrupt, the revenue is no longer realisable and a bad debt has been incurred that needs writing off.

Based on the above information, you can understand that cash doesn't have to change hands for sales to be earned and realisable. To address this fact, a company has a 'trade receivables' (often referred to as 'trade debtors') account holding the monetary amount of revenue that hasn't been paid by customers. I discuss accounts receivable in Chapter 7.

Other income

You classify all other income the company brings in peripherally as *miscellaneous income*, *sundry income* or *other income*. (All of these names are fine.) During your accounting studies, or day-to-day working life in accountancy, you may come across three kinds of other income:

- » **Interest:** Revenue a company earns from money in a bank deposit account
- » **Dividends:** Revenue a company earns on investments it owns, such as shares in other businesses
- » **Gain on disposal of an asset:** The profit a company makes when it sells one of its assets, such as a car or machine, for an amount higher than its value in the company's balance sheet

Note that while the sales account is your first income statement account, other income doesn't appear until later in the statement. That's because, frankly, it's not quite as significant as some of the other financial facts about the business. But the main reason in financial accounting is that's what generally accepted accounting practice (GAAP) dictates. (I explain why following GAAP is important in Chapter 4, but in a nutshell, everyone doing the same thing enables comparability between businesses.)

Contra revenue accounts

In Chapter 5, I give you the lowdown on the rules of debits and credits. One of the immutable rules of accountancy is that revenue accounts normally carry a credit balance. However, in the wonderful world of accountancy, you have what are called *contra accounts*, which means the account carries a balance contrary to the normal balance. So a contra revenue account carries a debit balance instead of a credit balance.

The two contra revenue accounts you're most likely to encounter are 'sales discounts' and 'sales returns and allowances', which I discuss here.

Sales discounts

Sales discounts reflect any discount a business gives to a customer, such as a settlement discount if the customer pays early. For example, a customer's invoice is due within 30 days of receipt of the goods or services. If the customer pays early (what's considered *early* is spelt out in the terms of the contract), it gets a 2 per cent discount. So, if the invoice is for £100, the customer need only pay £98. This doesn't seem like such a big deal, but consider the difference between the invoice amount and payment amount if the invoice is for £10,000 or £100,000. These discounts can soon mount up.

Sales returns and allowances

Sales returns reflect all products that customers return to the company after the sale is complete. For example, after I buy a pair of trousers for my father, perhaps I decide purple trousers are a fashion faux pas, and I no longer want them. Back to the department store I go to return the trousers and get a full refund for the purchase price.

Sales allowances reflect a discount in price given to a customer wanting to purchase damaged goods. A perfect example is that some shops sell slightly damaged appliances (sometimes referred to as *seconds goods*).

Gross sales less sales discounts and sales returns and allowances equals *net sales*. Figure 10-4 shows an example of how this calculation looks if a company has gross sales of £300,000, sales discounts of £25,500 and sales returns of £1,000.

		£	£
Gross sales			300,000
Less:	Sales discounts	(25,500)	
	Sales returns and allowances	<u>(1,000)</u>	
			<u>(26,500)</u>
Net sales			<u>273,500</u>

FIGURE 10-4:
Net sales.

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REMEMBER

If a business is registered for value added tax (VAT) with HM Revenue and Customs (HMRC), the sales figure in the profit and loss account (income statement) is always shown net of VAT. When I say *net of VAT*, I mean the amount of the sale *before* VAT is charged. This is because the VAT amount does not belong to the business – it's a tax charged on the value of sales by HMRC, which must be remitted to them net of any purchases VAT the business has incurred from suppliers.

Cost of sales

The *cost of sales figure* in the income statement reflects all costs directly tied to any product a company sells, be it a retailer or a manufacturing company. A service company generally doesn't have a cost of sales line because it doesn't sell a tangible product.

Because retailers sell products they purchase from manufacturers, their cost of sales figure is usually easy to calculate. That's because retailers have only one type of inventory to keep track of: goods they purchase for resale. As I note in the

'Manufacturing a product' section earlier in the chapter, a manufacturer has several different types of inventory, so calculating its cost of sales is a little trickier.

In this section, I talk about the easier cost of sales (for retailers) first and then tackle the more difficult cost of sales for the manufacturing company.

Retailing cost of sales

Calculating cost of sales for a retailer starts with *opening inventory*, which is the stock the company has available for sale at the beginning of the month (in other words, the leftover inventory from the prior month). I discuss inventory in depth in Chapter 13.

Next, you have to work out the cost of purchases. To do so, you add together two items:

- » **Purchases:** Any new goods the company buys during the current month
- » **Freight costs:** The shipping expense the business incurs in order to get the goods from the manufacturer to their location

For example, if purchases for the month of April are £125,000 and freight costs are £10,500, your cost of purchases is £135,500.

Your next step is to work out *net purchases*, which means cost of purchases less contra purchases. Once again, contra accounts raise their ugly heads! Two contra purchase accounts exist:

- » **Purchase discounts:** This contra account reflects any discount a company receives from a supplier, such as a settlement discount because it pays a supplier's invoice early. It's the flip side of the contra revenue account 'sales discount' – looking at the same event from the eyes of the customer rather than the seller.
- » **Purchase returns and allowances:** This contra account consists of items a retailer orders and returns to the supplier. Items may be returned if an order arrives too late to use, arrives damaged or doesn't contain what the company actually ordered. This account is the flip side of 'sales returns and allowances' – looking at the same event from the side of the customer instead of the seller.



REMEMBER

Because purchases are an expense and carry a debit balance, a contra purchase expense will carry a credit balance.

Cost of purchases less the two contra purchase accounts equals *net purchases*. For example, start with our cost of purchases of £135,500. Assume that purchase discounts are £5,000 and purchase returns and allowances come to £7,000. Your net purchases amount is £123,500.

Adding net purchases to opening inventory gives you *cost of goods available for sale*. So, if opening inventory is £5,000, cost of goods available for sale is £128,500 (£123,500 + £5,000).

Okay, just one more calculation! Subtract *closing inventory*, which is the stock of goods the company still has available for sale on the last day of the accounting period, from cost of goods available for sale. (Because the closing inventory wasn't sold, we're subtracting its costs from the goods available for sale.) Then you have your cost of sales! Continuing our example, if closing inventory is £10,000, your cost of sales is £118,500 (£128,500 – £10,000).

Manufacturing cost of sales

Manufacturers have three types of inventory: raw materials, work in progress and finished goods. To work out a manufacturing company's cost of sales, you first have to calculate the cost of goods manufactured. What appears to be a simple single line item in the cost of sales for a manufacturing company is really a calculation in which many different variables are added and subtracted.

Check out Figure 10–5 to see how the manufacturing company's cost of sales shows up in the income statement. Looks pretty bare-boned, doesn't it?

		£
FIGURE 10-5: Computing cost of sales for a manufacturing company.	Opening finished goods in inventory	175,000
	Plus Cost of goods manufactured during the period	<u>132,110</u>
	Equals Cost of goods available for sale	307,110
	Less Closing finished goods in inventory	<u>(88,900)</u>
	Equals Cost of sales	<u>218,210</u>

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Here, I walk you through the preparation of the cost of sales line item 'cost of goods manufactured during the period'. Most of the terms I use in this calculation have already been explained in this chapter, but I throw in a couple of new ones too:

» **Direct labour:** This expense includes only what the company pays to workers who are directly involved in making the items the company manufactures. So,

if the company makes clothing, direct labour includes the payroll for the employees who make the clothing patterns, cut out the fabric pieces and assemble the fabric pieces into a wearable garment.

» **Factory overhead:** This expense includes all manufacturing costs except those you include in direct materials and direct labour. It also includes indirect materials and labour:

- *Indirect materials:* These are materials that a manufacturer would use for more than one product. For example, your clothing manufacturer has to use thread to sew the pieces of the clothing patterns together to make a complete, wearable garment. If the thread is a generic colour (such as black or white) that the company uses to make various other garments such as jackets, it would properly be classed as indirect materials. That's because the thread is not directly associated only with the clothing.
- *Indirect labour:* This item includes employee payroll that doesn't directly tie to a specific finished product. A good example of an indirect employee is a quality control inspector who makes sure the goods flowing down the assembly line are made properly.

Another example of factory overhead is *depreciation of factory equipment*, which is the process of spreading the cost of the factory equipment over its useful life. For example, you include the depreciation of the sewing machines the company uses to make the clothing in factory overhead. Depreciation of the computers that the number-crunchers use in the accounts department *isn't* included. I explain different methods of depreciation in Chapter 12.

Utilities you include in factory overhead are the heating and air conditioning, lights, power to run the factory machines and factory water. These expenses are classed as overhead because while the business incurs them when manufacturing products, it cannot tie these expenses to one particular product (unless the company makes only one product).

Other overhead items can include any other manufacturing costs that can't be attributed to a specific product. One example is the repair and maintenance expenses to keep the factory machines running smoothly. A good example is if the company buys the same brand of lubricant to oil all the machines.

Now that you know all the terms you see when preparing the 'cost of goods manufactured during the period', I walk you through the preparation itself in Figure 10-6.

		£	£
	Opening direct materials inventory		250,000
Plus	Net purchases		<u>115,000</u>
Equals	Total direct materials available		365,000
Less	Closing direct materials in inventory		<u>(195,000)</u>
Equals	Direct materials used		170,000
Plus	Direct labour		65,000
Plus	Items of factory overhead:		
	Depreciation of factory equipment	12,000	
	Utilities	6,500	
	Indirect factory labour	6,000	
	Indirect materials	7,000	
	Other overhead items	<u>2,500</u>	
Equals	Manufacturing cost incurred during the period		34,000
Plus	Opening work in progress		120,000
Less	Closing work in progress		<u>(88,000)</u>
	Cost of goods manufactured during the period		<u>301,000</u>

FIGURE 10-6:
The step-by-step
preparation of
cost of goods
manufactured
during a period.

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Gross profit

Well, this is an easy one! On the income statement (refer back to Figure 10-2), *gross profit* is what's left over after you subtract the cost of sales from revenue. Basically, gross profit shows you how much money the company makes if it doesn't have any other expenses such as office rent, salaries, and so on. (Note that this line doesn't appear on the format two profit and loss account format, such as the one shown in Figure 10-2.)



REMEMBER

Gross profit is very important in financial accounting because it gives the users of the financial statements a measurement upon which to compare this company to others. (See Chapter 14 for information about ratio analysis.) A company showing a higher gross profit than others in its industry will be more likely to attract investors, as long as expenses other than cost of sales are kept in line.

Distribution and administrative expenses

First up, in order to set the context, think of this section as *selling* and *distribution* expenses. Two principal categories of operating expenses show up in the income statement and follow on from each other:

» **Distribution costs:** Any expenses a company incurs to sell its goods or services to customers. Some examples are salaries and commissions paid to sales staff, shipping costs to get the goods to the customer and storage costs.

» **Administrative expenses:** All expenses a company incurs to keep up the normal business operations. Some examples are office supplies, general administrative wages/salaries, non-factory rent and utilities, and accountancy and legal services.

Heading toward the bottom line

When you hear the phrase *bottom line* it refers to the profit made by the business. If you've gone through this chapter section by section, you've worked through a lot of different income statement accounts so far. Bet you never thought that making money could be so complicated! However, you're fast approaching the finish line, where you find out if the company has made or lost money during the accounting period (and the point at which many directors' nerves start to kick in!).

Other income and expenses

In the earlier section 'Revenue and other income', I explain that *revenue* includes only the amount of money the company brings in doing whatever it's in the business of doing; it doesn't include any investment income. Well, here's the section of the income statement where you record all the other types of revenue.

This line of the income statement also includes expenses that the company incurs other than costs associated with normal operations. Here are two types of expenses you typically see reflected on this line:

» **Interest payable:** This includes the cost of using borrowed funds for business operations, expansion and cash flow. Why wouldn't interest expense be included as an operating expense? Well, operating expenses are for the day-to-day activities involved in running a business. Under GAAP (which I explain in Chapter 4), interest expense is not considered to be a day-to-day activity unless the company is in the business of lending money.

» **Loss on disposal of a fixed asset (non-current asset):** I talk about 'gain on disposal of an asset' earlier in the chapter (see the 'Other income' section). Loss is the flip side of the coin. If a company sells an asset it no longer needs and loses money on the transaction (meaning it sells the asset for lower than its book value), the loss is recorded in the income statement as 'loss on disposal of fixed asset'.

Profit before tax

The sum total of all income less cost of sales less expenses gets you to the *profit before tax* figure. The profit before tax figure is an important number because it's

generally what most investors are interested in seeing. HM Revenue and Customs (HMRC) is also very interested in this figure because this is the baseline that will be used in calculating the company's corporation tax (see Chapter 18 for more on a company's corporation tax provision).

Provision for income tax

Before you can arrive at the final total for net profit or loss, you have to adjust profit before tax by subtracting a provision for the corporation tax the company will pay when it files its corporation tax return. I discuss accounting for income taxes in Chapter 18.



TIP

If you're a student accountant and are studying financial reporting, you probably won't be asked to calculate corporation tax as this exercise will be covered in your tax studies. You'll more than likely be given the corporation tax charge to include in the financial statements. For example, if the profit chargeable to corporation tax is £120,000 and you have a corporation tax rate of 19 per cent, your provision for corporation tax is £22,800. That makes profit from continuing operations after taxes equal to £97,200 (£120,000 – £22,800). To record the £22,800 tax charge in the financial statements, you debit income tax expense in the income statement of £22,800 and credit income tax payable as a current liability in the balance sheet with £22,800.

Finally – net profit!

If no unusual items are listed in the income statement, such as *exceptional items* (items which are not expected to arise again and which are not normal business transactions, which I look at later in the 'Exceptional items' section), the income from business operations after taxes is called *net profit* (or *profit after tax*). That line in the income statement reflects all revenue less all expenses incurred in the production of that revenue.



REMEMBER

If expenses are more than revenue, the company has a net loss rather than net profit.

Earnings per share

Earnings per share (EPS) shows the spread of net profit when you divvy it up among shareholders. Potential investors in a company like to see this type of information so they can make informed investment decisions.

Before I get into the discussion of earnings per share, it's important to understand the two types of shares an investor may own in a company:

- » **Ordinary shares:** People who own ordinary shares are the ultimate owners of the company and have voting privileges. For example, ordinary shareholders can elect the company's board of directors.
- » **Preference shares:** This type of share gives shareholders a claim to the company's assets. In case of *liquidation* (when the company shuts its doors and disposes of all its assets), the preference shareholders are paid back for their ownership in the company before ordinary shareholders, and any leftovers go to the ordinary shareholders. Be very careful with preference shares because if they entitle the preference shareholder to receive cash (such as dividends or by way of redemption at a later date), this means that they must be treated as a liability in the company's accounts and not shown within the equity section of the balance sheet. This is the case for companies that report under UK and Ireland GAAP and UK-adopted IFRS.

Preference shareholders may have a much more favourable position when it's time for the company to pay dividends. If a company decides it's going to pay dividends, the preference shareholders normally get their share of the pie first before ordinary shareholders.



WARNING

When you're doing the EPS calculation, you must only ever use the ordinary shares figure – you ignore preference shares for the purposes of calculating EPS.



EXAMPLE

Here's an example of how to calculate the EPS figure:

Heaton Enterprises Limited makes a profit for the year ended 31 December 2027 before tax of £11,100 and a profit after tax amounting to £10.6 million. It has 12 million ordinary £1 shares and 3 million £1 preference shares in issue. To work out the EPS figure, take the following steps:

1. **Find the profit (the *earnings*) to be used in the calculation.** This must always be the profit attributable to the shareholders, which is the profit *after tax* figure of £10.6 million.
2. **Find the amount of issued ordinary share capital.** You must take only the *ordinary* shares – you ignore the preference shares for the purposes of the basic EPS calculation. So, Heaton Enterprises has 12 million ordinary shares.
3. **Divide the profit after tax (the *earnings*) into the ordinary shares figure.** The calculation is therefore earnings (£10,600,000) divided by shares (£12,000,000), which equals 88.3 pence per share.

Watching Out for Unusual Income Statement Items

You're almost done! Only a few more issues to come to grips with, where unusual items are concerned. I discuss two in this chapter: Discontinued operations and exceptional items. These items are broken down into 'profit from continuing operations' to give users of the financial statements a better idea of the probable results of future operations. Separating out non-recurring events from regular recurring business results makes it easier for the users of the financial statements to form an accurate opinion about the company.

Discontinued operations

Discontinued operations arise when a component of a business has been disposed of during the accounting period and all of the following criteria are met:

- » The discontinued operation represented either a separate major line of business or a geographical area of operations.
- » The discontinued operation was part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations.
- » The discontinued operation is a subsidiary acquired exclusively with a view to resale.



EXAMPLE

Here's an example to breathe a little life into this concept for you. Say a company that manufactures shoes has four different segments: boots, tennis shoes, sandals and walking boots. The company sold its tennis shoe segment to a well-known manufacturer of sports shoes part-way through the year. The company's income statement must be split between *continuing operations* (the boots, sandals and walking boots segments) and *discontinued operations* (the tennis shoes segment) for both the current year and the prior year. This is to make sure it is crystal clear to the user that part of the business has been discontinued during the year.

Exceptional items

To meet the criteria laid out by GAAP for *exceptional item* treatment, the item in question must be something that occurs infrequently and is by its very nature unusual. To meet both criteria is very hard.

An example that may possibly meet these strict criteria is when a company makes a profit or loss on the sale of a business operation. A company selling off part of its operations is likely to be an infrequent transaction, and GAAP requires such profits or losses from the sale or termination of an operation to be shown separately on the face of the income statement (profit and loss account).



REMEMBER

The important thing to remember is that you report exceptional items that are material separately on the face of the income statement (profit and loss account). Figure 10-7 shows how to represent an exceptional item relating to the sale of a business operation in the income statement under UK and Ireland GAAP.

	31.12.2027 £'000	31.12.2026 £'000	
Turnover	X	X	
Cost of sales	(X)	(X)	
Gross profit	X	X	
Distribution costs	(X)	(X)	
Administrative expenses	(X)	(X)	
Operating profit	X	X	
Profit on disposal of operations	X	-	(This is an exceptional item)
Interest payable and similar expenses	(X)	(X)	
Profit before tax	X	X	
Tax on profit	(X)	(X)	
Profit after tax	<u>X</u>	<u>X</u>	

FIGURE 10-7:
Reporting an
exceptional item.

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Arriving at the Final Result

Ta-da! Here you are, ready to take everything you know from this chapter and use it to produce your final result: an income statement or profit and loss account (depending on which title you prefer).



REMEMBER

Every company may have a slightly different system to handle the financial accounting work that begins with sales and purchase invoices and ends with all transactions being recorded in the accounting records. In the past, I've worked for a very large company where my only job was to manage trade payables (trade creditors), and I've also worked for a business where I was the only finance department employee doing everything from opening the mail to producing the financial statements. How the finance function works varies from company to company.

Figure 10-8 provides an example income statement for a company with no exceptional items or discontinued operations prepared under UK and Ireland GAAP. Figure 10-9 provides an example of an income statement for a company prepared under UK-adopted IFRSs. Figure 10-10 provides an example of an income statement prepared under IFRS 18 *Presentation and Disclosure in Financial Statements*.

Bart Baling Equipment Ltd
Profit and Loss Account
For the year ended 31 December 2027

	31.12.2027	31.12.2026
	£	£
Turnover	7,283,681	7,037,637
Cost of sales	<u>(5,968,041)</u>	<u>(5,586,593)</u>
Gross profit	1,315,640	1,451,044
Distribution costs	(68,937)	(61,373)
Administrative expenses	(1,118,641)	(897,665)
Other operating income	<u>21,289</u>	<u>17,196</u>
Operating profit	149,351	509,202
Interest payable and similar expenses	<u>(10,377)</u>	<u>(6,440)</u>
Profit before tax	138,974	502,762
Tax on profit	<u>(25,779)</u>	<u>(119,283)</u>
Profit after tax	<u>113,195</u>	<u>383,479</u>

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FIGURE 10-8:
A profit and loss
account under UK
and Ireland GAAP.

Bart Baling Equipment PLC
Income Statement
For the year ended 31 December 2027

	31.12.2027	31.12.2026
	£	£
Revenue	7,283,681	7,037,637
Cost of sales	<u>(5,968,041)</u>	<u>(5,586,593)</u>
Gross profit	1,315,640	1,451,044
Distribution costs	(68,937)	(61,373)
Administrative expenses	(1,118,641)	(897,665)
Other operating income	<u>21,289</u>	<u>17,196</u>
Operating profit	149,351	509,202
Finance costs	<u>(10,377)</u>	<u>(6,440)</u>
Profit before tax	138,974	502,762
Tax on profit	<u>(25,779)</u>	<u>(119,283)</u>
Profit after tax	<u>113,195</u>	<u>383,479</u>

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FIGURE 10-9:
An income
statement
prepared under
UK-adopted IFRS.

Bart Baling Equipment PLC
Income Statement
For the year ended 31 December 2027

	31.12.2027	31.12.2026	
	£	£	
Revenue	7,283,681	7,037,637	} <i>Operating</i>
Cost of sales	(5,968,041)	(5,586,593)	
Gross profit	1,315,640	1,451,044	
Distribution costs	(68,937)	(61,373)	
Administrative expenses	(1,118,641)	(897,665)	
Other operating income	21,289	17,196	} <i>Investing</i>
Operating profit	149,351	509,202	
Share of profit from associate	6,000	5,000	} <i>Financing</i>
Profit before financing and income tax	155,351	514,202	
Interest expense on borrowings	(10,377)	(6,440)	} <i>Income taxes</i>
Profit before income tax	144,974	507,762	
Income tax expense	(25,779)	(119,283)	
Profit from continuing operations	<u>119,195</u>	<u>388,479</u>	

FIGURE 10-10:
 An income
 statement
 prepared
 using IFRS 18.

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IN THIS CHAPTER

- » Separating cash from profit and costs from expenses
- » Joining the dots with the statement of cash flows
- » Looking at the sections of the statement of cash flows
- » Presenting cash flow using the direct or indirect method
- » Interpreting the statement of cash flows

Chapter **11**

Figuring Out the Statement of Cash Flows

While financial accounting is all about the *accruals* method, which means revenue is recorded when it is earned and expenses are recorded when they're incurred, the missing piece of the jigsaw is cash changing hands. For the financial statements used to get a complete picture of the health of the business, cash payments and receipts have to be reconciled with accruals-based transactions.

You accomplish this reconciliation by preparing a statement of cash flows (or *cash flow statement* as it is often referred to). In this chapter, you find out about the three classifications of cash flows – operating activities, investing activities and financing activities – and what types of cash flows are reported in each.

To mix things up a little bit, two acceptable ways to prepare the statement of cash flows exist: using the direct method and using the indirect method. Many companies use the indirect method because this is generally easier than the direct method, as you'll discover later on in this chapter.

Understanding the Difference between Cash and Profit

Accountancy is all about the accruals method of accounting. As I explain in Chapter 6, with the accruals method, you record revenue when it's earned, regardless of whether money changes hands. On the flip side, you record expenses when you incur them, regardless of whether they're paid.



WARNING

As I also note in Chapter 6, another accounting method exists – the cash method – which uses the criterion of cash changing hands to record revenue and expenses, but this method is not recognised under UK and Ireland generally accepted accounting practice (GAAP; see Chapter 4). Only the accruals method can be used under GAAP. Because the accruals method of accounting doesn't rely on cash being exchanged, chances are that there will always be a difference between a company's cash balances and profit shown in the income statement (see Chapter 10). That's because all costs that a business incurs aren't expenses, and until a cost is an expense, it doesn't hit the income statement.

In this section, I start off by showing you how non-cash transactions influence a company's net profit. Then I illustrate the difference between costs and expenses.

Seeing how non-cash transactions affect profit

The statement of cash flows homes in on the difference between the cash a company receives and the profit it's earned. Profit shows the real net income for the accounting period – factoring in revenue earned but not yet collected from customers (meaning debtors/receivables) and expenses incurred but not yet paid (that is creditors/payables) – rather than reflecting only transactions involving cash.

For example, assume that in June a company pays £2,000 into its bank current account and does some bank transfers to pay bills from suppliers for £1,800. If you only look at the cash flowing in and out of the business, the company spent £200 less than it made, so it shows a profit of £200. But what if, in June, the company also used a credit card which won't be paid off until August (or a loan it took out in May or any other non-cash resource) to pay monthly bills amounting to £1,000? Taking this transaction into account, the company actually spent more than it made, resulting in a loss of £800 (£2,000 money in less £1,800 money out less £1,000 credit card expenditure).

Distinguishing costs from expenses

Generally accepted accounting practice (GAAP) pretty much dictates the accruals method for financial accounting. Some variations on this theme do exist, however, which you can find out about in Chapter 22. However, your number-one focus when talking about costs and expenses is to remember that, in the world of business, costs are not the same as expenses.

Let's say a company buys a new car for £40,000 cash. A company car is an example of a fixed asset (sometimes called a non-current asset) (see Chapter 7), which goes on the balance sheet (or statement of financial position). When the company buys the car, the price it pays, or promises to pay, is a *cost*. Then, as company employees drive the car on company business, the company depreciates the car.

Depreciation (see Chapter 12) is the process of reclassifying the cost of buying the asset as an expense of doing business. So over time, the resources (in this case, £40,000 cash) that the company uses to purchase the car are reclassified from the balance sheet (where they're a cost) to the income statement (where they're an expense) by way of depreciation charges.

Assume that the amount the company depreciates the car by in the year of purchase is £10,000. So, in that first year, the company's *expense* is £10,000 and the *cost* is £40,000. Big difference, eh? That's why the statement of cash flows is so important; it ties together the costs shown on the balance sheet with the expenses shown in the income statement.



TIP

Think of the statement of cash flows as a 'bridge' between the income statement and the balance sheet.



REMEMBER

Make sure you don't get confused about the difference between costs and expenses! A *cost* is the value of money the company uses to produce or buy something – money that is not available to use anymore. Costs are the ways a company uses cash, be it to purchase inventory, make investments or pay back debt. *Expenses* are costs that directly tie back to revenue the company earns during an accounting period.

Getting to Grips with the Statement of Cash Flows

The primary purpose of the statement of cash flows is to show how a company has made cash and what it has spent that dosh on during the accounting period. While cash can come from many different sources, such as customer receipts, loans and

sales of assets and equity, uses of cash directly trace back to costs. This information is very interesting to the external users of the company's financial statements, who aren't privy to the day-to-day operations of the business, because it provides a basis for understanding how wisely a company manages its cash.



REMEMBER

A company can be a real go-getter in the business world, but if cash is thrown around unwisely, the business may not be able to give the external users what they're looking for, which is basically a return on their investment. This holds true for both potential investors looking for dividend payments (a return on their investment) and potential lenders wanting to make sure the company can pay back the capital part of any loan, plus any interest the lender charges.



TECHNICAL
STUFF

A third category of external users of financial statements is HM Revenue and Customs (HMRC). Its main focus is whether the company is reporting taxable profit correctly, a topic I discuss in Chapter 18. In that respect, a statement of cash flows has limited value.

The statement of cash flows provides guidance for the following questions:

- » **Does the company have the ability to generate positive cash flow in the future?** You don't want to invest in a one-hit wonder (and definitely not a none-hit wonder!). Viewing a current statement of cash flows does give a hint as to the company's future prospects.
- » **Does the company have enough cash to make loan or dividend payments?** Obviously, if you're a potential investor or lender for a company, you aren't going to let the business use your money for free. The statement of cash flows will give you an idea as to how the business manages its money and gauge the probability of the company having enough cash to satisfy its obligations and pay dividends.
- » **Is the reason for the difference between net profit and cash transactions indicative of a healthy business?** All cash is not created equal. Cash a company brings in from gross receipts is a lot more exciting to me as a potential investor than cash the company has left over because it sold some assets. After all, the business can own only a finite number of assets, while with a well-run business, the sky's the limit for bringing in revenue from operations.

You dig out this information by reviewing the different sections of the statement of cash flows. Each section ties back to how accounting transactions affect the income statement and balance sheet. So you're not looking at new information; instead, you're looking at the same information shown in a different way.

Walking through the Cash Flow Sections

A statement of cash flows, prepared under FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 7 *Statement of Cash Flows*, has three sections: operating, investing and financing:

- » The sources and uses of cash in the **operating** section come from revenue, expenses, cash received from gains and losses shown in the income statement and cash paid out for other costs.
- » The **investing** section shows sources and uses of cash from debt and equity investment purchases and sales; purchases and sales of property, plant and equipment; and collection of the capital element (principal) on debt.
- » The **financing** section shows long-term liability (paying or receiving loans beyond a period of 12 months from the balance sheet date) and equity items (the sale of company shares and payment of dividends).



REMEMBER

If a business is *listed* (meaning it sells its shares a stock market such as the London Stock Exchange), it will prepare a statement of cash flows under UK-adopted IAS 7 *Statement of Cash Flows*. That standard uses the same three sections.

Some of these terms may be unfamiliar to you. Don't worry, by the time you finish reading the rest of this section, you'll be a whizz on cash flow. First, I satisfy your curiosity about the operating section.

Looking at net cash flow from operating activities

FRS 102 states that *operating activities* are the principal revenue-producing activities of the business, including other activities that aren't investing or financing activities. In other words, income statement items. You can think of the operating cash flow section as the 'default' section. Here, I offer examples of operating sources and uses of cash.

Operating sources of cash

Here are examples of operating sources of cash:

- » **Cash receipts from the sale of goods or services:** This source is the cash that customers pay the company at the point of contact or what the company collects at a later date from existing trade receivables. For example, I go into an electrical goods shop and buy a new Air Fryer. It costs £140. I hand over the

cost of the purchase plus value added tax in cash. The shop then records this receipt as a source of cash.

On the flip side, assume that on 12 October, I go into another electrical appliance shop to buy a new widescreen TV. The shop is holding a 'buy now pay later' interest-free promotion for 90 days, which means that as long as I cough up the cash for the TV within 90 days, I pay no interest. On 12 October, the electrical shop has no cash source from me, and it won't have that source until I pay for my purchase on or before 12 January.

- » **Cash receipts from short-term investments:** Sometimes a business has some spare cash lying around that it doesn't need access to in the immediate future. Rather than leaving the cash in the bank earning little or no interest, the company buys *highly liquid* (easily convertible to cash) shares, bonds or loans.

The business tries to invest in something that won't go down in value during the holding period. Then, when the company sells the investment, the cash it receives goes on the statement of cash flows in the operating section rather than investing. The key here for operating section placement is that the investment is *short term*. See Chapter 7 for more information about short-term investments.

- » **Interest and dividends:** If a company makes loans to other businesses or individuals, any interest income it receives on those loans goes in the operating section. An example is a loan to a shareholder who is also an employee and needs cash beyond what they are receiving in their salary towards the cost of a new car. This situation happens often in a smaller, owner-managed company.

Dividends are income paid to shareholders based on their proportional ownership of the company. For example, Warrington Limited owns 2,000 shares of Wolves Limited. Warrington receives dividends from Wolves at £2 per share totalling £4,000 ($£2 \times 2,000$ shares); this amount shows in the operating section as a source of cash. However, dividends paid are financing cash outflows. You can find out more about the process behind declaring and paying dividends in Chapter 9.

Operating uses of cash

Next, I look at uses of cash payments showing up in the operating section of a statement of cash flows. The cash outflows are the flip side of the cash inflows. For example, trade receivables from customers is an inflow, and trade payables paid to suppliers is an outflow.

TRADING AT A PERSONAL LEVEL

Even though you're not a business, you may have invested some of your own personal cash to earn interest for you. For example, let's say your grandparents gave you £5,000 to put towards your university tuition. Your tuition is already paid for the next 12 months. So, since you know you won't need this money until then, you put the money into a high-interest savings account that matures just in time to make your next tuition payment. That way, you have both the £5,000 gift from your grandparents and the interest you earn on the high-interest savings account at your disposal instead of just keeping the cash in a non-interest-bearing bank account doing nothing.

Here are the operating cash outflows you'll come across in your dealings with the statement of cash flows:

- » **Paying trade payables:** *Trade payables* (or *trade creditors*) is the amount a company owes suppliers for services and products the suppliers provide to the company. When the original purchase on credit takes place, no money changes hands between the customer and the supplier. Rather, a promise to pay within a certain amount of time exists.

For example, I buy £500 of office supplies from a stationery supplier on credit. When the goods are delivered by the stationery supplier, my company doesn't record this amount as a cash outlay. That's because the supplier hasn't been paid yet. An invoice will eventually be received from the supplier, and I pay that invoice within an agreed *credit period*, which can be any length of time, but usually around 30–60 days. The £500 will become a cash outflow only after I make the payment to the stationery supplier.

- » **Payments for other business expenses:** This category includes any cash outflows to pay employees, pay taxes or pay any other suppliers (such as utility providers). Chapter 18 shows how to account for income taxes.

- » **Interest payments:** Any cash paid to lenders in the form of interest also goes in the operating section. It doesn't make any difference what the purpose of the loan or source of the loan is. So, interest paid to a related party, such as a shareholder, for a *working capital* loan (cash made available for day-to-day business requirements) is treated in the same way as interest paid to a vehicle financing company for the lease of the company car.

Keep in mind that FRS 102 and IAS 7 allow a business to classify interest paid as a financing cash flow because it is a cost of obtaining finance (this is a choice available to the business, but if it does this, it must be consistent from

one period to the next – continuing to present interest paid as a financing cash flow). However, in practice, it is commonplace to include interest paid as an operating cash flow.

- » **Corporation tax:** Payments made to HMRC for corporation taxes should be separately disclosed within operating cash flows.



REMEMBER

What about dividends, which I list as a source of cash? Did I forget to add them here as a use of cash? Nope! FRS 102 allows a company to classify dividends paid within cash flows from operating activities on the basis that they are paid out of operating cash flows (even though they are not a business expense – they are an appropriation of profit). However, this is down to the entity's specific choice. In practice, it's more common to see dividends paid as a financing cash outflow (see the later section 'Finding out about financing activities') because they are a cost of obtaining financial resources.

Gaining an understanding of investing activities

Investing activities are those involving the purchase and sale of non-current assets (see Chapter 7). *Non-current assets* (sometimes called *fixed assets*) are assets the company anticipates owning for more than one year past the date of the balance sheet. Examples of non-current assets are long-term debt and equity investments; property, plant and equipment; and intangible assets such as patents and copyrights.



REMEMBER

What exactly are 'debt and equity investments'?

- » Ordinary shares are an example of an *equity* investment. Let's say you buy some ordinary shares in a company. As a shareholder, you don't have a payable/creditor and receivable/debtor relationship with the company. Instead, you are an investor who'll be paid back for the purchase of the shares only if you sell them to someone else or the company buys the shares back.
- » Bonds are *debt* investments. For example, say a public authority sells bonds to the public for the purpose of financing a new hospital. The public authority eventually has to pay the bonds back plus interest. Companies generally issue bonds to raise money for capital expenditures, operating expenses and acquisitions. Bondholders receive interest payments at the bond's stated interest rate. When the bond matures, the company pays the bondholder back the face value of the bond.

Investing sources of cash

Here, I show you specifically how investing transactions show up as sources of cash:

- » **Cash advances and loans:** Cash advances and loans made to third parties and the receipts from the repayment of those advances and loans are investing cash flows.
- » **Sales of equity investments:** If the company sells shares it owns in other companies, the cash it receives is an investment source. So, suppose your company owns 500 shares in Currie Computers Limited, and decides to sell all 500 shares to finance another purchase. The money the company receives from the sale of its shares in Currie Computers Limited goes in the investing section.
- » **Sales of property, plant and equipment (PP&E) and intangibles:** The cash proceeds from any PP&E the company owns and sells (such as cars, buildings or equipment) is an investment source of cash. Ditto if the company sells an *intangible* (a fixed asset that doesn't have a physical form) such as a patent. (A *patent* provides licensing for inventions or other unique processes and designs, thus limiting who can profit from them.)

Investing uses of cash

Here are the potential uses of cash that would appear in the investing section of the statement of cash flows:

- » **Loans and debt purchases:** Any cash the company loans to another company is a cash outflow. So is any cash the company uses to buy bonds.
- » **Purchase of equity investments:** This category includes any cash the company uses to buy shares in another company.
- » **Purchase of PP&E:** If the business pays cash for any non-current asset acquisition (such as a new van) or an intangible asset, this outflow of cash must appear in the investing section.

Finding out about financing activities

If your head is spinning at this point, I have some good news for you! You're on the last section of the statement of cash flows. In addition to that uplifting piece of information, financing activities are the flip side of investing, so if you've managed to get a grip on the investing activities section of the statement of cash flows, you'll be able to whizz through financing activities.

Okay, so in a nutshell, what are these financing activities? Financing activities show transactions with lenders such as long-term liabilities (paying or receiving loans beyond a period of 12 months from the balance sheet date) and equity items (the sale of company shares and payment of dividends). Sound familiar from the investing section?



REMEMBER

Financing activities are activities that result in changes in both the size and composition of the company's equity (for example, shares) and its borrowings.

For example, Bury Enterprises Limited sells £3,000 of shares to Bolton Industries Limited. The cash Bury Enterprises receives from Bolton Industries for this transaction is a financing source of cash on Bury Enterprises' statement of cash flows.



REMEMBER

Both short-term and long-term debt that the company becomes liable for goes in the financing section. How long the creditor plans to hold the debt determines whether it goes on the creditor's books as short- or long-term debt.

Now, here are the uses of cash that would appear in the financing section of the statement of cash flows:

» **Treasury share transactions:** *Treasury shares* are shares that were previously sold and have since been bought back by the issuing company. The use of the cash is to buy back shares from shareholders. See Chapter 9 for more information about treasury shares.

» **Cash dividend payments:** *Cash dividends* are amounts paid to shareholders based on the number of shares they own. As I mentioned earlier in the section 'Operating uses of cash', FRS 102 allows a choice of presenting dividends paid as operating cash flows or financing cash flows. In practice, dividends paid are generally presented as financing cash flows because they are a cost of obtaining financial resources. This flexibility in presentation is a choice available to the company, and it's important that the company sticks with same classification from one period to the next; otherwise, the user of the accounts will get confused. You find more information about cash dividends, plus some info on stock splits (also a non-cash transaction), in Chapter 9.

» **Paying back debt:** Any capital payments a company makes on bonds or loans constitute a financing activity. Capital payments on leasing obligations are financing activities as well. Leasing transactions are examined in more detail in Chapter 19.

Delving into the Two Methods for Preparing the Statement of Cash Flows



REMEMBER

A statement of cash flows can be prepared in two ways: using the direct method or the indirect method. Whichever method the company chooses to prepare its statement of cash flows, it should stick with that method from one period to the next.

Regardless of which method you use, the bottom-line cash balance is the same, and it has to equal how much cash you show on the balance sheet. If it doesn't equal how much cash is on the balance sheet, you must provide a *reconciliation* (showing how the difference is made up).



TIP

At the end of this chapter, I show you how to prepare a statement of cash flows using both the direct and indirect methods. Whichever method you use in your day-to-day work, or in your accountancy studies, you must have a grip on how both methods work. In accountancy studies, chances are both methods will be examinable.

Using the direct method

The direct method of preparing the statement of cash flows shows the net cash from operating activities, so it shows all operating cash receipts and payments. The *direct method* derives its name because the transactions are lifted direct from the *cash book* (a ledger that records cash in and cash out).

The main source of operating cash flows under the direct method is cash receipts from customers. Other examples include interest and dividends the company receives, and other operating cash receipts such as cash received if the company sells an asset. Examples of cash payments are cash paid to employees and other suppliers and interest paid on bank loans, finance leases (see Chapter 19) or other loans.



REMEMBER

Here are three key facts to remember about the direct method:

- » You present cash received and paid – not net profit or loss as shown in the income statement (see Chapter 10).
- » Any differences reflecting when using the direct versus the indirect method take place only in the operating section of the statement of cash flows. The financing and investing sections are the same regardless of which method you use.
- » Some users prefer the direct method because they say it gives them a more complete picture of the financial health of the business.

Using the indirect method

When you use the indirect method to prepare the statement of cash flows, the operating section starts with a measure of profit from the income statement. A *measure of profit* can be any profit figure disclosed in the income statement (such as operating profit or profit before tax) because FRS 102 doesn't specify which profit line can be used. In most cases, the indirect method starts with profit before tax.

You then adjust profit before tax for any non-cash items hitting the income statement. Your two biggies are depreciation (see Chapter 12) and amortisation (see Chapter 7) expense, both of which are non-cash transactions.



REMEMBER

As depreciation is an *expense* in the income statement, it serves to reduce profit before tax. In the statement of cash flows, depreciation is added back to profit before tax when calculating net cash from operating activities because we're calculating the cash generated from operating profits. Conversely, a *gain* on disposal of a fixed asset serves to increase profit before tax. In the statement of cash flows, a gain on disposal of a fixed asset is deducted from profit before tax when calculating net cash from operating activities, and the cash proceeds received from the sale are included as investing cash inflows. Figure 11-2 demonstrates this technique.

In addition, increases or decreases in inventory, receivables and payables from the previous period need to be adjusted for when calculating net cash from operating activities. This is because the income statement is prepared on an *accruals basis* (see Chapter 6). If the sale is recognised but the cash hasn't been received, you'll include a trade receivable in the accounts. Similarly, if goods have been bought on credit but the suppliers haven't been paid, you'll recognise a trade payable in the accounts. So, these increases and decreases need to be adjusted for.



TIP

Think about the effect the increases and decreases in inventory, receivables and payables have on cash when deciding whether to add or deduct the increase or decrease to or from profit when calculating the net cash flow from operating activities. If inventory has increased, this means more cash is tied up in inventory as it's not yet been sold, so you deduct the increase from profit. If inventory has decreased, it means that inventory has been sold and has turned into receivables or cash so you add any decrease in inventory to profit. If receivables have increased, you've collected less cash in the period, so this means you deduct the increase from profit. If receivables have decreased then you've collected in more cash in the period, so you add the decrease to profit. Conversely, if payables have increased, it means you've paid out less cash to suppliers, so there's more cash in the bank, so this increase is added to profit. If payables have decreased, it means you've paid

out more cash to suppliers, so there's less cash in the bank, and this decrease is deducted from profit. Take a look at Figure 11-2 later in the chapter to see this in action.

Other common items requiring adjustment are gains and losses from the sale of fixed assets (see Chapter 10). This is because the gain or loss shown in the income statement for the sale will rarely, if ever, equal the cash a company receives. In other words, gain or loss is based on the difference between the asset's *net book value*, which is cost less accumulated depreciation and (where relevant) impairment, and the amount the item was sold for – not how much cash the buyer hands over to the seller.



EXAMPLE

Morley Manufacturing Ltd sells a machine it no longer needs for £1,500. The £1,500 sale proceeds will appear in the company's statement of cash flows, but what about any gain or loss when the company sold the machine?

To work that amount out, suppose the company originally paid £3,000 to purchase and install the machine. During the time it owned the machine, it *depreciated* the machine (spread the cost of ownership over the machine's useful life) to the tune of £2,000, making its book value £1,000 (£3,000 – £2,000). The resulting gain on disposal is £500, which is the difference between net book value and the selling price (£1,500 – £1,000). The £500 gain will be included in the income statement as an increase to the company's profit because it's a gain – the company has sold the machine for more cash than its balance sheet value.

In the statement of cash flows, only the £1,500 sale proceeds are the cash *inflow*. The £500 gain on disposal is a non-cash transaction and is deducted from the profit before tax figure when arriving at net cash flow from operating activities.

Interpreting the Statement of Cash Flows

Users of the statement of cash flows are primarily interested in whether the company has positive cash flows from operations. As a general rule, a company should be covering its costs by cash it brings in from the day-to-day running of the business rather than from borrowed funds. As a potential investor or creditor, I want to see that the cash the company brings in through operations exceeds any cash brought in by selling assets or borrowing money. This is because selling assets or borrowing money can never be construed as a continuing event like bringing in cash from selling goods or services. If a company must keep selling its assets or taking out loans to generate cash, there's a problem somewhere down the line, and it can put off potential investors in that company.



A company may issue shares in order to expand. The amount it generates may well exceed the net cash from operations. On a non-recurring basis, that situation can be okay because successful expansion is a good thing for investors and creditors. However, unless cash from operations regularly exceeds cash from other sources, a company will be paying back debt with debt, which is usually not a good thing.

Here's how an investor and a lender (such as the bank when it makes a loan to the company) use the statement of cash flows:

- » **Investor:** An investor wants to make sure the company has enough cash flow to pay an adequate return on investment. In other words, can the investor anticipate getting a cash dividend each year? Also important is using the statement of cash flows to evaluate how well the company is managing its cash because investors will eventually sell their shares, something that won't be possible if the company mismanages its cash to such a point that it goes out of business. This is why an investor really wants to see a positive cash flow from operations figure.
- » **Lender:** The lender also has a vested interest in making sure the company has sound cash management. After all, in addition to the interest the company pays for the use of the loan, the lender wants to make sure it also gets paid back the capital portion of the loan as well as the interest. It's never a good sign if a business is paying back debt by taking on more debt.

Looking at Two Sample Statements of Cash Flows

Here, I show you what the statement of cash flows looks like when you use both the direct and indirect methods of preparation. Figure 11-1 is the statement of cash flows using the direct method, and Figure 11-2 is the statement of cash flows using the indirect method. As you look at both, note that the cash balance at 31 December 2026 is the same for both methods.

The decrease in cash of (£27,483) in the figures is the sum of the net cash provided by operating activities, net cash used for investing activities and net cash used for financing activities (£45,287 – £35,000 – £37,770).

King Industries Ltd
Statement of Cash Flows
For the year ended 31 December 2026

	£	£
Cash flow from operating activities		
Cash receipts from customers	462,376	
Cash paid to suppliers	(196,142)	
Cash paid to employees	(175,132)	
Other cash payments	(13,222)	
Interest paid	(4,132)	
Tax paid	(28,461)	
<i>Net cash from operating activities</i>		<u>45,287</u> A
Cash flow from investing activities		
Purchase of property, plant and equipment	(45,000)	
Proceeds from disposal of property, plant and equipment	10,000	
<i>Net cash from investing activities</i>		<u>(35,000)</u> B
Cash flow from financing activities		
New bank loan	40,000	
Capital repayments on bank loan	(8,640)	
Capital repayments on lease liability	(9,130)	
Equity dividend paid	(60,000)	
<i>Net cash from financing activities</i>		<u>(37,770)</u> C
Increase (decrease) in cash during the year	A+B+C	<u>(27,483)</u>
Cash and cash equivalents at start of year		<u>73,315</u>
Cash and cash equivalents at end of year		<u><u>45,832</u></u>

FIGURE 11-1:
A direct method
statement of
cash flows.

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REMEMBER

The closing figure on the statement of cash flows (shown as ‘Cash and cash equivalents at end of year’ in the figures) must agree to the cash at bank and in hand figure on the balance sheet. If it doesn’t then a reconciliation must be provided so the user understands where the difference lies. Differences usually arise when a company has some bank accounts with money in them and one or two bank accounts that are overdrawn. The bank accounts with money in them are shown within current assets, whereas the overdrawn bank accounts will be shown as current liabilities. To make sure the user understands this, a *reconciliation* will be provided to show the reader how the closing cash and cash equivalents figure in the statement of cash flows is made up.

King Industries Ltd
Statement of Cash Flows
For the year ended 31 December 2026

	£	£
Cash flow from operating activities		
Profit before tax	119,053	
Depreciation charge	23,460	
Loss on disposal of fixed assets	2,000	
(Increase) decrease in inventory*	(6,903)	
Decrease (increase) in trade receivables**	16,400	
(Decrease) increase in trade payables***	<u>(76,130)</u>	
Cash generated from operations		77,880
Interest paid		(4,132)
Tax paid		<u>(28,461)</u>
<i>Cash generated from operations</i>		<u>45,287</u> A
Cash flow from investing activities		
Purchase of property, plant and equipment	(45,000)	
Proceeds from disposal of property, plant and equipment	10,000	
<i>Net cash from investing activities</i>		<u>(35,000)</u> B
Cash flow from financing activities		
New bank loan	40,000	
Capital repayments on bank loan	(8,640)	
Capital repayments on lease liability	(9,130)	
Equity dividend paid	(60,000)	
<i>Net cash from financing activities</i>		(37,770) C
Increase (decrease in cash during the year	A+B+C	(27,483)
Cash and cash equivalents at start of year		73,315
Cash and cash equivalents at end of year		<u>45,832</u>

*Inventory has increased which means more cash is tied up in inventory (a cash outflow) so is *deducted* from profit.

**Receivables have decreased which means more cash has been collected from debtors so is a cash inflow hence is *added* to profit.

***Payables have decreased which means more cash has been paid out to creditors so is a cash outflow hence is *deducted* from profit.

FIGURE 11-2:
 An indirect
 method
 statement of
 cash flows.

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- » Seeing how depreciation affects the financial statements
- » Knowing the ins and outs of costs and expenses
- » Calculating depreciation
- » Looking at a schedule of depreciation

Chapter 12

Discovering and Understanding Depreciation

This chapter is your introduction to a company's *tangible* fixed assets, which you can touch and feel – meaning they have a physical presence. Tangible fixed assets, sometimes just simply called *fixed assets* or *non-current assets*, include property, plant and equipment (PP&E). Many fixed assets are used for years, and a company uses an accounting concept called *depreciation* to keep its financial statements in line with the company's expectation of how long those assets may be used for in the business.

In this chapter, I help you understand what depreciation is, how it affects all three financial statements, and how it connects a business's costs to its expenses. (Yes, costs and expenses are two different things in the business world – but hey, surely you didn't expect it to be anything other than straightforward!) I also show you the various depreciation methods financial accountants use: the straight-line method and the reducing balance method (sometimes called the *diminishing balance method*), and show you how the methods compare. And I walk you through what information you find in a schedule of depreciation.

The presentation in this chapter follows the setup of most financial accounting textbooks, so you can relate the information you find here back to your accountancy studies. With this chapter's help, you can discuss the concept of depreciation with confidence in any exam (or work) situation.



TIP

Intangible fixed assets, which are assets that you can't see or touch, receive an accounting treatment similar to depreciation that's called *amortisation*. See Chapter 7 for the lowdown on intangibles.

Discovering How Depreciation Affects the Financial Statements



REMEMBER

Let me start with a simple definition of depreciation: it is a method of allocating a company's costs to the relevant accounting period. Later in the chapter, I define the word *costs* and help you understand what the *appropriate accounting period* may be for a given item. For now, sit tight with this definition, and keep in mind that depreciation is *not* used to find out an asset's *fair* (sometimes called *market*) *value* (the amount of money the company can receive upon the sale of that asset to an unconnected, willing third party in an arm's length transaction). Companies depreciate the fixed assets, which they own or lease (see Chapter 19 for more on leasing transactions).

Many transactions in the accounts affect more than one financial statement. Depreciation is a *non-cash transaction* (no money changes hands when you account for depreciation), and it affects all three financial statements: the balance sheet (see Part III), the income statement (see Chapter 10) and the statement of cash flows (see Chapter 11). So getting depreciation calculations right is important in the world of financial accounting.



TECHNICAL
STUFF

If you're a student accountant and have perhaps taken some tax exams, or if you work in practice doing accounts and tax returns for clients, you're probably familiar with the term 'capital allowances', which are basically HM Revenue and Custom's version of depreciation but are instead used for tax purposes. An important point to keep in mind is that a tax authority's depreciation methods (sometimes called *tax allowable depreciation*) are quite different from the financial accounting depreciation methods you get to grips with in this chapter.

How does depreciation take place and affect all three financial statements? When a company buys something that it anticipates being able to use for more than one year, generally accepted accounting practice (GAAP; see Chapter 4) spells out that this purchase must not be recognised as a reduction to income all at once (in other

words, posted to the income statement in one go). (Keep in mind that *income* is the operating and non-operating revenue the company brings in.) Accountants refer to the process of recording the cost of an asset on the balance sheet as *capitalisation*.

When an asset is *capitalised*, here's how the purchase affects each financial statement:

- » **Balance sheet:** The purchase goes on the balance sheet as a fixed (non-current) asset.
- » **Income statement:** Through the process of depreciation, the purchase eventually moves from the balance sheet into the income statement. (The 'Distinguishing between Depreciation Methods' section, later in this chapter, shows you exactly how this process happens.)
- » **Statement of cash flows:** At the time of purchase, the asset's cost goes on the statement of cash flows as a reduction in cash for the entire purchase price. (If cash doesn't change hands at the time of purchase, the transaction still shows up on the statement of cash flows – just in a different way.) As the asset is depreciated, the depreciation amount has to be added back onto the statement of cash flows if you use the indirect rather than direct method to prepare the statement of cash flows. (That's because it's a non-cash transaction that has been included as an expense that makes up the final profit (or loss) figure.) See Chapter 11 for a run through on the indirect versus direct method of presenting the statement of cash flows.



REMEMBER

When determining what items can be capitalised, common sense has to come into the equation. For example, I have a litter bin in my office that I've used for over three years. Does that mean that the bin should have been capitalised at the time of purchase? Well, unless this was some sort of expensive designer bin costing a lot of money, the answer is no. Most companies have a capitalisation policy setting a monetary benchmark for items to be capitalised rather than expensed – for example, items that cost under £500 are automatically expensed, no matter how long a company will use them for. Larger companies may have a higher monetary benchmark capitalisation policy than smaller companies, but so long as the capitalisation policy is reasonable and appropriate to the size and complexity of the company, there shouldn't be a problem. Companies take into consideration the *materiality* of such transactions when they are devising their capitalisation policy. Something is *material* when it can influence the decisions third parties make about the financial state of a company. For example, consider a company that doesn't capitalise anything below £500. If it bought 20 laptops for £400 each and wrote the entire cost of these off to the income statement, this treatment wouldn't be appropriate; it can capitalise the entire £8,000 and write this off over the useful economic life of the laptops.

Mastering Costs

You probably use the terms *cost* and *expense* interchangeably to describe a situation where you're paying cash, or a promise of cash, in order to purchase a good or service. For example, you buy a pint of milk at the supermarket and pay cash, or you fill up your car at the petrol station after using your Apple Pay or other contactless method. In either situation, you may have a moan about the *cost* of the item you're buying or how that *expense* seems too high. In the business world, costs and expenses are two separate things. I explain why in Chapter 11, and I start this section with a refresher about the difference.

Defining costs and expenses in the world of business

In the world of business, day-to-day costs are not the same as expenses. When a business incurs a *cost*, it exchanges a resource (usually cash or a promise to pay cash in the future) to purchase a good or service that will allow the company to generate revenue. But in the future, the cost will probably turn into an expense. That's because all expenses have to be matched with revenue for the financial period. This is also true where the depreciation of fixed (non-current) assets is concerned, and I discuss this principle further in the next section, 'Making sense of the matching principle'.

Confused? Well, keep reading, and hopefully all will become clear.

Here's an example of how a common business transaction can initially be recorded as a cost and eventually migrate into an expense.



EXAMPLE

Amanda is the owner of Female Funky Fashions, a manufacturer of women's designer clothing. Demand for her products has been very high, and she has decided to add a new line of women's formal clothing. She needs to purchase five new sewing machines, which, for this type of business, are fixed assets as they will be used to make the clothes to sell to retailers to generate money for Amanda's business.

When Amanda buys the sewing machines, the price she'll pay (or promise to pay) is a cost. Then, as the company uses the sewing machines in the normal course of business, she'll *depreciate* them: in other words, she'll reclassify the cost of buying the assets as an expense of doing business. So the resources Amanda uses to purchase the sewing machines move from the balance sheet (cost) to the income statement (expense).



The income statement shows revenue and expenses. The difference between those two numbers is the company's *net profit* (when revenue is more than expense) or *net loss* (when expenses are higher than revenue).

Still wondering what the big deal is with financial accountants having to depreciate fixed assets? Well, the process ties back to the matching principle, which I discuss in the next section.

Making sense of the matching principle



In financial accounting, every transaction you work with has to satisfy the matching principle (see Chapter 5). You have to associate all recognised revenue (both earned and realisable) during the accounting period with all expenses you incur to produce that revenue.

Continuing with the sewing machine example in the last section, assume that the expected useful life of a sewing machine – the expected amount of time the company will be able to use the sewing machine before having to replace it – is five years. The average cost of a commercial sewing machine is £1,500. If the company expenses the entire purchase price (cost) of £1,500 in the year of purchase, the net profit for this particular year is understated and the net profit for the next four years is overstated. This doesn't depict a true financial performance for the business.

Why? While the company forked out £1,500 in year one for a machine, the company anticipates using the machine for another four years. So to truly match the sales the company generates from garments made using the sewing machine, the cost of the machine has to be allocated over each of the years it will be used to churn out those garments for sale.

Identifying the different types of costs

How a company classifies a cost depends on the category it falls into. Using GAAP (see Chapter 4), business costs fall into three general categories: product, period and systematic. The subject of this chapter, depreciation, is a *systematic cost*, which means it's a cost expensed over time. I discuss depreciation in more detail in the next section.

Here, let me briefly define product and period costs so you can see how they differ from a systematic cost such as depreciation:

» **Product costs:** Any costs that relate to manufacturing or buying an item for resale to customers. A common example is inventory (often referred to as

stock; see Chapter 13), which reflects the costs a manufacturing company incurs when buying all the different items or raw materials it needs to make the items it sells to its customers. For a retailer, the cost of inventory is what it pays to buy the finished goods from the manufacturer.

» **Period costs:** Costs that, while necessary to keep the business going, don't relate to any specific item the company sells (commonly referred to as *overheads*). Examples of period costs are rent, telephone expenses and office salaries.

Learning which items are depreciated

When a company purchases a fixed asset (see Chapter 7) like a computer or plant and machinery, the cost of the asset is spread over its useful life, which may be years after the purchase. Therefore, depreciation is a *systematic cost*: it's allocated to different accounting periods based on when the company receives the benefit of the cost.

Your next question may be this: 'Which costs associated with purchasing a fixed asset do you bring in to work out the total cost of the fixed asset? Just the purchase price? Purchase price plus VAT and shipping? Other costs?'



REMEMBER

Except for the allocation of cost between land and buildings, which I discuss in the next section, working out a total cost price that is depreciated over an asset's useful life is straightforward. Following UK and Ireland GAAP, the business has to record all fixed asset purchases on its balance sheet at their original cost plus all the costs necessary to get the fixed asset ready to use (these additional costs are sometimes known as *incidental, incremental or directly attributable costs*).



EXAMPLE

Pat's Pencil Company Ltd makes pencils and buys a new machine to automatically separate and shrink-wrap ten pencils into saleable units. Here are examples of various costs of the machine: the purchase price, VAT, shipping costs, and assembly of the shrink-wrapping machine on the factory floor. (*Shipping costs* are Pat's Pencil Company's cost to get the machine from the seller to the pencil company.)

Handling property depreciation

Now, what about *property* – land and buildings? Both are clearly fixed (non-current) assets, but the cost of the land a building sits on is not depreciated because land doesn't have a finite useful life and therefore has to be separated from the cost of the building for the purposes of depreciation. Why? The answer is that UK and Ireland GAAP mandates that separation – no *ifs* or *buts* about it.

ALLOCATING COSTS BETWEEN LAND AND BUILDINGS

A question that's commonly asked by both student accountants and professional accountants is how to work out the allocation between land and building. After all, you work in the world of accounting; you're not a building surveyor! How do you manage to get your head around whether the company appropriately allocates costs between the land and the building? The best way to do this is for the business to have a valuation done during the purchasing process.

A *valuation* occurs when a professional building surveyor/valuer determines the value of the property. If you've ever purchased a house and applied for a mortgage, you're probably familiar with surveys. Basically, the survey provides assurance to the mortgage company that you're not borrowing more than the property is worth.

Even if a business doesn't have to secure a mortgage to purchase a property, it still gets a valuation to make sure it's not overpaying for the property. Alternatively, the Land Registry may show an allocation of building to land. However, that allocation (where it exists) may not be materially correct for depreciation purposes.

If you're a student accountant, the allocation information will be given. Just remember to subtract land cost from the total if working out a property depreciation question because land doesn't depreciate, which I explain in the section 'Handling property depreciation'.



REMEMBER

The cost of land is never depreciated under UK and Ireland GAAP. That's because the land a building stands on is assumed to retain its value. In other words, it won't be used up or run down through use over time – it has an indefinite lifespan, whereas buildings don't.

So, in the example earlier in this chapter, if Pat's Pencil Company Limited pays £250,000 to purchase a building to manufacture its pencils and the purchase price is allocated 90 per cent to building and 10 per cent to land, how much of the purchase price is spread out over the useful life of the building? Your answer is £250,000 multiplied by 90 per cent: £225,000.



TECHNICAL
STUFF

However, just to keep you on your toes, land *improvements* are depreciable. Examples of land improvements are fences, roads and gates. If a business purchases a piece of raw land and constructs its own building, the accounting for this is dead easy because you have a sales price for the land and construction costs for the building – bonus!

Expensing repairs and maintenance



REMEMBER

Repair and maintenance costs are expenses of the period in which they are incurred and not systematic depreciation costs. For example, on 14 June 2026, a floristry business has the oil changed and purchases a new set of tyres for the delivery van. The cost of the oil change and tyres goes in the income statement as an operating expense for the month of June.

The next month, the delivery van's engine blows up, leaving the driver and flowers on the hard shoulder of the motorway. Replacing the engine significantly increases the useful life of the delivery van, so you have to add the cost of the new engine to the net book value of the van on the balance sheet. *Net book value* (also shortened to just *book value*) is the difference between the cost of the fixed asset and its accumulated depreciation at any given time.

I discuss accumulated depreciation in the 'Preparing a Depreciation Schedule' section later in this chapter. For now, just remember that *accumulated depreciation* refers to how much depreciation has been charged to a particular asset so far since the asset was acquired.

Distinguishing between Depreciation Methods

Financial accounting generally uses two methods of depreciation, which are based on time: the straight-line method and the reducing balance method (sometimes called the *diminishing balance* method).



REMEMBER

Depreciation is the systematic allocation of the depreciable amount of an asset over its expected useful life. The *depreciable amount* of an asset is the cost of the asset (including incremental costs such as non-refundable taxes and shipping costs) less the asset's *residual value*. An asset's *residual value* is the estimated amount of money that the business would *currently* obtain if it were to dispose of the asset, if the asset were already of the age and in the condition expected at the end of its useful life. So, there's a bit of forward-thinking needed here. In a lot of cases, the residual value of an asset might be nil. However, if the business does think it will be able to sell the asset for cash at the end of its useful life, that amount must be estimated based on current expectations and not what the business thinks it will get when it's ready to sell the asset.

The total cost less residual value is then subjected to systematic depreciation (see later in this section for an illustration of how depreciable amount is calculated).

Here's a brief explanation of each method of depreciation:

- » **Straight-line method:** This method spreads out the cost of the fixed asset evenly over its useful life.
- » **Reducing balance method:** This is an *accelerated* method of depreciation, meaning the depreciation expense is higher in the earlier years of ownership but lower in the later years.

Don't worry, I walk you through an example of each of the above methods of depreciation in detail later in this section. And to show how the choice of a depreciation method can greatly affect the amount of depreciation expense taken in each year, I use the same asset facts and circumstances for each depreciation example to show you a comparison of the two methods.



EXAMPLE

First, however, you need to understand what information you need to know about each fixed asset before you calculate depreciation. For the purposes of calculating depreciation for this chapter, here are the facts and circumstances for your sample fixed asset – a delivery van that the company buys on 3 January 2026:

- » **The cost of the asset:** In the earlier section 'Learning which items are depreciated', I explain what costs have to be included in the *depreciable amount* – the total cost of the fixed asset. The cost of the delivery van is £30,000. (I am deliberately ignoring any VAT implications.)
- » **How long the company anticipates being able to use the fixed asset:** The company may measure the length in years, in production hours or in miles driven. For this example, the business anticipates using the delivery van for five years.
- » **The value of the asset after the company has finished using it (known as its residual value):** The *residual value* is an estimate that management makes for how much the fixed asset would currently fetch if it were already of the age and in the condition expected at the end of its useful life. The company anticipates receiving £3,000 in trade-in value.
- » **The depreciation method the company uses:** I introduced the two commonly used methods earlier in this section (the straight-line method and the reducing balance method). The method the business uses is a matter of choice as long as the method is appropriate for the asset. For financial accounting purposes, the standard of appropriateness is met if the company uses the method that most closely matches expenses to revenue.



WARNING

A business can switch methods after it's started using one depreciation method for an asset. However, to do so would be a change in estimation technique rather than a change in an accounting policy (see Chapter 15).

» **Date of purchase and whether the company is on a calendar or other year end:** The *date of purchase* is the date on which the fixed asset is ready for use. Calendar year end is on 31 December. These annual accounting periods are known as *financial year ends*. For example, many companies have a 31 March financial year end; others have a 30 September financial year end. This business has a calendar year end of 31 December. The delivery van is purchased on 3 January 2026.

Ready? Well, start your engines and let's depreciate this delivery van!

Walking through the straight-line method



EXAMPLE

When using the straight-line method, the residual value reduces the depreciable amount. So the cost of the delivery van (£30,000) less its residual value (£3,000) gives you a depreciable amount of £27,000.

The expected useful life is five years. So depreciation expense for the van would be £27,000/5 or £5,400 depreciation expense per year for each of the five years. The van's book value at the end of year five is £3,000.

Running through the reducing balance method

Unlike the straight-line method, you don't deduct residual value when calculating the depreciable amount with the reducing balance method. However, you do have to limit depreciation so that, at the end of the day, net book value is the same as the residual value. Clear as mud? Stick with me.

For your depreciation rate, you take a multiple of the straight-line method (for student accountants, this will more than likely be given to you in any practice questions you're set or in an exam situation). In this example, I'm going to use the *double reducing balance method*, which is twice the straight-line rate. All will become clear very soon – trust me!



EXAMPLE

Because the delivery van has a useful life of five years, shown as a percentage, the straight-line rate is 1/5 or 20 per cent per year. Double that to get your double declining balance rate of 40 per cent. That's not so bad to work out!

Figure 12-1 shows how to calculate double reducing balance depreciation. Note that in year five, the rate doesn't matter because you have to limit the depreciation to residual value. Because the closing net book value is £3,888 in year four, depreciation is limited to £888 in year five.

FIGURE 12-1:
A double
reducing balance
depreciation
calculation.

	Opening net book value	Rate	Depreciation expense	Accumulated depreciation	Closing net book value
	£		£	£	£
2026	30,000	40%	12,000	12,000	18,000
2027	18,000	40%	7,200	19,200	10,800
2028	10,800	40%	4,320	23,520	6,480
2029	6,480	40%	2,592	26,112	3,888
2030	3,888	*	888	27,000	3,000

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Seeing how the methods compare

Just for fun, Figure 12-2 shows how the different depreciation methods result in a different amount of depreciation expense per year. You'll see that over the entire five-year useful life of the van, the total depreciation is £27,000 regardless of the method used. Thus, the different methods result in different depreciation expense amounts in each of the years, but not in a difference in total depreciation over the life of the asset.

Pretty cool, eh! Depending on the depreciation method the company uses for the fixed asset, depreciation expense can be all over the place. A business can use a different depreciation method for different types of assets as long as the depreciation method fairly shows the use of the asset over time. You'll see the same method and expense variations in Chapter 13 when you learn about stock/inventory cost flow assumptions.

FIGURE 12-2:
Comparison of
depreciation
expense between
methods.

Year	Straight-line	Reducing balance
	£	£
2026	5,400	12,000
2027	5,400	7,200
2028	5,400	4,320
2029	5,400	2,592
2030	5,400	888
	<u>27,000</u>	<u>27,000</u>

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You can also see from Figure 12–2 that the reducing balance method charges more depreciation in the earlier years and less depreciation in the later years. ‘Why?’ I hear you ask! Well, the reason is that (particularly for motor vehicles, which are often subjected to the reducing balance method of depreciation) in the early years, when the asset is new, it will require less maintenance and servicing. However, in the later years, as the asset becomes worn out through use, it will require more maintenance and servicing, so what you’ll see in a company income statement is repairs and maintenance costs increasing (because of additional maintenance and servicing costs of the asset), but less depreciation being charged. The reducing balance method recognises that, in the later years, more costs will be incurred for repairs, so this method reduces depreciation as a direct result.



REMEMBER

More depreciation expense in an accounting period means less net profit, and vice versa.

Pro-rating the depreciation charge

The delivery van example above was neat and tidy because the company purchased the van at the very beginning of January (so effectively the company had the van for a full financial year). What happens, then, if the company buys a fixed asset mid-year?

Well, all that would actually depend on the company’s accounting policy for depreciation. Some companies have a policy of charging a full year’s depreciation in the year of purchase, even if the asset has been purchased mid-way through the financial year. The flip side to this approach is that many companies don’t charge any depreciation in the year they dispose of the asset (either by sale or as scrap), which then levels out the depreciation charge. However, some companies are known to charge depreciation on a *pro-rata* basis, which means the cost of a particular item is divided in proportion, according to a factor that can be calculated exactly. If you come across a situation where depreciation is charged on a *pro-rata* basis in the year of acquisition, then you *pro-rate* the depreciation expense among the accounting periods involved. For example, if a company with a 31 December year end buys a new machine with a useful economic life of five years on 1 June, the first year of depreciation is *pro-rated* using the fraction $\frac{7}{12}$ (because seven months remain in the financial year). Any surplus depreciation is charged in year 6.

Consider the delivery van example above while using the straight-line method. Depreciation expense in year 1 is now £3,150 ($£5,400 \times \frac{7}{12}$). For years 2 to 5, the depreciation expense remains £5,400. In year 6, you finish up by charging the remaining £2,250 ($£5,400 \times \frac{5}{12}$).



The journal entry (see Chapter 5) to get the depreciation charge into the accounts is to debit depreciation expense in the income statement and credit accumulated depreciation in the balance sheet.

Preparing a Depreciation Schedule

All businesses keep a depreciation schedule for their assets showing all relevant details about each asset. The depreciation schedule is also known as the *fixed asset register* or *non-current asset register*. Here are some of the more common examples of items that show up on a basic depreciation schedule:

- » **Description:** The type of asset and any other identifying information about the fixed asset (such as an asset number).
- » **Cost:** The purchase price of the asset plus any other costs requiring capitalisation. While most additions to purchase price take place when the company acquires the asset, the fixed asset cost can be added to after the event if material renovations are performed. (Think about the new engine in the van example from the earlier section 'Expensing repairs and maintenance'.)
- » **Life:** How long the company estimates it will use the fixed asset.
- » **Method:** The method of depreciation the company uses for this fixed asset.
- » **Residual value:** The current estimated value of the fixed asset if it were already of the age and in the condition expected at the end of its useful life.
- » **Date purchased:** The day the asset was purchased.
- » **Current depreciation:** The depreciation expense charged in the current period.
- » **Accumulated depreciation:** The total amount of depreciation expensed from the day the company started to use the fixed asset to the date of the financial report.
- » **Net book value:** The difference between the fixed asset cost and its accumulated depreciation.

Depending on the size of the company, the depreciation schedule may also have the fixed asset's identification number, the location where the fixed asset is kept and other relevant facts about the asset.

Having a nicely organised depreciation schedule allows the company to keep an accurate record of activity for each fixed asset. Why is this information important? As you find out in Chapter 7 (when learning how companies account for fixed assets), this info cannot be obtained by looking at the balance sheet.

Check out Figure 12–3 to see the basic organisation for a depreciation schedule.

Date of purchase	Description	Residual Cost	Depreciation value	method*	Useful life (years)	Opening depreciation	Current year depreciation expense	Accumulated depreciation	Net book value
		£	£			£	£	£	£
01.05.2026	Delivery van	30,000	2,000	25% RB	5	7,500	5,625	13,125	16,875
20.05.2026	Macbook laptop computer	1,500	0	3 yr SL	3	500	500	1,000	500
15.09.2026	Reception desk	2,500	300	3 yr SL	3	733	733	1,466	1,034
03.10.2026	Fixtures	700	100	10 yr SL	10	60	60	120	580

RB = Reducing balance
SL = Straight-line

FIGURE 12-3:
Example of a depreciation schedule.

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TIP

See Chapter 18 if you're wondering how to account for the difference between UK and Ireland GAAP and capital allowances granted by HM Revenue and Customs.

IN THIS CHAPTER

- » Seeing how inventory calculations impact the financial statements
- » Focusing on service companies
- » Recognising a variety of inventory types
- » Coming to grips with the inventory valuation methods
- » Looking at an inventory worksheet

Chapter **13**

Dealing with and Accounting for Inventory and Work in Progress

Some people think that inventory is only the products available for sale in a retail shop or supermarket. I discuss that kind of inventory (called *retail inventory*) in this chapter, but I also introduce you to other kinds of *product inventory* used by manufacturers, which includes raw materials, work in progress (WIP) and finished goods.

You also find out in this chapter about two methods a company may use to keep track of retail inventory, as well as the two methods businesses may use to value their closing inventory: first-in, first-out and weighted average. Some businesses actually won't have *any* inventory, and I explain when you can expect this situation to occur and how to handle any minimal amounts of inventory this type of business may keep on hand.

Discovering How the Valuation of Inventory and WIP Affects the Accounts



REMEMBER

In financial accounting, you're preparing financial statements for external users, such as investors and lenders (see Chapter 1). They need accurate financial information to make informed decisions as to whether they want to invest in the company or lend it money.

For *manufacturing* companies (which make products) and *retail* companies (which sell the products made by the manufacturers), inventory can (and usually is) a large number on the balance sheet. Actually, it may be their largest current asset account. So accurate accounting for inventory is very important – including determining what costs go on the balance sheet rather than in the income statement to making sure the business values its closing inventory properly.



WARNING

Inventory affects both the profit and loss account (income statement) and the balance sheet (statement of financial position). A company can end up with a set of highly inaccurate financial statements by writing off purchases to the income statement rather than keeping them on the balance sheet as inventory. This may be an innocent error, in which case it can be easily corrected. However, because the value of closing inventory affects a company's profit, it is one of the most easily manipulated figures in the accounts that significantly influences the level of profit a business reports.



TIP

So what costs are okay to write off directly to the income statement, and which costs should stay on the balance sheet? Here's a full and frank answer: any items a company buys to sell that it will put to use in periods beyond the current accounting period are taken to inventory.

Inventory ties into the revenue process and to cost of sales (see Chapter 10). Putting inventory hand in hand with cost of sales makes common sense – you have to buy something before you can sell it. But you may be wondering how revenue and inventory relate to each other. Well, remember that you need to use generally accepted accounting practice (GAAP), which I introduce in Chapter 4.

How does inventory come into the revenue equation? In Chapter 10, I show you how to prepare a cost of goods sold calculation for a retailing and manufacturing company. Product costs are part of the cost of goods sold. Product costs that relate to inventory are any costs that a company incurs when purchasing or manufacturing an item for sale to customers. The cost of sales in the income statement is what the company pays to buy or manufacture the goods that it sells to its customers *in that specific accounting period only*. The rest of the cost of the product purchases stays on the balance sheet as a current asset.

Seeing How Service Organisations Deal with Inventory and WIP

While discussions of inventory focus on manufacturing and retail companies, you also need to consider *service organisations*: those that don't provide a tangible good and normally won't have any type of appreciable inventory. Service companies provide more of a knowledge-based work product. (Think about what you get from your solicitor, for example.)



EXAMPLE

If you're a student accountant, you'll probably be asked to demonstrate your knowledge of accounting for inventory. A typical scenario you may come across in your accountancy or bookkeeping studies is as follows.

The facts will generally be that the company purchases a certain amount of supplies in a month. The question may ask you to set up the journal entry to record both the purchase and expense of the supplies in that month. In this example, let's say the company purchases supplies *on account*, which means the company has an agreement in place with its supplier to pay for the supplies at a later date. The supplies cost £700 at the beginning of September. On the last day of September, an inventory count is done and supplies amounting to £230 remain in stock.

Your journal entry to record the purchase is to debit 'inventory' (an asset account) and credit 'trade payables' for £700. So far, you have not affected the income statement.

Now at the end of the month, you must adjust closing inventory to the actual value you've got left over, which involves expensing the portion of supplies used during the period to the income statement. The company purchased £700 of supplies and only £230 remains, so you know that £470 ($£700 - £230$) of supplies were used and can be expensed for the month of September. So your journal entry is to debit 'purchases' (an income statement account) and credit 'inventory' (the asset account).



REMEMBER

Sometimes, off-the-shelf software may record the purchase as debit 'purchases' (a cost of sales account) and credit 'trade payables'. This is fine, but if all the stock is not sold, a further adjustment will be needed to debit 'inventory' in the balance sheet and credit 'closing stock' in the income statement for the value of the unsold goods.

Technically, anything the company purchases that will not be used up in the current period can go to some sort of inventory account. However, retail shops sometimes take shop supplies (such as carrier bags, price tags and cash register receipts) to the income statement expense when they're purchased instead of to a

balance sheet account, such as shop supplies inventory. Doing so is not normally a big deal, provided that the expense is not a material amount (*material* means the significance of the item on the accounts). For a larger retailer (such as a national supermarket chain), the amount would be material because it purchases everything in huge volumes.

Classifying Inventory

Depending on the type of business, you'll encounter different sorts of inventory. To make life easier, in this section, I break the subject down into inventory for retail companies and inventory for manufacturing companies.

Accounting for the purchase of goods

Accounting for goods in a retail company, while it has its moments, is easier than accounting for manufacturing inventory. That's because a retail company, such as a home improvement store, has only one class of inventory to keep track of: goods the business purchases from various manufacturers for resale.



EXAMPLE

Here's an example of the basic flow of inventory for a retailer. A sales assistant in the pet outlet within a major department store notices and informs their manager that they're running low on a certain popular brand of dog food. The manager follows the department store's purchasing process by filling in a purchase requisition form and sending it to the central purchasing department, where a buyer orders the dog food from one of its approved suppliers. The end result is that the department receives a shipment of dog food from its approved supplier.

This transaction is a purchase (cost), but it's not an expense until the department store sells the dog food. So the business records the entire shipment of dog food on the balance sheet as an addition to both inventory and trade payables (see Chapter 8), in other words:

Debit: Inventory	£X
Credit: Trade payables	£X

I use *trade payables* instead of *cash* because the business has payment terms with this supplier, and money has yet to change hands during the transaction.

Say that, in August, the business sells dog food to customers for £150, which costs the company £75 to purchase from the supplier. Sales revenue increases by £150,

cost of sales increases by £75 and inventory decreases by £75. Matching the expense to revenue, the business makes a gross profit of £75 (£150 sales – £75 costs).

Pretty basic stuff, eh? The company buys inventory and sells it. Next, I talk about how retail shops normally keep track of their inventory. Two major types of inventory monitoring systems exist: perpetual and periodic.

Perpetual system

Most larger retailers have electronic cash registers (ECRs). If you've used a self-checkout at a supermarket, you'll be familiar with them. The checkout features a glass window with a scanner. You run the bar code of a product over the scanner, and the selling price of the item automatically records as a sale for which you are charged and the business receives revenue.

If the business also uses a *point-of-sale system* (also called an *Electronic Point of Sales* – or EPOS – system), which means transactions at the register automatically update all accounting records, the inventory count is updated constantly, *perpetually*, as the ECR records the item sold. This means that the cost of the item sold is taken out of the asset inventory account and moved to cost of sales.



REMEMBER

With point-of-sale systems, transactions taking place at the cash register update all inventory, cost of sales and sales information throughout the system in real time as the transactions occur.

Let's say you go into a department store and buy a birthday card for a friend. As you check out, the point-of-sale software is updating the greeting card department records showing that one less birthday card is available for sale. The software is also updating cost of goods sold showing the cost for the card, and it's updating revenue to reflect the retail price (what you just paid) for the birthday card.



TIP

Even if a company uses a point-of-sale system, undertaking a physical inventory count at year end (or periodically) is still very important to verify that the perpetual system is working correctly. Doing a physical inventory count is also the best way to identify breakage and employee or customer theft issues, and certainly your external auditors will need one doing at the year end to corroborate the year-end inventory valuation.

Periodic system

With a periodic system of inventory counting, the physical inventory count is carried out periodically, and the resulting figure is used to adjust the balance sheet 'inventory asset' account. Retail shops using periodic inventory usually count their inventory at their particular year end. However, inventory can be taken more often, such as quarterly or at the end of every heavy sales season (such as Valentine's Day, Mother's Day and the Christmas holidays).

Here's how the periodic system works. The business counts *closing inventory*, arriving at a final monetary amount for all unsold inventory as at the last day of the accounting period. Next, the company's accounts department deducts closing inventory totals from the opening inventory after adding in all inventory purchases made during the period. The resulting number is the cost of sales. The balance sheet inventory account is reduced by the cost of sales figure, and the income statement expense account 'cost of sales' is increased by that number to match expenses with revenue.



REMEMBER

The closing inventory figure in the balance sheet (a debit because it is an asset) must always equal the closing inventory figure in the profit and loss account (a credit).

Using the periodic system, cost of sales can be determined with a fairly high degree of accuracy, but only after the physical inventory is counted and valued. When companies prepare financial statements and a physical inventory is not carried out, they use an estimate, which is basically a 'best guess' for inventory and cost of sales (see Chapter 15). For example, they may use past history or experience to estimate cost of sales. If in prior years cost of sales for the month of May was 75 per cent of gross sales, the company uses the same percentage for current cost of sales, adjusting that figure to actual at year end using the physical inventory figures.



REMEMBER

Consignment goods, those a retailing business offers for sale but does not officially own (often seen in car dealerships), aren't always included in inventory. With a consignment arrangement, the retailer (consignee) is acting as a middleman between the owner of the goods (consignor) and the customer.

Accounting for the manufacturing of goods

To account for all expenses it incurs while making products for resale, a manufacturing company has a 'cost of goods manufactured' account. (See Chapter 10 to see how to go about preparing the cost of goods manufactured section of the income statement.) The cost of goods manufactured contains three types of inventory: raw materials, work in progress and finished goods.

Raw materials

Raw materials inventory reflects all the materials the company uses to make a product. For example, for a car manufacturer, this includes the steel to form the body, leather or fabric for the seats, and all the bits and bobs that go under the bonnet. (Hey, I'm an accountant – not a mechanic!) In essence, any materials that you can directly trace back to making the car are raw materials inventory.



TIP

Keep in mind that manufacturing companies can use the perpetual inventory method of keeping track of their inventory, which I describe in the previous section. For example, components that a computer manufacturer needs to assemble laptops for sale to retail stores will have serial numbers that are scanned in when purchased from the component manufacturer and scanned back out when put into the computer made by the computer manufacturer. Thus, the manufacturer keeps a running total of components in inventory.

Work in progress

At any point in time during the manufacturing process, the company probably has items that are in the process of being made but are not yet complete, which is *work in progress*. With a car manufacturer, imagine the car going down the production line. At the stroke of midnight on the last day of the accounting period, there will be cars up and down the production line at various stages of completion. The company values its work in progress based on how far each product has been completed.



TIP

If you're a student starting out in the world of financial accounting, chances are you'll be given the value of work in progress. The calculation of this figure is usually dealt with in management accounting subjects.

Finished goods

Finally, the costs you associate with goods that are completely ready for sale to customers, but haven't yet been sold, are classified as *finished goods* inventory. For the car manufacturer, this category consists of cars not yet sold to individual dealerships.

WORKING OUT WHO OWNS THE FINISHED GOODS

Obviously, any finished goods that haven't been bought by a customer are part of the manufacturer's inventory. But suppose the finished goods have been purchased and are in transit to that customer. Who owns the finished goods then?

To make this determination, you need to find out whether the terms of the sale are ownership *at the shipping point* or when the goods reach their *destination*. If the terms state that it is at the shipping point this means the customer owns the item as soon as it leaves the manufacturer's loading bay; ownership transfers to the buyer at the shipping

(continued)

(continued)

point to the freight company. Ownership which passes when the product reaches its destination is the opposite: the customer owns the inventory only after it has hit its own loading bay; any goods in transit to the customer will still be counted as part of the supplier's/manufacturer's inventory. This is also a very important consideration for revenue recognition because the company can only recognise a sale when it has absolutely no responsibility at all for the goods after they have been dispatched.

Getting to Know Inventory Valuation Methods

In the world of financial accounting, you come across two methods to value closing inventory: first-in, first-out (FIFO) and weighted average. Like depreciation (see Chapter 12), depending on the method the company uses, the amount transferring from the balance sheet inventory account to the income statement cost of sales can vary wildly.



WARNING

You may also come across another inventory valuation method, the *last-in, first-out* (LIFO) method. This will more than likely crop up when a company is valuing its inventory for management accounts (internal accounts) purposes. LIFO cannot be used as a valuation method for financial accounting purposes, so we don't examine the concept of LIFO in this book. I explain why this method is prohibited later in this chapter in the section, 'Doing It Right: Knowing the Restrictions'.



REMEMBER

The user of the financial statements must be aware of which inventory valuation method a company uses. The method is always spelt out in the accounting policies note, which is found in the notes to the financial statements (see Chapter 15). If the method used is unclear, any comparison between one company's financial statements and another's will be inaccurate because the user may be comparing financial results from dissimilar valuation methods. This can end up in the user forming the wrong conclusions about the business, which must be avoided at all costs.

In this section, I walk you through each of the two methods, show you how to calculate it for your accountancy studies or day-to-day working life, and show you the monetary amount differences when the same number of items in closing inventory is treated using the two methods.

First-in, first-out (FIFO)

Using the FIFO method, the company assumes that the oldest items in its inventory are the ones first sold. Consider buying a bottle of milk in a supermarket. The cartons or bottles with the most current sell-by date are pushed ahead of the cartons that have more time before they go sour. The oldest cartons of milk may not always actually be the first ones sold (because some people dig around looking for later sell-by dates), but the business is basing its numbers on the oldest bottles of milk being sold first.



REMEMBER

The *inventory assumption* here states that, under FIFO, the oldest units are presumed to be sold first, regardless of whether they actually were.

Weighted average

When a company uses the weighted average method, inventory and the cost of sales are based on the average cost of all units purchased during the period, as well as those held in opening stock/inventory. This method is generally used when inventory is substantially the same.

If the company sells running shoes, the total cost of all running shoes available for sale is divided by the total pairs of running shoes available for sale. Multiply that figure by the number of running shoes remaining in inventory at the end of the period to get your closing inventory figure.

Comparing inventory assumptions

It's easier to understand how to value closing inventory using FIFO and weighted average if you have an example of each method. (The specific identification method is pretty straightforward, so I don't include it here.) In this section, I offer some practical calculations to help you along the way.

For the closing inventory calculation examples, I use a retail sports shop called Fast Feet Sports Goods, which sells a range of running shoes. Ready to start? Let's figure out this shop's closing running shoe inventory!

Figure 13-1 shows opening inventory and purchases from 1 July 2026 to the end of the calendar year (no purchases took place in December). Your job is to calculate closing inventory and cost of goods sold as at 31 December 2026.

FIGURE 13-1:
Fast Feet
inventory
analysis.

Date of purchase	Number	Cost per unit	Total cost
		£	£
1 July 2026 (opening inventory)	200	10	2,000
15 July 2026	250	12	3,000
05 August 2026	100	15	1,500
06 September 2026	450	9	4,050
03 October 2026	325	13	4,225
21 November 2026	<u>50</u>	11	<u>550</u>
Total available for sale	1,375		15,325
Pairs sold	(600)		
Pairs remaining at 31 December 2026	<u>775</u>		

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Calculating closing inventory and cost of goods sold using FIFO

The company sold 600 pairs of shoes in the period. Using FIFO, you start at the top of the running shoes list because the shoes in opening inventory are first in, followed by the shoes purchased on 15 July, those purchased on 5 August, and 50 of the 450 purchased on 6 September. As you can see from Figure 13-2, cost of goods sold is £6,950. That means closing inventory is £8,375 (£15,325 – £6,950).

FIGURE 13-2:
FIFO cost
assumption.

Date of purchase	Number	Cost per unit	Total cost
		£	£
1 July 2026 (opening inventory)	200	10	2,000
15 July 2026	250	12	3,000
05 August 2026	100	15	1,500
06 September 2026	<u>50</u>	9	<u>450</u>
Total	<u>600</u>		<u>6,950</u>

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Calculating closing inventory and cost of goods sold using weighted average

Here's the calculation for the weighted average method: the total cost of £15,325 divided by the total number of running shoes available for sale (1,375) equals £11.15 per unit. The shop sells 600 pairs of shoes in the second half of the year. Multiply 600 pairs sold times an average cost of £11.15 to get a cost of goods sold of £6,690. Closing inventory is £8,635 (£15,325 – £6,690).

Depending on which method a business uses, closing inventory for the same facts and circumstances ranges from £8,375 to £8,635. While this isn't a dramatic difference, consider what a difference the accounting method makes when a company has sales in the thousands or millions of units!



TECHNICAL
STUFF

The inventory calculation methods shown in this example assume the inventory is valued at cost rather than estimated selling price less costs to complete and sell (which is also known as *net realisable value*). This is the price the company can charge when it sells its goods. If a business sells items whose estimated selling price less costs to complete and sell is less than what the company paid for the inventory, it would be selling the goods at a loss and so this means the inventory is *impaired* (its value has gone down) and the inventory needs to be written down to estimated selling price less costs to complete and sell to comply with UK and Ireland GAAP.



EXAMPLE

Sunnies' Shoes has a batch of ladies' summer shoes that cost £500. In October, none of the shoes had been sold. A nearby retailer has offered Sunnie's Shoes £300 to take the shoes, and the director accepted this offer on 3 November 2026. Sunnies' Shoes' year end is 31 October 2026. In this example, the realistic selling price of the shoes of £300 is lower than cost of £500. This means that Sunnie's Shoes must write down the cost of this inventory in its year-end financial statements by £200 as follows:

Debit: Cost of sales (impairment loss)	£200
Credit: Inventory	£200

This will ensure that Sunnie's Shoes, inventory is valued at the lower of cost or estimated selling price less costs to complete and sell.

Preparing an Inventory Worksheet

I want to show you what a simple inventory worksheet looks like. Using Fast Feet from the previous section as an example, Figure 13-3 shows all running shoes theoretically in stock as of 31 December 2026. The last column, 'Actual qty on hand per count', is filled in by Fast Feet employees while counting the physical inventory.



REMEMBER

Even if a retail shop uses the perpetual method, it's important to take a physical inventory at year end to identify thefts and breakages. If, after totalling up the 'Actual qty on hand per count' column, the company has a figure less than 775, it'll know that running shoes have left the shop in other ways than by being bought by paying customers. Under UK and Ireland GAAP, the company has to prepare a journal entry (see Chapter 5) to record the cost of the missing footwear – in other words, it adjusts the inventory balance to the actual count.

Fast Feet Sports Goods Ltd Inventory Worksheet

Item name		Item description	Qty on hand per stock control system	Actual qty on hand per count
Running shoes:				
	Ladies	Ladies XYZ brand running shoes	210	_____
	Ladies	Ladies ABC brand running shoes	125	_____
	Men's	Men's XYZ brand running shoes	250	_____
	Men's	Men's ABC brand running shoes	115	_____
	Children's	Children's Lil' Mite running shoes	75	_____
			<u>775</u>	

FIGURE 13-3:
Partial inventory
worksheet.

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Doing It Right: Knowing the Restrictions

Under UK and Ireland GAAP (as well as IFRS Accounting Standards – see Chapter 4), the use of LIFO is strictly prohibited.



WARNING

The reason LIFO is prohibited for financial accounting purposes is that the method does not reflect actual cost. This means that the inventory figure calculated under LIFO will bear little relation to recent cost levels. In other words, it produces a misleading inventory valuation.

While some companies do use LIFO as a method of inventory valuation for internal management accounts purposes, for statutory reporting purposes, the company will need to use an acceptable method for its inventory valuation. This will be FIFO, weighted average cost or another acceptable basis (for example, the retail method, which I don't discuss in this chapter but would be an acceptable method).



REMEMBER

The users of the accounts will need to know what method has been used to value a company's inventory, so don't forget to check that this has been disclosed in the accounting policies section of the notes to the financial statements (see Chapter 15 for more on the notes to the accounts).

5

Analysing the Financial Statements

IN THIS PART . . .

Use different calculations to see how good (or bad) a company is doing financially.

Understand why there are lots of disclosure notes in the financial statements and the purpose they serve.

Navigate the annual report and understand the various types of information needed by shareholders and potential investors.

- » Measuring liquidity
- » Putting profitability measures to the test
- » Focusing on the flow of cash

Chapter 14

Using Ratios and Other Tools

The information in this chapter helps you understand why financial accounting principles are so nit-picky. Properly classifying transactions and balances is key for user analysis, which is the subject of this chapter. Here, you learn about key measurements that financial statement users perform to gauge management's effectiveness and efficiency in running the company.

Three major measurement categories are a company's liquidity, profitability and cash flow. You may assume that all investors care about is how profitable a company is, but that's not necessarily true. *Liquidity*, which indicates how well a company can cover its short-term debt, and *cash flow*, which shows how well a company is collecting its cash and paying its suppliers, have to be considered along with profitability to form a complete picture of how well the business is performing.



REMEMBER

A company can make a lot of profit but still have cash flow difficulties and eventually go bust! This is why it's important to consider the bigger picture when it comes to analysing the financial statements rather than simply looking at how much profit a company generates in a period.

Ready to get started? The next stop on your exciting financial accounting journey is . . . liquidity measurements!

Learning about Liquidity



REMEMBER

Liquidity is a company's ability to free up cash to meet its business obligations. Liquidity measurements reflect a company's ability to meet its short-term obligations. These measurements are important because a company that can't pay its bills in the short term more than likely has going concern problems. The phrase *going concern* refers to the presumption that the business will continue for the foreseeable future. The *foreseeable future* usually means at least the next 12 months from the date on which the financial statements are approved. If a company has going concern problems, you can't be certain it's going to stay in business for the foreseeable future, and the more worrying the going concern problems might be, the higher the exposure to risk is.

The account balances you use to measure liquidity are taken from the balance sheet. Because liquidity is concerned with the short term, the accounts you use for these measurements are all current rather than long-term.



TIP

A quick heads up: later in this chapter (in the 'Measuring Profitability' section), I talk about *trend analysis*, which is looking at ratios over a period of years. Trend analysis isn't normally applicable to liquidity measurements because, when it comes to liquidity, financial statement users are looking at what's going on in the short term – not over a long period of time.

Accounting reference material may discuss three principal evaluations to measure liquidity: current ratio, acid-test ratio (also known as the *quick ratio*) and working capital. The first two show up in the form of (you guessed it!) ratios. You express working capital as a monetary amount. These measurements are all easier to understand if you use account balances to work through them, so let's get to work crunching some numbers!

Conquering the current ratio

You find a company's current ratio by dividing its current assets by its current liabilities. I discuss current assets in Chapter 7 and current liabilities in Chapter 8, but here are some quick examples of each:

- » **Current assets:** Accounts such as cash, trade receivables, inventory and short-term investments.
- » **Current liabilities:** Trade payables and all other debt that's due within 12 months of the balance sheet date, such as *accrued payroll*, which is wages or salaries that employees have earned but have not yet been paid.

So, you're looking at a balance sheet. A company's current assets are £120,000, and its current liabilities are £57,000. The current ratio is 2:1 (£120,000 divided by £57,000).

The current ratio tells you a lot about how liquid a company is because current assets are either cash or are easily converted to cash in the short term; in theory, they can be used to pay short-term obligations. Being able to meet short-term obligations is crucial to a company remaining a going concern.



TIP

The theory behind the current ratio is pretty simple. If you're a student accountant and financial reporting is on your syllabus, the chances are you're definitely going to have to calculate some ratios – one of which will undoubtedly be the current ratio. Getting to grips with ratio analysis (sometimes called *financial statement interpretation*) is very important. Below is an example similar to what you may be asked during your studies, or in accountancy practice if a client is potentially thinking about investing in a business.



EXAMPLE

Weavers Wedding Dresses has current liabilities on 31 December of £140,000, and its current ratio at that time is 2:2. What are the company's current assets?

Okay, you know that current assets divided by current liabilities equals the current ratio. You are trying to find out the value for current assets (the unknown variable x), so your equation is x divided by £140,000 equals 2:2.

$$x/140,000 = 2:2$$

Isolating x on one side of the equation gives you £140,000 times 2:2.

$$x = 140,000 \times 2:2$$

So your current assets are £308,000 (£140,000 $\times$ 2:2).

You can prove this by plugging that figure into the first equation: £308,000 divided by £140,000 does equal 2:2. Hooray!



REMEMBER

The method a company uses to value its closing inventory affects the carrying amount of inventory on the balance sheet. (I discuss inventory valuation methods in Chapter 13.) That is one of the reasons why disclosing inventory valuation methods is a required disclosure in the notes to the financial statements, as I explain in Chapter 15.

Putting the acid test to work

As I explain in the previous section, a company whose current assets are £120,000 and whose current liabilities are £57,000 has a current ratio of 2:1. This business appears to have more than adequate resources available to pay any short-term debt. However, one current asset account, *inventory* (goods that a company holds for resale to customers), isn't always all that easy to convert to cash quickly because the company would first need to sell it, which then turns it into a receivable, and then collect any accounts receivable resulting from the sale. So the acid-test ratio is used in conjunction with the current ratio to evaluate the worst-case scenario: that the company can't sell any of its existing inventory. If it can't sell any of its existing inventory, can it still pay its bills?



REMEMBER

Analysts generally believe that if a business has an acid-test ratio of more than 1:0, it can meet its short-term obligations. If it's less than 1:0, alarm bells should ring as this would suggest it can't meet those short-term obligations.

To work out the acid-test ratio, you first add together cash, all short-term investments, and trade and sundry receivables. *Short-term investments* are those that the company is willing and able to sell within one year of the balance sheet date. Next, you divide that figure by the company's current liabilities.

So assume a company has current assets worth £120,000 and inventory is valued at £40,000. That means its other current assets (such as cash, short-term investments and trade and sundry receivables) are £80,000 (£120,000 – £40,000). Dividing £80,000 by the company's current liabilities of £57,000 gives you an acid-test ratio of 1:4.



TIP

As a general rule, if a company has both a current ratio of at least 2:0 and an acid-test ratio of at least 1:0, that shows it has adequate liquidity to pay current obligations as they fall due. You may be asking, 'What if ratios are less than these targets – should the investor or lender walk away or pull the plug?' This question is difficult to answer; it depends on the investor and that person's goals. Certainly an interested party can consider doing trend analysis before making a firm decision (see the upcoming 'Measuring Profitability' section).

Working with working capital

The working capital measurement is simply current assets less current liabilities. If a company has current assets of £120,000 and current liabilities of £57,000, working capital is £63,000 (£120,000 – £57,000).

It's not rocket science to realise that most healthy companies have positive working capital. In your personal life, you work to maintain positive working capital (meaning that you strive to make your income more than your expenses) so you can pay your bills. Likewise, a business very much wants, and needs, to have enough cash rattling around in the bank accounts to pay its bills. When the coffers get too low, some businesses take out *working capital loans*, which are short-term loans that carry companies through a rough patch.

Many businesses won't have enough cash on hand to cover all their short-term debts at any one point in time. The assumption is usually that it sells its inventory and collects money from its trade receivables, thus converting those current assets to cash.



TIP

Always keep in mind that you express the working capital measurement as a monetary amount, not a ratio. In the real world, a client (or one of your non-financial colleagues) can ask you to explain how working capital is affected by the payment of short-term debt. Always remember this immutable fact of accounting: working capital is never affected by the payment of short-term debt because both current assets and current liabilities decrease by the same amount.



EXAMPLE

Here is an example. On 1 December 2026, Byrne Breeze Blocks Limited has current assets of £50,000 and current liabilities of £10,000. Working capital is £40,000 (£50,000 – £10,000). Now assume that Byrne Breeze Blocks pays £5,000 of the current liability balance on 15 December 2026. Does this payment affect its working capital? No, it does not, because now current assets are £45,000 (£50,000 – £5,000) and current liabilities are £5,000 (£10,000 – £5,000). Working capital remains at £40,000 (£45,000 – £5,000).



TIP

While the payment of short-term debt doesn't affect working capital, it does affect the current ratio. Using the same example, on 1 December 2026, Byrne Breeze Blocks' current ratio is 5:0 (£50,000 divided by £10,000). On 15 December 2026, Byrne Breeze Blocks' current ratio is 9:0 (£45,000 divided by £5,000). Quite a difference!

Getting to grips with the gearing ratio

Gearing refers to the proportion of finance provided to a company by debt relative to the amount of finance provided to it by equity (by the company's shareholders). While the gearing ratio is concerned with how liquid a business is, it also focuses on the long-term financial stability of a company, so it is a ratio that's crucial to investors, such as a bank that may be considering offering the company a long-term loan. They'll be very much interested in the gearing ratio to assess whether the company can afford the loan it may be offered.

In a nutshell, the higher the level of borrowing (gearing), the riskier the business because the payment of the capital amount of a loan and the interest portion are not optional (as dividends are). Gearing is calculated by taking a company's long-term liabilities (non-current liabilities) and dividing this number into a company's *capital employed* (share capital plus retained earnings plus long-term liabilities) and multiplying the result by 100 to turn it into a percentage.



EXAMPLE

Here's an example. You have obtained the following information for James Joinery Company Limited for the two years ending 31 December:

	2026	2025
	£,000	£,000
Long term liabilities	1,300	1,500
Capital employed	5,765	4,895

To calculate the gearing ratio for both years, you divide long-term liabilities into capital employed and multiply by 100 to arrive at a gearing percentage. Here's how it is done:

31 December 2026:

$$£1,300/£5,765 \times 100 = 22.5\%$$

31 December 2025:

$$£1,500/£4,895 \times 100 = 30.6\%$$

You can see from the above information that James Joinery Co's gearing ratio has dropped from 30.6 per cent in 2025 to 22.5 per cent in 2026, which is a good sign! (Remember, the higher the gearing figure, the more risky the company.) The reason the gearing ratio has dropped is that long-term borrowings reduced in 2026 by £200,000, and the company added £870,000 to retained earnings through the profits it generated.

The gearing ratio is one of the *financial position ratios* because it is the company's statement of financial position (balance sheet) that is being analysed.



REMEMBER

The balance sheet shows the financial *position* of the business at a point in time (a 'snapshot' of assets, liabilities and equity). The profit and loss account shows the financial *performance* of the business over a period of time (from the first day of the financial year to the last day of the financial year), hence is regarded as a *performance statement*.

Measuring Profitability

In addition to getting a grip on how well a company covers its current debt with current assets, most financial statement users want to be able to evaluate the relative robustness of a company's income over a number of years or financial periods. Looking at a company's performance over a long period of time is called *trend analysis*.

In this section, I explain how trend analysis works and why it's so important when evaluating profitability. Then, I move on to explain two profitability measures: return on investment and return on equity.

Explaining trend analysis

A single profitability measure on its own doesn't tell you much about a company or how it's performing compared to its competition. This is true for two reasons:

» **The company may have had an exceptionally good or bad year.** Unless a company's performance is static from year to year, looking at only one set of figures gives the financial statement user an inaccurate picture of the company as a whole.

Consider a personal example. Assume you have a windfall in 2026: you win £50,000 on the lottery, making your total income (after adding in your earnings from your part-time job) £62,000. The next year and the year after that, you don't have any winning lottery tickets, and your average income is £13,000 per year. Clearly, looking only at your income for 2026 doesn't give anything near an accurate picture of your income because that year's income includes an unusual, one-off event.

» **Under generally accepted accounting practice (GAAP), companies are allowed to use various methods to estimate some expenses.** If a financial statement user is trying to compare Company A to Company B by using a single set of profitability ratios, they're not going to see the whole picture.

For example, Chapter 13 talks about inventory valuation methods. A company's decision to use one method against another can cause a huge variation in net profit. The same holds true for depreciation of non-current assets, which I discuss in Chapter 12. Different options are also available for recording an estimate for the *allowance for inventory obsolescence*, which is the value the company reckons it will lose on its inventory because it becomes out of date. Many more differences may exist using allowable GAAP methods, but you can see where I'm coming from.

Trend analysis provides much more meaningful information to the financial statement user because differences in accounting methods tend to smooth out over time. For example, while whichever method a company uses for depreciation affects the amount of depreciation expense by year, it never affects the original historic cost. In other words, an asset costing £1,000 can never be depreciated by more than £1,000. So, factoring in any alternative financial accounting methods in use, ratios over a period of several years should be somewhat consistent, which permits the financial statement user to do some useful trend comparisons.



Using trend analysis means looking at profitability ratios over a number of years. Doing so is usually more helpful to the financial statement user than is any single ratio because everything is relative. Seeing how profitability ratios go up and down (when comparing current performance to past performance and when comparing the company with other companies in the same industry) is more meaningful than just looking at one stand-alone ratio. Most investors consider at least five years – sometimes up to ten or maybe more.

Going through the gross profit ratio

The gross profit ratio helps to assess how much gross profit (pence in the pound) a company is making on its sales. A key point to remember is that a company needs to make sufficient gross profit to enable it to make enough net profit to pay its expenses. It works a bit like your monthly salary: in theory, the higher your gross pay, the higher your net pay will be and the more surplus dosh you'll have available to fritter away (assuming your expenses don't also increase).

The gross profit ratio expressed as a percentage is calculated by taking gross profit (sales/revenue less cost of sales), dividing it into sales/revenue and multiplying it by 100 to arrive at a percentage. Let me show you a quick example.



Extracts from the financial statements of Dexter's Days Out are as follows:

	2026	2025
	£,000	£,000
Revenue	100,000	80,000
Cost of sales	75,000	70,000
Gross profit	25,000	10,000

From this information, you can work out the gross profit, as follows:

31 December 2026:

$\pounds 25,000 / \pounds 100,000 \times 100 = 25$ per cent (or 25 pence made for every $\pounds 1$ sold)

31 December 2025:

$\pounds 10,000 / \pounds 80,000 \times 100 = 12.5$ per cent (or 12.5 pence for every $\pounds 1$ sold)

You can see that Dexter's Days Out's gross margins have increased considerably in 2026 as compared to those in 2025, which is encouraging. Companies want to make as much gross profit as possible and it may be that, in 2026, Dexter's Days Out increased its prices to increase its gross margins, or changed suppliers to reduce its cost of sales. Other issues may also have arisen in 2025 that dragged down margins, such as an incomplete sales figure or too much going into cost of sales (usually referred to as *cut-off errors*), which means invoices (sales and cost of sales) go into the wrong accounting period. Flick over to Chapter 10 for an insight as to what types of costs go into cost of sales and other types of expense.

Focusing on return on investment

Return on investment (ROI) is a tool investors use to see how well their investment in a particular company is doing – and to help them make that important decision of whether to sell an investment and move on or to stick with it. Potential investors also use ROI when trying to choose from among different companies in which to pump their spare cash.

Basically, investors want to see how well company management is using the company's resources to make money. This information gives the investor some idea of the competency of management and the relative profitability of a business when compared to others the investor is considering.

Investors can calculate ROI, which is expressed as a percentage, in a few different ways. All the methods involve using some form of comparing profit to assets. Here are two methods that are fairly common:

» **Profit before tax divided by average total assets:** *Profit before tax* (see Chapter 10) is the bottom-line total of what's left over after you deduct all business expenses and losses from all revenue and gains for the same financial period. I discuss *assets* in Chapter 7; in a nutshell, they're all the resources a company owns. So if a company has a net profit of $\pounds 100,000$ and average total assets of $\pounds 27,000$, its ROI is 370 per cent ($\pounds 100,000$ divided by $\pounds 27,000$).



TIP

To work out the *average* figure, you do it by adding the account balance at the beginning of the financial period to the closing balance and dividing that figure by two. So, if total liabilities are £50,000 at 1 January 2026 and £75,000 at 31 December 2026, average total liabilities are £62,500 (£125,000 divided by 2).

» **Operating profit divided by average operating assets:** This form of ROI calculation starts with profit before tax and interest (see Chapter 10 for more info) and divides it by average *operating assets*, which are non-current (fixed) assets such as property, plant and equipment (see Chapter 7). So if a company's operating income is £82,000 and its average operating assets are £12,000, ROI using this method is 683 per cent.

In real life, each method has its own characteristics and uses. However, if you want a fairly general perspective, as long as the chosen method is used consistently, trend analysis using any ROI method will give the investor a significant resource for making a decision as to which company to invest in.

Homing in on return on equity

Return on equity (ROE) measures the profit earned for each pound invested in a company's shares. You work out ROE by dividing net profit by *owners' equity* (see Chapter 9), which is what's left over in the business after all liabilities are subtracted from all assets.

The higher the ROE ratio, the more efficient management of the company is at utilising its equity base. This measurement is important to shareholders and potential investors because it compares earnings to owners' investments. Particularly because it takes into account *retained earnings* – the company's cumulative net profit from day one, less dividends – it gives the investors much-needed information on how effectively their capital is being used. Having net profit grow in relation to increases in equity presents a picture of a well-run business.

Let's walk through a quick calculation. If a company's net profit is £35,000 and the owners' equity is £250,000, ROE is 14 per cent (£35,000 divided by £250,000). Once again, to make wise investment decisions, users of this information will look at ROE as it trends over a series of years and will compare it to the ROE of other companies.

Exploring the Cash Position

In this section, I discuss *cash flow measures* that quantify the relationship between how well a company collects money in and how quickly it's able to meet its short-term obligations with suppliers. Here, I discuss the ones most commonly used: those measuring trade receivables, trade payables and inventory activity.



REMEMBER

Ratio analysis, which studies activity, as well as cash flow, shows you how well a company is using its assets to make money. This calculation is an expansion of the return on investment (ROI) measurement (see the earlier section 'Focusing on return on investment'). Basically, the premise is that how well a company uses its assets to generate revenue goes a long way towards telling the tale of its overall profitability. That's because a business that's effectively and efficiently operated, as activity measures show, will generally be more successful than its less effective and efficient competition.

Asset turnover analysis shows how quickly an asset comes in and goes out again. The quicker the better! By this, I mean that in normal circumstances, efficiently moving assets indicates a well-run business. The basic formula to calculate turnover is this: turnover equals sales divided by average assets.

Calculating debtor/receivables days

This calculation looks at how efficient the company is at collecting its debts from customers (receivables). You've more than likely heard the old phrase 'cash is king' – well, this is as appropriate today as it was 400 years ago, and the trade receivables days calculation is a valuable tool in helping companies set credit and collection policies. If a company runs out of cash, it's going to be in financial dire straits, and even the most profitable of companies have been known to go bust in that circumstance. Trade receivables days is worked out by dividing trade receivables as at the last day of the financial period by revenue/sales (all sales in the financial period) and then multiplying this by 365 to represent the number of days in the year. The number calculated is expressed in *days*.

Let me walk you through an example.



EXAMPLE

The financial statements for Westhead Enterprises Limited show that in 2026 revenue is £1.2 million (in 2025 it was £975,000) and trade receivables were £175,000 (in 2025 they were £125,000). You can calculate the receivables days as follows:

2026:

$$(\pounds 175,000 / \pounds 1,200,000) \times 365 = 53 \text{ days}$$

2025:

$$(\text{£}125,000/\text{£}975,000) \times 365 = 47 \text{ days}$$

You can see that in 2026 it takes an average of 53 days to collect money in from trade receivables, but in 2025 it only took 47, so it may be that the credit control system at the company needs to be improved, or customers are suffering from cash flow difficulties, which result in them paying much more slowly. Alternatively, it may be that the company has extended credit periods to customers, or it might simply be the timing of sales and receipts around the year end as the balance sheet is only a snapshot on the day.

Working out creditor/payables days

In the section above, I talk you through how to work out calculating receivables days – that is, how many days, on average, it takes the company to collect money from its customers. On the flip side of that process, interested parties also want to see how efficient the company is at sorting out its trade payables (sometimes known as *trade creditors*). Like trade receivables days, this number is expressed in *days* and is calculated by taking the trade payables figure in the financial statements and dividing it into trade purchases (or cost of sales) and multiplying it by 365.

Here's an example.



EXAMPLE

Westhead Enterprises had trade payables of £15,000 in 2026 and £128,000 in 2025. Cost of sales in 2026 were £170,000 and £530,000 in 2025. The trade payables days is calculated as follows:

2026:

$$(\text{£}15,000/\text{£}170,000) \times 365 = 32 \text{ days}$$

2025:

$$(\text{£}128,000/\text{£}530,000) \times 365 = 88 \text{ days}$$

You can see from the above that a drastic reduction in trade payables days has occurred, which means that either the company has been paying its suppliers far too quickly in 2026, or they've had credit terms seriously squeezed (or even withdrawn). Either way, such a reduction isn't good news because it puts pressure on the cash in the bank. But on the flip side, you don't want to increase your payables days to such an extent that supplier goodwill suffers because, if you do, the supplier won't supply goods, or will reduce your credit terms, which is never a good thing. Regularly paying your suppliers late will also have a bad impact on the company's credit rating, which is never good.

These sorts of calculations are all about the *working capital cycle*. The working capital cycle measures the amount of time that elapses between the business buying a product or providing a service and payment being received from its customer. A short working capital cycle means the business has good cash flow, whereas a long working capital cycle can result in the business suffering from cash flow problems. The working capital cycle is calculated as inventory turnover days *plus* receivable days *less* payable days. Inventory turnover days is calculated as cost of sales divided by average inventory multiplied by 365.

Inventory holding period/turnover

This activity measure shows how efficiently the company is handling inventory management and replenishment. The less inventory a company keeps on hand, the lower the costs to store and hold it, thus lowering the cost of inventory having to be financed with debt or *owners' equity* (the ownership rights left over after deducting liabilities).

However, keep in mind that running out of inventory is not a good place to be, either. Low levels of inventory can cause a company to deliver an order late to a customer, resulting in the loss of customer goodwill. Also, running low on inventory may cause the company to panic and buy the same inventory for a higher price to get it *right now*. Too much of that sort of thing can play havoc with the bottom line.

To work out inventory turnover, you divide sales by inventory value, and the number is expressed in *times*. So if a company's sales are £35,000 and inventory is £8,500, inventory turnover is 4.12 times (£35,000 divided by £8,500).



TIP

Some financial analysts use cost of sales instead of sales when calculating inventory turnover. That's because inventory is reported at cost, not at its selling price.

- » Touching on corporate governance
- » Studying the characteristics of a company
- » Finding out more about a company by reading its notes and disclosures
- » Looking at who's responsible for full disclosure

Chapter **15**

Delving into Disclosures

This chapter begins with a quick overview of corporate governance and ends by shedding light on the explanatory notes and other information found in most companies' annual reports. I provide the complete picture on companies' annual reports in Chapter 16. Basically, they give shareholders an insight into the company's operations for the past financial year.

Also in this chapter, you learn how a business becomes a company, and you review four characteristics of a company: continuity, easy transferability of shares, separation of ownership and control and (the biggie) limited liability.

The complete list of notes and disclosures that may appear in a company's annual report is quite long, so I can't cover them all here. Instead, I focus on the most common explanatory notes and disclosures popping up in various companies' annual reports.

Touching on How Corporate Governance Works

Put simply, *corporate governance* is the framework under which a company operates. At its core, this framework involves establishing financial *controls* (policies and procedures that govern how the company's finances are handled), showing

accountability to the shareholders, and making sure the management acts in the best interest of the shareholders and the community in which it operates. I talk about financial controls and accountability in the upcoming sections ‘Reviewing the Notes to the Financial Statements’ and ‘Looking for information about important events’.



REMEMBER

Part of a company’s self-regulation includes fully disclosing information in its financial statements so that it is entirely transparent to the users of those accounts. Hence the focus on corporate governance in a chapter about financial statement notes and disclosures.

I cannot cover the subject of corporate governance in depth here; I’d need another book to do so. But here are just a couple of examples of ways that companies need to self-regulate:

- » **Acting in the best interests of the shareholders:** The company should operate so that the shareholders can expect a reasonable rate of return. For example, the company doesn’t pay excessive bonuses to directors that reduce cash flow to such an extent that the business can’t effectively operate.
- » **Being sensitive to environmental concerns:** The company shouldn’t pollute or cause health issues through its business waste or other by-products for those living in the communities in which the business operates.

ENRON: A CAUTIONARY TALE OF CORPORATE GOVERNANCE AT ITS WORST

The fact that Enron represented such a massive failure to safeguard investors’ interests still continues to fascinate. Here’s just a glance at how financial reporting played a part.

A primary contributor to the problem was the use of *mark-to-market accounting*, which essentially means accounting for expected profits before they’re earned. It’s actually a fairly easy concept to understand if you break it down to its lowest common denominator. Here’s an example of how it works.

Let’s say I invent a machine that will rearrange the molecules in the fabric of a pair of jeans so that the jeans fit your body perfectly every time you wear them. I have a five-year contract with a retailer for the sale of this machine. My best guess is that sales over five years will be £50 million. Instead of waiting and recording the profits as the

machine is sold, under mark-to-market accounting I can record the entire £50 million at the time the contract is signed with the retailer.

You may be wondering, Why would I want to do this? What would be the purpose? After all, the £50 million was just my best guess – a figure I wrote down on a scrap piece of paper at the local coffee shop while drinking a cup of coffee. Why not wait and see what sales are really going to be?

Here's the deal: high-ranking employees at most listed companies (by *listed*, I mean the company's shares are publicly traded on a stock market) are rewarded by methods other than just their agreed-upon salaries. This reward system allows for millions of pounds of incentive payments and share options to be given to those employees as they deliver faster and faster revenues and earnings growth. Meeting and exceeding revenue projections has only one effect on the price of shares as traded on the open market: the price goes up. The increase in share price will have a direct effect on the amount of money I make when I exercise and sell any share options tied to an incentive plan.

At Enron, mark-to-market accounting treatment was a condition of the (then) CEO, Jeffrey Skilling, accepting employment at Enron. Enron's auditors, the accountancy firm Arthur Andersen, signed off on the treatment, and the US Securities and Exchange Commission (SEC) approved it. Unfortunately for the lower-ranking employees at Enron, Enron's top management lacked corporate governance awareness. Large bonuses were paid to top management based on excessively optimistic revenue stream projections that never came to fruition.

In the end, all employees at Arthur Andersen and Enron lost their jobs and health insurance benefits, and Arthur Andersen collapsed. Many Enron employees and retirees lost their entire pensions, these having been invested in Enron shares whose value bottomed out at 40 cents per share. An all-round disaster due to bad governance methods.

Recognising How Companies Work in the UK

Many trainee accountants only have a basic understanding of how a business becomes a company and what it means to be a company. I quickly walk you through the process in this section and explain the characteristics of a company to provide a broader context for understanding corporate governance and financial statement disclosures.

Incorporation – the process of turning a regular old business into a company, or forming a new business as a company – is governed by companies' legislation. If a business wants to set up shop as a company, it must play by the rules of the Companies Act 2006 (www.legislation.gov.uk/ukpga/2006/46/contents) (and other specific legislation that may apply, such as the Charities Acts – see www.legislation.gov.uk/ukpga/2011/25/contents).

In the UK, the whole process kicks off when the company files information with Companies House notifying them of:

- » Company name and address
- » People with significant control (meaning anyone owning 25 per cent or more of the shares or voting rights in the company)
- » Details of the director(s) and company secretary (where appropriate)
- » Company share capital and shareholders' details

It currently costs £50 to form a company at Companies House (this fee may be higher if you use a third party to do this for you, such as a formation agent). Companies House will then send a certificate of incorporation and the company's memorandum and articles of association. The memorandum and articles of association contain all pertinent facts about the new company, including its objectives, its name, address and information about the type and number of shares it's issued. The person who initiates the process and files the required information is called the *formation agent*. This may be a third party, but there is no reason why any member of the public with a great idea for a company can't do this themselves (but they can be sure to check up on the finer details beforehand). The company must also have a *registered office* and a registered email address: the address which the Registrar of Companies contacts with questions about the company or where the Registrar will send documentation.



WARNING

There have been some significant changes made to company regulation since the introduction of The Economic Crime and Corporate Transparency Act in 2023. No new directors can act as a director unless their identity has been verified by Companies House. If a company fails to notify Companies House within 14 days of a person becoming a director, the director will be committing a criminal offence if they continue to act. If you're not sure about some of these new detailed regulations, it's always better to leave it to the professional, as there are a lot of pitfalls.



REMEMBER

This is a very simplified version of the whole process, which can also vary by country. An initial public offering (IPO) – when a company offers shares to the public for the first time – is much more complicated than the previous paragraph may lead you to believe. However, these basic facts are what you need to know in your day-to-day dealings with companies.

Four characteristics of a company are:

- » **Limited liability:** This term means that the shareholders in a company normally can't be pursued for corporate debt. If the company is sued by a supplier, a financier or some other entity to which it owes money, the individual shareholders are generally off the hook.

However, exceptions to this general rule can exist, which hinge on the company managing itself according to company law. In certain situations, usually when some dodgy goings on have occurred at the company, the government and HM Revenue and Customs (HMRC) can go after the directors personally, or possibly the shareholders for certain types of unpaid taxes, such as unpaid corporation tax or pay as you earn (PAYE).

- » **Easy transferability of shares:** This characteristic means that, if a person has the money, they can purchase shares in any company – with the expectation of selling the shares in the future if they need the money. However, for companies with only a few shareholders, this characteristic doesn't quite ring true. If you're the majority shareholder in a private company, you don't have to sell shares to just anyone.

Easy transferability of shares applies more to the purchase and sale of shares in listed companies. For example, if you want to buy shares in Sainsbury's, you don't have to get permission from the CEO at Sainsbury's. You can just open a brokerage account with a stockbroker (or an online trading platform) and cough up the cash for the shares.

- » **Separation of ownership and control:** The management of a company shouldn't be divided among many different groups. Therefore, for the company to function at full efficiency, shareholders give up the right to be involved in every decision it makes. The shareholders elect the board of directors, who oversee the company's operations and choose the management to handle the day-to-day business operations.

- » **Continuity:** Until the company is formally dissolved, it's assumed to have unlimited life. The members of the board of directors can change, management can change, or a different mix of shareholders may exist, but the company just keeps going on and on.

Reviewing the Notes to the Financial Statements

As I note earlier in the chapter, one aspect of corporate self-governance is giving financial statement users the complete information they need in order to accurately gauge the company's performance and financial health. Some of that information comes in the form of explanatory notes contained within the annual financial statements.

Knowing how the notes interact with the accounts

Explanatory notes (called the *Notes to the Financial Statements*) are discussions of items accompanying the financial statements; they contain important disclosures that may not be presented in the financial statements themselves. The financial statements we are concerned with in this book are the profit and loss account (income statement; see Chapter 10), balance sheet (or *statement of financial position*; see Part III) and statement of cash flows (or the *cash flow statement*; see Chapter 11).

The notes to the financial statements are essential to fulfil the needs of the external users of the financial statements such as: people like you and me who may be interested in investing in the business, banks thinking about lending the company money or HMRC making sure the company has complied with tax legislation. External users don't work for the company, so they aren't privy to the day-to-day accounting transactions taking place within the business.

Important information that can't easily be gleaned from reviewing the financial statements must be spelt out in notes and disclosures, which explain how or why a company deals with a transaction, event or condition. These disclosures allow external users to understand what's going on at the company and creates a level playing field so an external user can compare the financial statements of one company with those of another company.

Such notes are part of the company's annual report, which provides shareholders with both financial and non-financial information about the company's operations in the past year. I discuss this report in Chapter 16.

The notes are always presented after the financial statements in the company's annual report and are ordered to mirror the presentation of the financial

statements. In other words, notes for income statement come first, followed by balance sheet notes and then items reflecting on the statement of cash flows. Other notes presented at the end usually relate to other information, such as related parties, the company's ultimate controlling party and any post-balance sheet events (events that have arisen between the balance sheet date and the date on which the financial statements are approved – see the section below 'Looking for information about important events').

In the next section, I explain the six explanatory notes that are commonly seen in the world of accountancy. Most of these subjects are presented elsewhere in this book in more detail, so I offer just a brief overview here and let you know where you can find more info.



REMEMBER

Keep in mind that I merely gloss over each of these explanatory notes. Depending on the company and the complexity of the underlying accounting transaction, explanatory notes can be long and boring to wade through for all but the most diligent and experienced investor. For each type of note, I give you a simple version of what you see in real life, which is more than sufficient for your initial dealings with financial statements.



TECHNICAL
STUFF

Some explanatory notes are required only for listed companies by the London Stock Exchange, which I introduce in Chapter 4.

Disclosing the company's accounting policies

The first thing a business has to do when it prepares its explanatory notes is to explain in general the business and its material accounting policies (see Chapter 20). These are split into two different notes. The first is called the 'Basis of Preparation' and the second 'Accounting Policies'.

Taking this first step creates a fairer presentation of the financial statements. Information about accounting policies helps financial readers to better interpret the statements. A note is needed for each significant accounting policy adopted by the company.



REMEMBER

At the very least, the accounting policies (see Chapter 20) should include the basis of consolidation (if applicable), the company's revenue recognition policies, the depreciation methods in use, the way the company accounts for intangible assets and how the company values its closing inventory. I touch on each of these subjects in turn.

Consolidated financial statements

In the context of generally accepted accounting practice (GAAP) and financial accounting, *consolidation* refers to the aggregation of financial statements of two or more companies so those financial statements can be presented as if a group were one, single reporting entity. A *group* would exist when one company (a ‘parent’) owns or controls at least one other company (the ‘subsidiary’), and so as well as producing its own financial statements, the parent will also produce a set of financial statements for the group it heads up. In this section of the notes, the company confirms the fact that the consolidated financial statements do indeed contain the financial information for all its subsidiaries. Any deviations from including all subsidiaries would have to be explained. See Chapter 17 for more information about consolidation.

Here’s a basic example of how a note addressing consolidation appears:

NOTE 1: BASIS OF CONSOLIDATION

All companies over which the group is able to exercise control are consolidated as subsidiary undertakings. Control is the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

Reporting revenue recognition policies

Revenue (or turnover) is often a company’s largest number in its financial statements; therefore, adequate disclosure of a company’s revenue recognition policy is essential. This will enable the user to understand at what point the company recognises revenue and how the revenue is calculated.

Here’s a basic example of how a typical accounting policy note may appear (please note that I use the term *turnover* as opposed to revenue as the Companies Act 2006 in the UK refers to turnover):

NOTE 2: TURNOVER

Turnover is stated net of value added tax and trade discounts and is measured at the fair value of the income received or receivable. The company recognises turnover when its contractual obligations are fulfilled, which is usually at the point the goods are dispatched to the customer. Turnover in respect of service contracts is recognised when performance obligations in the contract give rise to the company having the right to receive consideration. Deferred income is presented as a creditor falling due within one year and is recognised in the period to which the income relates, subject to performance-related conditions being satisfied.

Reviewing depreciation methods

In Chapter 12, I discuss *depreciation*: spreading the cost of a non-current (fixed) asset over its useful life, which may be years after the purchase.

The methods a company chooses to use for depreciation expense can cause significant fluctuations for the amount of assets shown on the balance sheet and the amount of net profit (or loss) shown in the income statement. Because of this fluctuation, the financial statement user needs to know which methods the company uses in order to more fairly compare one company's financial statement figures to another's. Differences in net profit can merely be a function of depreciation methodology – a fact the user would be unaware of without the explanatory note.

Here's an example of what you may see:

NOTE 3: TANGIBLE FIXED ASSETS

Depreciation is provided at the following annual rates in order to write off the cost less estimated residual value of each asset over its estimated useful life:

Plant and machinery:	5 years straight line
Computer equipment:	3 years straight line
Motor vehicles:	25 per cent reducing balance

Tangible fixed assets are initially recognised at cost and subsequently measured in the financial statements at depreciated historic cost. At each reporting date, the directors carry out a review to identify if there are any indicators of impairment. If indicators of impairment are present, an impairment test is carried out and the asset is reduced to recoverable amount by way of an impairment loss, which is recognised in profit or loss in the period.

Walking through intangibles

Intangible assets aren't physical in nature like a desk or computer. Two common examples of intangibles are *patents*, which license inventions or other unique processes and designs, and *trademarks*, which are unique signs, symbols or names that the company uses. (See Chapter 7 for more information about intangibles.) Besides explaining the different intangible assets the company owns via an explanatory note, the business also needs to explain how determines the intangible assets' value showing on the balance sheet.

Here's an abridged example of how such a note looks:

NOTE 4: INTANGIBLE ASSETS

The company measures its intangible fixed assets under the cost method (cost less amortisation less impairment). The company's policy of writing off the costs incurred in respect of the patents and licences is to write such costs off over ten years. The directors consider this amortisation policy to be adequate based on the useful economic life of the development costs.

Investigating inventory policies

Inventory (or *stock*) is another thorny issue because of the ease of which this figure can be manipulated. Again, companies have been known to inflate, or reduce, profit disproportionately by manipulating the closing inventory figure in the balance sheet and the income statement to manipulate the profit before tax figure, sometimes as a way of trying to reduce the company's tax liability (though not all companies are guilty of this dodgy practice). Financial statements must adequately disclose the policy of inventory valuation by a company so users can see exactly how the closing inventory figure is arrived at.

Here's a basic disclosure of inventory valuation (please note, again I used UK terminology due to the Companies Act wording):

NOTE 5: STOCK

Stock is valued at the lower of cost and estimated selling price, less costs to complete and sell and is valued using the first-in first-out method of valuation. Cost comprises the cost of products plus other direct costs involved in getting stock to its saleable condition and shipping the goods to the company. Estimated selling price is based on the price the company can expect to receive in the marketplace, less further costs to be incurred to completion and disposal. Provision is made for obsolete, slow-moving or defective items where appropriate.

Looking for information about important events

A company must also provide information in the notes to the financial statements explaining the following issues: accounting policy changes, contingencies and events after the balance sheet date.



TIP

Various accounting reference/textbooks usually cover events after the balance sheet date separately from the discussion of explanatory notes that accompany financial statements. But keep in mind that events after the balance sheet date disclosure information goes in the notes to the financial statements.

Accounting policy and estimate changes

A company may have up to two types of accounting changes to report: a change in accounting policy (see Chapter 20) or a change in an accounting estimate. Narrative descriptions about these issues go in the explanatory notes to the financial statements usually in the first or second note.

Below is an explanation of each type of accounting change:



TECHNICAL
STUFF

» **Accounting policies** guide the way the company records its accounting transactions. Under GAAP, a company is usually allowed different ways to account for transactions. For example, in Chapter 7, I discuss inventory and how this can be valued using different methodologies (first-in, first-out and average cost being the two main ones). Any change in this methodology would be a change in accounting policy.

For the financial statements, changes in accounting policies must be shown by retrospective application to all affected prior periods (unless doing so is not practicable or the change is not material). This process involves three steps:

- Adjust the carrying amounts of affected assets and liability accounts for the cumulative effect of the change.
- Take any offset to opening retained earnings.
- Disclose why each new accounting policy is thought more appropriate, together with the effect of the change on the financial statements in the prior period, and (where practical) an indication of the effect of a change in accounting policy on the results for the current period.

I discuss each of these steps in more detail in Chapter 20.

» **Accounting estimates** are numbers a company enters into the financial records to reflect its best estimates as to how certain transactions will eventually pan out. For example, changing the basis on which a warranty provision is calculated. If something happens to make you believe your original estimate of warranty claims is no longer valid and you change it, that's a change in accounting estimate.



A change in accounting estimate must be recognised currently and prospectively. For example, if the warranty provision is recalculated, the current and future financial statements show the residual value as corrected. No change is made to prior period financial statements. You can find more on this topic in Chapter 20.

Contingencies

A *contingent liability* exists when an existing circumstance may cause a loss in the future depending on other events that have yet to happen (and, indeed, may never happen). For example, the company is involved in a corporation tax dispute. Disclosing this contingent liability is a requirement if the company may end up owing a substantial amount (often referred to as a *material* amount) of additional tax penalties and interest should the unsolved tax inspection end up in HMRC's favour. See Chapter 8 for more information about reporting contingencies.

Here's a basic example of how a contingency note looks:

NOTE 6: CONTINGENT LIABILITIES

As at 31 December 2027, the company was contingently liable for guarantees of indebtedness owed by third parties in the amount of £3 million. These guarantees relate to third-party suppliers and customers and have arisen through the normal course of business. The amount represents the maximum future payments that the company can be responsible for making under the guarantees; however, the directors do not consider it probable (meaning more likely than not) that the company will be required to satisfy these guarantees.



A contingent liability is only reported as a disclosure note in the financial statements (amounts aren't recognised as a *provision* – a liability that's uncertain in terms of its timing or amount – in relation to the contingent liability). This is because it doesn't meet the criteria to be a provision. It becomes a *provision*, and hence an estimated monetary amount recognised in the financial statements, if:

- » the company has an obligation to the third party;
- » its probable (meaning more likely than not) that the company will need to cough up some dosh (or another asset) to settle the liability; and
- » the amount of loss that may be sustained is reasonably estimated (see Chapter 8). This 'liability' is known as a provision, which is defined as a liability of uncertain timing or amount.

Events arising after the balance sheet date

The company also has to address any subsequent events happening after the close of the accounting period but before the financial statements are approved. Such events are known as *post balance sheet events* or *events after the end of the reporting period* in UK and Ireland accounting standards. Like contingent liabilities, depending on their nature, post balance sheet events may just need a disclosure in the notes to the financial statements, or they may require both a disclosure and an adjustment to the figures in the financial statements to reflect the monetary amount effect of the subsequent event.

How the company handles the event arising after the balance sheet date, but before the financial statements are approved, depends on whether the event is classified as an *adjusting event* or a *non-adjusting event*:

» **Adjusting events:** These are events after the reporting period that provide further evidence of conditions that existed at the end of the reporting period. A good example is a customer who goes bankrupt shortly after the balance sheet date. This customer's debt (the debtor) exists in the books at the balance sheet date, but the company isn't going to get paid because the customer has gone bust. The customer going bust will be a culmination of events leading up to the bankruptcy, which confirms that the company had already suffered a loss at its balance sheet date. Therefore, the financial statements are adjusted at the balance sheet date to write the customer's debt off (reducing the value of trade receivables; see Chapter 7) and recognise a bad debt expense in profit or loss. Disclosure notes can be used to explain the event as well.

» **Non-adjusting events:** These are events that arise between the balance sheet date and the date of approval of the financial statements. The difference is that their conditions did *not* exist at the balance sheet date. An example of a non-adjusting event would be a company that has a 31 December 2027 year end and on 10 January 2028, a fire damaged a significant amount of company property. The damaged property will remain at its value before the fire in the 31 December 2027 accounts, but a non-adjusting events disclosure will explain the impact of the fire (with financial consequences if practicable to disclose these).

Material, non-adjusting events must be disclosed as a note to the financial statements even though the financial statements themselves are not adjusted.

Here's a basic example of how a note on an event taking place after the balance sheet date may look:

NOTE 7: NON-ADJUSTING EVENT AFTER THE REPORTING PERIOD

On 1 February 2027, an electrical fault caused a fire which damaged part of the building, including the company warehouse. The insurance company has estimated that the damage caused is in the region of £630,000.

Putting the Onus on the Preparer

Here's the million-dollar question: who's responsible for preparing the notes and disclosures to the financial statements? If you decide to pursue accountancy as your career, are you going to be stuck writing disclosure notes for the rest of your life?

Well, it depends. The answers to these questions take us back to the very purpose of financial accounting, which is the preparation of financial statements for a business. The explanatory notes and disclosures, like the financial statements themselves, are, legally, the responsibility of the company's directors. The directors and the internal accounting staff may prepare the explanatory notes and disclosures using a disclosure checklist. Sometimes, however, if you work in a general accountancy practice, you yourself may prepare the financial statements and associated disclosures for a company.



TIP

Powerful automated accounts production software systems now produce most of the detailed notes required in the financial statements (especially in accountancy practices). However, these systems should not be relied upon to get the job done 100 per cent. The preparer needs to make sure the disclosures are as accurate as possible, and this may need the use of an up-to-date disclosure checklist. In any case, the directors are legally responsible for ensuring the disclosure notes are accurate as well as making sure the financial statements give a true and fair view.

After management prepares the financial statement, explanatory notes and disclosure information, the company may need to engage an independent auditor to evaluate the truth and fairness of the financial statements. The auditor is *independent*, which means they have no special relationship to, or financial interest in, the company (see Chapter 1).



REMEMBER

An auditor must be appropriately qualified, for example, a member of the Association of Chartered Certified Accountants (ACCA) with statutory auditor status, or a member of the Institute of Chartered Accountants in England and Wales (ICAEW), again holding statutory auditor status. However, chartered certified or chartered accountants can perform three major types of financial statement work:

» **Audits:** *Auditing* is the process of investigating information that's prepared by someone else, usually the company's management and the financial accountants the company employs, in order to determine if the information enables the financial statements to give a true and fair view. Auditors performing audits must carry out procedures to ensure the amounts and disclosures in the financial statements are fairly stated, and this is known as gathering *audit evidence*.

An audit provides a reasonable level of *positive assurance*, which means the auditor states that, in their opinion, the financial statements give a true and fair view, are free from material misstatement, whether caused by fraud or error and have been correctly prepared in accordance with GAAP and legislative requirements. An audit does not, however, provide an absolute guarantee that the financial statements contain no mistakes.



REMEMBER

While financial accountants employed by the business prepare the financial statements (including the notes and disclosures), only an independent qualified accountant who's a member of one of the Consultative Committee of Accountancy Bodies (CCAB) with statutory auditor status can sign the auditor's report on them. Check out www.ccab.org.uk for a list of accountancy bodies that are members of the CCAB.

» **Reviews:** When an accountant conducts a *review*, they look at the company's documents and provide *negative assurance* (unlike positive assurance in an audit – see the previous bullet), which means the accountant does not believe that the information prepared by company management isn't correct. For example, the accountant looks over the company's financial statements, noting whether they appear to have been properly prepared. In doing this work, the accountant will ask themselves, do the financial statements contain appropriate explanatory notes and disclosures as required under the Companies Act 2006? Do they conform to UK and Ireland GAAP or UK-adopted IFRS? Reviews are usually performed for privately-owned companies when the users of the financial statements require some sort of assurance about the financial statements' assertions, but don't require a full-blown audit.

» **Compilations:** Accountants can be engaged to prepare financial statements for a company and/or prepare the company's corporation tax return. Here, the accountant is not providing any form of assurance that the financial statements are completely correct – the accountant is merely compiling the financial statements based on information and explanations given to them by the client. This sort of work is usually done for smaller companies, such as those that are exempt from the statutory audit requirement, and the accountant's report that's attached to the accounts will confirm that no audit has been carried out and the financial statements have been prepared based on information and explanations provided by the client, and hence no assurance is provided.

IN THIS CHAPTER

- » Staying private or going public: why annual reports differ among companies
- » Identifying the three purposes of a company's annual report
- » Looking at some common sections in an annual report
- » Sifting through the auditor's report

Chapter **16**

Reporting to Shareholders

Much of this book is devoted to explaining how financial statements, meaning the income statement (profit and loss account), balance sheet (statement of financial position) and statement of cash flows (or cash flow statement) are prepared. But what happens to them after they're done? Do they just get filed away in case anyone asks to see them?

Absolutely not! The financial statements become the heart of a company's annual report to its shareholders. An annual report is a document that the company can share with its current owners, potential investors, creditors, the media . . . it can be an important public relations tool that shows the outside world how the company is doing. For many companies, the annual report is also a regulatory requirement.

In this chapter, I explain the ins and outs of an annual report, including the three key purposes it serves. I also look at a couple of the sections at the 'front end' of the annual report called the *strategic report* and the *directors' report* to explain their purpose and how they are prepared.

I round off this chapter by taking you through some elements of an auditor's report. An *audit* is a rigorous and independent inspection of the financial statements that ends up with the auditor forming an opinion as to whether the financial statements give a true and fair view.

Understanding Why Private and Public Companies Treat Annual Reports Differently

A company's annual report (which may also be called the *annual report to shareholders* or the *annual review*) may look very different depending on whether the company in question is private or public.

The annual report for a *private* company – one whose shares aren't traded on the open market – is usually a bare-bones document that may just give users the mandatory information about how the company performed in the past year. You don't find many bells and whistles in a private company's report. That's because most private companies are at the smaller end of the scale, so they aren't too concerned about how a larger audience will react to the report. On the other hand, a public company's report is often loaded with extra bits of information, such as marketing material designed to tout the company to potential investors and creditors.

Another key difference between the annual reports of private and public companies is that a lot of private companies don't always have their financial statements audited, while public interest and listed companies do. A private company usually has its financial statements audited only if doing so is legally required; for example, having turnover of more than £15 million and gross (fixed plus current) assets of more than £7.5 million means the company cannot claim audit exemption in the UK. As I explain later in this chapter, public companies' financial statements must always be audited in order to fulfil regulatory requirements. What does it mean for the statements to be audited? After the company prepares the financial statements, it engages an independent professionally-qualified auditor to gather sufficient and appropriate evidence to express an opinion on whether the statements give a true and fair view. In other words, they don't contain any material misstatements that can significantly impact the decisions made by the financial statement users.



REMEMBER

Only after a public company's financial statements are audited can they be included in the company's annual report to the shareholders.

In this chapter, I focus on the annual reports that large public companies prepare. That way, you get a picture of what the most elaborate reports look like.

Fulfilling Three Purposes

This section sets out the three distinct goals of the annual report for a public company: to promote the company, to display its financial performance and goals, and to meet regulatory requirements.



TIP

Something to keep in mind: nowadays, large public companies distribute their annual reports electronically. Doing it this way is not only a cost-saver but it demonstrates a company's commitment to using resources wisely as environmental issues become more important for companies, particularly given the Net Zero targets the UK government want to achieve.

Serving a marketing and PR function

Who doesn't like to blow their own trumpet? A substantial portion of an annual report is devoted to bragging about what the company has accomplished during the preceding year and where it expects to go in the forthcoming year. The language can be quite full of hype and excitement. The purpose of this marketing and public relations material is to keep existing shareholders happy about the wisdom of their investment and to attract new shareholders to the fold.

Stating financial performance and goals

Less flashy but of decidedly more interest to serious investors are the sections addressing the company's financial performance in the past year and its financial goals. The information in these sections indicates how closely the company came to hitting projected revenue figures, where the company wants to be in the next 12 months and how it plans to get there. Additionally, the company addresses how it intends to measure its success in achieving these goals.

Here are some examples of financial goals:

- » Increasing revenue by expanding into global markets.
- » Becoming regarded as a premier employer.
- » Managing operations for the greatest effectiveness while striving to become more environmentally friendly.

- » Increasing brand awareness. This phrase is a fancy way of saying the company wants to make sure consumers know about its products. The purpose of brand awareness is also tied to making the company's products preferred over similar ones marketed by the competition.

Meeting regulatory requirements

Most large companies would produce an annual report even if they weren't required to do so by company law. That's because an annual report is such a crucial marketing and PR tool. However, because stringent regulatory requirements for publicly traded companies exist, not issuing an annual report isn't an option.

Companies that issue securities that are traded publicly on the various stock markets have to meet certain deadlines when releasing information about their annual reports. Table 16-1 shows the deadlines for PLUS-quoted companies, Alternative Investment Market-listed companies and fully listed companies.

TABLE 16-1

Financial Statement Deadlines

	Release of Interim Announcement	Release of Preliminary Announcement	Release of Annual Accounts
PLUS-quoted companies	3 months	Optional – but as soon as possible	6 months
AIM-listed companies	3 months	Optional – no deadline	6 months
Fully listed	2 months	Optional – but as soon as possible	4 months

Accounts for all of the companies listed in Table 16-1 must be sent to the Registrar of Companies (Companies House) within six months of the accounting period/year end and shareholders must receive the accounts at least 21 days before the annual general meeting (AGM) to comply with Section 424 of the Companies Act 2006.



WARNING

Substantial penalties exist for both public and private companies that file their accounts late with Companies House! For delays of up to one month, the fine is £750 (£150 for private companies); between one and three months it's £1,500 (£375 for private companies); between three and six months it's £3,000 (£750 for private companies); and for more than six months it's £7,500 – yikes! (£1,500 for private companies). It doesn't stop there, either. Where accounts were also late in the previous year, the penalty doubles!

Reading the Annual Report to Shareholders

This section takes you through the sections that you most often find in a company's annual report. With the exception of the audited financial statements, the sections are put together in an effort to draw the external reader into the inner workings of the business in an attempt to raise the users' comfort with – and confidence level in – the company.



Keep in mind that this section contains just a brief overview of what you may expect to see in an annual report. Especially if a company is very large, it may include a plethora of additional information.

Meeting the chair of the board of directors

Most casual investors in a company have absolutely no idea who or what the chairperson of the board of directors is. While the duties of the chairperson are quite similar from company to company, the individual holding the position is unique to the particular company.

The chairperson of the board of directors is the head honcho who oversees that board (and is usually elected by the other members of it). The board of directors consists of individuals elected by the shareholders to guide the overall philosophy of the business. The guidance as to how all this operates is the UK Corporate Governance Code, a copy of which can be found at www.frc.org.uk.



The day-to-day activities of any business aren't handled by the board of directors; they're handled by company management. *Executive directors* handle the activities of the business, whereas *non-executive directors* don't get involved in the day-to-day running of the company but instead monitor the work of the executive directors and contribute to the company's strategy. However, approving the hiring of upper management personnel, such as the chief financial officer (CFO) and chief executive officer (CEO), is a function of the board of directors.

In the annual report, you meet the chairperson via a letter whose salutation is something like 'Dear Fellow Shareholder'. The letter gives the company's top management team a chance to review for the users all the great accomplishments the company achieved during the last financial year. The letter also outlines the company's goals for the future. It usually ends by thanking the shareholders for their support and offering a firm promise to work tirelessly to continue earning the trust of the shareholders and growing their investment in the company's shares.

Highlighting key financial information

At the beginning of the annual report will usually be the *strategic report*. This is the report where the company provides shareholders with a condensed version of how well the company performed during the last financial year. This condensed information provides a high-level view of what the company perceives as the main points of interest. At the very least, this section contains a summary of operations, details of earnings per share and balance sheet information:

- » **Summary of operations:** This summary shows the company's bottom line net profit. Sometimes this may be presented for more than one year. *Net profit* is the excess of revenue and gains over expenses and losses during a financial period.
- » **Earnings per share (EPS):** This metric shows the distribution of net profit over all company shares that are in issue. Many investors pay close attention to this figure, comparing it to their other investments and to other companies' EPS in the same industry. For example, an investor may compare the EPS of Warrington Wolves Rugby Club to Leigh Leopards Rugby Club to gauge the value of one company's shares over the other.

Three metrics you may see in an annual review are basic EPS, diluted EPS and dividends per share. Here's an example of each:

- **Basic EPS:** To work out basic EPS, take net profit for the financial period and divide it by the weighted average number of ordinary shares issued. The weighted average factors in the fluctuations of shares issued during the entire year instead of just taking shares issued as at 1 January and shares issued as at 31 December and dividing them by two.

If Lucas Lighting PLC has a net profit of £10,000, and the weighted average number of ordinary shares is 21,833, basic EPS is 0.46p (£10,000/21,833).

- **Diluted EPS:** If the company has issued share options or long-term debt that the investor has the option to convert into shares when the debt matures, the company also has to show diluted EPS, which is a complicated calculation. (*Share options* are benefits allowing employees to purchase a certain number of shares in the company at a determined date.)

Diluted EPS calculates earnings per share by estimating how many shares can theoretically exist after all share options and convertible debt have been exercised.

Continuing with the example of Lucas Lighting PLC. If weighted average shares after adding in these extras is 24,989, its diluted EPS is 0.40p (£10,000 divided by 24,989).



EXAMPLE



EXAMPLE

- **Dividends per share:** This calculation is the amount per share paid to investors in dividends. It usually isn't the same amount as EPS, although EPS is one tool the board of directors can use when deciding the dividend to pay to the shareholders. See Chapter 9 for more information about dividends.

» **Balance sheet information:** This section shows selected figures from the balance sheet in which the company believes the shareholders have an interest. For example, the company may show *total assets*, which are all assets (current and long term) that the company owns as at the balance sheet date. The company may also show *long-term debt*, which is any debt the company won't have paid off within 12 months of the balance sheet date.

Figure 16-1 shows an example of this condensed financial data.

	2027	2026	2025
	£'000	£'000	£'000
Summary of operations			
Net operating revenues	100,000	98,000	105,000
Earnings per share:			
Basic	10.58	10.75	13.89
Diluted	7.00	7.25	8.97
Dividends per share	11.75	11.62	11.24
Balance sheet extracts:			
Total assets	16,200	17,180	17,445
Long-term liabilities	5,060	3,782	1,138

FIGURE 16-1:
Selected financial
information.

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REMEMBER

Even though these figures are very condensed (check out Chapter 10 to see a full-blown income statement and Part III to see a fully-developed balance sheet), the figures are based upon – and must reconcile with – the audited financial statements.

Promoting company achievements

In this section of the strategic report, which has a distinct public relations purpose, the company expands upon any facts the chairperson of the board discusses in his letter to the shareholders. For example, this section may break down how the company has increased growth *per capita*, which is the average per person living in an area the company serves. Per capita growth can mean that the company sold more products to existing consumers or expanded its sales base into new markets or countries. Companies want to emphasise that they're attracting new customers while still maintaining a bond with existing customers.



CALCULATING WEIGHTED AVERAGE

Say that on 1 January 2027, Breary Bricks PLC has 10,000 shares in issue. On 1 July 2027, it issues another 7,000 shares. You need to calculate the weighted average number of shares in issue during the year to 31 December 2027.

Date	No. of months	No. of shares in issue	Time fraction	No. of shares in issue × the time fraction
1.1.27 to 30.6.27	6	10,000	6/12	5,000
1.7.27 to 31.12.27	6	17,000	6/12	<u>8,500</u>
				13,500

So Breary Bricks PLC had a weighted average number of 13,500 shares in issue from 1 January 2027 to 31 December 2027.

Looking into the future

In its annual report, a company also addresses where it sees itself in the short- and long-term future. Doing so addresses any concerns that an investor may have that the business is a *going concern*: that it will be able to stay in business for at least 12 months beyond the date the financial statements are approved, generating or raising enough cash to pay its operating expenses and make appropriate payments on debt.



If the company's management decides that the company will *not* be able to stay in business for at least 12 months beyond the date the financial statements are approved, they cannot prepare the financial statements on a going concern basis. Instead, they'll prepare them on a basis other than the going concern basis. Among other things, this includes writing the company's assets (see Chapter 7) down to estimated selling price and making provisions (see Chapter 8) for any contracts that have become onerous at the balance sheet date. A contract becomes *onerous* when the company must continue to make payments under that contract to comply with its terms, but receives no benefit in return for those payments. Investors aren't going to get all fired up about their ownership in the company's shares if they believe the company will be around for only a few more years. Therefore, annual reports normally give a plan on growth for a longer period of time.

Getting to know key management and board members

This section of the annual report introduces other members of the board of directors, the management team for each division of the company and committee members (such as members of the audit committee). It's not uncommon for the company to include pictures of all of them posed at the company headquarters.

Making Sense of Other Sections in the Annual Report

When you look at a company's strategic report and directors' report, you see all sorts of bits and bobs from commentary about the company's financial performance, how the directors have fulfilled their duty to promote the success of the business (known as a *Section 172 Statement*), details about Streamlined Energy and Carbon Reporting to info about where management want the company to be in the future. Some of these details are required to be included in the strategic report and directors' report by company law; other details are included because the company's management team wants them in for public relations purposes. Here are some of the more common types of disclosures you see in a directors' report:

- » **Statement of directors' responsibilities:** This statement outlines the company directors' obligations in the preparation of the company's financial statements. These responsibilities include, among other things, preparing the financial statements in accordance with UK and Ireland generally accepted accounting practice (GAAP); selecting suitable accounting policies and applying them consistently; making judgements and accounting estimates that are reasonable and prudent; stating whether UK and Ireland accounting standards have been followed, subject to any material departures disclosed and explained in the financial statements; and preparing the financial statements on the going concern basis unless it's inappropriate to presume the company will continue in business.
- » **Statement of disclosure to auditors:** This statement confirms that the directors are not aware of any relevant audit information needed by the auditors of which the auditors are not aware. It also confirms that the directors have taken all necessary steps to make themselves aware of any relevant audit information and to establish that the company's auditors are aware of that information.

- » **Principal activities and review of the business:** This disclosure outlines the day-to-day activities of the business (that is, what it does) and gives an overview of the financial results for the accounting period.
- » **Principal risks and uncertainties:** In the annual report, the company must outline principal risks and uncertainties and explain to the user how the company manages them. For example, it may be that it conducts a lot of business overseas and acknowledges that foreign currency fluctuations pose a key risk to the company. The directors must outline these risks and what the company does to mitigate them. This information reassures the shareholders that the company has processes in place to manage those external risks that it can't control.
- » **Future developments:** The company should disclose where the company's directors want the company to be in the future, details of planned expansions, and information about any projects that the company is currently undertaking that are expected to be finished or projects that the company is planning on undertaking.
- » **Events that have happened after the year end:** The company should disclose any material *events after the balance sheet date* (sometimes called *post-balance sheet events* or *subsequent events*). These are events that have occurred in the succeeding financial year that are considered to be significant (such as the acquisition or disposal of a subsidiary).

Checking through the strategic report

The strategic report is always found at the front end of the annual report – it's one of the first reports you'll often see before you get to the financial statements themselves. This report provides a comprehensive overview of the company's financial performance, financial position, key performance indicators (such as total revenue for the year, measures of profit and net assets). It may also include non-financial key performance indicators (such as customer retention rates) and the company's future prospects.



REMEMBER

The primary objective of the strategic report is to provide information for shareholders to help them determine how the directors have promoted the success of the business. This not only includes the interests of the shareholders (which is clearly very important), but it must also consider the interests of other stakeholders which have an impact on the long-term success of the business. Examples of other such stakeholders include employees, suppliers and the bank. Hence, the strategic report must always provide a balanced and informed picture about the

company. So, you can expect to see information about what's gone fantastically well for the business during the year, and what's proved to be a challenge, or not gone as well as planned.



WARNING

There is certain information that absolutely must be included in the strategic report because the law says so. For example, a fair review of the business and principal risks and uncertainties that the business faces. Large companies are required to include other specific information in the strategic report such as a description of the business model and information on environmental matters.

The strategic report for public companies (including listed companies) is usually very long because it covers a variety of issues. A strategic report for a medium-sized private company will not be as lengthy or detailed but will contain certain minimal information such as a fair review of the business and future developments for the company.

Looking at the report of the auditors

Auditing is the process of systemically gathering a sufficient and appropriate amount of evidence to support the amounts and disclosures in the financial statements. The results of an audit are communicated to the company's shareholders in an auditor's report, which is included in the annual report. The auditor's report is always included near the financial statements.

The objective of a financial statement audit is for the auditor to form an opinion as to whether the financial statements give a true and fair view. Auditors aren't responsible for preparing the financial statements they're auditing. In fact, they *can't* prepare them for public interest or listed companies; to do so would violate the concept of independence (see Chapter 1).

The preparation of the financial statements is always management's responsibility and will always contain *management assertions* – management's assurance that the information provided is materially correct.



TECHNICAL
STUFF

While management assertions must be included in the financial statements using GAAP, auditors conduct their audits using International Standards on Auditing (UK), also known as ISAs (UK). In the UK, the Financial Reporting Council – which will eventually be known as the *Audit, Reporting and Governance Authority* (see Chapter 4) – takes the auditing standards issued internationally by the International Auditing and Assurance Standards Board and then tweaks them so they are UK-specific. These are often called the *ISA Plusses* because they initially started as ISAs and bits have been added in to cater for UK law and regulation hence the 'Plusses' which is represented by the '(UK)' reference in ISAs (UK).

After conducting the audit of the financial statements, the auditor can express one of four basic options:

- » **Unmodified:** An unmodified (sometimes referred to as an *unqualified* opinion) is the best the client can get! It means the financial statements give a true and fair view and have been properly prepared in all material respects. But it's not a guarantee that the financial statements are bang on to the penny and 100 per cent correct. I'll explain why shortly.
- » **Qualified 'except for':** An auditor may have to express a qualified 'except for' opinion when the company doesn't use GAAP consistently, or circumstances may have prevented the auditor from getting enough evidence to be able to issue an unqualified opinion. When the end user (a potential investor, for example) sees this opinion, they know they can't rely on the information in the financial report as much as they can if the auditor expressed an unmodified opinion. 'Except for' refers to the fact that the matter giving rise to the qualified opinion is isolated to a certain aspect of the financial statements, hence 'except for' the issue, the financial statements otherwise give a true and fair view. It's not a good opinion to get, but it's the lesser of the other two evils.
- » **Adverse:** As you can probably guess, an adverse opinion isn't good! The auditor issues an *adverse* opinion if, in their view, the financial statements don't present the client's financial position, results of operations and cash flows in conformity with GAAP and the auditor concludes the financial statements do not give a true and fair view. This type of opinion is issued only when the financial statements contain material and pervasive misstatements or omissions that the client either cannot or will not remedy. (In Chapter 4, I explain what constitutes an accounting fact being material. For now, just keep in mind that what's material for one business may not be material for another.)
- » **Disclaimer of opinion:** This happens when the auditor can't form an opinion on a client's financial statements. For example, a disclaimer may be expressed where the accounting records have been destroyed and the auditor can't gather sufficient and appropriate audit evidence.



REMEMBER

When the auditor expresses an unmodified opinion, they are not providing absolute assurance that the financial statements are 100 per cent correct. Auditors cannot do that because of the way in which they conduct their work. What they are saying, however, is that they have obtained *reasonable assurance* that the financial statements are free from material misstatement, whether caused by fraud or error, and that the financial statements have been properly prepared in accordance with law and other regulation.

6

Tackling More Advanced Financial Accounting Topics

IN THIS PART . . .

Come to grips with how and when a company recognises revenue in the profit and loss account.

Understand the way in which a company's tax on its profit or loss is calculated and why taxable and accounting profit are usually different.

Examine accounting for leasing transactions and find out which leases must go on-balance sheet and which may not need to.

Understand when a company may change its accounting policies for certain transactions and how to action those changes in the accounts.

IN THIS CHAPTER

- » Looking at the five steps involved in revenue recognition
- » Segmenting different revenue streams
- » Discovering the agent versus principal relationship
- » Getting the disclosures right
- » Splitting revenue in the right way

Chapter 17

Accounting for Revenue

This chapter looks at one of the most crucial aspects of a business – revenue. Revenue is also commonly referred to as ‘turnover’ or ‘sales’. Whichever description you attribute to revenue, a business simply cannot survive without it. It’s the main generator of cash, and as the old saying goes, cash is king. If a business does not have adequate cash flow running through it, danger signs start to appear.

You may think that accounting for sales is straightforward. In some businesses, it can be, but for many, there’s a whole host of things to consider. In this chapter, you’ll come across the five-step model, which has been introduced into UK and Ireland accounting standards (FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime* – see Chapter 4). However, it’s been a key feature in international accounting standards for a few years now, and some businesses have been applying the five-step model since 2018.

New concepts and principles invariably bring new disclosure requirements, so I also outline what companies reporting under UK and Ireland Generally Accepted Accounting Practice (GAAP) need to think about when it comes to the various disclosures.

Explaining the Importance of Revenue

All trading businesses will need to generate some form of revenue to survive. Revenue is also a key metric that is looked at by many *users* (interested parties or stakeholders) of a company's financial statements. It's the top line figure in the accounts and provides the basic premise for understanding a company's financial performance.



REMEMBER

It's not always just about the numbers. While it's true that revenue is a key to understanding the entity's ability to generate sales, it's also a way of measuring the company's success in attracting and retaining customers and generating sales. In many companies, it's also a way of determining how successful a company's sales and marketing strategy is. This can then help management to make key decisions about the business – for example, whether prices need to change, product development, whether to discontinue a product line or whether the company needs to change direction.

Revenue is also the starting point for calculating net profit (or net loss, as the case may be). The income statement starts with revenue and then deducts from revenue all the direct costs (cost of sales) and overhead expenses the business incurs. This arrives at *net profit*.



TECHNICAL
STUFF

When you look at some annual reports produced by businesses, you'll find that there's often a lot of commentary at the front end of the report before the income statement and balance sheet. This commentary is usually in the form of the company's *Strategic Report* or *Directors' Report*, which tells a story about the financial performance and financial position of the business during the year and about future developments. I look at some of these reports in Chapter 15. One of the key performance indicators that you'll often see in this commentary is the amount of revenue that has been generated during the year/period.



REMEMBER

Before I get into the nitty-gritty of revenue recognition, it's important to understand these key terms:

- » **Income:** FRS 102 has quite a technical definition of income but for the purposes of statutory accounts, income is the net profit earned by a business after it's paid out everything in expenses and taxation. So, it's a bit like what you have left in your personal bank account once you deduct all your outgoings from your incomings.
- » **Revenue:** This is the amount of money a company brings in purely from selling goods and/or rendering services. In other words, it's the gross amount of money (excluding Value Added Tax or VAT) the company receives before any deductions for cost of sales and other expenses.

As you can see, it's very important to be able to distinguish between 'income' and 'revenue' because while the two terms may seem to mean the same thing, in financial accounting, they don't.

Looking at Revenue Recognition in Detail

Over the years, there have been plenty of scandals that sent shockwaves through the business community. Not all of them involved revenue, but they have involved questionable accounting treatments, which have then led to the regulator (the Financial Reporting Council or FRC, which will become the Audit, Reporting and Governance Authority at some stage in the future) to investigate these treatments.



WARNING

Revenue is a very easy figure to manipulate and one of the motivators that incentivise a company's management to manipulate this figure is twofold:

- » **Management may want to pay less tax.** A way to do this is to artificially suppress the revenue figure. Less revenue will mean less profit before tax which means less tax. In this situation, management will want to delay recognising revenue.
- » **Management may want to present the company in a much better position than it really is.** A way to do this is to make the company's profit higher than it is. In this situation, management will want to accelerate recognising revenue.

Of course, there are other ways in which management can manipulate the accounts to achieve an outcome they want; but revenue can be an easy target for unscrupulous management and this is why auditors (those who inspect the accounts with a fine toothcomb to make sure they give a true and fair view) need to have their wits about them when looking at revenue recognition.



WARNING

Most companies try to get things as right as possible. However, mistakes do sometimes happen. To try to reduce the scope for error and fraud, there are detailed accounting requirements for revenue. These accounting rules can be found in:

- » **IFRS 15:** *Revenue from Contracts with Customers* (this standard only applies to companies preparing accounts under UK-adopted IFRS)
- » **FRS 102, Section 23:** *Revenue from Contracts with Customers*
- » **FRS 105, Section 18:** *Revenue from Contracts with Customers*

All three of these set out various conditions that must be met before a company can recognise revenue. If all the relevant conditions are not met, revenue cannot be recognised. FRS 102, FRS 105 and UK-adopted IFRS Accounting Standards are examined in more detail in Chapter 4.



REMEMBER

Accounting standards dealing with revenue recognition have a clear objective in mind. They require companies to recognise an appropriate amount of revenue at an appropriate time. In other words, no more and no less; and no sooner and no later. If you comply with the relevant accounting standard, you can sleep soundly at night knowing the company can justify the amount of revenue it's recognised.

THE TESCO SCANDAL

Back in 2014, the supermarket chain, Tesco, was involved in an accounting scandal that gave rise to the supermarket overstating its profits by approximately £250 million.

The bombshell hit the headlines in September 2018 when the company admitted that issues in previous years meant that it was likely to have overstated profits by some £250 million. In one single day, the announcement wiped £2 billion from the share price of the supermarket. It transpired that a whistleblower in Tesco Stores Ltd's finance department filed a report with the supermarket's legal team because they were concerned about the company inflating commercial income to meet the division's financial targets.

And if Tesco's management thought that was bad news, it was later confirmed that the overstated profits needed to be revised upwards to £326 million! These are staggering amounts. However, they happened over more than one year, so the effects in single years wouldn't have been felt as much as the final numbers that were published were, especially considering the size of the supermarket chain and what its numbers looked like.

The scandal surrounded the way in which certain types of revenue were recognised in the accounts. Some revenue that arose from a deal the supermarket made with suppliers was recognised too early (meaning revenue recognition was accelerated).

The supermarket paid £129 million under a *Deferred Prosecution Agreement* (DPA), which is an agreement that enables a prosecution to be suspended for a certain period if specific conditions are met. The Serious Fraud Office also brought charges of fraud against three of the supermarket's former executive directors. All three directors were eventually acquitted despite the supermarket entering into a DPA. Even after the acquittal, the Serious Fraud Office stated that Tesco's UK business had, in 2014, created a false account of its financial position by overstating its profits and the supermarket accepted this responsibility by entering into the DPA.

Understanding the Five-Step Model

So, let's get to the nitty-gritty of recognising revenue. A company can only recognise revenue when it has gone through all five steps of the comprehensive five-step model approach. I'm going to look at each step and provide you with a basic overview of what each step requires the company to do. In real life, once the company can tick off each step, it can recognise revenue.

The five steps that a business must go through before revenue is recognised are detailed in this section, step by step.



WARNING

Unless all five steps above have been successfully completed, a business will not be able to recognise revenue. Any income it receives from a customer prior to being able to recognise a sale will be recognised as a liability (see Chapter 8) like this:

Debit:	Bank account (or trade receivables if the transaction is on credit)
Credit:	Deferred income (presented as a current liability in the balance sheet)

This reflects the fact that the business still has some performance obligations to complete before it can eventually tick all five steps off and then transfer the money from deferred income into revenue in the income statement.

Step 1: Identify the contract(s) with a customer

The first thing a business must do is to identify any contracts with a customer that fall within the scope of the five-step model. To do this, all five of the following criteria must be met:

- » The parties to the contract have approved the contract and are committed to carrying out their obligations under the contract.
- » The business can identify each party's rights regarding the goods or services to be transferred.
- » The business can identify the payment terms.
- » The contract has commercial substance (meaning economic reality).
- » It is probable (which means more likely than not) that the customer will be able to pay and has the intention to pay when payment is due.



EXAMPLE

The principal activity of an IT services provider is to provide support and repair services via the internet and on-site, if required. It entered into a verbal contract with a new customer to clean up some redundant files and scan the server for viruses. The price to perform this work was agreed with a sales consultant by telephone. Payment was taken by debit card at the end of the phone call.

The services will be performed at an agreed date when the IT services provider will log in to the customer's server and carry out the work.

This is a verbal contract. A contract doesn't need to be in writing for it to be enforceable. The customer has provided payment details and has paid for the services to be provided. The IT services provider is committed to performing the work on the customer's server.

In this situation, the contract is within scope of the five-step model.

Now, we move to Step 2.

Step 2: Identify the performance obligations in the contract



REMEMBER

A *performance obligation* is a promise in a contract with a customer to transfer goods and/or services.

Many sales contracts will only have one performance obligation (meaning the business simply has to ship goods to the customer when the contract is agreed and payment may be within a specified credit period, such as 30 days from the date of the invoice).

However, some contracts have more than one performance obligation. For example, if you've bought a new car from a dealership, there may be two performance obligations in one contract between you and the dealership:

- » You receive the car of your dreams in exchange for payment.
- » The dealership will provide one year's free servicing and maintenance.

These performance obligations must be separately identified to enable the business to proceed to the next step in the five-step model.



EXAMPLE

A bookkeeping software developer enters into a three-year contract with its customer to provide a licence to access the bookkeeping software. The contract stipulates that the developer will provide periodic software updates and technical support throughout the duration of the contract.

The bookkeeping software is delivered prior to installation, updates and technical support and is functional without the updates and/or technical support. This means the customer benefits from each good or service individually. The developer has also determined that the licence, installation, updates and technical support are separately identifiable.

In this scenario, there are four performance obligations in the contract:

- » The licence to supply bookkeeping software
- » The installation service
- » Updates to the software
- » Technical support

Now, we move to Step 3.

Step 3: Determine the transaction price

The *transaction price* is the value that will be recognised in the income statement as revenue. It is the amount of money the business expects to receive in exchange for transferring goods or services that are promised in a contract.



REMEMBER

Any amounts collected on behalf of third parties, such as HM Revenue and Customs for VAT must be excluded. A business does not recognise these amounts in revenue; they are recognised as a liability (see Chapter 8) until they are paid over to the third party.

When determining the selling price, the business must also consider *variable consideration*. Variable consideration is what it says on the tin – consideration that may go up or down in value.

For example, at a retailer of electronic goods such as TVs, computers and audio equipment, sometimes a customer will buy a product but then return it for whatever reason. If a product is sold with a right to return, the consideration is said to be *variable*. Any refunds the business expects to make are recognised as a liability (see Chapter 8) to reflect the amount that the business does not expect to be entitled to.

The business must estimate the variable consideration that is to be included in the selling price and update that estimate at the end of each reporting period.



EXAMPLE

Lenny Industries Ltd enters into 30 contracts to supply products to various customers. Each contract includes the sale of one type of product with a selling price of £1,200. The cost to Lenny of this product is £700. Customers can return the products within 30 days for a full credit. The financial accountant can reliably

estimate the return rate for this type of chemical based on past history. On this basis, the financial accountant has estimated that 26 products will not be returned. This means that four will be returned. As the customers can return the products, the consideration is variable.

Here are the steps to deal with this variable consideration:

- 1. Calculate the estimated variable consideration.** The estimated variable consideration is £31,200 (26 products × £1,200 selling price).
- 2. Calculate the refund liability to be recognised.** Lenny Industries expects four products to be returned. Therefore, the refund liability is £4,800 (4 products × £1,200 selling price).
- 3. Calculate the company's right to recover products.** The products it has sold will be deducted from inventory (see Chapter 7) because they have been transferred to customers.

Lenny will also recognise a refund asset (see Chapter 7) to represent its right to recover four products from customers on settling the refund liability (see the final bullet of the preceding steps). The value of the refund asset is £2,800 (4 products returned × £700 cost price). The corresponding credit entry will be recorded in cost of sales.

Now, we move to Step 4.

SPECIFIC CONSIDERATIONS

It is impossible for any regulator to develop accounting standards that cover every single business transaction. To do so would be a virtually endless task. However, in developing the five-step model in FRS 102, the FRC (which will eventually become the Audit, Reporting and Governance Authority) has included detailed requirements for certain types of variable consideration.

There are specific requirements for sales- or usage-based royalties; refunds; and sales with a right of return. Remember the analogy I mentioned earlier about a retailer of electronic goods that customers can return? Well FRS 102, Section 23 now deals with those situations.

In addition, there are detailed requirements for specific situations that can affect the selling price, such as the time value of money especially when payment is expected after more than one year, non-cash consideration and cash or non-cash consideration payable by the business to a customer.

Step 4: Allocate the transaction price to the performance obligations in the contract

This step requires the business to allocate the selling price to each performance obligation on a relative standalone selling price basis (unless discounts or other variable amounts are allocated on an alternative basis).

So, if a customer is offered a discount for purchasing a bundle of goods and/or services, the discount is allocated across all the performance obligations within the contract in proportion to their standalone selling prices. The exception to this rule would be where there is evidence that doing this would be inaccurate.



REMEMBER

A *standalone selling price* is the price that a business would sell a good or service separately to a customer.



EXAMPLE

Doug Industries enters into a five-year contract with Bert Enterprises to provide a data management system in exchange for a contract price of £120,000. The contract states that Doug Industries will provide the software licences, installation services, software updates and ongoing technical support for the term of the contract. Each element of the contract has a standalone selling price as follows:

	£'000
Software licences	50
Installation service	20
Software updates	35
Technical support	45
	150

The selling price of £120,000 is allocated across the four performance obligations as follows:

		£'000
Software licences	$120 \times 50/150$	40
Installation service	$120 \times 20/150$	16
Software updates	$120 \times 35/150$	28
Technical support	$120 \times 45/150$	36
		120

Now, we move to Step 5.

Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

And so, we arrive at the final step in the five-step model approach – recognising the revenue! A business may recognise revenue at a *point in time* or *over time*.

Where the business recognises revenue at a point in time, this will be when all four steps above have been achieved.

If the business recognises revenue over time, things get a bit tricky. FRS 102 tells us that the business satisfies a performance obligation over time if any of the following criteria are met:

- » The customer simultaneously receives and consumes the benefits provided by the organisation's performance as it performs.
- » The organisation's performance creates or enhances an asset which the customer controls as the asset is created or enhanced.
- » The organisation's performance doesn't create an asset with alternative use to the organisation and the organisation has an enforceable right to payment for all performance completed to date.



EXAMPLE

Fred's Phones is an independent mobile phone retailer. Stefan decides to enter into a two-year contract with Fred's Phones paying £50 a month and receives a 'free' handset worth £600. Similar contracts with other providers are charged at around £45 per month (or £1,080 over two years).

The total sales price for Stefan's contract is £1,200 (£50 per month × 24 months). Fred's Phones will allocate the sale to Stefan as follows:

		£
Handset	$\text{£}1,200 \times \text{£}600 / (\text{£}600 + \text{£}1,080)$	429
Service	$\text{£}1,200 \times \text{£}1,080 / (\text{£}600 + \text{£}1,080)$	771
		1,200

Fred's Phones will recognise the sale in respect of the handset when Stefan takes it out of the store (this is a sale recognised at a point in time). The revenue for the service will be recognised over the two-year contract (this is a sale recognised over time).

Putting Things Right When They go Wrong

We all make mistakes – it's a fact of life and sometimes mistakes can happen when it comes to recognising revenue. If it's an honest mistake, it can be corrected; but if it's an intentional misstatement, then trouble can be on the horizon.

When a business makes a mistake on an invoice, it will usually issue a *credit note*. This is a document that reduces the value of a sale. It can be a mistake on the invoice that has meant a credit note is needed, or it can be that the customer has returned goods. So, credit notes aren't always down to mistakes – they can be issued because some goods are just no longer needed by the customer so they are returned.

When a credit note is issued, it reduces the value of revenue in the income statement. So, the figure you see in the accounts for revenue is the net of all sales invoices raised less all credit notes issued.



The business can also provide a discount to the customer. This can be done at the company's discretion to apologise for making a mistake. Or it can be that the customer has bought lots of goods in bulk and the company has given the customer a discount for the large sale. When discounts or rebates are provided by the business, they, too, are netted off the revenue figure.

Exploring the Agent versus Principal Relationship

Agent versus principal, eh? This sounds like something you would read in a court transcript, but thankfully this issue doesn't relate to legal proceedings.

Some businesses use another party to provide goods and/or services to a customer. When this arrangement is in place, the business must determine whether it is acting as a *principal* or *agent*, and this requires a bit of thought:

- » If the business is acting as *principal*, it controls the goods/service prior to it being transferred to the customer. In such cases, the revenue that the business recognises is the *gross* consideration for the sale.
- » If the business is acting as *agent*, the business arranges for the other party to provide the goods or service. In such cases, the revenue that the business recognises is only the *fee* or *commission* agreed with the principal.



REMEMBER

The fee or commission that has been agreed can be the net consideration, which the business keeps after paying the other party the consideration received in exchange for the goods or service.

FRS 102 provides some indicators that an entity is a principal and controls the goods/services before it is provided to the customer as follows:

- » The entity is responsible for fulfilling the contract, such as meeting customer specifications.
- » The entity has *inventory risk* (the risk that the goods may become obsolete or the risk of return of the goods by the customer).
- » The entity has discretion in establishing prices for the good/service.



EXAMPLE

On 10 March, Ashton Ltd entered into a contract with Bamber Ltd to sell a metal cutting machine with unique specifications. Ashton and Bamber agree on the specification and enter into a contract with Breary Ltd, who will manufacture the machine. Breary will deliver the equipment to Bamber when it is completed.

Ashton agrees to pay Breary £120,000 when the machine is delivered to Bamber. Ashton and Bamber agree to a selling price of £150,000 that Bamber will pay to Ashton. Ashton's profit is £30,000. The contract between Ashton and Bamber states that Ashton must be liable for any corrections due to errors in the specification.

In this scenario, Ashton is acting as *principal* based on the following:

- » Ashton is responsible for fulfilling the contract because it must ensure that the machine meets certain specifications.
- » Ashton has inventory risk because it is responsible for correcting any defects in the specification (even though the manufacturer, Breary, has inventory risk during production).
- » Ashton has discretion in establishing the selling price.

Getting the Disclosures Right for Revenue

We'll start with the easy bit first when it comes to disclosures (see also Chapter 15 on disclosures). Micro-entities preparing their accounts under FRS 105 don't need to make any specific disclosures in the notes to the accounts. This doesn't mean that micro-entities are not allowed to make any disclosures; if the directors want

to make certain disclosures, they can do so, but they must refer to FRS 102, Section 1A *Small Entities*, which relates to that information.

Now, for businesses preparing accounts under FRS 102, there's a whole host of disclosure requirements. I can't go into every single one because there's a lot of them and you'll find them in FRS 102 at paragraphs 23.131 to 23.139.



TIP

Because the disclosure requirements for revenue are so vast, it's always worthwhile having an up-to-date disclosure checklist to hand. These checklists are very useful in making sure that you include the correct disclosures so that the accounts don't become misleading.

Small companies (described in Chapter 4) can use FRS 102, Section 1A (Section 1A is optional). Section 1A has a simpler disclosure regime but does require the following disclosures to be included for small entities in the UK:

- » A description of when the business typically satisfies its performance obligations, such as when the company has dispatched goods to customers.
- » A description of significant payment terms such as when payment is typically due and if any consideration is variable.
- » A description of the nature of the goods and/or services which the business has promised to transfer to its customers, including any promises to transfer goods or services to a third party.

Disclosing Accounting Policies for Revenue

I go into more detail about accounting policies in Chapter 20. However, it's important that the user of the accounts has sufficient information to understand enough about the business to make reasoned decisions. The user won't necessarily know all the ins and outs about the business, but the accounts will need to provide them with some information.

The business must disclose sufficient information in the accounting policies section of the financial statements about the reported revenue figure in the accounts.



REMEMBER

The accounting policies section of the notes to the accounts describes the way in which the business deals with certain transactions, events and conditions. In other words, they 'tell the story' of how the material (meaning, significant) amounts you see in the accounts were calculated.

If you've looked at a set of accounts for, say, a large multinational business, you'll have seen that the accounting policies section is usually very long. Smaller businesses tend not to go into anywhere near the same amount of detail as a large multinational.

Clear and concise accounting policies are needed for revenue. Why? Well, don't forget that revenue is usually the biggest number in the financial statements and so deserves the attention that it requires.



TIP

Keep in mind that the accounting policy which the business discloses in respect of revenue is in addition to any other disclosures required by company law or accounting standards. In other words, the accounting policy is not the be-all and end-all of the disclosures. You are likely to find details about the company's revenue cropping up in a number of areas when you read the notes to the accounts (see the next section).



TIP

If you're involved in preparing the accounts for a business, it's always worthwhile looking at the accounting policy for revenue and asking yourself, "Does this tell me everything I would want to know about how revenue is recognised if I weren't involved in this business?"

Now, getting the accounting policy wording right is a fine art, and there is no one-size-fits-all when it comes to what wording to use. Typically, you'd expect to see the following in the accounting policy for revenue:

- » The point at which revenue is recognised (for example, on dispatch of the goods or when the customer receives the goods).
- » How revenue is measured (for example, at the fair value of consideration received or receivable).
- » A description of any revenue that has been deferred (that is, recognised as a liability).



WARNING

The three suggestions I've listed are not exhaustive. It's very important to ensure the revenue accounting policy is specific to the business.

If the business has several revenue streams, you may need to provide an accounting policy for each significant stream.



REMEMBER

This is all about making sure the user has sufficient information to make decisions about the business. Accounting policies need not be *War and Peace* disclosures; but conversely, they should not be sparse or watered down.

Splitting Revenue in the Notes to the Accounts

I mentioned in the last section about information concerning revenue cropping up in several places in the financial statements. That's because revenue is such an important number and a key metric that there's often more than one piece of information about it in the accounts.

Many businesses will sell more than one product line or provide a range of services. Some businesses may even sell goods and/or render services worldwide.

FRS 102 and UK-adopted IFRS 15 require a business to split revenue into certain categories. This is so that the user can see how a company's revenue *and* cash flows are affected by economic factors.



TIP

Some flexibility is given by accounting standards as to how this disaggregation should be presented. Some companies present a geographical split of their revenue; others present the split by product line. Typically, appropriate categories may be:

- » Type of goods or service
- » Geographical market such as country or region
- » Market or type of customer
- » Timing of transfer of goods or services (such as goods or services provided at a point in time and goods or services provided over time)
- » Revenue earned as principal or agent

Whichever category the business decides to use, it should make sure that it continues to use that same category from one reporting period to the next.

- » Understanding why accounting profit and taxable profit may differ
- » Recognising deferred tax assets for an accounting loss
- » Seeing how the balance sheet is affected by timing differences

Chapter 18

Accounting for Taxes

As you read this chapter, you may shudder at the mere thought of the last time you prepared and filed your own individual tax return. The fact is that there's no getting away from tax, and the reality is that income taxes are a fact of life. Depending on your employment status, you may pay tax directly through your payroll via pay as you earn (PAYE) or, if you have any additional income, or are self-employed, you may have to pay tax via the self-assessment regime (which means you have to fill in a tax return each year or engage an accountant to do it for you).

Most businesses must pay taxes, too. I say *most* because not all businesses pay tax on their profits. For example, a *partnership* files a partnership tax return, but that's for information only. That business (the partnership) will prepare a tax return comprising its income and expenditure, which then results in a profit (or a loss). The individual partners will then pay tax on their share of the profit – the partnership itself does not pay tax. The same can be said for more complex partnerships, such as Limited Liability Partnerships (or *LLPs* as they're often called).

While preparing tax returns may not always be in the job description of a financial accountant, knowing how to account for the various taxes a business has to deal with is. Financial information (for financial statements) is prepared according to generally accepted accounting practice (GAAP – see Chapter 4), whereas financial information prepared for tax returns will take account of tax rules. Certain revenue and expenses are treated differently under accounting rules and tax rules, which can result in differences. This chapter shows why the differences exist and why they're classed as either *temporary* or *permanent* differences.

In addition, this chapter reveals how to account for deferred tax, which directly relates to timing differences. I also cover the issue of *temporary differences* that will also give rise to deferred tax when a business prepares its financial statements under UK-adopted International Financial Reporting Standards (UK-adopted IFRS Accounting Standards). I also discuss taxable losses, which can serve to reduce taxable profit in previous or subsequent years.



REMEMBER

The amount of tax that a business pays is based on *profit*, which must not be confused with *revenue*. Revenue in the context of financial accounting is sales or turnover and I discuss the type of profit that is used to calculate tax in the next section.



TIP

For the purposes of this chapter, I keep things simple and only stick to tax relating to companies. Any additional tax issues are best left to the tax people or your tax studies.

Understanding the Difference Between Accounting Profit and Taxable Profit

A company's accounting profit that you see in the financial statements (its *profit before tax*) often differs from the profit the business pays tax on (its *taxable profit* or *profit chargeable to corporation tax*). That's because some items that are included in the financial statements of a company that make up profit or loss are often not allowable for the purposes of arriving at *taxable* profit or loss. These differences primarily arise because accounting standards may say one thing, whilst tax legislation may dictate another. Consider the following two sets of users:

- » **Accounting standards:** As a financial accountant preparing or reviewing financial statements for a business, you follow the standards set by regulatory bodies such as the Financial Reporting Council (or the Audit, Reporting and Governance Authority as they'll eventually be called, explained in Chapter 4). A tax accountant, on the other hand, follows tax legislation issued by the government and applied by HM Revenue and Customs (HMRC).
- » **Users:** As I note in many chapters in this book, the users of a company's financial statements are usually individuals and businesses. They may be considering whether to invest in or lend money to the company. The users of a corporation tax return, on the other hand, are usually governmental entities such as HMRC.

Figuring out accounting profit

A business reports accounting profit on its income statement (sometimes known as the *profit and loss account*; see Chapter 10). The income statement has different sections, starting with revenue/turnover and ending with net profit (or loss, as the case may be). The relevant section of the income statement for this chapter is the part fairly close to the end of the income statement, 'profit before tax'. This section is also known as 'pre-tax profit'.



REMEMBER

Profit before tax reflects the final result of subtracting all business-related expenses and losses from all business-related revenues and gains. You determine this type of profit before tax by following GAAP. Figure 18-1 shows a portion of a company's income statement revealing that it had a profit before tax of £10,000.

FIGURE 18-1:
Profit before and
after tax extract.

	£
Profit before tax	10,000
Tax on profit	<u>(1,900)</u>
Profit for the financial year	<u>8,100</u>

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Before you can arrive at the final total for the company's net profit or loss (known as *post-tax profit* or *profit after tax*), you must reduce profit before tax by subtracting a provision for the corporation tax the company will pay when it files its corporation tax return (known as *form CT600*). In Figure 18-1, I assume a tax rate of 19 per cent (as that is the UK corporation tax rate that's currently in force for smaller companies that make taxable profits of less than £50,000), so the company's provision for income taxes line equals £1,900. The amount of corporation tax due to HMRC is worked out by preparing a separate schedule on file known as the *corporation tax computation* (commonly referred to as the *tax comp*). The tax comp takes profit before tax as reported in the company's income statement and adjusts it by adding back items in the financial statements that aren't allowable for tax purposes (usually depreciation and customer entertaining). The tax accountant will then grant allowances or other tax reliefs that are allowable for tax purposes that aren't in the financial statements (such as capital allowances). This arrives at a taxable profit figure on which tax is then worked out using the relevant rate.



REMEMBER

The corporation tax year runs from 1 April to 31 March each year (unlike the personal tax year, which runs from 6 April to 5 April). The Chancellor of the Exchequer announces applicable tax rates in the Budget. Sometimes tax rates may change; other times they don't.

Taking a look at taxable profit

The starting point for any tax comp is the profit (or loss) before tax in the company's income statement. This profit (or loss) has been arrived at using GAAP, because those are the rules financial accountants must stick to. Tax accountants work out *taxable* profit using tax legislation, such as the Corporation Taxes Act 2010.



TECHNICAL
STUFF

Tax legislation in the UK is renowned for being extremely complex. In fact, some critics say the UK has the most complex tax system in the world!

In most cases, a company's profit before tax and its taxable profit will rarely be the same. This is caused by various adjustments to the accounting profit to arrive at a taxable profit figure on which corporation tax is charged. These adjustments (known as *addbacks* and *reliefs*) are necessary because the rules for GAAP and the rules for tax are different. Typically, certain items of business expenditure are allowable for tax, whereas some aren't. Conversely, some items of income are taxable, whereas some aren't. There are also other factors to consider, which I discuss in the next section.

Figure 18-2 shows how accounting profit is used in arriving at taxable profit:

	£'000	£'000
Profit before tax per financial statements		180
<i>Addback items not allowable for tax purposes:</i>		
Depreciation	10	
Fine for illegal act	5	
Accrued pension contributions	8	
Staff loan written off	<u>3</u>	
		<u>26</u>
		206
<i>Less</i>		
Capital allowances	(4)	
Income not taxable	(1)	
Gain on disposal of motor vehicles	<u>(2)</u>	
		(7)
Profit chargeable to corporation tax		<u>199</u>

FIGURE 18-2:
A basic
calculation of
taxable profit.

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So what's the point of all this taxing malarkey? Before you start worrying about the government incurring all sorts of pointless items of expenditure, stop to consider how you got to work or college this morning. Did you take public transport? Or drive on a motorway? Have you recently been in hospital? Do your children attend a state school? Do you know anyone who receives Personal Independent

Payment or Jobseeker's Allowance? All these aspects of our lives (and many more) are subsidised by the government through the taxes it collects.

Tax accountants report taxable profit on a corporation tax return. For a company, this is form CT600 *Company Tax Return*. You can download form CT600 from HMRC by visiting www.hmrc.gov.uk, but it must be filed electronically with HMRC.



REMEMBER

Like individuals, companies in the UK currently have a *sliding scale tax rate*, which means their tax rate goes up based on the level of their taxable profit. The amount of tax (at the time of writing) based on taxable profit is shown in Figure 18-3. For example, if the company has taxable profit on 31 March 2025 of £92,500, corporation tax, the tax charge would be £17,575 ($£92,500 \times 19$ per cent).

Corporation tax rates from 1 April 2023

Small profits rate 19%

This applies to companies that generate taxable profits of between £0 and £50,000.

Headline rate 25%

This applies to companies that generate taxable profits exceeding £250,000.

Marginal rate Sliding scale

This applies to companies that generate taxable profits which fall between £50,001 and £250,000.

FIGURE 18-3:
Corporation
tax rates.

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Explaining why the two types of profits differ



TIP

Accountants use a bit of technical lingo to talk about the two ways in which business profit is calculated. The phrase *book values* refers to financial statements prepared using GAAP. The phrase *tax values* (logically enough) refers to calculations prepared for tax purposes. In some cases, the difference between book and tax values, such as profit figures, is huge: a business may have a high amount of accounting profit but can have a taxable loss.

The gap between accounting profit and taxable profit is generally caused by three types of differences: timing differences, permanent differences and loss carryforwards/carrybacks.

Tackling timing differences



REMEMBER

It's important to understand that the financial statements of a company, prepared on an accruals basis (see Chapter 6), reflect all transactions, events and conditions up to and including the year- or period-end date. Anything after that date is included in the next period's accounts. When the accounts are finished, the financial accountant knows what the profit before tax figure is, and that's when the tax calculation (the *tax computation*) is done to work out what the company owes in corporation tax.



WARNING

This is where things get a bit complicated, because accounts rules and tax rules don't always sing from the same hymn sheet. Certain transactions will be included in the accounts to comply with GAAP but may not be included in the tax computation for that year due to differences between what the accounting rules say and what the tax law mandates. The transactions may be included in the next period's tax computation. These differences are known as *timing differences*. There's also the issue of permanent differences, which I discuss in the next section.



REMEMBER

A *timing difference* is an item that is taxed or allowed as a tax deduction in the company's tax computation in a period different from that in which it is reflected in the company's accounts. In other words, a timing difference is capable of being created in one period and reversing in another.

Quite a few things can give rise to a timing difference. Here are three of the most common events that give rise to timing differences, which will reverse in time:



TECHNICAL
STUFF

» **Pension contributions:** A company's monthly pension contributions, properly accrued at the year end, may not be physically paid until after the year end. Contributions due to be paid will be a liability owed to the pension fund, with the corresponding debit going to pension costs in the income statement. This reduces the company's profit (or increases a loss).

In the UK, tax law states that the company only gets tax relief on pension contributions that are physically paid. This means any accrued pension contributions are added back to profit before tax in the tax computation, and tax relief is granted in the next tax computation when the contributions are paid over to the pension fund.

» **Depreciation:** A company is free to choose whichever depreciation rate or method it likes to write off the cost of fixed assets over their useful lives (see Chapter 12 for a full discussion of depreciation). Because of this freedom of choice, HMRC generally disallows the depreciation expense in the accounts (though there are some instances when it can be allowable on assets subject to a lease, but that's beyond the scope of this book).

Instead of depreciation, HMRC grants *capital allowances* on certain qualifying assets at prescribed rates (capital allowances sort of do the same job as depreciation in that they write off the value of the asset, but over a specified period of time rather than over its useful life). Sometimes a company can claim a more generous capital allowance on a qualifying asset (such as a 100 per cent Annual Investment Allowance, which means the company can write off the whole value of a qualifying asset for tax purposes in the year of acquisition). At the same time, the company's depreciation method may require the same asset to be written off over, say, ten years. So, in other words, in some instances, tax legislation may allow for writing off of the full cost of the asset in year 1, while for accounting purposes, GAAP depreciation (in this case, straight-line over ten years) must be used.

- » **Capital losses:** A company can buy and sell investments in other companies. However, if a company sells shares or other investments and has an overall loss on the transactions for the year, for tax purposes, the company can't deduct this capital loss. Don't panic! The loss can be offset against any future capital gains. For financial accounting, the entire loss serves to reduce net profit (or increase a net loss).

Reviewing permanent differences

A *permanent difference* is an accounting transaction the company reports for accounting purposes but can't – and never will be able to – report for tax purposes. While GAAP requires the transaction to be included in the accounts, tax legislation does not grant tax relief on the expenditure or – in the case of income – the income may not be taxable at all. In other words, a permanent difference does not reverse in time.

Quite a few accounting transactions lead to a permanent difference. Here are five common ones:

- » **Entertaining:** A company's directors or management may take its customers for a night on the tiles, or to a restaurant to thank them for their business. This type of entertaining is always disallowable for tax purposes. (However, staff entertaining up to a value of – at the time of writing – £150 per head, which meets certain conditions is allowable.)
- » **Clothes to meet a specific dress code:** Such clothes are not allowable for tax purposes because HMRC states that people must wear some sort of clothing regardless of the specific requirements of certain professions (common decency requires people to wear clothes but certain dress codes are required in carrying out certain roles; these 'conflicts' are often coined *duality of purpose* in tax speak) and aren't allowable as a deduction for tax purposes.

- » **Fines:** Fines for illegal activities aren't tax deductible, such as pollution or criminal acts. Certain penalties imposed by HMRC (such as those for late payment of certain taxes) are also disallowable for tax purposes.
- » **Training costs:** Training costs that allow staff to develop new skills or knowledge aren't allowable for tax purposes as HMRC regards such new skills or knowledge as being of a capital nature rather than an expense.
- » **Irrecoverable loan to a member of staff:** A loan made to a member of staff that's written off is not allowable for the purposes of tax (unless the trade in question is one of making loans).

Explaining deferred tax



WARNING

Deferred tax can be a tricky issue to deal with. The good news is that here I'll be keeping it as simple as I can.

The first thing to understand is that *deferred tax* is an accounting concept. It is not a tax that is actually paid by a company (unlike Value Added Tax VAT, PAYE or corporation tax). Financial statements must be prepared using the accruals basis (see Chapter 6). The *accruals basis* requires transactions to be recognised in the financial statements when they arise rather than when cash is received or paid (again see Chapter 6). The *cash basis* of accounting is not recognised in UK and Ireland GAAP (although it does exist for some sole trader taxpayers and for very small charities, but that's outside the scope of this book).

The accruals basis of accounting requires the *tax effects* of a transaction to be reported in the financial statements in the same period as the transaction itself. As explained in the earlier section 'Tackling timing differences', some transactions may be recorded in the financial statements in one year but appear in a tax computation in another year. This is one of the main triggers of deferred tax. The financial accountant must recognise the tax impact of a transaction in the current year's accounts, even though the tax consequences may not be felt in a tax computation until the next year (or even some years later).



EXAMPLE

Here's an example:

Ratchford Enterprises Ltd buys a new machine for £1 million on 2 January 2025. HMRC allows Ratchford to claim 100 per cent capital allowances on the cost of this machine in the year of purchase. Ratchford Enterprises estimates that the machine will have a useful life of four years, so it is planning to write the cost of the machine off over four years (a depreciation charge of £250,000 per annum). Ratchford has made a profit before tax in the year to 31 December 2025 of £1.2 million and expects profits to be in this region for the next four years. The company pays tax at 19 per cent.

If Ratchford does not recognise deferred tax, this is what will happen to its profits:

Tax summary	2025	2026	2027	2028	Total
	£'000	£'000	£'000	£'000	£'000
Accounting profit before tax	1,200	1,200	1,200	1,200	4,800
Depreciation not allowable for tax	250	250	250	250	1,000
Capital allowances granted by HMRC	(1,000)				(1,000)
Taxable profit	450	1,450	1,450	1,450	4,800
Tax charge at 19%	86	276	276	276	914
	2025	2026	2027	2028	Total
	£'000	£'000	£'000	£'000	£'000
Profit before tax	1,200	1,200	1,200	1,200	4,800
Tax charge	(86)	(276)	(276)	(276)	(914)
Profit after tax	1,114	924	924	924	3,886

If Ratchford does recognise deferred tax this is what will happen to its profits:

Deferred tax calculation	2025	2026	2027	2028
	£'000	£'000	£'000	£'000
New machine: net book value in balance sheet	750	500	250	-
Value for tax purposes	-	-	-	-
Timing difference	750	500	250	-
Deferred tax liability at 19%	142.5	95	47.5	-
Opening deferred tax liability	-	142.5	95	47.5
Charge (credit) to profit and loss	142.5	(47.5)	(47.5)	(47.5)

	2025	2026	2027	2028	Total
	£'000	£'000	£'000	£'000	£'000
Profit before tax	1,200	1,200	1,200	1,200	4,800
Tax charge	(86)	(276)	(276)	(276)	(914)
Deferred tax provision	(142.5)	47.5	47.5	47.5	-
Profit after tax	971.5	971.5	971.5	971.5	3,886

You can see that if Ratchford does not recognise deferred tax, the profit after taxes shows a decline between 2026 and 2028 (from £1,114,000 to £924,000). This is caused by the timing difference of the current tax charge on profits. When Ratchford does recognise deferred tax, the profits are smoothed out and there is no decline. This provides management with a more meaningful performance profile of the company.



TIP

The calculation is fairly easy to understand, but how can you tell if deferred tax is an asset or a liability? When a transaction causes the company to pay more tax in the future (as in the example of Ratchford because enhanced capital allowances are only available in one year), the deferred tax is a *liability*. Conversely, if a transaction causes the company to obtain a tax advantage in a subsequent year, deferred tax becomes an *asset*. Such a transaction can be where the accounts include accrued pension contributions, which is granted tax relief in the next financial year. Next year, the tax charge, in theory, is lower because of the tax relief that is granted, so a deferred tax asset is recorded.

Examining Deferred Tax Liabilities and Assets



REMEMBER

Although I've tried to keep a very complex and technical subject simple, you can be forgiven for finding the overlap between accounting and tax confusing. Just keep in mind the following main points:

- » A *deferred tax liability* represents tax payable in a future period because a transaction(s) has been recognised in the accounts but the transaction(s) will be appearing in a tax computation in a future period.

- » A *deferred tax asset* represents tax that is recoverable because of a transaction that has been recorded in the accounts and for which tax relief is owed to the company. A deferred tax asset can also arise if the company has made a taxable loss, which will be offset against a taxable profit in the future.

In the earlier section ‘Explaining deferred tax’, I note that timing differences create one of two balance sheet accounts: a deferred tax liability or a deferred tax asset. How do these two accounts show up on the balance sheet?

UK and Ireland GAAP don’t specify any particular presentation requirements for deferred tax assets. Generally, they are presented within current assets (see Chapter 7) either as a separate heading or as a sub-heading of debtors. Deferred tax liabilities, on the other hand, are presented within provisions for liabilities (head to Chapter 8 for more on provisions for liabilities) on the basis that a deferred tax liability is uncertain in terms of its timing of settlement or amount.

UK-adopted IFRS Accounting Standards drill down into a little more detail. An entity preparing its accounts to IFRS Accounting Standards should never classify deferred tax assets or liabilities as current. They must always be presented as non-current (long-term) assets or liabilities. Chapter 7 shows a complete balance sheet with these examples of these accounts.

You may be wondering whether you can offset a deferred tax asset and liability accounts. For example, your current deferred tax asset is £7,800 and your deferred tax liability is £5,400. Can you just show the difference of £2,400 (£7,800 – £5,400) as a deferred tax asset? The answer is . . . it depends. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 29 *Income Tax* states that deferred tax debits and credits may be regarded as capable of being offset, and thus presented as a single net asset or liability only if:

- » There is a legally enforceable right to offset them.
- » They relate to taxes levied by the same tax authority on either the same taxable entity or different taxable entities, which will settle current tax liabilities and assets on a net basis, or realise the asset and settle the liability at the same time in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered.

In practice, most entities report deferred tax assets and deferred tax liabilities gross without any offsetting.



TECHNICAL
STUFF

IAS 12 *Income Taxes* takes a similar approach to FRS 102.

NOTING THE DIFFERENCE BETWEEN UK AND IRELAND GAAP AND UK-ADOPTED IFRS FOR DEFERRED TAX

Deferred tax under FRS 102 is calculated on a *timing difference* approach, which means that deferred tax is based on when income and expense hit the income statement (profit and loss account). The primary focus of deferred tax under UK and Ireland GAAP is the differences between *accounting profit* and *taxable profit*, so the focus is on profit and loss.

IAS 12 *Income Taxes* operates on a *temporary difference* approach, which means that deferred tax is based on when assets and liabilities are received and settled, so the focus of IAS 12 is on the balance sheet.

As UK and Ireland GAAP are broadly aligned to IFRS principles, the result of deferred tax calculations under the timing difference versus the temporary difference should not be too dissimilar. The good news is that for financial accountants preparing accounts under UK and Ireland GAAP, the timing difference approach is simpler than the temporary difference one.

- » Laying the foundations for leases
- » Understanding the on-balance sheet model
- » Identifying how the lessee accounts for leased equipment
- » Discovering how lessors deal with leasing transactions

Chapter 19

Accounting for Leases

Most businesses need property, plant and equipment (sometimes called *tangible fixed assets* or *non-current assets*) for their day-to-day operations. Rather than shelling out the money to purchase all the necessary fixed assets, many companies opt to lease equipment instead. A major advantage to leasing rather than buying fixed assets is that leasing can allow for up to 100 per cent financing, which greatly increases a company's cash flow (see Chapter 11).

This chapter looks at leasing from the point of view of both the *lessee* (the party acquiring the right to use the asset) and the *lessor* (the party that legally owns the leased asset). You learn about the accounting treatments for leases, which have been through a huge change in the last few years, as well as the journal entries a lessee makes to record a lease in the financial statements. You also receive a brief introduction to the classification of leases for the lessor. Specifically, I give you the lowdown on how a lessor handles finance and operating leases.



WARNING

In this chapter, I only cover the basics to ease readers into what is a very complex subject. Leasing has a multitude of technical areas, so much so that some large firms of accountants even have specialists who deal specifically with lease accounting!



REMEMBER

When a business enters into a lease agreement, there will be documentation outlining the terms of the lease. This is important because for a lease to exist, the contract must allow the lessee to control the use of an identified asset for a period of time in exchange for consideration. The term *consideration* essentially means cash. After all, a lessor isn't going to provide a leased asset for free, is it?

Reviewing Lease Basics



REMEMBER

Whether a business is a small family-run company or a large multinational, it is likely to need some *fixed assets*: tangible assets the company expects to use for more than a year (remember, tangible assets are those assets that you can physically touch). Common examples include computers, furniture and office fixtures, but depending on the type of business, the fixed assets required can be much more extensive. For example, a business making food needs all sorts of mixing, cooking and packaging equipment. And a large retail clothing shop needs a significant amount of fixtures, like display cases and shelving. (A retailer may also lease its shop.) As I explain in Chapter 7, on a company's balance sheet, such fixed (or non-current), tangible assets are grouped in a category called 'property, plant and equipment' (PP&E) or 'fixed assets'.

Businesses won't always buy their PP&E; sometimes they lease these assets. You may have entered into a lease yourself at one time or another. Maybe you're renting a flat or a car. Perhaps you rent your television, and the terms of the lease say that, after the specified lease term, you pay a small sum and then become the owner of the TV.

Business leases are a bit more complex than most personal leases, so you can't always compare a business lease to a personal one. (However, if you've ever leased a car rather than financing it or purchasing it outright, you probably have some understanding of how convoluted the lease process can be.) When you rent a house for personal use, you have no claim to that house after your lease expires – you either renew the lease or move out. But depending on how a business lease is set up, the company may be the eventual owner of a piece of leased equipment.

Identifying the advantages of leasing

Why would a business lease instead of buy its equipment? Here are some key motivators:

» **Ker-ching!** A major advantage to leasing rather than buying is this: a company usually doesn't have to incur a large outlay of cash at the start of the lease, the

way it would have to with an outright purchase. This keeps cash in the business that it can use for its day-to-day business expenses.

In fact, many business leases come with 100 per cent financing terms, which means no money changes hands at the commencement of the lease. Can you imagine what a boost to cash flow this can be? Of course, the business must make the lease payments each month. But the assumption is that the company makes the payments from the revenues it earns from the new equipment as a result of entering into the lease.

- » **Avoiding obsolete equipment:** Another advantage to leasing is working around obsolescence, which means the company anticipates frequently replacing the fixed asset. For example, being able to upgrade computer equipment certainly comes in handy for businesses that need to stay up to date with new and faster computer processing technology. The basic purpose of constantly updating computer hardware (and software) is to maximise employee productivity.
- » **Having asset flexibility:** Say that the managing director of a company decides to change the company car they're driving. Or say that the employee for whom a company leases a vehicle leaves the company. In either situation, with a leased vehicle, the company needn't worry about advertising the car for sale and trying to find a buyer; it just sends the car back to the leasing company. Although the company will have to be alert to the possibility of any early termination clauses that may be triggered if the asset gets sent back before the lease expires, as this can mean a fee is payable for the privilege of getting out of the lease earlier than originally expected.
- » **Tax savings (possibly):** Depending on how the business structures a lease, tax advantages may be possible. I discuss this topic later in the chapter in the 'Understanding when a lease does not have to go on-balance sheet' section. For now, just remember that in some (quite limited) cases, a company can treat lease payments like rentals, expensing the entire lease payment to the income statement.



TECHNICAL
STUFF

Some additional economic advantages to leasing can come into play. For example, it may be the case that the equipment the business needs to make its products isn't available for purchase – the company that actually owns the equipment only wants to lease it. This situation may occur if the piece of equipment is highly technical, or the company makes more money through leasing than through selling the item.

Introducing the lessor and lessee

Before I get into the nitty-gritty of accounting for leases, I want to provide a brief lease introduction. Don't worry – it doesn't involve anything too complex! You

simply need to know who the parties are in a lease. Knowing who's who in a lease transaction makes the subject easier to understand.



REMEMBER

A lease agreement always has two parties involved: a *lessor* and a *lessee*. The *lessor* is the party who legally owns the asset that's going to be leased to the lessee. The *lessee* is the party who wants to acquire the right to use the asset. Let's assume you decide to buy another car and rent it out to your mate, Les: Les acquires the car to use it for social and business purposes, and therefore is the lessee and you, as the owner of the car, are the lessor.

One interesting fact about leases is that the lessor doesn't necessarily own the fixed asset immediately prior to entering into a lease agreement. Sometimes purchasing the fixed asset is dependent upon finalising the lease agreement. In other words, part of the agreement is that the lessor commits to purchasing the leased asset. This situation may happen if the piece of equipment is expensive or not in high demand. Rather than keeping potentially leasable equipment in inventory that may become obsolete fairly quickly, the lessor advertises that it can lease the asset and then purchases the asset only when it has an interested potential lessee. This approach makes a lot of sense because it cuts down on the expense of storing the equipment and increases the lessor's cash flow; the lessor doesn't shell out the dosh to purchase the asset until that asset is poised to become a source of revenue.



TIP

How a company accounts for leased assets differs depending on whether the company is the lessor or the lessee. Many of you reading this book may only have come across leases from the viewpoint of the lessee, so pay close attention to the next section. But to get the complete picture, make sure you check out the last section of this chapter, which gives you a brief insight on accounting for lease transactions from the standpoint of the lessor.

Accounting by the Lessee



WARNING

Lease accounting under FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* has just undergone a significant overhaul. The Financial Reporting Council (FRC; which will eventually become the *Audit, Reporting and Governance Authority*) concluded that the 'traditional' method of classifying a lease between a finance and an operating lease is no longer appropriate under FRS 102 and, therefore, most leases for lessees will be recognised on-balance sheet (as an *asset* which I discuss in Chapter 7; and a *liability* which I discuss in Chapter 8). This section looks at some of the technicalities to help make a mind-blowing topic a lot friendlier.

To complicate things further, if you're a micro business preparing your accounts under FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime*, you do continue to distinguish between a finance lease and an operating lease as you've always done. I explain more about this later in the section 'Understanding when a lease does not have to go on-balance sheet'.

Looking at the on-balance sheet model

In March 2024, the FRC issued a raft of changes to UK and Ireland accounting standards that are mandatory for accounting periods that start on or after 1 January 2026. One of the headline changes is how a business accounts for a leasing transaction when the business is a lessee.

You may have heard a lease referred to as either a *finance lease* or an *operating lease* (and you'll see these classifications again later in the section 'Accounting by the Lessor'). A lease is classified as a *finance lease* when the risks and rewards incidental to ownership pass from lessor to lessee. A lease is classified as an *operating lease* when the risks and rewards incidental to ownership remain with the lessor. Finance leases get recognised on-balance sheet, whereas operating leases do not. Lease rentals in an operating lease are simply expensed immediately to the income statement.



REMEMBER

Under the new rules coming in for accounting periods commencing on or after 1 January 2026, there is no distinction between a finance lease and an operating lease under FRS 102. To put it simply, under FRS 102, a lease is a lease is a lease! That's it, and most leases will go on-balance sheet. There are some exceptions to this rule that I'll look at in the section 'Understanding when a lease does not have to go on-balance sheet' later in the chapter. However, under FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, micro-entities (which are the very smallest of companies – see Chapter 4) must continue to distinguish between a finance lease and an operating lease based on the risks and rewards approach (see Table 19-1 in the section 'Understanding when a lease does not have to go on-balance sheet'). The FRC has not changed the accounting rules under FRS 105. So, the good news for micro-entities preparing accounts under FRS 105 is that it's very much business as usual.

The on-balance sheet model in FRS 102 basically requires most leases to be presented on the balance sheet. Why? Well, the basic premise of this model is that the company has acquired an asset for use in its business, which will contribute to generating revenue, and that asset has been financed through a leasing transaction. Think of it in the same way as, say, a bank loan. If the company had acquired a machine and took out a bank loan to pay for the machine, the machine gets recognised as a fixed asset (see Chapter 7) and the bank loan (see Chapter 8) is recognised as a liability.

Bringing a new lease on-balance sheet

So, you've entered into a new lease to acquire an asset for use in the business. The next thing to do is to record the right to use that asset on the balance sheet. Remember, it's the right to use the asset that is being recorded on the balance sheet, not the actual asset itself.



TIP

You need three things before you can do this:

- » The *lease agreement* between the lessee and the lessor (to see the terms of the lease)
- » The value of the *lease payments* the lessee will make to the lessor (as you'll need these to correctly account for the lease)
- » The *discount rate* to discount the lease payments (you'll need this to bring the leased asset onto the balance sheet and then deal with the interest element of the lease agreement)

The first two pieces of information in the bullet list are easy to get as the payments will be in the lease agreement (so you can kill two birds with one stone there). The discount rate, however, is going to need a bit of thought. The first thing to understand is why you need a discount rate.

Well, to bring the right-of-use asset onto the balance sheet, you bring it on at the *present value* of the lease payments that the lessee is required to make under the agreement. You also recognise a lease liability at the same value. FRS 102 says the discount rate to use can be either:

- » The interest rate implicit in the lease (usually quite difficult so less common)
- » The lessee's *obtainable borrowing rate* (usually the easiest to get)
- » The lessee's *incremental borrowing rate* (also quite easy to get)



EXAMPLE

The best way to see how all this fits together is to look at an example. To keep things simple, I'll use the lessee's *obtainable borrowing rate*. This is the rate of interest that the lessee would pay on an equivalent borrowing. For example, if the lessee went to the bank to take out a loan to acquire the asset, it would be the interest rate payable on the loan.

Sunnie Ltd agrees to rent an office for three years on 2 January 2026. Annual lease payments to the landlord are £20,000, made at the end of each year, meaning the payment is made in arrears. So the lessor is committed to receive £60,000 in total over three years in exchange for renting the office space. If Sunnie were to get a three-year bank loan for £60,000 on 2 January 2026, the bank would charge 7 per cent interest on that loan.

Sunnie needs to take steps to bring the lease on-balance sheet, as outlined in the following sections.

Step 1: Discount the cash flows in the lease

The best way to discount the cash flows in the lease is to use a spreadsheet, as it can be kept on file for subsequent years, too.

Year	Lease payment	Discount rate at 7%	Present value
	£		£
31.12.26	20,000	1.07 ¹	18,692
31.12.27	20,000	1.07 ²	17,469
31.12.28	20,000	1.07 ³	16,326
	60,000		52,487

Here you can see that the present value of the total lease payments of £60,000 (discounted using the obtainable borrowing rate of 7 per cent) is £52,487. We do this by dividing £20,000 by 1.07 in year 1, then by 1.07 squared in year 2 and by 1.07 cubed in year 3. That's the value you bring the right-of-use asset on the balance sheet together with a corresponding lease liability, so:

Debit: Property, plant and equipment	£52,487
Credit: Lease liability account	£52,487

Being acquisition of new right-of-use asset (new office)

Step 2: Record the lease payments throughout the year and allocate the interest in the lease agreement

Over the course of the year, Sunnie will pay the landlord lease payments totalling £20,000. These payments are recorded in the accounts as follows:

Debit: Lease liability account	£20,000
Credit: Bank account	£20,000

Being payments to landlord for lease of office

Now, it's not just the lease payments you have to correctly allocate in the accounts. Over the course of the three-year lease agreement, interest must be recorded in the accounts at a rate of 7 per cent. Again, it's best to do this using a spreadsheet:

Year	Opening balance	Cash flow	Interest at 7%	Closing balance
	£	£	£	£
31.12.26	52,487 (Step 1)	(20,000)	3,674	36,161
31.12.27	36,161	(20,000)	2,531	18,692
31.12.28	18,692	(20,000)	1,308	0

You can see that the opening balance of £52,487 is the value of the lease liability calculated in Step 1, which was the credit to the lease liability account. The interest at 7 per cent is interest on the opening balance, so $£52,487 \times 7 \text{ per cent} = £3,674$. This interest needs to be recorded in the income statement as a finance cost. The way to do this is as follows:

Debit: Finance costs (income statement)	£3,674
Credit: Lease liability account	£3,674

Being interest on lease liability

Once you've dealt with the interest portion, the table shows Sunnie owes £36,161 to the landlord, and this should be the balance on the lease liability account as well. This £36,161 liability is then split between the *current liability* and the *non-current liability* (see Chapter 7) because company law requires liabilities to be split between their current portion and non-current portion. The current liability is £17,469 (£36,161 – £18,692), and the non-current liability is £18,692. To check

you've done the maths right, just take £17,469 and add it to £18,692, and you can come back to the year 1 closing balance of £36,161 shown in the table.

So, you've now finished with the lease liability account. There's just got one more step to go and then you're all done.

Step 3: Depreciate the right-of-use asset

As with all other types of fixed assets (see Chapter 7), you must depreciate the leased asset as well. *Depreciation* (see Chapter 12) is the act of writing the cost of an asset off to the income statement on a systematic basis over its useful life. To keep things simple, I'm going to depreciate this office space over the term of the lease (which is three years).

To do this, take the value at which Sunnie Ltd capitalised the right-of-use asset (see Step 1) of £52,487 and divide this by three to get £17,496 (rounded up). This is the annual depreciation charge for this right-of-use asset. The depreciation is recorded in the accounts as follows:

Debit: Depreciation expense (income statement)	£17,496
Credit: Depreciation account (balance sheet)	£17,496

Being annual depreciation charge for right-of-use asset

And that's it. You've brought the leased asset onto the balance sheet, dealt with the lease liability and the depreciation element and can move onto the next area of the accounts.

Understanding when a lease does not have to go on-balance sheet

You'll probably have noticed that, so far in this chapter, I've said that *most* leases under FRS 102 will go on-balance sheet (I haven't said *all* leases go on-balance sheet). That's not me being non-committal or playing it safe; it's because there are some limited exceptions to on-balance sheet recognition whereby the lease payments can be immediately expensed to the income statement:

Debit: Lease expense (income statement)	£X
Credit: Bank account	£X

These exceptions *only* relate to leases which:

- » Are *short-term leases*: In other words, the lease only has 12 months or less to run at the start of the lease.
- » Are leases of assets which are *low value*.

The *short-term lease* exception isn't a problem. If the lease has one year or less to run at the commencement date, the company can simply write off the lease payments to the income statement as they are incurred:

Debit: Lease expense (income statement)	£X
Credit: Bank account	£X

Simple!

The *low-value* exception is a bit more challenging. You can be forgiven for thinking that somewhere deep in the technical detail of FRS 102 is a figure that we can use that tells us what 'low value' is. You'd be wrong, I'm afraid. This is because it's very much up to the business as to what it considers low value to be. Now, this doesn't mean it's a free-for-all and the business can just make a number up. There's a bit more to it than that.

Firstly, when determining what low value is, we must first look to the *value* of the underlying leased asset. We can use the list of assets in FRS 102 (which I look at shortly) to guide us here.



WARNING

Don't look at the value of the lease payments because they don't come into the mix when we're looking at the low-value exemption. It's the value of the asset itself that's the important bit.

Secondly, there is no limit to the number of *individual* assets that can be considered to be low value for the purpose of this recognition exemption.

What FRS 102 does do to help us with this is provide a list of examples of asset types that would *not* be low value, as follows:

- » Cars, vans, buses, coaches, trams, trucks and lorries
- » Cranes, excavators, loaders and bulldozers
- » Telehandlers and forklifts
- » Tractors, harvesters and related attachments

- » Boats and ships
- » Railway rolling stock
- » Aircraft and aero engines
- » Land and buildings
- » Production line equipment



TIP

When you're considering whether an asset can be a low-value asset and qualify for the exception for on-balance sheet lease accounting, just keep in mind that if you can climb into the asset or it has an engine, the chances are it's not low value. The bullet list is intended to be a guide so if the asset is similar in value to those on that list, it won't be low value, and off it goes onto the balance sheet.



REMEMBER

If the business is a micro-entity preparing its financial statements under FRS 105, the accountant must establish whether the lease is a finance lease or an operating lease because there have been no changes to the lease accounting rules under that standard. The lessee has a finance lease when the risks and rewards incidental to ownership of the asset pass from the lessor to the lessee (see Table 19-1). If the risks and rewards incidental to ownership of the asset remain with the lessor, the lease is an operating lease.

If the micro-entity (as lessee) has a finance lease, the treatment is the same as in the example of Sunnie Ltd featured earlier in this chapter. If it has an operating lease, the operating lease rentals are simply recorded as an expense in the income statement over the term of the lease. In other words, this transaction increases expenses by the total amount of the lease payment. Your cash account is reduced when the lease payment is made. That sounds easy! Well, you'd be right because that's the extent of accounting for operating leases. Operating lease rentals are generally allowable for corporation tax purposes as well – what a bonus!

TABLE 19-1

Risks and rewards of ownership where the micro-entity is a lessee

Examples of risks	Examples of rewards
Losses incurred due to idle capacity of the leased asset	The micro-entity expects to benefit from increases in the value of the leased asset
The leased asset becomes technically obsolete due to enhancement or changes in technology	The micro-entity will benefit from profitable operations over the useful life of the leased asset
Economic conditions reduce the level of economic benefits the leased asset generates	

Presenting a lease in the financial statements



REMEMBER

The substance (meaning the commercial reality) of a leasing transaction is that the lessee has acquired an asset for use in its business, which has been financed through a leasing transaction. This means the business must record an asset and a liability (see Chapter 7 for more on assets and liabilities). Keep in mind that the financial statements of a business must always report *substance over form* (see Chapter 2). This means the entity reports the substance of a transaction as opposed to its legal form.

As described in the example of Sunnie earlier in this chapter, the business records a fixed asset (remember: substance over form). This *right-of-use asset* may sit within PP&E in whatever sub-class it belongs, such as plant and machinery, fixtures and fittings, motor vehicles, computer equipment, and so on. The business doesn't have to do this if it doesn't want to, and it can present leased assets separately from other assets. In practice, most businesses present leased assets within a category of PP&E and then disclose which line items in the balance sheet contain those leased assets.

In terms of the *lease liability* (the money owed to the lessor at the balance sheet date), these may be presented separately from other liabilities. This is the most common way of presenting them in real life. If the business chooses not to do this, it must disclose which line items in the balance sheet include those lease liabilities. Figure 19-1 provides an illustration of how this works in practice. It presents the non-current assets with a note cross-referencing to the value of the items of PP&E that are leased from a lessor. It then shows a breakdown of the creditors' figures, where you can see the value of lease liabilities.

Balance Sheet (extracts only)

		31.12.2026	31.12.2025
		£'000	£'000
Fixed assets			
Property, plant and equipment	Note 10	<u>1,250</u>	<u>1,360</u>
Creditors			
Amounts falling due within one year	Note 11	<u>(535)</u>	<u>(487)</u>
Creditors			
Amounts falling due after more than one year	Note 12	<u>(150)</u>	<u>(175)</u>

In the notes to the financial statements:

Note 10: Property, plant and equipment (extract)

Fixed assets, included in the above, which are held under leasing arrangements are as follows:

	31.12.2026	31.12.2025
	£'000	£'000
Plant and machinery	<u>260</u>	<u>285</u>

Note 11: Creditors: amounts falling due within one year

Trade creditors	225	231
Leases	110	106
Other creditors	<u>200</u>	<u>150</u>
	<u>535</u>	<u>487</u>

Note 12: Creditors: amounts falling due after more than one year

Leases	<u>150</u>	<u>175</u>

FIGURE 19-1:
Balance sheet
extracts for a
leasing transac-
tion for a lessee.

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Accounting by the Lessor

You'll probably only get involved with accounting for a lease as a lessee unless you work for a company that specialises in leasing out assets. Lessees get more attention than the lessors, who tend to be left out altogether. So, while this subject goes beyond what you need to know for your day-to-day dealings with leases from the lessee's viewpoint, I want to give you a brief heads-up on how to handle leases from the lessor's perspective, so you can see the accounting issues from both sides of the fence.



REMEMBER

The lessor decides how much it charges for leasing an asset and structures its lease based on many different criteria. Obviously, the most important criterion for the lessor is how much profit it makes in the transaction. The lessor also looks at the credit rating of the lessee and how long a lease term the lessee requires. For example, the lessor is likely to charge a potential lessee with a bad credit rating more than it would charge a lessee with a good credit record to reflect the higher risk.

Lessors have two major classifications of lease agreements: finance leases and operating leases.



WARNING

The accounting for these types of leases from the perspective of the lessor is very complex. Due to the complexity of these transactions, if you're ever unsure of how to deal with these in real life, I recommend that you let your manager or another person with experience in this area deal with the accounting issues as errors can be very costly to sort out.

Finance leases

Dealing with finance leases from the perspective of the lessor involves a lot of detail, so here I give only a brief overview of what's involved.



TIP

It's not always clear cut when a lease is a finance lease or when it's an operating lease. When the risks and rewards incidental to ownership of the leased asset (see Table 19-1 earlier in this chapter) pass to the lessee, the lease is a finance lease.

To help lessors make this distinction, FRS 102 provides examples of situations that may lead to a lease being classified as a finance lease, such as:

- » The lessee gets to own the asset at the end of the lease term.
- » There's an 'option to purchase' clause in the lease term that allows the lessee to buy the asset at a significantly reduced price and it's likely that this option will be taken up on commencement of the lease.
- » The lease term is for the major part of the leased asset's useful economic life (even if legal title is not eventually transferred).
- » At the start of the lease, the present value of the lease payments (see the example of Sunnie earlier in this chapter) amounts to at least substantially all of the fair value of the leased asset.

- » The underlying asset is so specialized that only the lessee can use it without major modifications to the asset being made.
- » If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee.
- » Gains or losses from fluctuations in the fair value of the leased asset accrue to the lessee.
- » The lessee can continue the lease for a secondary period at a rent that is substantially lower than market rent.

In a finance lease, the lessor recognises a receivable (see Chapter 7) and income received from the lessee goes towards reducing the balance of this receivable.

Operating leases

When the risks and rewards incidental to ownership of the leased asset (see Table 19-1) remain with the lessor, the lease is an operating lease. The leased asset is recognised as a fixed asset in the lessor's balance sheet and is depreciated (see Chapter 12) over its useful life.

All income received from the lessee is recognised in the income statement.

- » Deciding which accounting policies to use
- » Changing estimates in the accounts
- » Correcting mistakes

Chapter 20

Reporting Changes in Policies and Estimates and Correcting Errors

Nobody is perfect. It doesn't matter how hard financial accountants try to get everything just right; occasionally, mistakes are made or views about the best way to handle transactions change. For example, someone (definitely not you!) simply enters a transaction incorrectly (such as by transposing two figures – entering £989,000 instead of £899,000). Or maybe the business has been using a particular accounting policy for years, but that policy no longer provides the most relevant and reliable results.

This chapter explains how to deal with changes in the accounting policies a company follows (and the accounting methods it uses to apply those policies), changes in accounting estimates (a company's best guess about how future accounting transactions will pan out), and correcting mistakes that have been made. You may be thinking that the heading of this chapter allows lots of free will. However, as a financial accountant, you realise that the idea of choice is really rather weighty (in fact the term 'Hobson's choice' springs to mind) – do things right, or do them wrong and risk getting into trouble!

Coping with Accounting Policy and Estimate Changes

As the business lifecycle progresses, stuff happens that changes the circumstances in which the business operates. For example, certain accounting methods used by the business may become outdated, and the management team may decide that an alternative method better suits the company. When that happens, the company needs to change the way it accounts for various transactions. Two broad types of accounting changes are possible: changes in accounting policies and changes in accounting estimates. Confused about these types of changes? Well, you're not alone! That's why I cover each in turn in this section.



REMEMBER

Correcting an error, which is an unintentional mistake, does not qualify as a change in accounting policy or estimation technique. To find out how to handle errors (which result in *restatements*), go to the 'Correcting Errors' section at the end of the chapter.

Reporting changes in accounting policies

Financial accountants use generally accepted accounting practice (GAAP; see Chapter 4) to record transactions and events, such as earning revenue, incurring costs and expenses, and purchasing assets. But GAAP doesn't dictate only one way to handle accounting transactions. Depending on what's going on at the company, the financial accountant may be able to choose among many acceptable ways to handle the same accounting transaction or event. At certain times in the life of the business, it may make sense to choose a different accounting policy than the one that's been used previously.



REMEMBER

The financial statements of a business must present a true and fair view. Correctly applying UK and Ireland GAAP (or UK-adopted International Financial Reporting Standards – also known as UK-adopted IFRS) enables this to happen. However, accounting standards such as FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland* (see Chapter 4) allow companies to use different accounting policies for similar transactions.



WARNING

Financial accountants must keep in mind that under FRS 105, *The Financial Reporting Standard applicable to the Micro-entities Regime* (see Chapter 4), there are no accounting policy choices available. For example, FRS 102 allows a company the choice of recognising certain costs, such as development costs as intangible assets (see Chapter 7) or recognising them as an expense in profit or loss. This is an accounting policy choice that the business must apply consistently from one period to the next. As FRS 105 contains no accounting policy choices, all such

development costs under FRS 105 must be recognised as an expense in profit or loss, because that's the only treatment under that standard.

Accounting policies are the specific principles, bases, conventions, rules and practices applied by a company in preparing and presenting its financial statements that are in line with GAAP. For example, some companies may measure an investment (see Chapter 7) at cost, whereas others may measure it at *fair value* (the value it is worth at the balance sheet date). The measurement choices of cost or fair value are accounting policy *choices* that are available to businesses under FRS 102.



REMEMBER

A company must disclose *material accounting policy information* in the notes to the financial statements (see Chapter 15). This tells the user important information about how transactions, events and conditions are dealt with in the accounts. Accounting policy information is deemed to be *material* when it would be capable of influencing the decisions that the users of the financial statements make about the business based on those financial statements.

For example, a user would be particularly interested in a company's accounting policy about how it recognises sales (for example, on dispatch of the goods or when the goods are received by a customer as well as how the sales value is derived), so this would be deemed to be material. However, the user would be less interested in a company's policy for recording petty cash expenditure, so any such policy in respect of this would not be disclosed.



WARNING

A company cannot simply switch accounting policies to improve its bottom line or financial position for a given year. A business may switch accounting policies for only two legitimate reasons:

- » The change is required by an accounting standard.
- » The change results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the company's financial position, financial performance or cash flows.

Next, I explain two ways of reporting accounting changes: the retrospective method and reclassification.

Making changes retrospectively

When you change an accounting policy, you must apply that change retrospectively – that is, going back to the previous period(s) reported in the financial statements and restating them as if the new accounting policy was

always in existence. You do this to make sure that the financial statements are comparable and consistent from one accounting period to the next. Here are three accounting policy changes you should know:

- » Changing from the first-in, first-out (FIFO) method for inventory valuation to another method; see Chapter 13 for the full lowdown on inventory.
- » Changing accounting policies in respect of how a company recognises revenue (such as from recognising revenue on dispatch of the goods from the warehouse to only recognising revenue when the customer receives the goods).
- » Changing accounting policies as required by a change in an accounting standard or legislation. (See Chapter 4 for an introduction to accounting regulatory bodies that can issue such changes.)



REMEMBER

Using retrospective application, you have to adjust the opening balance on retained earnings to what it would have been if you applied the accounting policy change retrospectively in all affected prior periods. This method sounds a lot more confusing than it is in practice.

Here are the steps you follow to apply a change in accounting policy retrospectively:

- 1. Work out the effect of the accounting policy change, and adjust the carrying amount of any affected assets or liabilities to reflect the change.**
For example, if the company changes its inventory valuation from FIFO to average cost (AVCO), the value of opening inventories will change. This will affect last year's closing inventory valuation and retained earnings and this year's opening inventory. See Chapter 7 for more information about assets and depreciation.
- 2. Make an adjustment to opening retained earnings for the effect of the change.** So if net assets increase by £1,000 when you adjust the carrying amount of affected accounts, retained earnings also increase by £1,000. Wondering why both increase? I discuss this topic in Chapter 5, but the quick answer is that you increase assets by debiting them and increase retained earnings by crediting it. Every debit must have a corresponding credit, so if your debit increases net assets, a credit will have the same effect on retained earnings.

Reclassifying financial statement items

A *reclassification* occurs when you change a transaction from the way it was originally presented in the financial statements (known as a *change in presentation*). For example, the directors of a company decide to reclassify depreciation from

overhead expenses to cost of sales, or they decide to move the production director's annual salary from administration salaries to cost of sales. Reclassification is acceptable if the effect of the change will create a more relevant and reliable reflection of the accounting transaction.

When using reclassification, the business may also provide an explanatory note or disclosure in the financial statements (see Chapter 15). For example, an explanatory note may state that £200,000 of long-term debt was reclassified to short-term debt during the accounting period because management is choosing to pay the debt off early (in the next 12 months) instead of over the projected 60 months. This keeps the user fully informed because current liabilities (see Chapter 8) will be much higher than expected, given that the long-term debt has been reclassified as non-current.



TIP

Switching to the FIFO inventory valuation method

Chapter 13 is all about inventory, so if you need more than a basic refresher on inventory concepts, check out that chapter before continuing to read this section.

A company can choose how to value its inventory. Two key methods for accounting for inventory are the first-in, first-out (FIFO) method and the average cost method (AVCO):

- » **FIFO:** Using the FIFO method, the company assumes that the oldest items in its inventory are the ones first sold. Consider buying a pint of milk in the supermarket. The pints of milk with the most current sell by date are pushed ahead of the cartons that have more time before they go sour. The oldest pints of milk may not always be the first ones sold (because some people dig around looking for later sell by dates), but the business is basing its numbers on the oldest pints of milk being sold first.
- » **AVCO:** Using the AVCO method, the weighted average cost of items held at the beginning of the year is calculated using the following formula:

$$\text{Weighted average cost} = \frac{\text{total cost of goods in inventory}}{\text{number of items in inventory}}$$

The weighted average cost is then used to value goods sold. However, a new weighted average cost must be calculated every time further inventories are bought during the year.



WARNING

The last-in first-out (LIFO) method cannot be used under UK and Ireland accounting standards. Nor can it be used under UK-adopted IFRS.

WORKING OUT WHAT'S IMMATERIAL

Only material changes in accounting policy need to be applied retrospectively as accounting standards only deal with material issues, so what is *immaterial* then? Put simply, *immaterial* means the monetary amount in question is not substantive – that is, it doesn't have an effect on the user's decision-making process. What's material for one business may not be material for another.

For example, let's say that a change in accounting policy causes a difference in net assets of £50,000. On the face of it, this amount can be considered a large sum of money. (I certainly wouldn't mind winning that much in the lottery!) But what if the net assets for the business are £6 million? In that case, you would more than likely consider £50,000 to be immaterial at less than 1 per cent of net assets. Financial accountants and auditors often use percentage guidelines to determine what's material.

What happens when a company changes its accounting policy to stop using the FIFO method and start using AVCO? Well, the company has to go back to the previous period reported in the financial statements and restate the inventory valuation as if the inventory were valued under the AVCO method, which results in a different closing inventory valuation in the previous accounting period, which then affects the previous period's retained earnings. This is because the company has changed an accounting policy and accounting policy changes require retrospective application. Remember, if AVCO produces an inventory valuation £5,000 higher in the previous accounting period, you'll have to uplift the inventory valuation in the previous period by £5,000 and then credit retained earnings to uplift those by £5,000.

The company will have to make some disclosures about the impact a change in accounting policy has on the financial statements, so the user is aware that something material has changed in the preparation of the company's accounts. These disclosures will generally require an outline of the nature of the change, the line items in the financial statements affected, the amounts involved, and the reasons why the new policy provides reliable and more relevant information. Other disclosures may be required depending on the circumstances surrounding the change in accounting policy.

Changing a company's estimates

Accounting estimates are a company's best estimate about how certain transactions will eventually pan out. Sometimes, until a whole transaction comes to fruition, the company isn't 100 per cent sure how much revenue or expense to account for.



FRS 102 has an official definition of an *accounting estimate*: 'Monetary amounts in financial statements that are subject to measurement uncertainty.'

When a company decides on a method to calculate various estimates, the estimates (and the estimation technique used) are not set in stone. Sometimes unexpected future events affect the validity of the estimate, so changes in estimates are frequently made as new and better evidence is gathered.

Consider a personal example: Say that you're saving to buy a new car. You estimate you'll need to save £5,000 for a deposit on the car of your dreams. Nine months later, when you are ready to buy the car, changes in the economy and car prices mean that your deposit only needs to be £4,000. Did you make a mistake by originally estimating £5,000? No, of course not. With the info you had available at the time, you made a valid estimate. You can not predict the changing conditions that created the difference in the deposit payment.

Reviewing types of business estimates

During your accountancy career, or your studies, you will likely come across at least four major estimates:

» **The useful life of tangible assets:** *Assets* are resources a company owns. *Tangible* (or *fixed*) assets include property, plant and equipment (PP&E) like computers, desks, and manufacturing equipment. When a company purchases *long-term* tangible assets (those that have an expected useful life of more than one year), it has to depreciate them. *Depreciation* spreads the cost of a long-term asset over its expected useful life (see Chapter 12).

How can a company tell with absolute certainty how long it will be able to use an asset? It can't. Usually, the estimate is based on past experience or company policy. For example, the company usually trades in vehicles after they hit the four-year mark, so the expected useful life for depreciation purposes is four years. For manufacturing equipment, the expected useful life can be how long the company plans to make the product for which it purchased the machine in the first place.

Suppose the company implements a cost-savings initiative dictating that its vehicles be traded in after six years instead of four. A sense of panic overcomes you! Fear not, I discuss how to handle this situation in the upcoming section 'Handling changes currently and prospectively.'

» **The residual value of a tangible asset:** Some methods of depreciation allowed by GAAP take into consideration the *residual value* of the tangible asset: how much a company estimates it can get for a non-current asset if that asset were already of the age and condition expected at the end of its useful life.

For example, the company estimates that when it comes to disposing of the asset in two years' time, it'll have a trade-in value of £3,500. This amount is merely an estimate; the company won't actually know how much it gets until the transaction occurs. (You can read more about this topic in Chapter 12.)

- » **Inventory provisions:** Inventory (or stock) can be slow-moving, become damaged or obsolete. In Chapter 7, I explain that inventory must be valued at the *lower* of cost or estimated selling price less costs to complete and sell. Arriving at the estimated selling price of inventory involves management using estimations, which will usually be based on historical experience. Sometimes the estimated selling price may be zero.



REMEMBER

Contra accounts carry a balance opposite to the normal account balance. Because inventory and work in progress normally have a debit balance, the contra asset account 'provision for inventory' or 'allowance for inventory' has a credit balance. You can find more about the rules of debits and credits in Chapter 5.

- » **Warranty costs:** When a company sells a product with a warranty or performance guarantee, it recognises the estimated cost of servicing the warranty in the same financial period the revenue from the sale is accounted for. You usually calculate the cost of the warranty by using an estimate based on recent experience. For example, in the last two years, the actual cost of product warranties was 2 per cent of sales net of discounts, so the company uses 2 per cent of sales net of discounts for its current estimate.



TIP

Here's how to calculate the estimate: Say that gross sales are £10,000 and *sales discounts* or *discounts allowed* (any discounts the company gives to its customers) are £2,000, making net sales £8,000 (£10,000 – £2,000). Two per cent of £8,000 is £160, which is the company's estimate for warranty expense.

See Chapter 8 for the full story about warranties. Because calculating the estimate for warranties is a critical aspect of many businesses (especially retail stores), in Chapter 8, I also walk you through facts and circumstances surrounding a typical warranty estimate transaction and show you the appropriate journal entries.

Handling changes currently and prospectively

Changes in accounting estimates (sometimes called a company's *estimation techniques*) must be recognised *currently* and also *prospectively* if appropriate. This means that a change in accounting estimate is shown in the current year and all subsequent years (in other words, going forward).



REMEMBER

While the current and future financial statements show the effect of the change in estimate, no change is ever made to prior period financial statements. This is because a change in estimation technique is *not* a change in accounting policy (only changes in accounting policy are applied retrospectively). See the above section 'Reporting changes in accounting policies'. Keep in mind that accounting estimates are used by businesses to implement or apply accounting policies, which is why there are significant differences in accounting between a change in an accounting policy and a change in an accounting estimate.



TIP

A lot of people starting out in the world of accountancy assume that a change in estimate will affect more than one year. To clear up this misconception, consider when a change in accounting estimate may only affect the current year. One example would be if the company originally estimates the useful life of a piece of manufacturing equipment to be ten years. When year eight comes around, the machine is on its last legs and clearly needs to be binned at year-end. Changing the useful life of the machine to eight years in year eight of its expected useful life does not affect any future periods – only the current period.

Correcting Errors

If you choose to pursue a career path as an accountant, you don't have to be perfect. That's quite a relief to see in print, I'm sure! However, you do have to handle any inadvertent mistakes in reporting accounting transactions in the financial statements to comply with GAAP requirements.

In this section, I explain the most common types of errors that occur in the financial statements, and I show you how to go about correcting them. The errors I refer to in this section are errors that were made in prior periods, because if you make an error in your current year's work, you just sort it out and carry on as normal.

Looking at common types of errors

Inadvertent errors fall into three broad categories:

- » **Arithmetical mistakes:** These mistakes occur when the financial accountant just makes a mistake with a spreadsheet or when manually adding something up. A typical example is when you enter the wrong figure in a list of

figures and end up with the wrong value for that particular account balance. The mistake may affect some aspect of data entry into the accounting software system, which then flows through to the financial statements, especially if the balance has not been reconciled properly.

You can also make transposition errors, such as entering £959 into the accounting software instead of the correct figure £599.

- » **GAAP mistakes:** GAAP errors occur in recognition, measurement, presentation, disclosure or just basically using an improper accounting method.
- *Recognition* means determining how an accounting transaction or event affects the company's financials, and examples are littered throughout this book. For example, Chapter 10 discusses recognising revenue and expenses.
 - An example of *measurement* is determining an item's fair value. Using assets as an example, the *fair value* is the price a company can receive to sell an asset to an unrelated third party on a certain date.
 - *Presentation* means you show the transaction in the right way in the correct financial statement. For example, assets go on the balance sheet and revenue goes in the income statement, and not vice versa.
 - *Disclosure*, which I discuss in Chapter 15, means you give the users of the financial statements all the necessary information they will need when elaborating on financial transactions.
- » **Interpretation of facts:** This error happens if the financial accountant misuses or misinterprets available information. For example, if the accountant decides to calculate depreciation (see Chapter 12) on a 25 per cent reducing balance basis instead of the company's declared policy for depreciation of that asset, which is on a three-year straight-line basis.

Letting cancelling errors lie

When an error occurs that cancels itself out (often referred to as a *contra*), management of a company (with the agreement of their auditors) may decide not to take any action.

For example, let's say the financial accountant screwed up recording depreciation in one year. Even though the depreciation entry in the second year was also incorrect, the two errors resulted in a zero net effect. If the books for both financial periods have already been closed, no further action may be necessary – especially if the error is immaterial. The financial accountant just moves on, making sure year three and all subsequent years are done correctly.



REMEMBER

Even if the cancelling error is immaterial, if the books for year two aren't closed yet, you do have to adjust the opening retained earnings balance (see Chapter 9) for year two and take action to correct the error in year two prior to closing the books. Any direct corrections of errors to retained earnings are called *prior-period adjustments*.

Restating the financial statements

A restatement of the company's financial statements may have to be done for many different reasons. For example, the error in question is material, prior period financial statements are shown with the current year for comparison purposes, or the company's auditor deems a restatement necessary.

The restatement process consists of three steps:

- 1. Adjust the balances of any assets or liabilities at the beginning of the first financial period shown in the comparative statements for the cumulative effect of the error.** Say that you are preparing the accounts for the year ended 31 December 2027, and you spot an error in depreciation that affects the 2026 year end. At the year end 31 December 2026, the cumulative effect of the error in the calculation of depreciation was £100,000. You adjust the book value of the depreciable asset(s) relating to the error by the £100,000.
- 2. Take the second half of your Step 1 entry to retained earnings.** You do so because the error would have affected the prior year's profit or loss, which would have transferred to retained earnings at the end of each year.
- 3. Deal with the disclosure issues.** Your last step is to make sure the notes to the financial statements (see Chapter 15) detail the restatement, providing all the information surrounding the event, such as the nature of the error and the effect on net profit and retained earnings.



REMEMBER

Keep all of this in proportion and consider the issue of materiality at all times. You don't need to write chapter and verse in the annual report if the bookkeeper inadvertently posted an invoice for motor expenses to the postage and stationery account. Significant changes and errors that arose in the prior year will need adjustment and disclosures, but insignificant over- or under-estimations or immaterial errors can simply be corrected in the current year with no major consequence.

A large, bold, white number 7 is positioned on the left side of the image. It has a subtle drop shadow effect, making it stand out against the light gray background.

The Part of Tens

IN THIS PART . . .

Discover how unscrupulous management try to present a misleading picture in the company's financial statements.

Understand how businesses in different industries prepare their financial statements.

IN THIS CHAPTER

- » Inflating revenue and misclassifying income
- » Devaluing liabilities and inflating assets
- » Keeping quiet about related party transactions
- » Capitalising costs
- » Changing accounting policies unnecessarily

Chapter **21**

Ten Financial Accounting Shenanigans

Financial statement shenanigans centre around making a company's financial statements look fantastic, even when they aren't. The major areas of concern all artificially inflate the results of operations or reduce profits to keep the tax bill down. The company may report higher net profit than it should or manipulate its balance sheet figures, perhaps by underreporting liabilities or showing long-term assets as current. Why do companies mess around with their books and deviate from generally accepted accounting practice? Because they want to attract new investors or creditors by showing them great operating results. In this chapter, I reveal ten such manipulations.

Reporting Revenue in the Wrong Period

In financial accounting, income shenanigans usually result from reporting revenue too early. The goal is to appease shareholders and provide justification for bonuses by showing higher-than-actual income. Also, management has a

motivation to inflate revenue because high-ranking employees at most listed (or publicly traded) companies are rewarded by means other than their salaries. These reward systems allow for millions of pounds of incentive payments and share options to be given to those employees as they deliver faster and faster revenues and earnings growth – on paper at least.



REMEMBER

With the accruals method of accounting, a company records revenue only when it is earned and realisable. For revenue to be *earned*, the performance-related conditions in the contract (whether it involves goods or services) must be complete according to the terms of the contract between the entity and its customer. For revenue to be *realisable* means there is an expectation that the company will be paid. Under UK and Ireland generally accepted accounting practice (GAAP) and UK-adopted International Financial Reporting Standards (UK-adopted IFRS), revenue cannot be recognised until the five steps in the revenue recognition model have all been met (see Chapter 17).

Massaging the Figures: Reporting Fictitious Income

When a company hires a tax accountant, it wants that accountant to legally apply tax legislation to reduce the company's taxable profit as much as possible (so it owes the least amount of tax). This is called *tax avoidance*, which is legal (it's *tax evasion* that's illegal), but more aggressive tax avoidance schemes are becoming more morally and ethically frowned upon. When it comes to financial accounting, unscrupulous business owners will seek to increase net profit using means not allowed under GAAP.



WARNING

In Chapter 17, I mention the Tesco scandal where the supermarket chain reported income in the form of rebates that were never going to be received. This is an example of how the figures can be 'massaged' so that shareholders are looking at metrics, such as Earnings per Share (see Chapter 10) and thinking that the company is doing far better than it actually is. Such acts are a criminal offence, and the directors can expect a long prison sentence for committing such acts.

Getting Income Classification Wrong

All money a company receives is not income. And sometimes, a company deliberately misclassifies money it receives in order to manipulate its financial statements.

For example, a business may get a loan from a shareholder or another third party, such as a bank. The loan amount should be recorded as a liability, but perhaps the business records it as income. Or the business generates funds by selling shares of the company. That amount can be recorded as equity, but again, the company may classify it as income.

A company may also try to boost its revenue by improperly adding to this category any profit made from a one-off sale of an asset (rather than classifying the amount as *gain on disposal of property, plant and equipment*). Another misclassification occurs if the business records interest or dividend income as a reduction of operating expense – for example, a reduction to interest expense – rather than as investment income.



You may be thinking, ‘What’s the big deal?’ After all, the effect of these manipulations on the company’s net profit is probably zero. The big deal (besides the possible fraudulent intent) is that misclassifying income statement items affects ratio analysis: a valuable tool used by potential investors and creditors for decision-making (see Chapter 14).

Failing to Record Liabilities

Liabilities are claims against the company by other businesses or by its employees, such as trade payables, unearned revenue (deferred income), and payroll accruals:

- » **Trade payables** include money a company owes its suppliers for goods and services it purchases in the normal course of business and anticipates paying back in the short term. For example, the company purchases inventory from a manufacturer or office supplies from a local stationer.
- » **Unearned revenue** (sometimes referred to as *deferred income*) is money received from customers paying the business for goods or services they haven’t yet received. An example of this is a deposit. For example, if you pay a deposit for a holiday, the travel agency does not recognise that deposit as income because they haven’t delivered the holiday yet. It recognises such deposits as a liability.
- » **Payroll accruals** are wages and other benefits earned by – but not yet paid to – employees. The accruals should be recorded in both the income statement and the balance sheet (see Chapter 8).

If a company doesn’t record its liabilities, the effect is to show the company in a better light by increasing both *net assets* (total assets less total liabilities) and *net*

profit (all income a company earns in an accounting period, less all expenses the company incurs while making that profit).

Reporting Liabilities in the Wrong Period

Reporting liabilities in the wrong accounting period can be just as bad as not reporting them at all. This tactic is often employed at year end to move items affecting the books in a less-than-positive way out of the current year and into the next. The ways to accomplish this manipulation are limitless.

Here are just a couple examples:

» **Holding onto supplier invoices:** For example, the company may not record all supplier invoices it receives during the last 15 days of its accounting period in its purchase ledger. So, for a 31 December year end, all invoices a company receives after 15 December won't be entered into the accounting system until 2 January, which in this case is the next reporting period. This action distorts the financial statements by reducing current liabilities and increasing pre-tax profit for invoices that would hit the income statement.

» **Recording an inadequate warranty reserve:** If a company provides a warranty for the goods it sells, it also has to account for an estimate of how much it will eventually cost to service the warranty. Companies usually calculate the cost of the warranty by using an estimate based on recent experience; for example, recent warranty costs have been 2 per cent of net sales, so the company bases its warranty charge at 2 per cent as well.

Suppose during the last month of the accounting period, the company decides to use 1 per cent instead of 2 per cent for the warranty reserve. Then, it makes up the shortfall in the first month of the new accounting period. This action serves to artificially reduce liabilities and increase net profit – presenting a rosier picture than what is actually factual to the users of the financial statements.

Inflating Asset Values

Assets are resources a company owns (such as property, plant and equipment and inventory) or investments (such as shares and bonds in other companies). Regardless of the assets' *fair value* – how much the assets would fetch in an open marketplace – most assets go on the balance sheet at their original historic cost.

So, if a company owns an office building it paid £500,000 for, and the fair value of the building increases to £700,000, the company doesn't increase the value of the office building on its books for the additional £200,000 (if reporting under the cost model (which means the company reports assets at cost less depreciation less any impairment) – it will do if reporting under the revaluation model (which means the company shows the value of its assets at market value at the end of each accounting period).

Continuing with the building example, if a valuation shows the fair value of the building increases by £200,000 and the company decides to add this increase to the books, there are many ways to hide the inappropriate change. Debiting an asset increases it, and for every debit there must be a credit (see Chapter 5). So if the company increases assets by £200,000, it also needs to credit an account for £200,000. To affect the books in a positive manner, the company can credit sales or owners' equity – both of which serve to artificially make the books look a heck of a lot better.

Here's another trick I see with new clients who don't know any better: A company may decide to bring forward a bank transfer to pay its suppliers. So, for example, a company may carry out a BACS run on 3 January but bring it forward onto the year-end bank reconciliation as at 31 December (so it looks like the BACS run was carried out right at the year end). What this does is reduce the bank balance (assuming the bank is in credit); but it distorts trade payables (a liability, see Chapter 8) by artificially reducing them. Therefore, the user thinks that the company doesn't owe as much as it does at the year end to its suppliers. This is called *window dressing* in accounting terms.

As the business hasn't paid its suppliers until 3 January, the payment should be recorded in the next accounting year, and the true value of trade payables should be shown in the year-end financial statements.

Changing Accounting Policies Inappropriately

Accounting policies are the GAAP that financial accountants use to record a company's accounting transactions, conditions and events. For example, a company uses a specific accounting policy to value inventory (see Chapter 13). Standards such as FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* and UK-adopted IFRS allow the financial accountant more than one acceptable way to handle certain transactions, so the company does have options.

However, there has to be a good reason for any change from one accounting policy to another. A company can't just willy-nilly switch back and forth between inventory valuation methods (or any other GAAP for that matter) merely to increase the bottom line. For more about this topic, see Chapter 20.

For example, using the first-in first-out (FIFO) method of inventory valuation results in a closing inventory of £300,000 and a net profit of £100,000 for Patton's Pottery Company Limited in 2026. Patton's Pottery Company wants to show its investors a higher net profit for the year, so it switches to the weighted average cost method of inventory valuation for 2026, which increases closing inventory and increases net profit by £100,000. Higher net profit equals happy investors. But this isn't a valid reason to change the accounting policy. The policy may only be changed if the new policy results in reliable and more relevant information being provided in the accounts – not just a higher profit for the investors.

Failing to Disclose Related Party Transactions

A *related party* may be a business such as a parent company or affiliate that has direct or indirect control over another business. It can also be individuals or entities that have a connection to the business allowing them to exert significant influence or control over the business's operations and financial decisions. This connection can be through ownership, family ties, or other business relationships.

Most business transactions you'll see as a financial accountant are conducted at *arm's length*. That phrase means the company is conducting business with an unrelated third party. For example, if you subscribe to a magazine, the subscription order is an arm's length transaction: you don't know the publishers, and they don't know you. The price of the subscription is the same for you, or Joe Public down the road.

Here's an example of a related party transaction. A company loans money to one of its directors. This situation can be problematic on many levels if not dealt with properly (there are strict rules in company law governing loans to directors), and especially if a verbal understanding exists that the director never needs to pay the money back. In this case, the loan incorrectly increases liabilities on the balance sheet, affecting investor and credit ratio analyses (see Chapter 14). Depending on the monetary amount of the loan, it may also affect the company's ability to pay dividends.

When parties to a transaction are related, the objectivity that naturally occurs in an unrelated third-party purchase or sale may be lost. Financial accountants must adequately disclose related party transactions (see Chapter 15) so that users of the financial statements are aware that these types of transactions exist. Related party issues are dealt with in FRS 102, *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, Section 33 *Related Party Disclosures* and UK-adopted IAS 24 *Related Party Disclosures* for those businesses preparing accounts under the UK-adopted IFRS regime.

Capitalising Expenses Inappropriately

Whether a purchase is *capitalised* (recorded on the balance sheet as a non-current (or fixed) asset) or *expensed* (recorded in the income statement as an expense) depends on both the monetary value and the type of purchase. Most businesses have a policy covering this decision; see Chapter 7. What a company can't do is decide to capitalise costs instead of expensing them to show a higher net profit.

For example, any costs that materially increase the life of an asset are capitalised. Routine repairs and maintenance costs are expensed. So for a car, rebuilding the engine (because it materially increases the car's useful life) is a capital cost. Oil changes and purchasing new tyres are expenses that have to be reflected in the income statement.

The distinction may not seem like such a big deal until you consider that large publicly traded companies may have thousands of cars. Misclassifying expenses as capitalised improvements can have a significant impact on the bottom line.

Hiding Provisions

A *provision* is a liability of uncertain timing or amount. For example, a business may sack its sales director, and the former sales director may bring a case of unfair dismissal against the company. The company may believe it was correct to dismiss the sales director and may consider that it has followed all relevant employment law leading up to the dismissal.

The lawyers advising the company may say that there's a 75 per cent chance the company will be successful in defending itself. In this case, the company discloses a *contingent liability* (see Chapter 8) but doesn't recognise any amounts that *could* be payable if the company loses. This is because it's not probable (meaning more

likely than not) that the company will have to cough up cash to settle any liability from the case. However, if the lawyers say there's a 75 per cent chance the company will be *unsuccessful* in defending itself, it must recognise a provision for a liability. The provision is valued at the best estimate of the amount that can rationally be paid by the business at the reporting date to settle the unfair dismissal claim.

If the company chooses not to make this provision, not only is this a bad decision on the part of the directors because they're not complying with GAAP, but the company's accounts will also be misleading. This is because provisions for liabilities will be understated, and expenses will also be understated. And the chances are the company has failed to make the required disclosures about the unfair dismissal case, so disclosures are likely to be inadequate (or missing).

IN THIS CHAPTER

- » Examining airline, finance company and franchise industries
- » Understanding natural resource and healthcare entities
- » Considering entertainment, not for profit and property companies
- » Accounting for a company's software

Chapter 22

Ten Industries with Special Accounting Standards

I bang on and on in this book about generally accepted accounting practice (GAAP) because it is such an integral part of financial accounting. While GAAP applies to most non-governmental entities, certain types of businesses must follow GAAP that is tailored to their specific industry. That's because the inherent nature of these industries may require modified accounting practices, financial reporting presentation, and required or recommended disclosures.

If you're a student accountant, some of these specialised instances of GAAP will probably be mentioned in your studies. Also, the info in this chapter will serve you well should you decide to work in one of these industries as a financial accountant. Keep in mind that in this chapter, I merely scratch the surface of this topic. Should you decide to work with a business in one of these industries, you'll have to crack open your GAAP guide to get the full lowdown.

Airlines

Accounting for the airline industry is complicated because recognition of revenue and expenses can change depending on the type of airline: *legacy* (a major airline such as British Airways), *regional* (such as Loganair), or *cargo* (such as UPS). For example, some regional airlines' expenses are reimbursed by the legacy airlines using their services; therefore, the regional airlines don't record them as expenses. While more than a few accounting issues affect this complicated specialised industry, I want to address two biggies in this section: revenue recognition and handling airport slots.



REMEMBER

» **Recognition of revenue:** Under GAAP, airlines have to account for flights paid for in advance as a liability until the conditions of the booking have been completed, which means the customer completes the flight as booked.

If a passenger fails to use a non-refundable ticket, airlines can consider the flight closed the next day and record the revenue for this unused ticket. Exchangeable tickets not used within a certain time period set by the airlines are similarly accounted for as revenue. To arrive at a reasonable time period for determining when it is appropriate to record revenue on an unused exchangeable ticket, the airline looks to historic information that tells them how long in the past it took passengers to re-book their exchangeable flights. This time period can be between 6 and 24 months.

» **Landing and take-off slots:** These areas owned by airlines to enter and exit airports can be one of their largest assets on the balance sheet. While they have a physical presence, landing and take-off slots are accounted for as intangible assets (see Chapter 7). This treatment means their cost is initially taken to the balance sheet and then *amortised*: The cost is transferred to the income statement using an allowable amortisation method (see Chapter 7).

Finance Companies

If you ever took out a loan to purchase a car, you probably had dealings with a *finance company*, whose purpose is to lend money to both consumers and businesses. Examples of finance companies include banks, credit unions, and mortgage providers. Two specialised accounting issues that finance companies encounter are creating a provision (sometimes called an *allowance*) for loan losses and transferring receivables:

- » **Provision for loan losses:** This provision has to be recorded in the financial statements when the finance company considers it probable that the loan is *impaired*, meaning it won't be paid back in its entirety. The provision is a reduction in the amount the company estimates that it will collect and is calculated using an *Expected Credit Loss Model*. The Expected Credit Loss Model is only found in adopted IFRS Accounting Standards because most banks and other financial institutions will usually report under adopted IFRS. The model itself uses a forward-looking approach, which is used to estimate potential losses on things such as loans receivable (see Chapter 7). Under UK and Ireland GAAP, the *Incurred Loss Model* is used. The Incurred Loss Model recognises a loss when there is objective evidence that a loss event has taken place (for example, if a customer has gone bankrupt).
- » **Transfer of receivables:** When a finance company (perhaps in an effort to increase its cash flow) transfers a receivable to another finance company, it reports the transfer as a sale if it gives up all control over the receivable in question. Otherwise, if it retains some control over the receivable, the finance company keeps the receivable on its balance sheet as an asset. However, the receivable must be shown separately from other non-transferred receivables.

Franchisors

You're probably familiar with the concept of *franchises*. What often happens is that a business that starts out on its own grows to be very popular. The original owners then start allowing other individuals to open shops using the same concept in other geographic locations. The parties to a franchise are the *franchisor* (the party granting the business rights) and the *franchisee* (the individual purchasing the right to use the franchisor's business model).

Some special accounting issues for the franchisor include the fact that the franchisor does not recognise revenue until it has substantially performed all material services contained in the franchise agreement; for example, the franchise agreement may call for the franchisor to provide a certain amount of training to the franchisee. Also, if the initial franchise fee required at the time of signing the franchise agreement is significant in comparison to the *continuing fees* (usually a percentage of sales), the franchisor defers a portion of the initial fee (in other words, recognises part of the initial fee as a liability on the balance sheet), recording it as earned through future services rendered to the franchisee.

Oil and Gas Companies

This industry is all about mineral extraction and the production of crude oil. The job of this industry is to find areas that may contain natural resources (including natural gas), conduct some exploration, develop the areas (for example, drill oil wells), and acquire or produce the natural resource.

Under UK-adopted IFRS (see Chapter 4) the standard that deals with such industries is that of IFRS 6 *Exploration and Evaluation of Mineral Resources*. There is no specific equivalent in current UK and Ireland GAAP. FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland* directs accountants to the provisions in IFRS 6. Clear as mud? Well, here are a couple of examples that may prove there is light at the end of the tunnel:

- » Let's say a company finds land in the UK that it believes contains mineral deposits. The cost of acquiring the land (regardless of whether the drilling ever reaps any rewards) is *capitalised at historic cost*, which means it is shown on the balance sheet as an asset at the amount the company paid for it plus any other costs involved in its acquisition, such as legal fees.
- » Any other costs that directly tie back to the successful discovery of any mineral/oil or gas reserves – for example, oil well drilling – are also capitalised.
- » Any other costs are expensed as they are incurred.

Pension Schemes

The UK has a pension *Statement of Recommended Practice* (SORP). A SORP is a sector-driven recommendation on accounting and auditing for specialised industries and supplements UK and Ireland accounting standards. There are a number of SORP-making bodies in the UK. One of those SORP-making bodies is the *Pensions Research Accountants Group*, which maintains the pensions SORP.



TECHNICAL
STUFF

Pension scheme accounting is complex, and many firms that deal with pension scheme accounts have a specialist in the team who knows the pensions SORP inside out. Two types of pension scheme are usually governed by the SORP:

- » A *defined contribution pension scheme*, which is a retirement savings plan where the contributions are paid by the employee and/or the employer. These sorts of pension schemes provide no guarantee as to how much income the pensioner will get in retirement.

- » A *defined benefit pension scheme* (sometimes called a *final salary pension*) is a pension that provides a guaranteed income in retirement. It is usually based on a percentage of the pensioner's salary and years of service.

Healthcare Entities

Examples of healthcare entities are hospitals, nursing homes, medical centres, and doctors' surgeries. A major accounting issue with this type of entity is the significant amounts of money healthcare entities may invest in drugs, linens, and other ancillary services. Because the amount of money is so large, proper treatment under GAAP is key to making sure financial results are accurate and understandable to the users of the financial statements.

Here are some specialised accounting issues in the healthcare field:

- » Accounting for and reporting contingencies (see Chapter 8) surrounding medical negligence claims
- » Accounting for revenue and cost recognition methods related to setting rates for services provided, working with third-party payers (insurance companies and BUPA), and contracting out certain services (such as x-rays and MRIs) to third-party providers

Film Production Companies

Motion picture accounting issues include how to account for the production, sale, licensing, and distribution of the films and product-related merchandise. The product-related merchandise aspects are pretty self-explanatory. But some issues are quite complex:

- » **Production:** Motion picture production involves every step of making the film, from deciding on an initial concept to securing a script to releasing the finished product.
- » **Sale:** The sale of a film takes place only when the master copy of the film and all its associated rights are transferred from the original owner to the interested buyer. After the sale takes place, the original owner has no right to any future profits.

» **Licensing:** Licensing means the owner allows others to show the film for a fee (like when you go to the cinema).

Accounting for the film production industry can be quite daunting because it is very difficult to estimate earned revenue and related costs over the life of a film. To deal with this problem, the motion picture industry calculates an appropriate estimation method that, as accurately as possible, matches revenue and expenses to show the film's financial performance.

Not-for-Profit Organisations

These sorts of organisations, such as charities, don't have a profit motive when providing their goods or services; see Chapter 6. Accounting issues tailored to this type of entity include recognising contributions, which must be recorded at *fair value* (their value in an open marketplace). This step is easy for cash – after all, cash is cash! But it can get fiddly when a donor contributes assets such as property building or artwork. Many times, a valuation has to be undertaken to properly value the contribution.

Another issue is the standard for financial statement presentation. Net assets and income statement accounts have to be broken down to distinguish those that have restrictions and those that don't. For example, a donor may specifically state that a donation is to be used only to support a specific project the not-for-profit provides – this money will be classified as restricted funds. If there are no restrictions, the money is classed as unrestricted funds.

You may also come across *Community Interest Companies* (CICs) during your working life as a financial accountant. These are companies that are specifically designed for those who want to operate for the benefit of the community, as opposed for the benefit of the company's owners (the shareholders). To be classed as a CIC, the company must pass a series of tests to make sure that the CIC is established for the purposes of the community and the profits made by the CIC are dedicated to these purposes.

House Builders

Specialised GAAP pertain to the costs a company (such as a social housing association) incurs when purchasing and developing land for rental – for example, developers who plough over trees and vegetation and level the land to build

residential or commercial properties. Most costs a developer incurs are originally capitalised rather than expensed. Here are two examples of capitalised land development costs:

- » **Pre-acquisition costs:** These costs take place prior to purchasing the land and will include legal fees for conveyancing costs to transfer ownership from the seller to the buyer.
- » **Directly attributable costs:** These costs are incurred after the land is purchased and directly tie back to the project, such as the bricks and mortar used to build the properties that will be rented by the housing association.

Computer Software

Here, I'm not focusing on a specific industry but on something that is employed in just about every industry: computer software. Accounting issues regarding software vary depending on whether a company buys software off the shelf to use in its business, purchases software from a developer for resale to others, or develops software in-house that is tailored to its specific business needs. (An example of developing in-house software is a manufacturer writing its own inventory software to monitor the use of raw materials required to make its products.)

The primary issues with software revolve around revenue recognition and expense. For your everyday owner-managed business that purchases software off the shelf, the recognition of the expense is relatively easy: the company follows its capitalisation policy, which usually means that if it plans on using the software for more than 12 months, the software cost is depreciated or amortised rather than immediately expensed if it is over the monetary benchmark capitalisation amount. The same holds true for retail stores purchasing software for resale to customers; they account for the software like any other inventory transaction.



REMEMBER

If the software is critical to the hardware to which it relates, operating properly (meaning it is part of the operating system), the software is treated as part of the cost of the hardware as property, plant and equipment. If the software is not necessary to operate the hardware it relates to, it is treated as an intangible asset.

The accounting gets more complicated when the software is developed internally, either for *proprietary use* (meaning for use only by the company that writes the software) or for sale to others (such as when a software developer sells a computer game to retail stores).

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Dedication

I would like to dedicate this book to each one of my family and friends. In particular, I would like to dedicate this book to Les Leavitt (managing partner at LWA), whose guidance and encouragement have enabled me to gain the knowledge and experience that is passed on to others in the accountancy profession through books such as this.

— Steve Collings

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— Steve Collings

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