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PART I

The accounting environment

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Introduction

Aim of this book

The aim of this book is to explain accounting to lawyers. This means to some extent explaining it as one would to any group of intelligent non-accountants. But I emphasise those aspects that are particularly relevant to the work that lawyers do. For example, chapters 3 and 4 on the legal framework of accounting, and on substance over form, are more detailed than they would be for a general reader. Similarly, the specific subjects covered in Part II reflect the likely interest of lawyers. Mergers and acquisitions, leases, capital instruments and realised profits are all discussed. But the reader will find little on methods of stock valuation and methods of depreciation. Similarly, this book does not deal with accounting for special industries and sectors such as banks, insurance companies and charities.

What is accounting?

Accounting is a broad term. It is used to cover the initial recording of transactions in a company's accounting records, though this is better termed 'bookkeeping'. Given the almost universal use of computers for record keeping, even this term is itself only literally accurate either historically, when entries were made in books of account or (historically leather bound) ledgers, or in the smallest of businesses.

The term 'accounting' more properly refers to either the processes that accountants carry out, namely of aggregating and shaping information into reports that are useful to users of those reports; or to the outputs of those processes, namely accounting reports that can be used internally within a business ('management accounting') or externally ('financial accounting' or 'financial reporting'). External reporting can be seen in terms of compliance with legal requirements, for example the requirement under the Companies Act 1985 (CA 1985) to lay accounts (also called 'financial statements') before a general meeting of shareholders and to file them at Companies House. Other regulatory purposes arise, such as the role of the Financial Services Authority in connection with the supervision of various financial institutions.

Whilst this compliance aspect is important, accounting – both internal and external – is perhaps better seen as a process that serves the decision-making

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needs of business people and various classes of users of accounts. Thus, within a company, the board and various other unit and divisional managers need accounting information to enable them to understand and control the business on a regular basis. In most medium-sized and larger businesses, budgets and subsequently monthly management accounts are prepared for this purpose. Managers will want to know about various financial indicators, such as growth in sales, margins, level of costs, amount of funds tied up in stock and debtors and so on. All of this has the overall objective of seeking to ensure that the company achieves its profit objectives. If the management accounting information shows that budgets are not being achieved, decisions will be taken relating to matters such as pricing, level of overheads such as marketing expenditure and staff numbers, or levels of capital expenditure, to try to steer the company back on course to achieving the sales, profit and other measures set out in the budget.

External reporting also has an important decision-making focus, as well as a compliance focus. In a narrow, traditional sense, a board of directors presents to shareholders an annual report that gives an account of its stewardship of the company's assets during the year. But even implicit in that is an assumption that the shareholders will consider whether they find the performance to be acceptable. If they do not, that might lead to their refusing to reappoint some directors. So even here there is a notion of decision making.

But, in a modern context, the decision-making role is more explicit. Certainly for companies listed on a stock exchange, the board is reporting to 'the market': the analyst and fund manager community in general and not just to those who happen to be shareholders at present. The market has expectations about earnings, and if the earnings reported disappoint the market, the share price, and sometimes the directors' careers, will suffer. The fundamental decisions taking place here, of course, are concerned with whether to hold, buy or sell the company's shares.

The components of a company's annual report

An annual report, especially of a listed company, is now a very substantial document. The following are currently its main components:

- *Chairman's report*. This is given by listed companies and some other public interest entities, but not generally otherwise.
- *Operating and financial review (OFR)*. This is recommended for listed and some other public interest companies by an Accounting Standards Board (ASB) statement of the same name. It is now becoming a statutory requirement for listed companies. See chapter 17.
- *Directors' remuneration report*. Certain disclosures relating to directors' remuneration are required by all companies, but in the case of listed companies these are more extensive and are presented as a separate report. See chapter 17.

The components of a company's annual report

- *Report on corporate governance.* This is required for listed companies, and, like the OFR and remuneration report, has been a growth area in recent years. See chapter 17.
- *Auditors' report.* This is an opinion from the auditor as required by the Companies Act. See chapter 5.
- *Directors' report.* This is a legal requirement, though the contents are somewhat arbitrary and not always interesting; hence the growth of the chairman's statement and OFR as channels of communication.
- *Performance statements.* For UK generally accepted accounting principles (GAAP) purposes, these comprise the profit and loss account and statement of total recognised gains and losses (STRGL). These are required by the CA 1985 and accounting standards respectively. The profit and loss account is the traditional way in which a company (or group) communicates its performance in the year. This extended in the 1990s to include the STRGL, which shows a more comprehensive picture of performance, including for example gains on revaluation of properties or other assets. For those reporting under international financial reporting standards (IFRS) (including listed groups), the profit and loss account is the principal statement; there is a broad equivalent of the STRGL but it is not quite so well established.
- *Balance sheet.* This sets out the company's assets and liabilities and its shareholders' funds. The balance sheet was traditionally seen as merely a collection of the assets and liabilities that were, so as to speak, left over at the end of the year following the matching of costs and revenues in the profit and loss account. More recently, the balance sheet has come to be seen as a more important statement in its own right. For example, stricter definitions of what should be treated as assets and liabilities, and the introduction of more fair valuing (see chapter 7) have increased the importance of the balance sheet.
- *Cash flow statement.* This is, almost literally, a statement of the cash receipts (inflows) and payments (outflows) during the year, categorised under various headings. It may thus correspond more closely to a non-accountant's view of performance than profit. See the next section for a comparison of the two.
- *Statement of accounting policies.* Even though much of accounting is specified, there is nonetheless scope in some areas for a company to select accounting policies. In this section of the annual report the company describes the accounting policies it has used in preparing its accounts.
- *Notes to the accounts.* Many pages of notes are presented in accordance with company law and accounting standards. In general the notes amplify what is in the profit and loss account and STRGL, the balance sheet and the cash flow statement. In addition there are notes dealing with matters such as related party transactions.

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The meaning of accounting terms

A glossary of terms may be found at p. x. In this section, we discuss a single set of related terms – profit and cash flow.

A question not infrequently asked by non-accountants is what exactly *profit* means and how it differs from *cash flow*. Both are measures of what has happened to a business during a year, but they shed different light on its activities. Cash flow is a natural idea, familiar to us all as individuals. By contrast, profit is an artificial construct. Profit arises from the use of *accruals accounting*, that is, recognising transactions in the period in which they occur, rather than in the period in which the cash is received or paid; it thereby measures the performance of a business. A simple example will illustrate the point.

P Limited:

- Sells goods to customers during 2003 of invoiced value £100. Of this, P receives £50 in cash during the year (the remaining £50 is received in the following year).
- Buys goods from suppliers during 2003 of invoiced value £60. P buys on extended credit and pays nothing in 2003.
- Spends £40 cash on buying office equipment.

P Limited's cash flow statement will show the figures indicated in Box 1.1.

Cash flow statement	
Operating inflows	
Receipts from customers	50
Capital expenditure	(40)
Increase in cash during the year	<u>10</u>

Box 1.1

The company's profit and loss account shows an entirely different picture (see Box 1.2).

Profit and loss account	
Sales	100
Cost of sales	(60)
Depreciation of equipment	<u>(4)</u>
Profit before tax*	<u>36</u>

*Tax is ignored in this simple example

Box 1.2

The meaning of accounting terms

The two results happen to be quite different in amount (though in other examples they might be similar) and are quite different in principle. The profit and loss account focuses on the transactions that relate to the year in question. So, it focuses on the sales that have been made in the year (£100), and on the cost of those sales (£60), without reference to whether these amounts have been collected or paid for in cash. Also, the purchase of office equipment is for use in the business over an extended period; it is not held for resale. Hence it is described as capital expenditure and the cost is spread in accounting terms over its useful economic life, in this case assumed to be ten years.

If we assume that P Limited is a new business that started the year by issuing 100 £1 shares at par for cash, we can see that at the end of the year it will have cash of £110 (opening cash of £100 plus increase in cash during the year of £10). But, as shown in Box 1.3, its closing balance sheet will reflect all the assets and liabilities of the business:

Balance sheet	
Fixed assets (cost £40 less depreciation £4)	36
Debtors (sales made, cash not yet collected)	50
Cash	110
Less: creditors (amounts owing to suppliers)	<u>(60)</u>
Net assets	<u>136</u>
Box 1.3	

These net assets are equivalent to shareholders' funds, as shown in Box 1.4.

Opening shareholders' funds	100
Profit for the year (retained)	<u>36</u>
Closing shareholders' funds	<u>136</u>
Box 1.4	

This simple example illustrates a number of points. First, it shows that:

$$\text{Assets less liabilities} = \text{Shareholders' funds}$$

This simple equation demonstrates that shareholders' funds (136 in this example) is the residual interest after all liabilities (60) are deducted from all assets ($36 + 50 + 110 = 196$).

The second point is that the profit and loss account and the balance sheet articulate with each other. They are both prepared on an accruals basis. Third, the profit and loss account and balance sheet show a much richer set of information than the cash flow statement. This is not to say that the cash flow statement is of

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little or no value. Indeed it is important that a business generates cash, otherwise it will run into difficulty; hence cash flow information is useful in its own right. It is also useful as a cross check on the quality of profits (or earnings).

The example also allows us to view profit in an economic way. Profit can be viewed as the amount that a proprietor can withdraw from a business at the end of a year, such that the business can continue in the following year. We can see from the examples in Boxes 1.2 and 1.4 that the shareholders could have withdrawn the £36 profit and the business would (leaving aside complications such as inflation) have maintained its capital and been able to continue. The £10 increase in cash in the year is not a helpful indicator in these respects.

Of course, merely to speak of ‘profit’ is an oversimplification. A typical company’s profit and loss account may include the figures shown in Box 1.5.

Sales	100
Cost of sales	<u>(60)</u>
Gross profit	40
Admin expenses	<u>15</u>
Operating profit	25
Interest payable	<u>7</u>
Profit before tax	18
Tax	<u>(5)</u>
Profit after tax	<u>13</u>

Box 1.5

The relatively simple profit and loss account in Box 1.5 uses four variants of the term ‘profit’. Whilst they are self-explanatory, it demonstrates the need for clarity in terminology.

The use of accounting terms in legal agreements

The above example of four variants of profit illustrates an important point for lawyers. A legal agreement that refers to profit should be as specific as possible as to which profit figure is envisaged. This is not just a matter of being clear as to which of the above four figures is being used. It also needs to be clear:

- Which year’s profits are intended.
- Which GAAP is intended (UK GAAP, IFRS etc. – see chapter 2).
- Whether the profit is as per the statutory accounts or whether it is adjusted in some way.
- According to which accounting policies the profit is calculated – for example, the bidder’s policies or the target’s policies.

Hence a reference to profit calculated according to GAAP is not helpful and can be the source of difficulty, not to say litigation.

Similarly, other terms may be used in various legal agreements, and the same general principle applies. Further examples of imprecision are the terms 'gearing' and 'interest cover' which are often used in loan covenants. This is discussed in more detail in chapter 18.

What is GAAP?

As mentioned above, GAAP refers to generally accepted accounting principles. There are different GAAPs in different jurisdictions, e.g. UK GAAP, US GAAP, French GAAP and so on. There are also international accounting standards (IASs) or international financial reporting standards (IFRSs), also sometimes called international GAAP. These aspects are discussed in chapter 2.

Although it has no precise meaning, UK GAAP is generally taken to refer to:

- Parts of company law, primarily the Companies Act 1985.
- Accounting standards (statements of standard accounting practice (SSAPs) and financial reporting standards (FRSs)).
- Abstracts from the Urgent Issues Task Force (UITF).
- For listed companies, the Listing Rules.

These are the core, compulsory components of GAAP. Each of them is now discussed in turn.

Company law. This is the foundation of accounts preparation and GAAP. The CA 1985 sets out the basic requirement for a company to prepare accounts, lay them before the members, and file them at Companies House. The Act also sets out some of the details regarding their preparation, for example, requirements as to what is a subsidiary undertaking and what should therefore be consolidated; basic accounting principles and measurement rules; formats for the balance sheet and profit and loss account; some disclosure requirements. Much of the detail is found in Schedule 4 (entity accounts) and Schedule 4A (group accounts) and this originates from the EU fourth and seventh company law directives respectively (Council Directive 78/660/EEC on the annual accounts of certain types of companies, OJ 1978 No. L222/11 and Council Directive 83/349/EEC on consolidated accounts, OJ 1983 No. L193/1).

Accounting standards. The current accounting standards in the UK are FRSs and these are produced by the ASB. The predecessor body until 1990 was the Accounting Standards Committee (ASC) which produced SSAPs, some of which are extant. Many accounting standards build on the foundations of company law. For example, FRSs 2, 6 and 7 provide further detail about how to prepare consolidated accounts. SSAP 25 deals with segmental disclosures, and adds to the basic requirements of the Act in this area. On the other hand, some subjects are not dealt with in company law at all. Examples are earnings

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per share (FRS 22) and deferred tax accounting (FRS 19). A full list of extant accounting standards may be found in appendix 1.

UITF Abstracts. These are produced by the UITF, which is a committee of the ASB. The UITF's role is to assist the ASB in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations have developed or seem likely to develop. Hence it deals with relatively narrow issues. Examples are Abstracts on website development costs, operating lease incentives, start-up costs, pre-contract costs and certain barter transactions. Perhaps the most important Abstracts in practice are those dealing with various aspects of employee share schemes.

The Listing Rules. These rules, insofar as they deal with accounting matters, are part of GAAP only for listed companies. In terms of regular reporting (as opposed, for example, to new listings) there are continuing obligations relating to disclosures that are additional to those in the law and accounting standards; examples are directors' interests and corporate governance issues. The Listing Rules also set out the basic requirement for interim reports and preliminary announcements, to which the ASB adds non-mandatory guidance.

In addition to the above, the term 'GAAP' is sometimes used in a less formal sense to include:

- Guidance from various bodies, e.g. guidance statements from the ASB on Interim reporting, Preliminary announcements, and on the Operating and financial review; Statements of Recommended Practice (SORPs) from the ASB; and the guidance from the Institutes of Chartered Accountants on matters such as realised profits.
- Manuals and similar guidance from firms of accountants.
- Quite literally, principles that are generally accepted in practice, say in a particular industry.

Two other sources also inform the application of GAAP. One is the ASB's Statement of principles. This document is not an accounting standard as such, but is the framework that guides the ASB in its setting of standards on individual subjects. It is also useful to preparers and auditors of accounts as a guide in those areas where no specific rules are set down. Secondly, it is sometimes appropriate to look to other GAAPs where UK GAAP is silent. US GAAP is more detailed and is sometimes used as a guide to practice. Increasingly IFRSs are used in this way.

Selecting and disclosing accounting policies

It is implicit in the definition of GAAP that there will sometimes be more than one acceptable method of treating a transaction or event in a set of financial statements. Sometimes, different treatments arise in practice in areas that are unregulated by formal GAAP. Some companies are more aggressive than others in terms of recognising revenue from transactions, or in terms of carrying

Selecting and disclosing accounting policies

forward costs. However, in practice the scope to take different judgements lies in a fairly narrow band: the basic legal requirement that accounts should give ‘a true and fair view’ guides directors to select policies that achieve this outcome. Moreover, FRS 18 ‘Accounting policies’ requires that, where there is a choice of policies, companies should ‘select whichever of those accounting policies is judged by the entity to be most appropriate to its particular circumstances for the purpose of giving a true and fair view’.

Sometimes there are choices within an accounting standard. For example, FRS 15 on tangible fixed assets allows companies to measure assets at cost or on a valuation basis (in each case, subject to depreciation). The same standard allows a company that incurs finance cost (e.g. interest cost) in the period of construction of an asset either to write it off as an expense when incurred, or to capitalise it, that is, add it to the carrying value in the balance sheet of the asset under construction.

Partly because there are choices of policies, and partly for clarity for the reader even where there is no choice, companies are required by FRS 18 to disclose ‘a description of each of the accounting policies that is material in the context of the entity’s financial statements’ (para. 55).