

Accounting Principles for Lawyers

Many lawyers, especially those dealing with commercial matters, need to understand accounting yet feel on shaky ground in the area. This book is written specifically for them. It breaks down and makes clear basic concepts (such as the difference between profit and cash flow), and explains the accounting profession and the legal and regulatory framework within which accounting operates. The relevant provisions of the Companies Act 1985 are discussed at some length. Holgate explains generally accepted accounting principles (GAAP) in the UK, the trend towards global harmonisation and the role of international accounting standards. He then deals with specific areas such as group accounts, acquisitions, tax, leases, pensions, financial instruments, and realised profits, focusing in each case on those aspects that are likely to confront lawyers in their work. This book will appeal to the general practitioner as well as to lawyers working in corporate, commercial, and tax law.

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The law as stated in this book is correct as at 31 March 2005.

Glossary of terms

ACCA. Association of Chartered Certified Accountants.

Accruals accounting. The method of accounting that underpins the profit and loss account and balance sheet, namely recognising transactions in the period to which they relate, rather than in the period in which the cash is received or paid. Hence (a) the charge in the profit and loss account for an expense is not (except by chance) the same as the amount of cash paid; (b) the amount recognised as revenue (or turnover, or sales) for the year, is not (except by chance) the same as the cash received from customers.

Act (or ‘The Act’). Unless specified to the contrary, ‘Act’ or ‘The Act’ refers to the Companies Act 1985.

AIDB. Accountancy Investigation and Discipline Board. Part of the FRC.

AIM. Alternative Investment Market.

APB. The UK Auditing Practices Board. Part of the FRC.

ARC. Accounting Regulatory Committee (of the EU).

ASB. The UK Accounting Standards Board. Part of the FRC.

ASC. The UK Accounting Standards Committee, which set standards from 1970 to 1990, when the ASB took over the activity.

Asset. In a formal sense, the UK Statement of principles (para. 4.6) defines assets as: ‘rights or other access to future economic benefits controlled by an entity as a result of past transactions or events’. Less formally, an asset is something of value that a company has; it is recognised as an asset on the balance sheet if it meets certain recognition criteria, such as whether it can be measured reliably.

Associated undertaking. An entity (other than a subsidiary or joint venture) in which another entity (the investor) has a participating interest and over whose operating and financial policies the investor exercises a significant influence. [FRS 9, para. 4]

CA 1985. The Companies Act 1985.

CCAB. The Consultative Committee of Accountancy Bodies in the UK and Ireland, which comprises:

- The Institute of Chartered Accountants in England and Wales (ICAEW)
- The Institute of Chartered Accountants of Scotland (ICAS)
- The Institute of Chartered Accountants in Ireland (ICAI)
- The Association of Chartered Certified Accountants (ACCA)
- The Chartered Institute of Management Accountants (CIMA)
- The Chartered Institute of Public Finance and Accountancy (CIPFA)

CESR. Committee of European Securities Regulators.

CIMA. Chartered Institute of Management Accountants.

CIPFA. Chartered Institute of Public Finance and Accountancy.

Combined Code. The UK code of corporate governance, the latest version of which (2003) is published by the Financial Reporting Council.

DB. Defined benefit (pension scheme).

DC. Defined contribution (pension scheme).

Debit/credit. These are bookkeeping terms. A debit entry represents either an expense or an asset (or a reduction of a liability). A credit entry represents either income or a liability (or a reduction of an asset). The application of accounting principles in drawing up financial statements involves determining which debits are to be treated as assets and which are to be treated as expenses; and determining which credits are to be treated as liabilities and which are to be treated as equity or income. As an example, a payment of cash of £100 to acquire stock is represented as: Dr Stock £100 (an increase in the asset 'stock'); Cr Cash £100 (a decrease in the asset 'cash').

Deferred tax. Estimated future tax consequences of transactions and events recognised in the financial statements of the current and previous periods. [FRS 19, para. 2]

DTI. The UK Department of Trade and Industry.

Earnings. An undefined term, broadly equivalent to profits. Generally refers to profit after tax and minority interest. More accurately, it refers to profit after tax, minority interest and preference dividend, this being the definition of earnings used in the calculation of EPS (see below).

EBITDA. Earnings before interest, tax, depreciation and amortisation. This is a measure of earnings favoured by some analysts and some companies. Depreciation and amortisation are added back because they are non-cash items. Hence EBITDA is sometimes called 'cash earnings' though this is something of a misnomer, as it still includes many items calculated on an accruals basis.

EFRAG. The European Financial Reporting Advisory Group, part of the mechanism used by Brussels to help it to consider endorsement of International Financial Reporting Standards for use in the EU.

Entity accounts. The accounts of an entity itself – for example the accounts of a single company – as opposed to consolidated accounts. See chapter 8.

Glossary of terms

EPS. Earnings per share. Broadly, earnings (profit after tax, minority interest and preference dividend) divided by the number of equity shares in issue during the year. The details are set out in FRS 22.

Equity. (1) The IASB's term for shareholders' funds. (2) An equity share, defined in section 744 of the Act as 'in relation to a company, its issued share capital excluding any part of that capital which, neither as respects dividends nor as respects capital, carried any right to participate beyond a specified amount in a distribution'. Note that FRS 4 'Capital instruments' defines non-equity shares in a way that gives equity shares for FRS 4 purposes a different meaning from that in the Act.

Equity accounting. This is also known as 'the equity method'. It is the method of accounting adopted for associated companies and in certain cases for joint ventures, as explained in chapter 8.

ESOP. Employee Share Ownership Plan.

Expense. A reduction in assets, charged in the profit and loss account. This includes non-cash items such as depreciation of fixed assets.

FASB. The US Financial Accounting Standards Board.

Financial statements. A company's annual financial statements, which comprise the profit and loss account, the statement of total recognised gains and losses, the balance sheet, the cash flow statement and various supplementary notes. They form the major part of the company's annual report; this is sent to shareholders and placed on the public record at Companies House. Can also refer to other contexts, such as interim financial statements.

FLA. Finance and Leasing Association.

FRC. The UK Financial Reporting Council, the body that oversees the regulation of corporate reporting and audit, including the UK ASB and the FRRP.

FRRP. The UK Financial Reporting Review Panel. Part of the FRC.

FRS. A UK Financial Reporting Standard, an accounting standard developed by the ASB. See also SSAP.

FRSSE. Financial Reporting Standard for Smaller Entities.

FSA. The UK Financial Services Authority.

GAAP. Generally accepted accounting principles, discussed in chapter 1.

Gearing. The relationship between debt and equity. Gearing can be calculated in a number of ways. See chapter 18 for details.

Gross profit. This is profit measured as revenue less cost of sales, that is, profit before deducting overhead expenses, interest and tax.

IAS. An international accounting standard issued by the IASC.

IASB. The International Accounting Standards Board, the global standard-setter from 2001.

IASC. The International Accounting Standards Committee, the global standard-setter until 2001.

ICAEW, ICAS, ICAI. See CCAB.

IFRIC. The International Financial Reporting Interpretations Committee, a subsidiary of the IASB.

IFRS. An international financial reporting standard issued by the IASB.

Income. An undefined term, used rather loosely. Can be used as a synonym for profit (e.g. in US parlance ‘net income’ means profit after tax). Sometimes also, confusingly, used to mean revenue.

Interest cover. The ratio of interest cost to profit before interest. So if profit before interest is 100 and interest cost is 25, interest cover is 4. That is, interest is covered 4 times by profits.

Interims. Interim reports published by listed companies, required by the FSA as Listing Authority.

Joint venture. An entity in which the reporting entity holds an interest on a long-term basis and is jointly controlled by the reporting entity and one or more other venturers under a contractual arrangement. [FRS 9, para. 4]

JV. Joint venture.

KPI. Key performance indicators.

Liability. In a formal sense, the ASB’s Statement of principles (para. 4.23) defines liabilities as: ‘obligations of an entity to transfer economic benefits as a result of past transactions or events’. Less formally, a liability is something that a company owes to a third party; it is recognised as a liability on the balance sheet if it meets certain recognition criteria, such as whether it can be measured reliably.

Listing Rules. The rules issued by the Financial Services Authority that apply to companies listed on the London Stock Exchange.

LTIP. Long-term incentive plan.

Minority interest. The interest of an outside shareholder in a partially-held subsidiary.

NASDAQ. National Association of Securities Dealers Automated Quotation system).

NRV. Net realisable value.

OFR. The Operating and Financial Review. This was for some time recommended by the ASB as a supplementary report to be given by listed companies, mainly in narrative form. It is now becoming a statutory requirement for listed companies.

Operating profit. A measure of profit after deducting all operating expenses but before adding share of results of associates and joint ventures,

Glossary of terms

and before deducting interest and tax. In UK GAAP, certain exceptional items (non-operating exceptionals, or ‘super-exceptionals’) are also added/deducted after operating profit.

P & L. Profit and loss.

Participating interest. An interest held by an undertaking in the shares of another undertaking which it holds on a long-term basis for the purposes of securing a contribution to its activities by the exercise of control or influence arising from or related to that interest. [CA1985, section 260]

POBA. The UK Professional Oversight Board for Accountancy. Part of the FRC.

Prelims. Preliminary announcements of results by listed companies as required by the Listing rules.

Profit. A measure of the results of a business on the basis of accruals accounting (see above). (See also Gross profit, Operating profit, Profit before tax, Profit after tax.)

Profit after tax. A measure of profit after deducting all expenses including tax.

Profit before tax. A measure of profit after deducting all expenses apart from tax.

Revenue. The amount earned by an entity from selling goods and services. The terms ‘sales’ and ‘turnover’ are broadly synonymous with revenue.

Sales. See Revenue.

SAS. Statement of Auditing Standards.

SEC. Securities and Exchange Commission.

Shareholders’ funds. The aggregate of a company’s share capital and its reserves. Called ‘equity’ in IFRS.

SIC. Standing Interpretations Committee of the IASC.

SoP. Statement of principles.

SORP. Statement of Recommended Practice.

SPE. Special purpose entity.

SSAP. A UK Statement of Standard Accounting Practice, an accounting standard developed by the ASC. See also FRS.

STRGL. The statement of total recognised gains and losses. This is a statement required by UK GAAP as a continuation of the profit and loss account. Together the two statements give a more comprehensive picture of economic performance than does the profit and loss account alone. Broadly, the distinction is that the STRGL includes value changes, such as gains and losses on revaluing a property, whereas the profit and loss account deals with transactions.

Subsidiary/Subsidiary undertaking. Under IFRS, a subsidiary is ‘an entity, including an unincorporated entity such as a partnership, that is controlled by

another entity (known as the parent)'. For UK GAAP and UK law purposes, there is a distinction between 'subsidiary' and 'subsidiary undertaking'. Section 736(1) of the Act defines a 'subsidiary' for the general purposes of the Act but not for accounting purposes. Section 258 of the Act defines a 'subsidiary undertaking' for accounting purposes, chiefly in connection with consolidation.

Turnover. See Revenue.

UITF. The UK Urgent Issues Task Force. This is a subsidiary of the ASB.

XBRL. Extensible Business Reporting Language.