Richard Lewis and
David Pendrill

Advanced Financial Accounting

seventh edition

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Advanced Financial Accounting

Richard Lewis MSc, FCA

Co-Director of the Centre for Higher Education Research and Information, Open University

David Pendrill BSc(Econ), MSc, FCA, CTA, LTCL

Esmée Fairbairn Professor of Accounting and Financial Management, University of Buckingham

FT Prentice Hall
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An imprint of Pearson Education

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Pearson Education Limited

Edinburgh Gate
Harlow
Essex CM20 2JE
England

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First published under the Pitman imprint 1981
Second edition published 1985
Third edition published 1991
Fourth edition published 1994
Fifth edition published under the Financial Times Pitman Publishing imprint 1996
Sixth edition published under the Financial Times Prentice Hall imprint 2000
Seventh edition published 2004

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ISBN 0 273 65849 2

British Library Cataloguing-in-Publication Data
A catalogue record for this book can be obtained from the British Library.

10 9 8 7 6 5 4 3 2 1
08 07 06 05 04

Typeset in 10/12pt Minion by 30.
Printed and bound in Great Britain by Bell and Bain Ltd, Glasgow.

The publisher's policy is to use paper manufactured from sustainable forests.

Brief contents

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Preface

This is undoubtedly a demanding time for practitioners and students of financial reporting. Accountants and business people in European Union countries need to master not only their national regulations but also the rules of the International Accounting Standards Board. Both sets of rules are voluminous, ever growing and presently undergoing a process of rapid change as a consequence of the convergence programme designed to bring national and international standards into line with one another.

The ASB, in the UK, has developed its *Statement of Principles for Financial Reporting*, a conceptual framework designed to underpin the development of accounting standards which adopts a rather different view from that of the accruals-based approach of traditional financial accounting. However, some of the principles are inconsistent with present company law and several of the Financial Reporting Standards in issue are inconsistent with the *Statement of Principles*. Company law is presently under review, with the publication of a White Paper which proposes major changes to the mechanism for setting and enforcing accounting rules in the UK. Once the law is changed, then it will be necessary to change numerous Financial Reporting Standards. It can perhaps be seen that the failure in the past to develop a generally-agreed theory underpinning financial accounting is not without its practical costs.

A 2002 EU Regulation requires all quoted companies in Europe to prepare their consolidated financial statements in accordance with international standards, rather than national standards, by the year 2005. Accounting rule setters in the various member states are attempting, with varying degrees of enthusiasm, to achieve convergence between their own standards and those of the IASB, but this process is difficult to achieve because of considerable, often major, differences between the respective standards and because the IASB is itself revising a large number of standards as part of its improvements project. National standard setters are therefore in the uncomfortable position of shooting at a moving target.

The EU Regulation applies only to the consolidated financial statements of quoted companies, although member states may permit, or require, the use of international standards in the single-entity financial statements of those companies as well as in both the single entity and consolidated financial statements of unquoted companies. At the time of writing it is unclear whether the various member states will require universal application of international standards or whether two sets of standards, national and international, will co-exist for application to different financial statements in the same country. In the view of the authors, even the consolidated financial statements of quoted companies in different EU countries are unlikely to be comparable until long after 2005, let alone the financial statements of unquoted companies.

While the world's standard setters still have their disagreements, most of them seem to suffer from the same condition – asking for more and more about what is in relative terms less and less. The phrase 'knowledge economy' might have become a stale cliché but it still has a relevance in that the major assets of an increasing number of businesses are knowledge and expertise rather than physical assets. Yet standard setters have poured far more of their energies into the production of longer and ever more detailed standards relating to tangible assets than they have to the critical questions of how an entity should report on the extent to which it has invested in enhancing its store of knowledge and what it has done to protect that store, for example through its staffing policies.

Another disappointing feature of the shared practices of standard setters is their reluctance to move away from the view that there is one and only one way of valuing an asset or a liability that should be reported. The standard setters argue that it would be confusing to report both the replacement cost and historical cost of an asset or the market value and original value of a liability. One of their strongest arguments is that the users of financial statements would not understand the different bases but, at the same time, they issue standards of such detail and complexity that the layperson attempting to interpret financial statements can now no longer even see the trees; the wood disappeared some while ago.

The practice of providing very detailed information about what is such a limited range of assets and liabilities does suggest that financial accounting practice is an area where, increasingly, spurious accuracy reigns.

We are grateful for the permission of the Accounting Standards Board to reproduce extracts from their large list of publications. As in previous editions, we have included a selection of questions from the professional examination papers of the Association of Chartered Certified Accountants, the Chartered Institute of Management Accountants and the Institute of Chartered Accountants in England and Wales. We gratefully acknowledge the permission of these three bodies to reproduce their questions, although we are disappointed that the ACCA will not permit us to include questions set in the two years preceding publication of the book, even though those questions are available on their website. We have chosen to include questions based on UK standards but would emphasise that both the ACCA and CIMA set alternative examination papers based on international accounting standards, should readers wish to make use of these.

A downloadable *Solutions Manual*, prepared by John Wyett, to whom both the authors and readers of this text owe a considerable debt, is available to Lecturers on the password-protected website to the book, **www.booksites.net/lewispendrill**, where we intend also to publish annual *Updates*.

As always, we wish to thank our long-suffering wives, Pamela and Louise, for all their help in reading and commenting on draft chapters and checking proofs, and for reminding us in such positive tones that there is a life beyond *Advanced Financial Accounting*.

RWL
DP

PART 1

The framework of financial reporting

chapter 1

The search for principles

overview

In this chapter we first introduce the subject matter of the book and explore the role of accounting theory before turning to some of the attempts which have been made to construct a conceptual framework for financial reporting. We examine the ongoing US Conceptual Framework Project and the International Accounting Standards Board (IASB) *Framework for the Preparation and Presentation of Financial Statements* before concentrating on the work of the UK Accounting Standards Board (ASB) that led to the publication of its *Statement of Principles for Financial Reporting* in December 1999.

Introduction

One of the most difficult tasks facing authors is deciding how to start their books. An elegant epigram or an eye-catching sentence might well fix the attention of prospective readers or, more importantly, potential purchasers of the book, but such devices do not seem appropriate in this case. We feel that it would be best to start the book in a fashion which reflects its approach, i.e. we shall adopt a practical stance and start by discussing what we mean by the three words which constitute the title of the book – *Advanced Financial Accounting*. It will be convenient to start at the end of the title and then work back.

A number of definitions of accounting are available in the literature, and of these we will select the oft-quoted description provided by the Committee of the American Accounting Association (AAA), which was formed in order to prepare a statement of basic accounting theory. In its report, which was published in 1966, the Committee defined accounting as:

> **the process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.[1]**

We feel that the definition is a useful one in that it focuses not on the accounting process itself but on the reasons why information is required. It is all too easy for accountants to become obsessed with the techniques of their craft and to forget that the application of these techniques is not an end in itself but merely a means to an end. In this book we shall constantly reiterate such questions as 'Why is this information required?' or 'How will this data be used?' We believe that a proper study of accounting must start with an examination of the needs of decision makers.

The distinction between financial and management accounting is a convenient one to make, but it must not be regarded as one which divides the two areas of study into watertight compartments. It would be better if the phrases 'financial' and 'management' accounting

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[1] *A statement of basic accounting theory*, AAA, New York, 1966, p. 1.

were replaced by 'external' and 'internal' accounting, as management accounting has financial implications while managers have more than a passing interest in financial accounting. But, however one describes the differences, it is generally agreed that financial, or external, accounting is primarily concerned with the communication of information about an entity to those who do not share in its management, while management, or internal, accounting refers to the communication of information to the managers of the particular entity. Thus the American Financial Accounting Standards Board (FASB) has defined financial reporting as activities which are intended to serve 'the informational needs of external users who lack the authority to prescribe the financial information they want from an enterprise, and therefore must use the information that management communicates to them'.[2] This is a helpful definition which indicates that in this book we will be concerned with financial information that is given to users rather than information which is required by an individual or group of individuals who are in a position to enforce their request.

A more recent description of the objective served by financial statements has been provided by the UK Accounting Standards Board (ASB), whose publications loom large in this book. In its *Statement of Principles for Financial Reporting*,[3] the Board states that:

> The objective of financial statements is to provide information about the reporting entity's financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity's management and for making economic decisions.

The reference to the making of economic decisions links back to the AAA's description of accounting and reminds us of the essentially utilitarian nature of the activity. The concept of stewardship reminds us of accounting's historical roots which were based on the desire of owners of assets to receive reports from their stewards on the way in which the assets entrusted to their charge had been used.

A more modern interpretation of the concept of stewardship suggests that it has two aspects. The obligation to render accounts, or provide financial statements, might be expected to motivate stewards (managers) to act in ways which best serve the interests of owners, while the receipt of such information might help owners make economic decisions (e.g. sell shares or sack the managers), thus indicating that the two purposes of the provision of financial information identified by the ASB are closely interrelated.

Another way in which our attitude to stewardship has changed is that there is now the question of whether stewardship is owed to parties other than the economic owners of the assets. Do managers have an obligation to report to other groups such as employees? Although many would contend that economic ownership is all, and that reporting to other groups is simply a means to the end desired by the owners, there are others who would argue that in a modern business enterprise shareholders are not the only stakeholders entitled to receive reports. We shall return to this theme later in the book.

In this book we shall concentrate on the question of accounting for limited companies. We do, of course, recognise that there are many other forms of entity which are of importance, including charities, universities, central and local government and their associated agencies. Our reason for deciding to concentrate on the topic of limited companies is not because we think that the other forms of entity do not merit the concern of financial accountants, but because we recognise that, at least at present, most accounting courses are concerned with the private profit-seeking sector of the economy. Our readers will appreciate

[2] Statement of Financial Accounting Concepts (SFAC) 1, *Objectives of Financial Reporting by Business Enterprises*, FASB, Stamford, Conn., 1978, Para. 28.

[3] *Statement of Principles for Financial Reporting*, ASB, London, December 1999.

that many of the topics that will be discussed in the context of limited companies are of direct relevance to other forms of economic entity.

We should also provide some indication of the interpretation that should be placed on the adjective ‘advanced’ in the title of this book. It does not mean that the text will concentrate on detailed and complex manipulations of debits and credits, although we shall of course have to deal with such matters from time to time. In the context of this book, ‘advanced’ means that we shall concentrate on the identification, measurement and communication of economic information in the light of our acceptance of the view of the ASB that such information is required to help in decision making. Thus we shall concentrate on such questions as what information is relevant to decision makers, how the information is relevant to decision makers, how the information should be measured, and the manner in which it should be communicated. In so doing we shall describe and evaluate alternative approaches to the solution of accounting problems.

The definitions of accounting which we quoted above stop at the ‘communication’ of information. However, it must be emphasised that the interpretation of information is a vital part of an accountant’s work, and it is clear that this aspect must be regarded as being an integral part of the process of communication. It should be noted that the definition of accounting does not extend to decision making. Of course, many accountants do become involved in decision making, but when they do so they are performing a managerial rather than an accounting role. We would not for one moment wish to argue that accountants should not become involved in management, but it is essential to distinguish between accounting and decision making. It is important that information provided by accountants should be as free as possible from personal bias but, if accountants do not keep the distinction between accounting and decision making clear in their own minds, there is a great danger that they might, possibly quite unconsciously, bias the information provided towards the decision which they would wish to see made.

The above discussion might suggest that we see the work of an accountant as being of a purely technical nature in which he or she is allowed little latitude for professional judgement. This is not the case, because we believe that the accountant must strive to find out and attempt to satisfy the information needs of decision makers and, as we shall show, this is no easy task.

Accounting theory

Academic accountants tend to bemoan the lack of generally accepted accounting theory. This is understandable because theory is the stock in trade of academics. Some ‘practical’ accountants are probably rather pleased that there is no generally agreed theory of accounting because such practical people are suspicious of theory and theorising as they believe that it gets in the way of ‘real work’. However, those who take this view are probably ignorant of the role that theory can play in practical matters and do not realise that an absence of theory does give rise to many real and practical difficulties.

The description of accounting theory provided by Hendriksen shows clearly the practical uses of theory. Hendriksen defines accounting theory as ‘logical reasoning in the form of a set of broad principles that (i) provide a general frame of reference by which accounting practice can be evaluated and (ii) guide the development of new practices and procedures’.[4]

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[4] E.S. Hendriksen and M.F. Van Breda, *Accounting Theory*, 5th edn, R.D. Irwin, Homewood, Ill., 1992.