Sir Shahbaz Ahmad
Aitchison College, ANS (USA)

Accounting Concepts:

1). *Historical Cost Convention:*

Assets and expenses are recorded in ledger accounts at the actual amounts expended on these items because this has the virtue of being objective that is beyond dispute.

2). *Business Entity:*

For accounting purposes, the business is treated as completely separate from the owner of the business. The accounting records are the records from the viewpoint of the business – the assets of the business, the money spent by the business, and so on. The owner's personal assets, the owner's personal spending etc. do not appear in the accounting records of the business.

3). *Going Concept:*

Accounting always assumes that the business will continue to operate for a foreseeable future or an indefinite period of time. The final accounts of a business are prepared on the basis that there is no intention to close down the business, or to reduce the size of the business by any significant amount. Applying this concept, the fixed assets of a business appear in the balance sheet at book value, that is, at cost less depreciation to date, and stock appears at the lower of the cost or not realizable value, which ever is less.

4). *Duality:*

In accounting, all entries are made on the basis that for every transaction there are two aspects – a giving and a receiving. For every outgoing there is a benefit received. The term double entry is used to describe how the dual aspect of all transactions is recorded.

5). *Money Measurement:*

Only transactions which can be expressed in money terms are recorded in ledger accounts. For example, a business can not record in money terms its highly motivated staff or workforce etc.

6). *Realization:*

Revenue should not be recorded in the accounts before it has been realized. A sale is deemed to take place when the goods which are the subject of the sale have been replaced by cash or a debtor for the sale. A promise by a potential buyer to purchase goods at a future date does not amount to a sale. Goods sent on sale or return remains the property of the seller until the consignee intimates, or does some act to imply, that he has accepted the goods.

7). *Consistency:*

In some areas of accounting, a choice of method is available, e.g. depreciation or valuing stock. The accounting method which is likely to give most realistic outcome should be selected. Once a certain method is chosen it should be applied consistently from year to year. Changing to a different method would lead to profits being distorted and would make comparison of the financial results of different years impossible.

8). *Matching/Accrual Concept:*

The purpose of this concept is to ensure that revenue, other income and expenses are recognized in the financial period in which they accrue or are incurred no matter when cash is being received or being paid, so that the real profit or loss made by a business of a particular period of time can be calculated. (Depreciation of Fixed Assets is also accounted for to generate revenue in a given accounting period).

9). *Prudence/Conservation:*

Prudence concept states that a business should anticipate its probable losses but not its probable incomes. So that profit should not be overstated and show a realistic state of the business.

Example:

(i) Provision for Bad Debts

(ii) Valuation of stock, that is at cost or net realizable value, which ever is less.

10). *Materiality:*

Business should record only those items which have some material significant value and ignore insignificant ones and should write off.

Example:

A firm buys a dust bin which has a useful life more than one year so a business should write off this as an expense and should not treat it as fixed asset.

Statements of Standard Accounting Practice (SSAP) are the guide lines issued by the major accounting bodies with regard to the manner and methods in which certain financial transactions are recorded and communicated to interested parties. These are gradually being replaced by FRSs (Financial Reporting Standards).

SSAP9

Stocks and long-term contracts: SSAP 9 states that stocks should be valued at the lower of cost or net realizable value. This is the overriding principle in the valuation of stocks.
Cost is the normal business expense incurred in bringing the goods (or services) to its present location and condition. This includes the historic cost of purchase, import duties, carriage charges, handling charges and any other costs which can be attributed to the product. Trade discount should be deducted.
Net realizable value is the actual or estimated selling price, less any costs incurred to getting the goods into a saleable state, including marketing, selling and distribution costs.

These same principles apply to the valuation of work in progress, except long-term contract work in progress.
The standard accepts FIFO, AVCO and standard cost (so long as it bears a reasonable relation-ship to actual cost) as bases of valuation. It does not accept LIFO, base stock or replacement cost (unless it is the best measure of net realizable value and this is less than cost).
Work in progress and manufactured goods should be valued at total production cost not prime cost. Long-term contracts should be valued at cost, plus any attributable profit, less any progress payments receives and receivable and any foreseeable losses.
SSAP 9 also require that all stocks should be valued as separate articles as far as this is possible, and the aggregate of the lower of cost or net realizable value for each articles is taken as the value of stock.

SSAP 13
Research and development: exploring new scientific methods of manufacturing and generally, using the results to produce an end-product.
Research and development can be:

- Pure research- no end–results was envisaged when the research was undertaken in the first place; its aim is to increase knowledge
- Applied research – is directed towards a practical application, e.g. a cure for asthma
- Development – is the application of knowledge gained in research to produce or improve a product or a process before it is marketed commercially

Research and development costs are normally written off in the financial period in which they occur; they are treated as period costs. The costs might be carried forward and amortized over the useful life of the process, if they can be clearly identified with future commercial viability.
Cash-flow statements FRS 1: this standard was revised in 1996. it shows how cash has been generated by a limited company and how cash has been spent. It is '….. recognized as a useful addition to the balance sheet and proftia and loss account in their portrayal of financial position, performance and financial adaptability….' This is the view of the Accounting Standard Board.
The standard sets out the structure of a cash flow statement using the following standard headings:

- Operating activities
- Return on investments and servicing of finance
- Taxation
- Capital expenditure and financial investment
- Acquisitions and disposals (this heading is relevant to the group accounts)
- Equity dividend paid
- Management of liquid resources
- Financing

A total cash inflow or out flow must be shown for each heading, plus a total cash inflow or outflow before financing.
FRS 1

FRS1 revised requires two reconciliation notes:

- A reconciliation of operating profit to net cash flow from operating activities
- A reconciliation of the movement in cash to the movement in net debt.

A cash flow statement shows information which is not available from scrutiny of the profit and loss account and balance sheet. It concentrates on liquidity, which is important for business survival. The inability to generate cash resources is the single biggest reason for many businesses going into liquidation. (Remember that the profit generated by a business is not necessarily the same as the cash generated by that business).

Worked Example:
The following are the balance sheets as 31 December 20*3 and 31 December 20*4 for Mose and Catt plc:

	20*3		20*4		
	$000	$000		$000	$000
Fixed assets at cost	3478			4368	
Less depreciation	1060	2418		1045	3323
Current assets:					
Stock	1481			1534	
Debtors	639			596	
Bank	846			1121	
	2966			3251	
Less Creditors – less than one year					
Trade creditors 720			745		
Taxation 240			316		
Dividends 300	1260	1706	308	1369	1882
		4124			**5205**
Less creditors – more than one year:					
8% debentures		1000			800
		3124			**4405**
Capital and reserves:		1750			2000
Issued share capital		875			1000
Share premium account		499			1405
Profit and loss account		**3124**			**4405**

Note: during the year, fixed assets costing $600000, which has been depreciated by $375000, had been sold for $300000. An interim dividend of $100000 was paid during the year. Debentures interest of $70000 was also paid during the year.

Required:
A cash flow statement for Mose and Catt plc for the year ended 31 December 20*4.

Solution:
Mose and Catt plc cash flow statement for the year ended 31 December 20*4

	$000	$000

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Operating activities		
Net cash inflow from operating activities		2000
Return on investment and servicing of finance		
Interest paid		(70)
Taxation		
Corporate tax paid		(240)
Capital expenditure and financial investments		
Payments to acquire tangible fixed assets	(1490)	
Receipts from the sale of fixed assets	300	(1190)
Equity dividends paid		
Equity dividends paid during the year		(400)
Net cash inflow before financing		100
Financing		
Receipts from issue of ordinary shares	250	
Receipts from share premium	125	
Repayment of debenture stock	(200)	175
Increase in cash		275

Reconciliation of opretating profit to net cash inflow from operating acivities

	$000
Operating profit	1700
Depreciation	360
Profit on disposal of fixed assets	(75)
Increase in stock	(53)
Decrease in debtors	43
Increase in creditors	25
	2000

Reconciliation of net cash to movements in net debt

	$000
Increase in cash during the period	275
Cash used to repurchase debentures	200
Change in net debt	**475**
Net debt 1 January 20*4	(154)
Net debt 31 December 20*4	**(321)**

Workings
Calculation of operating profit

	$000
Change in retained earnings	906
Provision of corporate tax	316

Proposed dividend	308
Interim dividend paid	100
Debenture interest paid	70
	1700

Workings
Net debt = borrowing – bank
Debentures – bank
1 Jan $1000- 846 = $154
31 Dec $800-1121 = ($321)

Cash flow and its uses:
The statement shows:

- How cash flows (positive and negative) have been generated during the year
- Major financing activities for the year
- How the company met it s obligation to service loans and pay dividends
- Why reported profits from related cash flows during the year.

Reporting financial performance FRS 3:
FRS 3 requires 'reporting entities….. to highlight a range of important components of financial performance to aid users in understanding the performance achieved … and to assist them in forming a basis for their assessment of future results and cash flows'. The standard superseded SSAP 6 when issued in October 1992. it modifies the format for the profit and loss account as given in the company act 1985. it requires that a layered format be used in the presentation of the profit and loss account. This will show clearly;

- The results of continuing operations (including the results of acquisition)
- The results of discontinued operations
- Profits or losses on the sale or termination of an operation*
- The costs of a fundamental reorganization or restructuring*
- Profits or losses on the disposal of fixed assets*
- Extraordinary items
- Exceptional items (these should be included under the statutory heading to which they relate)

  - A statement of total recognized gains and losses
  - A reconciliation of movements in shareholders' funds.

Prior to the issue of the standard it was possible for the earnings per share figure to be increased by excluding certain elements of expenditure, e.g. redundancy costs and costs of reorganization.

Exceptional items are shown with an asterisk (*) above. They are defined in the FRS as material items which drive form events or transactions that fall within the ordinary activities of the company and which, because of the amounts involved, need to be disclosed if the financial statements are to give a true and fair view.

Exceptional items should be shown under their natural heading in the format of the profit and loss account as prescribed by the companies Act 1985. They should be identified with the continuing Act 1985. they should be identified with the continuing new or discontinued operations as appropriate.
Extraordinary items, since the introduction of FRS 3, are now so rare that identifying them cause some difficulty. Students are not likely to be questioned on such items.
Statement of total recognized gains and losses. Only realized gains and losses are recognized in the profit and loss account; but the net worth of a company is determined by unrealized gains and losses as well as those that have been realized. An example of an unrealized gain or loss occurs when, for example, an asset is revalued, or shares are issued at premium.

EXAMPLE: (based on assumed figures)

Zakoota Ltd
Profit and loss account for the year ended 30 September 20*4

	$000	$000
Turnover: continuing operations	5000	
Acquisitions	460	
	5460	
Discontinued operations	134	5594
Cost of sales		(3845)
Gross profit		1749
Net operating expenses		(957)
Operating profit/loss		
Continuing operations	968	
Acquisitions	80	
	1048	
Discontinued operations	(256)	792
Profit on disposal of properties in continued operations		86
Loss on disposal of discontinued operations		(100)
Profit on ordinary activities before interest		778
Interest payable		(25)
Profit on ordinary activities before taxation		753
Taxation on profit on ordinary activities		(32)
Profit on ordinary activities after taxation		721
Dividends		(70)
Retained profit for the year		651

Statement of total recognized gains and losses

	$000
Profit on ordinary activities after taxation	721
Unrealized surplus on revaluation of property	100
Unrealized loss on trade investment	(70)

Net gain in year ended 30 September 20*4	751

Reconciliation of movements in shareholders' funds

	$000
Profit for the year after taxation	721
Less dividends	(70)
	651
Other recognized gains less losses in the year	30
New share capital*	125
Net addition to shareholders' funds in the year	806
Shareholders' funds at 30 September 20*3	2300
Shareholders' funds at 30 September 20*4	3106

*issue during the year of 100 000 ordinary shares of $1 at $1.25 per share
The companies act 1985 requires companies to provide information regarding movements in reserves during the year. The following note should be given in Zakoota Ltd's accounts.

Reserves	Share premium account	Revaluation reserve	Profit and loss account	Total
	$000	$000	$000	$000
At 30 September 2003	150	-	410	560
Premium on issue of shares (nominal value of $100000)	25			25
Surplus of revaluation of property		100		100
Retained profit for the year			651	651
	175	100	1061	1336

Reporting the substance of transactions FRS 5 requires companies to ensure that financial statements observe the commercial substance of transactions rather than just their legal form. The vast majority of cases, the commercial substance of the transactions is likely to be the same as their legal form. The main applications of the standard will be in cases where:

- An asset is being acquired using a hire-purchase contract
- A transaction is only part of a series of transactions, and that single transaction can only be fully understood as part of the whole series
- A transaction includes option and it is very likely that the company will exercise one of the option

Goodwill and intangible assets FRS 10:
This standard seeks to ensure that purchased goodwill and intangible assets are charged to the profit and loss account in the time periods when they are depleted. Goodwill, and certain intangible assets, should therefore be capitalized and amortised through the profit and loss account. Amortization should usually take place over 20 years or less. It defines goodwill as the 'the cost of acquisition less the aggregate fair value of the purchased … assets and liabilities'

Goodwill should be included in the purchaser's balance sheet as an asset. Internally generated (inherent) goodwill should not be capitalized.
Internally developed intangible assets should only be capitalized where they have an ascertainable market value.
Goodwill, basis of valuation: the accepted factors that can be taken into account when arriving at a value for the goodwill of a business. What is acceptable to parties involved in the transaction will depend on the type of business in question. Methods used to value include:

- Average weekly sales for the previous accounting period x an agreed figure
- Gross annual fees x an agreed figure
- Average annual net profit x an agreed figure
- Super profits x an agreed figure

The agreed multiple has to be acceptable to the parties involved in the purchase of the business.
Disclosures by way of note to the Balance Sheet: FRS 10 requires the following to be disclosed by way of a note to the balance sheet:
The basis on which Goodwill has been valued
The basis on which Goodwill has been amortized
The basis on which any revaluation has taken place
Details of negative goodwill
Details of exceptional depreciation (impairment) of goodwill

FRS 15 Tangible fixed assets

FRS 15 seeks to ensure:
Tangible fixed assets are valued on a consistent basis when first recorded in the books
Revaluation of tangible fixed asset is carried out and recorded on a consistent basis and regularly reviewed
Sufficient information is disclosed in the accounts to enable users of the accounts to understand the company's accounting policies regarding the amount at which tangible fixed assets are stated in accounts, revalued and depreciated.
Tangible fixed assets should be recorded initially in the books at cost. Cost is restricted to those costs which are incurred in bringing an asset into working condition for its intended use. Cost will include:

- Delivery charges to bring the asset to its intended location
- Expenses of preparing the site for its installation
- Installation costs, including a proper proportion of the wages of the user's own workforce involved in the installation
- Professional fees (e.g. surveyors, lawyers, etc)
- Interest on money borrowed specifically to finance the acquisition of the asset

A policy of revaluing fixed assets should be applied to individual classes of fixed assets and consistently to all assets in each of selected classes. The amount at which an asset is car4ried forward in a balance sheet should be it s current value at the balance sheet date. The current value should be reviewed regularly, though not necessarily annually.

Revaluation of property should base upon the valuation of the property by a qualified valuer.

Directors:

Directors are appointed by, and are accountable to, the shareholders of a limited company, and help manage the company. Executive directors are actively involved with the day-to day running of the company. They usually head a large division or section of the company. Non-executive directors are not company employees. They attend board meetings but only act as independent advisors.
Although accountable to the shareholders, directors exert a great deal of influence over the affairs of the company because of the diffusion of shares among large numbers of shareholders.
The board of directors reports annually to the shareholders of the company.
Director's emoluments, directors' fees, directors' remuneration are all payments made to directors of a limited company for the work that they do on behalf of the company.

Directors' report:
A summary, prepared by the directors, of the main activities undertaken by a business during the year. It is a requirement of the companies' act 1985. it should deal with:

- A review of the business during the year and its position at the end of the year
- The principle activities of the company during the year and significant changes in those activities(the accounting statements prepared for FRS 3 cannot explain the activities carried on by the company or give complete information about new and discontinued activities)
- Particulars of important events that have occurred after the end of the financial year and which affect the company [post balance sheet events take place after the end of a company's financial year and may affect items in the balance sheet or profit and loss account (adjusting events) Non-adjusting events occur after the date of the balance sheet but do not require the profit and loss account or balance sheet items to be changed.]
- Dividend payments recommended
- Future development in the business of the company
- Research and development activities of the company
- Significant changes in the company's fixed assets during the year
- Name of directors who have served the company during the year, also their interests in shares or debentures in the company
- Donations to political parties or charities in excess of two hundred pounds
- Information regarding the health, safety and welfare of the workforce
- Policy regarding the employment of disables person if the company employs more than two hundred and fifty people.

Auditors:
People, usually trained accountants, who specialize in checking financial accounts that have been prepared by someone else. External auditors are appointed from outside the

organization to ensure objectivity. The auditors of a limited company are appointed by the shareholders.
Auditors' remuneration: the amount paid to the auditors for the work done in checking the business's final accounts.

Auditors report:
The auditors' report will indicate that the financial statements have been audited and it will also give the auditors' opinion about the financial statements. The report is usually quite brief and would normally contain very little information. The auditors report is attached to the main financial statements published by limited company as a statutory requirement
The shareholders appoint auditors to report at each annual general meeting whether

- Proper books or account have been kept
- The annual financial statements are in agreement with the books of account
- In the auditors' opinion, the balance sheet gives a true and fair view of the position of the company at the end of the financial year and the profit and loss account gives a true and fair view of the profit or loss for the period covered by the account.
- The accounts have been prepared in accordance with the companies' acts and all current, relevant accounting standards.

If auditors are of the opinion that the continuance of a company is dependent on a bank loan or overdraft, they have a duty to mention that fact in their report as it is relevant to the going concern concept.
The auditors' responsibility extends to reporting on the directors' report and stating whether the statements in it are consistent with the financial statements. They must also report whether, in their opinion, the report contains misleading statements.
Auditors must be qualified accountants and independent of the company's directors and their associates. They report to the shareholders and not to the directors; as a result, auditors enjoy protection form wrongful dismissal form office by the directors.

Capital reduction:

A revaluation of both assets and liabilities at a lower level than previously recorded. It might be necessary when the share capital of a limited company is not represented by the assets of the company. This generally happens when a company has suffered poor results over a number of years leading to a debit balance on the profit and loss account.
A capital reduction scheme needs the support of shareholders and other interested parties and must receive the consent of the court. This support will be forthcoming if the directors of the company can give assurances that the same situation will not occur again in the future.

Worked Example:
Seok Chin plc has the following balance sheet as at 31 December 20*7:

	$

Net assets	**270 000**
Capital :	
500 000 ordinary shares of $1 each	500 000
Less: debit balance – profit and loss account	230 000
	270 000

The following scheme of capital reduction has been agreed by the shareholders and sanctioned by the court:
The ordinary shares are to be reduced to 50 pence per share.
The net assets are to be written down to $250000.
The profit and loss account balances is to written off.

Required:
Journal entries to record the above transactions in the company's books
The balance sheet of Seok Chin plc after the scheme has been completed

Solution:

i) Seok Plc Journal

	Dr	Cr
	$	$
Ordinary Share capital	250000	
Capital reduction account		250000
Capital reduction account	250000	
Net assets		20000
Profit and loss account		230000

The principle involved in a reconstruction can be seen very clearly if we construct our balance sheet using a horizontal layout:

	$		$
Net assets	270000	Share capital	500000
Profit and loss account	230000		
	500000		**500000**

The left-hand side of the balance has to be reduced by $250000, so the right-hand side must also be reduced by $250000.

ii) Seok Chin plc balance sheet after the capital reduction scheme has been implemented

	$
Net assets	250000
Capital and reserves	
500000 ordinary shares of 50 pence each	250000

Capital redemption reserve:

Capital redemption reserve is created when a limited company redeems share or buys back some of its own shares with out issuing new shares to fund the redemption. The company must protect its creditors by replacing the redeemed shares, which have not been funded by a new issue of shares, with a capital reserves transferred out of profits that would otherwise have been available for distribution as dividends.

Worked example:

The following is an extract from the balance sheet of Dibson plc:

	$
Cash	140000
Ordinary share capital	400000
8% redeemable preference shares	80000
Share premium	100000
Profit and loss account	370000

Dibson plc redeems all the preference shares at a premium of 20%. There is an issue of $45000 ordinary shares at par for the purpose. The preference shares had originally been issued at a premium of 15%.

Required:

Show the journal entries to record the above transactions in the books of Dibson plc.

Solution:

Narratives have not been used. Explanation of some entries are included in brackets.

Dibson plc journal:

	Dr	Cr
	$	$
8% redeemable preference shares	80000	
Redemption account (the redemption account is used to 'collect' the shares and the premium)		80000
Share premium account	12000	
Redemption account (only $12000 of the $16000 premium to be paid to the preference shareholders can be taken from the share premium account since this is the amount that was raised when shares were originally issued. The remainder of the $16000 premium must be transferred out of the company's retained profit)		12000
Profit and loss account	4000	
Redemption account		4000
Redemption account	96000	
Cash		96000

Cash	45000	
Ordinary share capital		45000
Profit and loss account	35000	
Capital redemption reserve (only $45000 was raised by a new issue of shares, so $35000 has to be transferred out of the distributable reserves into a capital reserve)		35000