CONTENTS

CHAPTER 1

INTRODUCTION TO ACCOUNTING AND ITS ETHICAL DIMENSIONS

LEARNING OBJECTIVES

At the end of this chapter you should be able to:

- Describe and contrast financial and management accounting
- Explain the ethics education and training which prospective professional accountants receive
- Summarize the rights and duties of auditors
- Identify the national and international bodies which have a major role in ethical conduct by accountants
- Explain the developments which are introducing an increase in the range of matters on which a company should report

EXECUTIVE SUMMARY

This chapter first examines the relationship between financial and management accounting. These are two separate and distinct branches of accounting but there are some similarities.

Financial accounting is primarily aimed at an external audience. It is concerned with the entire organizational activities and has little specific data about the daily operations. Financial accounting is governed by regulations, and financial statements are produced regularly, at least annually.

There are no legal requirements placed on businesses to have a management accounting system; it is a purely voluntary activity. The information is for internal purposes to assist managers in their responsibilities of planning, control and decision making. The information is also used for performance evaluation.

To ensure that the information has value, the information must be generated in time to be used and it may be necessary to relax the need for the reliability of the information to ensure that it is relevant to managers' needs. Cost estimation techniques and forecasts are widely used in management accounting.

The individual accountant, both those who have studied a degree in accounting at college or university and those who have studied further to qualify as a member of one of the professional accounting bodies, have received instruction on ethical issues.

Professional accounting bodies expect their members to have a knowledge base for ethical decision making, the cognitive skills to support them and a strong sense of moral responsibility.

Many professionally qualified accountants will work as auditors and, as such they have specific rights and duties. Standards and guidance are issued by the Financial Reporting Council (FRC) and it also covers ethical standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence.

The most important regulatory body in the United Kingdom for accounting matters is the FRC. It is the primary independent regulator responsible for promoting high-quality corporate governance and reporting.

At the international level there are several bodies which are influential, although they have no direct regulatory powers in the United Kingdom. The International Federation of Accountants seeks to reinforce professional accountants' adherence to ethical values through the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants*.

The expanding areas of interest in accounting reflect a wider ethical view of organizations' responsibilities than just the financial statements. Environmental Accounting and Reporting, Sustainability Accounting and Reporting, Green Accounting, Corporate Social Responsibility (CSR) all are on the accounting agenda.

The International Integrated Reporting Council is a global coalition of regulators, investors, companies, standard setters, the accounting profession and non-governmental organizations (NGOs). It promotes the adoption by organizations of an integrated report. This contains details of how an organization's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term. Integrated reports are aimed at the providers of financial capital but contain information of interest to a wide range of stakeholders.

CONCEPTUAL AND PRACTICAL ISSUES

As you read through this chapter, regardless of your preconceptions, you will appreciate that accounting is dominated by the concepts and conventions used in the discipline. Subsequent chapters will examine these in greater detail. This is not to deny that the actual recording of economic transactions by the use of 'bookkeeping' is not important. However, it is a mundane activity which only addresses a small part of the entire accounting discipline.

In this chapter we examine the structure of the accounting profession in the United Kingdom and explain the ethical aspects of the work. This chapter does not attempt to define ethics in the broad sense. To do so adequately would require a discussion of various philosophies through the ages. Instead the chapter concentrates on how accountants view ethics and the importance they attach to it. This is demonstrated in their education and training, the methods they adopt to carry out their work, the regulations and guidance they follow and the pronouncements by various accounting bodies and institutions.

Towards the end of this chapter we discuss the shifting boundaries of accounting and how this reflects the concerns and issues of society. For example, large-scale business activities, particularly connected with energy production and mineral extraction, can be extremely profitable but sometimes at a social and environmental cost. Should this be taken into the equation and companies compelled to disclose the full benefits and burdens of their activities? Our final section describes the most recent initiatives in this area.

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THE DISCIPLINE OF ACCOUNTING

> **Definition – Accounting**
>
> The process of identifying, measuring, recording and communicating economic events and transactions to those who require the information.

Most definitions of accounting are similar to the one given above but newcomers to the study of the discipline tend to concentrate on the recording of financial numbers. Unfortunately, this is a narrow view of the accounting process. Numbers are certainly important but, as we will see in this book, accounting draws heavily on concepts and conventions, some of which are debatable. The numbers attempt to capture complex business activities but it is how we determine what to capture and how to measure it which is the most substantial aspect.

The discipline is also separated into several sub-disciplines which have different purposes. The main division is into financial accounting and management accounting. The relationship between the two accounting systems and the process is shown in Figure 1.1).

The purpose of financial accounting is to provide information on the performance, position and cash activities of an organization over a period of time. This will be at least annually, but could be half-yearly or quarterly.

The information is communicated in the form of financial statements. The users of the financial statements are the owners of the business and individuals and groups external to the organization. These users are discussed in Chapter 2.

The main financial statements generated by financial accounting are:

- The statement of cash flows which shows the actual cash which has flowed into the organization during the financial period. It also shows the cash which has been expended. We examine this statement in Chapter 5.
- The income statement or profit and loss account which shows the financial performance over a period of time. The key information is the revenue for that period, the costs which were incurred and, by subtracting the costs from the revenue, showing the profit or loss for the period. We explain this statement in Chapter 6.
- The balance sheet or statement of financial position can, with reservations, be considered a snapshot of the business at one specific point of time: the last day of the financial period. It will show the resources the organization has to conduct its activities and its sources of finance and liabilities. We explain this statement in Chapter 7.

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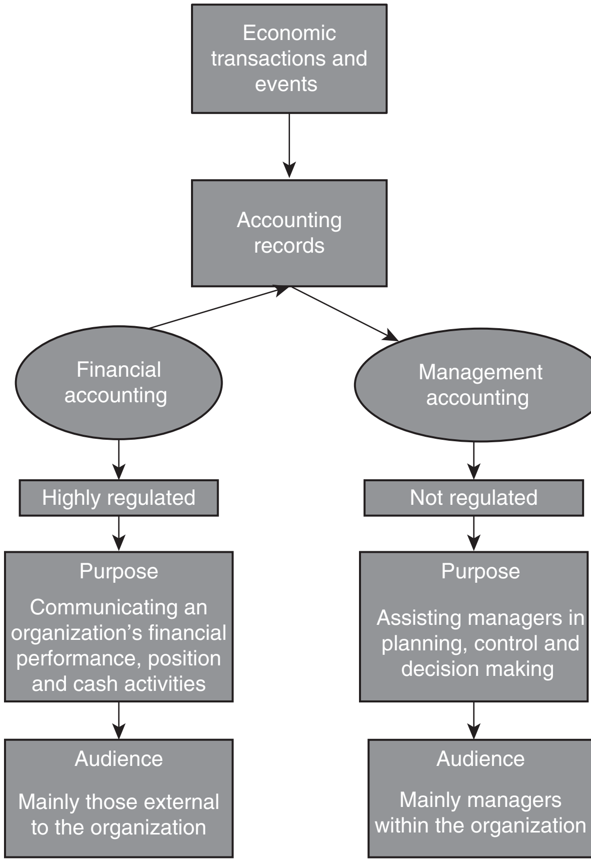

Figure 1.1 Financial and management accounting compared

Financial accounting is highly regulated and the information disclosed is expected to be very reliable. It is also the aim of financial accounting to make the information relevant to the external user.

Management accounting is aimed at providing highly relevant information for managers inside the company. This information should assist them with their responsibilities of planning and controlling the activities of the organization and making decisions. Clearly, there must be a need to ensure a certain level of information reliability, but timeliness in providing the information enhances relevance.

As timing is important, estimates and forecasts can be more useful than the preciseness of the information. For the busy manager, the time frame for receiving information they can use may be only days or even hours.

In Part II of this book, the various methods and techniques of management accounting are explained. The range of techniques means that the information generated and communicated will have many forms. It is essential that the information is relevant to the recipients who will be internal to the organization.

Given the different purposes of the two forms of accounting, the degree of regulation for financial accounting and the presumed users of the information, it is not surprising that the nature of the information generated has different characteristics. In Figure 1.2, the characteristics of financial and management accounting data are compared.

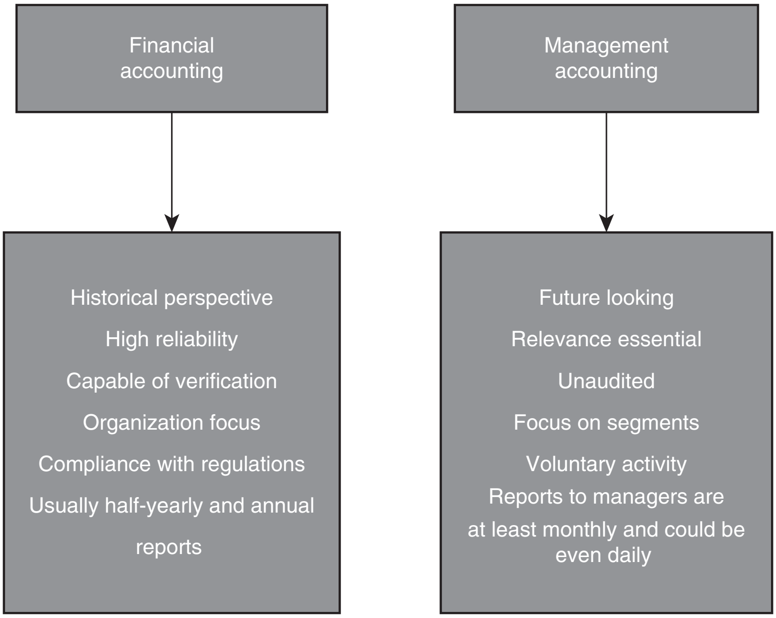

Figure 1.2 Characteristics of financial and management accounting data

THE PROFESSIONAL ACCOUNTANT

In the United Kingdom, the title accountant does not have the same protection as, for example, lawyers. Anybody can describe themselves as an accountant, but a person claiming to be a 'qualified' or 'professional' accountant is normally a member of one of the main professional bodies of accountants in the United Kingdom. The maturity and size of the accounting bodies is reflected in Table 1.1.

All but the Association of International Accountants (AIA) has received a Royal Charter at some stage in their history, but not all the members of the above bodies are able to conduct audits of companies' accounts. It is possible that they did not

Name	Date founded	Number of members	Number of students
Association of Chartered Certified Accountants	1905	154,000	432,000
Association of International Accountants	1928	7,000	8,500
Chartered Accountants Ireland	1888	22,000	6,000
Chartered Institute of Management Accountants	1919	203,000	
Chartered Institute of Public Finance and Accountancy	1885	14,000	2,800
Institute of Chartered Accountants in England and Wales	1880	140,000	20,000
Institute of Chartered Accountants of Scotland	1854	19,000	3,000

Table 1.1 UK professional accounting bodies 2012

do the necessary training or their career has followed a different direction. It is the recognition of the professional body by the FRC which is essential to the status of the accountant as an auditor.

Table 1.1 separates the groups into members and students. Members are those who have passed all the examinations required of the professional body and undertaken the appropriate training. Students are exactly that. They will have their undergraduate degree and are at some stage in the long trek of becoming a qualified accountant. This will require passing various examinations, and the pass rates are much lower than those for a degree from a university.

If that professional accounting body is registered and the individual has studied specific subjects during their training, they can conduct audits.

Definition – Audit

An independent examination of, and the subsequent expression of opinion on, the financial statements of an organization.

The FRC has statutory powers delegated to it by the government for the recognition, supervision and de-recognition of those accountancy bodies responsible for supervising the work of auditors or offering an audit qualification. The FRC provides independent oversight of the regulation of the auditing profession by the recognized supervisory and qualifying bodies (RQBs and RSBs) in the United Kingdom.

There are currently five Recognized Supervisory Bodies (RSB) and six Recognized Qualifying Bodies (RQB) recognized by the FRC, and these are:

Recognized Supervisory Bodies (RSBs)

1. Association of Authorised Public Accountants (AAPA)
2. Association of Chartered Certified Accountants (ACCA)
3. Chartered Accountants Ireland (CAI)
4. Institute of Chartered Accountants in England and Wales (ICAEW)
5. Institute of Chartered Accountants of Scotland (ICAS)

Recognized Qualifying Bodies (RQBs)

1. Association of Chartered Certified Accountants (ACCA)
2. Association of International Accountants (AIA)
3. Institute of Chartered Accountants in England and Wales (ICAEW)
4. Chartered Accountants Ireland (CAI)
5. Institute of Chartered Accountants of Scotland (ICAS)
6. Chartered Institute of Public Finance and Accountancy (CIPFA). CIPFA's status as an RQB is currently in abeyance.

A major UK accountancy body not recognized by the FRC is the Chartered Institute of Management Accountants (CIMA). CIMA is the world's largest professional body of management accountants and its members do not undertake studies and training on auditing. This does not detract from the status of the members of that professional body but reflects the direction of their training and work.

Discussion point

Do you consider that there should be only one body of professionally qualified accountants to conduct audits rather than the present system?

The various bodies of professional accountants have substantial influence on the business activities of organizations. This is not only because of their work within an organization but because of their representations at national and international levels.

Due to their knowledge and skills, accountants serve on numerous committees and boards concerned with national economic policy. The bodies of professional accountants are also extremely active in conducting research into issues of public interest.

THE ROLE OF AUDITORS

It is possibly in the role of auditor of a public limited company that many perceive accountants. In that role, the comments in the above section on individual accountants still apply. Auditors, however, have certain statutory rights and duties which are summarized below.

An auditor's rights

- Access at all times to the company's books, accounts and vouchers.
- The provision of necessary information or explanations from key personnel.
- The receipt of all communications given to a member of the company in relation to a written resolution under the relevant statutory provisions.
- The receipt of all notices of and other communications relating to any general meeting that a member of the company is entitled to receive.
- Attendance at any general meeting of the company.
- To be heard at any general meeting on any part of the business of the meeting that concerns the auditor.

An auditor's duties

- To ensure all the necessary information and explanations for the audit have been obtained.
- To ensure that proper books of accounts have been kept and maintained by the organization.
- To confirm that the accounts dealt with in the report are in agreement with the books of accounts and are in conformity with UK Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards.
- To confirm that the financial statements derived from the books of accounts give a 'true and fair view' of the organization.
- To issue an auditor's report which should contain a clear written expression of opinion on the financial statements taken as a whole.

The most publicly visible part of the auditors' work is the audit report which can be found in every annual report and accounts issued by a company that is not exempt from an audit for some reason. All the companies listed on the London Stock Exchange publish in their annual report and accounts an audit report. We have extracted below specific paragraphs from the audit report for J Sainsbury plc.

LINK TO PRACTICE

Independent Auditors' report to the members of J Sainsbury plc.

We have audited the financial statements of J Sainsbury plc. for the 52 weeks ended 17 March 2012 which comprise the Group income statement, the Group and Company Statements of comprehensive income, the Group and Company Balance sheets, the Group and Company Cash flow statements, the Group and Company statements of changes in equity and the related notes. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards ('IFRSs') as adopted by the European Union and, as regards the Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

Respective responsibilities of Directors and Auditors

As explained more fully in the Statement of Directors' responsibilities, the Directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit and express an opinion on the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's Ethical Standards for Auditors . . .

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Company's affairs as at 17 March 2012 and of the Group's profit and Group's and Company's cash flows for the 52 weeks then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union;
- the Company financial statements have been properly prepared in accordance with IFRSs as adopted by the European Union and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006 and, as regards the Group financial statements, Article 4 of the IAS Regulation . . .

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