Jocelyn Hunt – AVCE Business Studies

Financial Accounting – Assignment One

Question One:

The two main reasons why it is vital for a business to keep accurate accounting records is 1. For legal reasons to do with acts enforced by parliament and 2. To record the performance of the business.

Every year companies are by law required to produce a set of accounting records that show a true and fair view of its financial position. Copies of these records then have to be filed with the Registrar of Companies at Companies' House and sent to every shareholder and debenture holder. The Companies Act 1985 states the minimum amount of information that has to be included, although many companies see it as a public relations opportunity and produce information on staff, products and other areas of the business. This is done in an attempt to make other parties such as shareholders aware of the company and of future developments. No matter the size of a business they must all comply with the legal requirements of the Companies' Act 1989.

From a practical point of view, if a company did not make any records of transactions carried out, it would prove to be impossible for them to evaluate the performance of the business or even compare it with another companies' performance. Good record keeping can show whether the business is improving, which items are selling and what changes are needed. By producing a profit and loss account and a balance sheet they can distinguish exactly where they have incurred expenses and what on e.g. Staff wages and electricity payments, and where money has been made e.g. profits from sales. The underlying need for these accounts to be kept is to establish whether a profit or loss has been made over the year. The balance sheet simply shows the firm's assets e.g. premises or stock, and liabilities e.g. creditors, at a single point in time, showing a picture of the stock of wealth held by the business and the current financial position.

Without these essential accounting documents problems can soon arise. The absence of a profit and loss account would mean the business were not keeping a sufficient eye on the outgoings and incomings of the firm, possibly causing them to slip into debt by spending more funds than they actually have available to them.

However, the main issue with not completing accurate records is concerned with value added tax (VAT) and corporation tax, which all companies have to pay. Corporation tax is the tax deducted from a companies profits and this is done before any dividends are paid to shareholders. By not having the appropriate and accurate information available, a company would have no sure way of telling if they were paying too much tax in relation to profits made or if they were not paying

enough tax, which would be seen as fraud and would accumulate into a large debt in the future.

Also, firms have to maintain accurate records to deal with the quarterly VAT returns that have to be produced. If exact records have not been kept then a business will not know how much VAT they have to pay or how much they have paid and need to claim back from the inland revenue. This could result in the business trying to claim back more money than they have actually paid which is aga in a fraudulent act and could get them into serious trouble.

Question Two:

When producing financial accounts there are five main concepts and conventions that one should follow. These have evolved over many years to deal with various practical problems that may arise in accounts. If Accountants did not follow these rules then it would be impossible to compare one firm's accounts with another and to monitor past performance within a business. Also a consistent record of this information can be useful for people wishing to assess the firm's financial stability, such as bankers, investors and trade creditors.

The first and most important rule is the *Concept of Prudence*. When this convention clashes with another, it is normally prud ence that overrides all others. This concept states that when there is either an optimistic or a cautious approach to be had, the cautious approach should always prevail. Profits should never be anticipated and losses should always be recorded as soon as the organisation is aware of them. The operation of this convention stops the common problem of managers overstating the financial position of the business. For example, if a firm was paid £20,000 for a contract but the management are certain that final cost will be £25,000, they should charge the £5,000 loss to this year's profit and loss account. However, if the management believe that the work will be completed for £17,000 then the £3,000 profit must not be shown in the profit and loss account until it has been earned.
Another situation where a pessimistic view should be had is when valuing stock. The stock can be valued at either the cost price or the resale price, but it has to be the lower of the two. This again stops the overstating of profits.

Another highly important concept is the *Accruals concept,* for it manages the way the profit and loss accounts are prepared. Expenses and sales are shown when they are incurred, not when they have been paid for. The amount owing for expenses is then shown as an accrual or put in with the creditors and shown as a current liability. The amount owing for

sales is either shown as a prepayment or lumped together with the debtors and shown in the balance sheet.
Example: A company paid an electric bill during the year totalling £450. A further bill for £300 was received but not yet paid. This means electrical expenses in the profit and loss account should still be shown as £750 even though only £450 of it has been paid.

The *concept of consistency* basically means that the same accounting method should be adopted every year and should not be changed form one financial year to another. An example of this is depreciation. If one year a firm decides to calculate an asset's depreciation using the *straight-line* method, then the next year they should also use this method. If they do not and decide to calculate it using the *reducing balance* method, then the profit figures would fluctuate due to this change in technique. By applying this concept it allows a firm to compare their accounts to a previous year's figures.

The *Going concern concept* is a convention that a business will continue to operate for the foreseeable future. This is the concept that governs how fixed assets are recorded in the final accounts, whether it is at cost price or market value. Fixed assets are purchased with the intention of keeping them for a number of years, not to sell them quickly for a profit, so they are shown at their cost price. However, if for example the owner was close to retirement and considering closing down, a note of this should be made clear in the accounts.

Finally, the *concept of Materiality* refers to the significance of a certain item on the financial statements of a business, which mainly depends on the size of the firm. Items should only be recorded in the accounts if it is considered to be worthwhile to do so. For example, in a delivery firm with 100 vehicles, it would not be seen worthwhile to calculate the amount of petrol in each vehicle.

The Accounting Standards Board are responsible for the regulating of financial statements and strive to improve the standards of financial accounting and reporting for the benefit of users. This is done by enforcing Financial Reporting Standards (FRS's), which are documents that detail all aspects of the accounting practice. These reports cover issues such as cash flow statements, mergers and how to report financial performance.

Source Of Reference

- **Name:** Financial Accounting
  Author: Peter Atrill and Eddie McLaney
  Gained information on concepts and conventions.

- **Name:** Essential Accounting for Managers
  Author: A. P. Robson
  Information acquired on performance measurement.

- **Name:** Accounting and Finance
  Author: Humphrey Shaw
  Attained information on concepts and conventions, taxation and Company Acts.

- **Interviewed** a Mr Graham, practising chartered accountant in Gerards Cross. Gathered information for questions one and two.

- **Interviewed** a Mr C.Ward, owner of a medium sized agricultural firm. Acquired information on VAT an corporate tax.

- **Internet:** Progress Interventions - http://www.pinterventions.org/good_record_keeping.htm
  Information acquired on the importance of keeping accounting records.

- **Internet:** Financial Accounting Standards Board - http://www.fasb.org/
  Information on accounting rules and regulations.

- **Internet:** Official Inland Revenue website - www.inlandrevenue.gov.uk
  Information on Taxation.