3 Understanding financial statements

About this chapter

Most business managers working in the hospitality, tourism and leisure industries will need at some point in their professional lives to be able to interpret and act upon financial information. The results of any commercial business are usually summarised in three key statements: the Income & Expenditure account (profit and loss), the Statement of Financial Position (balance sheet) and the Statement of Cash Flow, and these are prepared at a minimum at least once per year in the form of audited, publicly available statements (for public companies) and internally within the business several times per year, usually on a monthly basis (management accounts). The aim of this chapter is to provide guidance for understanding how these statements are prepared and the importance of the information contained within them. There will be no attempt in the text to illustrate and teach the principles of double entry bookkeeping as this aspect is covered in a multitude of resources on the subject. However, this chapter is very much concerned with the accounting principles and concepts which support the preparation of financial statements, which then helps the reader to understand the purpose and meaning. This includes a detailed review of each of the financial statements and an explanation of the relationship between the statements. A more detailed review of the techniques for interpreting statements, using a variety of forms of ratio analysis, is given in Chapter 8.

Learning objectives

On completion of this chapter, you should be able to:

- ☐ Appreciate the role of the regulatory framework in accounting
- ☐ Understand the fundamental concepts of accruals and prepayments
- ☐ Understand the principles for adjusting non-current asset accounts with regard to depreciation
- ☐ Appreciate the methodologies for the adjustment of the stock records to calculate cost of sales and incorporate the current valuation
- ☐ Recognise the structures for the income and expenditure account, cash flow and statement of financial position.

Introduction

Accounting is divided into separate but related branches of accounting called financial accounting, management accounting and cost accounting. The function of financial accounting is to record clearly every single financial transaction of the business in both the selling and the production of goods and services, and to classify and summarise these transactions for presentation in a series of published reports produced on an annual basis to meet statutory requirements. These reports are then used by external users who have access to very little other information other than that which is published about the business. These external users include shareholders, bank and other lenders, government, and the tax authorities and of course customers and competitors. Management accounting and cost accounting are for internal use.

Accounting principles

The statements contained in the published reports are required to give a fair and true representation of the business. To assist in the preparation of the statements to this standard, there are a series of rules and regulations to be adhered to. In the UK these are derived from:

- International Financial Reporting Standards (IFRS)
- UK Generally Accepted Accounting Practice (UKGAAP)

Non-statutory regulation is based on recommendations issued by the professional accounting bodies. The six accountancy bodies in the UK are:

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

The preparation of financial statements is also clarified by the acceptance of accounting principles which should be uniformly applied. In practice, however, there is a considerable degree of user interpretation. The following notes provide a summary of the basic principles in statement preparation.

- **Consistency:** The accounting treatment of any items should be the same from period to period. For example, a change in the methodology for depreciating non-current assets could have a material impact on the reported profit. If this is the case, then the change made should be revealed.
- **Going concern:** An organisation is assumed to continue in operation for the foreseeable future with appropriate investment to sustain it.
- **Matching:** The costs for a period should be matched with the corresponding revenue for that period. For example, outstanding operational costs at the year end should be included if they were used to deliver the revenue.