Sixth Edition

Financial Accounting

An International Introduction

David Alexander & Christopher Nobes

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An International Introduction

David Alexander and
Christopher Nobes

with an appendix on Double-entry Bookkeeping
by Anne Ullathorne

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Foreword to the first edition

For many years Professor Christopher Nobes and I have worked together as the two British representatives on the Board of the International Accounting Standards Committee. He and I have argued in many fora for the notion that there should be one single set of high-quality worldwide standards so that a transaction occurring in Stuttgart, Sheffield, Seattle or Sydney should be treated in exactly the same way. That is not the case at present.

In a book published by Professor Christopher Nobes and David Cairns, *The Convergence Handbook* (ICA, 2000), they outlined the existing differences between British and International Accounting Standards. The intention of the book and the request by the UK's Accounting Standards Board for its production was to eliminate these differences. It is particularly important that this should be done over the next five years as the European Commission has stated its intention that all consolidated statements of listed companies in the European Union should comply with International Accounting Standards by 2005. Clearly British Standards will have to change, although as British Standards themselves are of high quality it is very likely that some International Standards will also change.

To meet this challenge and to ensure that all countries have the same accounting standards, the International Accounting Standards Committee has been reconstituted with effect from 2001 to form a virtually full-time International Accounting Standards Board, the main mission of which is to seek convergence of accounting standards throughout the world.

This book by my friends, David Alexander and Christopher Nobes, is therefore particularly timely. It is based on a background in the European Union. It is written extremely clearly. (The real mark of a teacher is not to complicate but to simplify and the authors have certainly done that.) It is unusual in that it takes as its base not one country's standards but International Accounting Standards, which I firmly believe are going to be the worldwide requirements of the future.

The book will be of interest not only to the beginner but also those who wish to understand the thrust of International Accounting Standards. The authors make clear that accounting is still in many ways a primitive subject and is in a period of change, removing the most irrelevant aspects of the historical cost model and replacing them with accounting for fair values. Those coming into accounting now are going to see huge changes in the first few years of their careers as many of the ideas promulgated by academics many years ago become professional practice and as each country's national standards are changed to converge with the international consensus.

I enjoyed reading this book and I am sure that its many readers will also. I congratulate the authors for their foresight in producing such an excellent book and wish them well.

SIR DAVID TWEEDIE

January 2001 *Chairman, International Accounting Standards Board*

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Preface

This is the sixth edition of our book that is designed as an introductory text in financial accounting. What sets it apart from many other books with the same basic aim is that this book is not set in any one national context. Consequently, instead of references to national laws, standards or practices, the main reference point is International Financial Reporting Standards (IFRS).

Nevertheless, real entities operate in real countries even where they follow IFRS, and so such entities also operate within national laws, tax systems, financial cultures, etc. One of the backgrounds chosen in this book is the European Union (EU) and the wider European Economic Area (EEA). Where useful, we refer to the rules or practices of particular European countries or companies. However, we also take examples from elsewhere, e.g. Australia and South Africa.

This book is intended for those with little or no previous knowledge of financial accounting. It might be particularly appropriate for the following types of financial accounting courses taught in English at the undergraduate or postgraduate (e.g. MBA) level:

- courses in any country in the EU (or EEA), given the increasing use of IFRS by companies including the compulsory use for listed companies' consolidated statements;
- courses outside the EU where IFRS is the basis of the accounting standards, e.g. in Australia, Canada, New Zealand, Singapore, South Africa and other parts of the (British) Commonwealth;
- courses in China, Japan or other countries where some companies use IFRS and where national standards have been converged with IFRS;
- courses anywhere in the world with a mixture of students from several different countries.

Depending on the objectives of teachers and students, stress (or lack of it) might be placed on particular parts of this book. For example, it would be possible to precede or accompany a course based on this book with an extensive examination of double-entry bookkeeping, such that Appendix A is unnecessary. Or, on some courses, there might not be space or appetite for double entry at all, such that Appendix A is again unnecessary. Coverage of some complex issues such as foreign currency translation (Chapter 15) might not be needed, but it is easy to leave a chapter out.

This edition is updated to include the extensive changes that have occurred in the three years since writing the fifth edition. We have also done the following, compared to the fifth edition:

- moved the section on types of entities from Chapter 4 to Chapter 1;
- included reference to accounting by SMEs and partnerships (Chapter 4);
- added material on integrated reporting and sustainability (Chapter 6);

- expanded the discussion of revenue recognition, including reference to IFRS 15 (Chapter 8);
- deleted the chapter on price change accounting, which is no longer topical and was not much used; but added a discussion on capital maintenance (Chapter 8).

In writing this book we have, of course, made use of our experience over many years of writing and teaching in an international context. Thus, in some parts of this book, we have adapted and updated material that we have used elsewhere in more specialist books to which the intended readers of this text would not have easy access. We have tried to remove British biases, but we may not have been fully successful and we apologize to readers who can still detect some.

There are five appendices, which we hope readers will find useful during and after a course based on this book. Appendix A is a substantial treatment of double-entry bookkeeping. Appendices B and C summarize the requirements of IFRS and the EU accounting Directive respectively. Appendix D gives the answers to the end-of-chapter multiple choice questions. Appendix E provides outline feedback to about half of each chapter's closing exercises. Feedback on the other exercises is given in an Instructor's Manual that is available electronically via the Companion Website at www.pearsoned.co.uk/alexander. The manual also contains other material to assist lecturers. This book ends with a glossary and an index.

Suggestions from many colleagues and users of the book have been very helpful. We are also grateful for much help from colleagues at Pearson. Despite all this help, there may be errors and omissions in our book, and for this we must be debited (in your books).

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Figures

Figures 6.1, 6.2, 6.3, 6.4, 6.5 and 13.6 adapted from *Bayer's Annual Report 2014*; Figure 7.5 adapted from *Marks & Spencer PLC Annual Report 2014*; Figure 8.2 from Published company financial statements; Figure 8.3 from *Volkswagen Annual Report2001*; Figure 11.5 from Authors' own work based on *published company accounts of Nokia*; Figures 17.1, 17.2 from *GlaxoSmithKline PLC Annual Report 2005*.

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Text

Case Study 9.1 and 11.2 *Extracted from BASF SE's Annual Report 2014*.

Abbreviations

ABC	activity-based costing
AE	anonymos etairia (public company, Greece – transliteration of Greek equivalent)
AG	*Aktiengesellschaft* (public company, Austria, Germany and Switzerland)
AktG	*Aktiengesetz* (German Stock Corporation Law)
AMF	*Autorité des Marchés Financiers* (France)
ApS	*anspartsselskab* (private company, Denmark)
ARC	Accounting Regulatory Committee (EU)
AS	*aktieselskab* (public company, Denmark)
	aksjeselskap (private company, Norway)
ASA	*almennaksjeselskap* (public company, Norway)
ASB	Accounting Standards Board (former UK body)
BV	*besloten vennootschap* (private company, Belgium and the Netherlands)
CESR	Committee of European Securities Regulators (now replaced by ESMA)
COB	*Commission des Opérations de Bourse* (former Commission for Stock Exchange Operations, France)
CONSOB	*Commissione Nazionale per le Società e la Borsa* (National Commission for Companies and the Stock Exchange, Italy)
CPP	current purchasing power
CRC	current replacement cost
CV	current value
DCF	discounted cash flow
DRSC	*Deutches Rechnungslegungs Standards Committee* (German Regulatory Standards Committee)
DV	deprival value
EBIT	earnings before interest and tax
EEA	European Economic Area
EFRAG	European Financial Reporting Advisory Group
EPE	etairia periorismenis efthynis (private company, Greece – transliteration of Greek equivalent)
EPS	earnings per share
ESMA	European Securities and Markets Authority
EU	European Union
EV	economic value
FAR	*Föreningen Auktorisade Revisorer* (a national accountancy body, Sweden)

FASB	Financial Accounting Standards Board (USA)
FIFO	first in, first out
FRC	Financial Reporting Council (UK)
FRRP	Financial Reporting Review Panel (UK)
GAAP	generally accepted accounting principles
GmbH	*Gesellschaft mit beschränkter Haftung* (private company, Austria, Germany and Switzerland)
GPLA	general price level-adjusted systems
HC	historical cost
HGB	*Handelsgesetzbuch* (Commercial Code, Germany)
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IIRC	International Integrated Reporting Council
IFRIC	International Financial Reporting Interpretations Committee (now the IFRS Interpretations Committee)
IFRS	International Financial Reporting Standard(s)
IOSCO	International Organization of Securities Commissions
JV	joint venture
Lda	*sociedade por quotas* (private company, Portugal)
LIFO	last in, first out
Ltd	private limited company (United Kingdom)
NBV	net book value
NRV	net realizable value
NV	*naamloze vennootschap* (public company, Belgium and the Netherlands)
NYSE	New York Stock Exchange
OCI	other comprehensive income
Oy	*Osakeyhtiö-yksityinen* (private company, Finland)
Oyj	*Osakeyhtiö julkinen* (public company, Finland)
PE	price/earnings
PCG	*plan comptable général* (general accounting plan, France)
PLC	public limited company (United Kingdom)
PPE	property, plant and equipment
RJ	*Raad voor de Jaarverslaggeving* (Council for Annual Reporting, the Netherlands)
ROCE	return on capital employed
ROE	return on equity
ROOE	return on ordinary owners' equity

SA	*sociedade anónima* (public company, Portugal)
	sociedad anónima (public company, Spain)
	société anonyme (public company, Belgium, France and Luxembourg)
Sarl	*société à responsabilité limitée* (private limited company, Belgium, France and Luxembourg)
SEC	Securities and Exchange Commission (USA)
SIC	Standing Interpretations Committee (former IASC body)
SMEs	small and medium-sized entities
SOX	Sarbanes–Oxley Act (USA)
SpA	*società per azioni* (public company, Italy)
SRL	*società à responsabilità limitata* (private company, Italy)
	sociedad de responsabilidad limitada (private company, Spain)
SRS	*Svenska Revisorssamfundet* (a Swedish accountancy body)
TFV	true and fair view
UK	United Kingdom
US	United States

Part 1

THE CONTEXT OF ACCOUNTING

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Chapter 1

Introduction

Contents

Objectives

After studying this chapter carefully, you should be able to:

- explain the scope and uses of accounting;
- explain different ways in which entities can be legally organized;
- outline the role of national and international regulators;
- give some examples of the usages of accounting terms in different varieties of English.

1.1 Purposes and users of accounting

Accounting began as a practical activity in response to perceived needs, and for most of its development it has progressed in the same way, adapting to meet changes in the demands made on it. Where the needs differed in different countries or environments, accounting tended to develop in different ways as a response to a particular environment, essentially on the Darwinian principle: useful accounting survived. Because accounting developed in different ways, it is likely that definitions suggested in different surroundings will vary.

At a general level, accounting exists to provide a service. In the box below there are three definitions. These have all been taken from the same economic and cultural source (the United States) because that country has the longest history of attempting explicit definitions of this type. Note that each suggested definition seems broader than the previous one, and the third definition does not restrict accounting to *financially* quantifiable information. As will be explored in this book, attitudes to accounting and its role differ substantially around the world and certainly between European countries.

Some definitions of accounting

Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.

('Review and resume', *Accounting Terminology Bulletin No. 1,* New York: American Institute of Certified Public Accountants, 1953, paragraph 5)

Accounting is the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.

(American Accounting Association, *A Statement of Basic Accounting Theory*, Evanston, IL: American Accounting Association, 1966, p. 1)

Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions, in making resolved choices among alternative courses of action.

(Accounting Principles Board, Statement No. 4, 'Basic Concepts and Accounting Principles Underlying Financial Statements or Business Enterprises', New York: American Institute of Certified Public Accountants, 1970, paragraph 40)

If information is to be useful, then some obvious questions arise: useful to whom and for what purposes? A number of different types of people are likely to be dealing with business entities.

1. *Managers.* These are the people who have to make decisions, both day-to-day and strategically, about how the scarce resources within their control are to be used. They need information that will enable them to predict the likely outcomes of alternative courses of action. As part of this process, they need feedback on the results of their previous decisions in order to extend successful aspects of the decisions, and to adapt and improve the unsuccessful aspects.

2. *Investors.* A large entity may have many investors who are not the managers of the entity. Some investors are owners (the shareholders); others provide long-term debt capital. These providers of capital are concerned with the risk inherent in, and return provided by, their investments. They need to determine whether they should buy, hold or sell their investments. Shareholders are also interested in information to assess the ability of the entity to pay them a return (known as a dividend). Potential investors have similar interests.
3. *Other lenders.* Lenders (such as banks) are interested in whether loans, and the interest attaching to them, will be paid when due.
4. *Employees.* Employees and their representative groups are interested in the profitability of their employers. They also want to assess the ability of the entity to continue to provide remuneration, retirement benefits and employment opportunities.
5. *Suppliers.* These want to be able to assess whether amounts owing will be paid when due. Suppliers are likely to be interested in an entity over a shorter period than lenders, unless they depend upon the entity as a major continuing customer.
6. *Customers.* Customers need information about the continuance of an entity, especially when they have a long-term involvement with the entity.
7. *Governments.* Governments and their agencies need information in order to regulate the activities of entities and to collect taxation, and as the basis for national income and similar statistics.
8. *The public.* Entities affect members of the public in a variety of ways; for example, entities pollute the atmosphere or despoil the countryside. Accounting statements (generally called 'financial statements') may give the public information about the trends and recent developments of the entity and the range of its activities. Environmental information, broadly defined, has become much more important in recent years.

This list leads to a very important distinction, namely that between *management accounting* and *financial accounting*. Management accounting is that branch of accounting concerned with the provision of information intended to be useful to management within the business. Financial accounting is the branch of accounting intended for users outside the business itself, i.e. groups 2–8 above. The above description of these groups is closely based on a document now called *The Conceptual Framework for Financial Reporting* of the International Accounting Standards Board (IASB), discussed further in Chapter 3.

It is clear from the previous paragraphs that the needs of users to whom financial accounting is addressed are very diverse, and so the same information will not necessarily be valid for all their purposes. The IASB is mainly concerned with groups 2 and 3 above. However, the Framework (paragraph OB 10 of the 2010 version) suggests that:

> Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful.

Accepting, however, that the needs of different users are likely to be different and that different users may predominate in different countries, it is clear that different national environments (cultural, political and economic) are likely to lead to different accounting practices. Indeed, financial reporting to various users (as opposed to the mere recording of transactions, which is known as bookkeeping) reflects the biases and norms of the societies in which it is embedded. This relationship is developed later in Chapter 5.

Activity 1.A

In what various ways can and should financial reporting (the end product of financial accounting) be different from reporting to management? Think about the different purposes of these two types of accounting, and how these purposes might affect their operation.

Feedback

Management accounting can be carried out on the basis that no information need be kept secret for commercial reasons and that the preparers will have no incentive to disguise the truth. This is because the management is giving information to itself. It also follows that the information does not need to be externally checked. It can be more detailed and more frequent than financial reporting because there is no expense of external checking or publication. Also, the management will not want any biases, whereas some outside users may prefer a tendency to understate profits and values where there is uncertainty. Management may be happy for many estimates about the future to be made, which might be too subjective for external reporting. Indeed, some management accounting involves forecasting all the important figures for the *next* year, whereas financial reporting concentrates on the immediate past.

Another point is that there is no need for any rules to be imposed on management accounting, because management can trust itself. By contrast, financial reporting probably works best with some clear rules from outside the entity in order to control the management and help towards comparability of one entity with another.

Having distinguished financial accounting from management accounting, there are some further issues to address. The function of external *auditing* is separate from financial accounting. Auditing is a control mechanism designed to provide an external and independent check on the financial statements and reports published by those entities. Financial reports on the state of affairs and the past results of entities are prepared by accountants under the control of the managers of the entities, and then the validity of the statements is assessed by auditors. The wording used by auditors in their reports on financial statements varies considerably between countries, and the meaning and significance of the words that they use varies even more. There is inevitably some conflict between the necessity for an auditor to work with the management, and the necessity for provision of an independent check. A study of auditing is outside the scope of this book, but the reader from any particular country should note that the role, objectives and effectiveness of the audit function in other countries may differ from those of his or her experience. For example, in Japan, the statutory auditors of most companies are not required to be either expert or independent; in contrast, in some other countries, statutory auditors have to comply with stringent technical and independence requirements.

Another set of distinctions that must be made clear are those between *finance*, *financial management* and *financial accounting*. Very broadly, finance is concerned with the optimal means of *raising* money or investing it in financial assets, financial management is concerned with the optimal means of *using* it inside the company, and financial accounting is the reporting on the results from having used it.

Finally, financial accounting must be carefully distinguished from bookkeeping. *Bookkeeping* underlies all the other types of accounting. It is about recording the data – about keeping records of money and financially related transactions. These raw data are used by financial accounting (and management accounting), which then chooses and presents them as appropriate for various purposes. Financial accounting acts as the *communicating* process to those outside the entity.

1.2 Entities

This book generally refers to business being conducted by 'entities', which is the word used by the International Accounting Standards Board (IASB). It is a word designed to cover all ways of organizing business operations. At one extreme, a business can be run by a single person with no other owners and no organization that is legally separate from the person. This business might be called a 'sole trader'.

The sole trader has unlimited liability for the debts of the business and pays personal income tax on the profits. If the business is to be sold, then the trader must sell the individual assets and liabilities because there is no separate legal entity to sell. Nevertheless, the trader keeps the accounts for the business distinct from other personal activities, in accordance with the 'business entity' convention, which will be discussed in Chapter 3. Otherwise, the success of the business and the basis for calculating tax will be unclear.

As the business becomes larger, it may be useful to have some joint owners (partners) who can contribute skills and money. The business then becomes a partnership, which is formalized by a contract between the partners that specifies their rights and duties. In common law countries, such as the United States and England (though not Scotland), a partnership does not have separate legal existence for most purposes. So, the partners are legally responsible for its assets and liabilities and they pay tax on their share of the profits. Nevertheless, it is possible to set up a 'limited liability partnership' (LLP) and, for example, many accountancy firms have done so. The purpose of this is to seek to protect the partners from some part of the liabilities of the business if there are large legal cases. In Roman law countries, some forms of partnership do have separate legal status, although generally the partners still pay the business' tax.

The complete legal separation of owners from their business is achieved by setting up a company, usually with limited liability for the owners, but private companies, the owners of which have unlimited liability, can and do exist. The ownership of the company is denoted by shares, which can be transferred from one owner (a shareholder) to another without affecting the company's existence. A company is a separate legal entity from its owners. The company can buy and sell assets and it pays tax on its own profit.

In many jurisdictions, including the whole of the EU and South Africa, companies can be either private or public. A private company is not allowed to create a public market in its shares, so they have to be exchanged by private agreement between the owners and the company. Many small businesses are set up as private companies. Table 1.1 shows some designations of such companies in the EU.

Table 1.1 Some EU (and EEA) company names

	Private	*Public*
Belgium, France, Luxembourg	Société à responsabilité limitée (Sarl)	Société anonyme (SA)
Denmark	Anpartsselskab (ApS)	Aktieselskab (AS)
Finland	Osakeyhtiö-yksityinen (Oy)	Osakeyhtiö julkinen (Oyj)
Germany, Austria	Gesellschaft mit beschränkter Haftung (GmbH)	Aktiengesellschaft (AG)
Greece	Etairia periorismenis efthynis (EPE)	Anonymos etairia (AE)
Italy	Società a responsabilità limitata (SRL)	Società per azioni (SpA)
Netherlands, Belgium	Besloten vennootschap (BV)	Naamloze vennootschap (NV)
Norway	Aksjeselskap (AS)	Almennaksjeselskap (ASA)
Portugal	Sociedade por quotas (Lda)	Sociedade anónima (SA)
Spain	Sociedad de responsabilidad limitada (SRL)	Sociedad anónima (SA)
Sweden	Aktiebolag-privat	Aktiebolag-publikt
United Kingdom, Ireland	Private limited company (Ltd)	Public limited company (PLC)

Public companies are allowed to have their shares traded on markets. Some designations of public companies are also shown in Table 1.1. Public companies have to comply with some extra rules because they can offer shares to the public but these rules vary by country and are of no importance for your accounting studies at this stage. Figure 1.1 shows the four types of enterprise discussed so far. Size and complexity tend to increase towards the right.

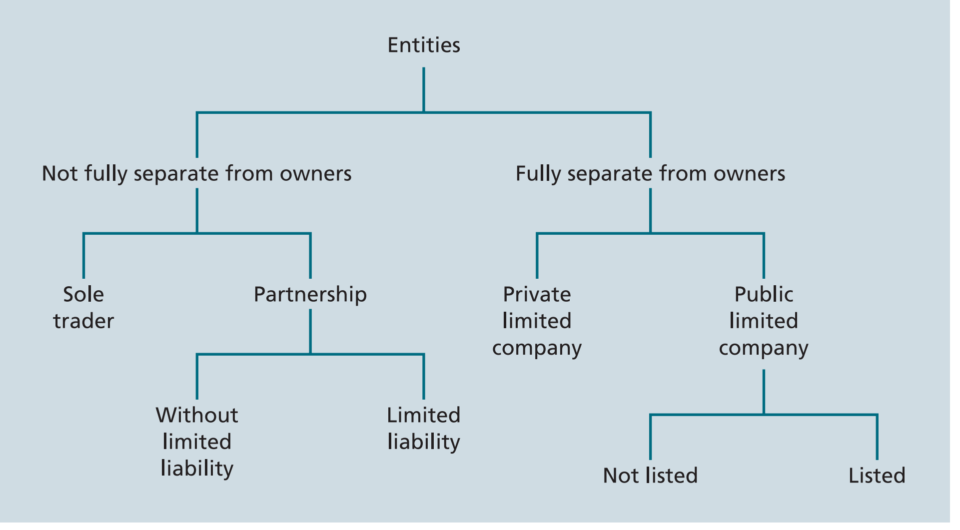
Figure 1.1 Four types of entity

Sole trader → Partnership → Private company → Public company

The biggest form of market for shares is a stock exchange. Companies that are listed (quoted) on a stock exchange have extra rules to obey coming from stock exchanges, regulators of stock exchanges or other sources.

There are some linguistic problems here. First, the English word ‘company’ has no exact equivalent in some other languages. For example, the French *société* and the German *Gesellschaft* are broader terms also covering partnerships. Another problem is that the term 'public company' tends to be used, particularly in the United States, to mean *listed* company. It is true that only public limited companies in the UK (and their equivalents elsewhere in Europe) are *allowed* to be listed, but most such companies choose not to be. So, most UK public companies are not listed. Figure 1.2 expresses some forms of entities in more detail than Figure 1.1.

Figure 1.2 Entities in more detail



Activity 1.B

For your own country, try to allocate legal designations (such as those in Table 1.1) to each of the types of entity identified in Figure 1.2.

Feedback

Let us take the example of France. Some designations are clear:

- partnerships can come in several forms, such as 'snc' (*société en nom collectif*);
- private limited companies are designated as 'Sarl' and public limited companies as 'SA'.

As another example, in the UK:

- partnerships have no designation, except that the limited liability partnership would be labelled 'LLP';
- private companies have 'Ltd' after their names and public have 'PLC'.

As a business continues to increase in size and complexity, it may find it useful to arrange its affairs as a group of companies. This is particularly the case when it operates in more than one country, because it has to deal with different laws and taxes. Figure 1.3 illustrates a possible group. In this example, the Dutch Flower Company is a public limited company with many shareholders. It owns all the shares in private companies in the United Kingdom and Germany. The Dutch company can be called the parent and the other two companies are subsidiaries.