

David Alexander & Christopher Nobes

FINANCIAL ACCOUNTING

AN INTERNATIONAL INTRODUCTION

Seventh Edition



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FINANCIAL ACCOUNTING

An International Introduction



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FINANCIAL ACCOUNTING

An International Introduction

David Alexander and
Christopher Nobes

with an appendix on Double-entry Bookkeeping
by Anne Ullathorne



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Preface

This is the seventh 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 when 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 set of European countries whose accounting rules are largely in line with the EU's, such as the UK and Norway. 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 Europe, given the use of IFRS for listed companies' consolidated statements;
- courses outside Europe 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 four years since writing the sixth edition. We have particularly done the following, compared to the sixth edition:

- updated the discussion of concepts to include the IASB's revised *Conceptual Framework* of 2018 (Chapter 3 and elsewhere);
- explained the effects on accounting of the UK's departure from the EU (Chapter 4);
- added to the material on non-financial reporting (Chapter 6); and
- amended the treatment of lease accounting to take account of IFRS 16 (Chapter 9).

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 apologise 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 summarise 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 for lecturers electronically at go.pearson.com/uk/he/resources. The manual also contains other material to assist lecturers. This book ends with a list of abbreviations, 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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CHRISTOPHER NOBES
*Royal Holloway (University of London)
and University of Sydney*

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Text

4 American Institute of Certified Public Accountants: 'Review and resume', *Accounting Terminology Bulletin No. 1*, New York: American Institute of Certified Public Accountants, 1953, paragraph 5. **4 Association of International Certified Professional Accountants:** American Accounting Association, *A Statement of Basic Accounting Theory*, Evanston, IL: American Accounting Association, 1966, p. 1. **4 Association of International Certified Professional Accountants:** 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. **11 International Federation of Accountants:** International Federation of Accountants (IFAC). **12 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) © IFRS Foundation 2017. **18, 24 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) in the 2018 version of its conceptual framework © IFRS Foundation 2017. **40, 41 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) conceptual framework © IFRS Foundation 2017. **48 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) conceptual framework, IAS1, paragraph 9 © IFRS Foundation 2017. **49 The International Financial Reporting Standards Foundation:** The Level A objective © IFRS Foundation 2017. **50 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) conceptual framework © IFRS Foundation 2017. **50 The International Financial Reporting Standards Foundation:** Conceptual framework © IFRS Foundation 2017. **68 Fiat Chrysler Automobiles:** Fiat's financial statements, as at 31 December 2005. **67 Web.com Group, Inc.:** R. David and J.E.C. Brierley, *Major Legal Systems in the World Today* (London: Stevens, 1985). **69 American Accounting Association:** R.D. Nair and W.G. Frank, 'The impact of disclosure and measurement practices on international accounting classifications', *Accounting Review*, July, 1980, Reprinted with permission from © American Accounting Association. **73 John Wiley & Sons:** Adapted from C.W. Nobes, 'Towards a general model of the reasons for international differences in financial reporting', *Abacus*, vol. 34, no. 2, 1998. **75 The World Federation of Exchanges:** Prepared using data from World Federation of Exchanges 2018 Full year market highlights, The World Federation of Exchanges. **75 The World Bank Group:** Prepared by the authors from World Bank statistics (such as <http://data.worldbank.org/indicator/CM.MKT.LDOM.NO>, accessed 25 April 2015). **79 BASF SE:** BASF's parent company financial statements for 2018, p. 72. **79 L'Oréal:** L'Oréal 'property, plant and equipment' financial statements, 2018 p. 312. **92 The International Financial Reporting Standards Foundation:**

International Accounting Standards Board (IASB) conceptual framework © IFRS Foundation 2017. **91 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) The conceptual framework for financial reporting (2018) © IFRS Foundation 2017. **101, 106–107, 115 The International Financial Reporting Standards Foundation:** IAS 1 — Presentation of Financial Statements © IFRS Foundation 2017. **102, 110, 111, 113 Bayer AG:** Adapted from Bayer's Annual Report 2018, pp. 165–68. **118–119 Bayer AG:** Prepared by the authors from the Management Report of Bayer. **142 Marks & Spencer PLC:** Adapted from Marks & Spencer PLC, Annual Report 2018, p. 77. **157 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) 2018 Conceptual Framework, paragraphs 4.3, 4.4 © IFRS Foundation 2017. **157 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) 2018 Conceptual Framework paragraph 4.26 © IFRS Foundation 2017. **158 BASF SE:** BASF Annual Report of parent company, 2018 p. 74. **159 The International Financial Reporting Standards Foundation:** IAS 38 — Intangible Assets paragraphs 54, 57, 69 © IFRS Foundation 2017. **161 Volkswagen AG:** Volkswagen's Annual Report, 2001. **161 BASF SE:** Prepared by the authors from BASF annual report. **164 Cepsa:** CEPSA's consolidated statement of income for year ended 31 December 1998. **166 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) 13 — Fair Value Measurement © IFRS Foundation 2017. **168 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) The conceptual framework, paragraph 4.68 © IFRS Foundation 2017. **173 BASF SE:** Adapted by the authors from the BASF full-listed financial statement. **181 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) 3 — Business Combinations © IFRS Foundation 2017. **182 European Union:** European Union Directive, Annexes III and IV. **184 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) Balancesheet © IFRS Foundation 2017. **192 L'Oréal:** L'Oréal Company statement, 2018 p. 312. **196 BASF SE:** Extracted from 2018 Financial Statements of BASF SE, p. 72. **204 European Union:** European Union level, Directive 34 Article 8 (9). **222 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) policy for inventory valuation for 2019 © IFRS Foundation 2017. **231 Panasonic:** Matsushita published financial statements for 1999. **231 BASF SE:** Financial Statements of BASF SE, Economic, environmental and social performance 2017. **234 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) The conceptual framework © IFRS Foundation 2017. **237 European Union:** European Union Directive (originally Article 20, now Article 12). **253 L'Oréal:** The French company L'Oréal states in its 2018 report of the parent company under French GAAP p. 312. **258 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) 15 — Revenue from Contracts with Customers and International Financial Reporting Standards (IFRS) 16 — Leases © IFRS Foundation 2017. **264, 268 The International Financial Reporting Standards Foundation:** IAS 7 Statement of Cash Flows ©

IFRS Foundation 2017. **264 The International Financial Reporting Standards Foundation:** IAS 7 Statement of Cash Flows, paragraph 7 © IFRS Foundation 2017. **273 BASF SE:** Consolidated statement of cashflow BASF for the financial year ended 31 December 2018. **278–279 The International Financial Reporting Standards Foundation:** International Financial Reporting Standards (IFRS) 10 Consolidated Financial Statements (Appendix A) © IFRS Foundation 2017. **283–284 Pubco Corporation:** Pubco's parent company, A typical policy statement for the year to 31 December 2020. **288 The International Financial Reporting Standards Foundation:** International Accounting Standards Board (IASB) definition of an asset © IFRS Foundation 2017. **304 BASF SE:** BASF's 2018 annual report (of the parent company, using German GAAP) page 74. **306 Bayer AG:** German pharmaceutical company, Bayer, notes in its 2018 IFRS report, p. 180. **306 BASF SE:** German pharmaceutical company, BASF, says in its 2018 IFRS report p. 192. **306 BASF SE:** BASF SE Financial Statements and Management's Report, 2018. **311 The International Financial Reporting Standards Foundation:** Conceptual framework © IFRS Foundation 2017. **317 Rolls-Royce Holdings plc:** Prepared by the authors from the company's Annual Report, Rolls-Royce Holdings plc, 2017. **342 Total Oil:** Annual report published by the French company, Total Oil. **343 BT plc:** Adapted from BT Group plc's Annual Reports, 1999 and 2008. **346 Norsk Hydro ASA:** Norsk Hydro's annual reports. **348 Massimo Zanetti Beverage Group:** Financial statements of an Italian entity, Massimo Zanetti Beverage Group S.p.A. 31 December 2018, p. 9. **396–408 The International Financial Reporting Standards Foundation:** Conceptual framework © IFRS Foundation 2017.

Part 1

THE CONTEXT OF ACCOUNTING

- 1 Introduction
- 2 Some fundamentals
- 3 Frameworks and concepts
- 4 The regulation of accounting
- 5 International differences and harmonisation
- 6 Company reporting
- 7 Financial statement analysis

Chapter 1

Introduction

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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 organised;
- outline the role of national and international regulators; and
- 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. It has progressed in the same way, adapting to meet changes in the demands made on it. Where the needs differed in different countries, accounting developed in different ways, essentially on the Darwinian principle: useful accounting survived.

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.

(*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 of 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 want to know about 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 loan repayments, and the interest attaching to the loans, will be received 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 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 1.10) suggests that there are other users, such as regulators and members of the public may find general purpose financial reports useful.

However, since the needs of users vary and since different users predominate in different countries, the diverse national environments (cultural, political and economic) lead to diverse accounting practices. 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 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 organising business operations. At one extreme, a business can be run by a single person with no other owners and no organisation 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 would 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 formalised by a contract between the partners that specifies their rights and duties. In common law countries, such as Australia, 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 one involving limited liability for the owners. 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

	<i>Private</i>	<i>Public</i>
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 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.

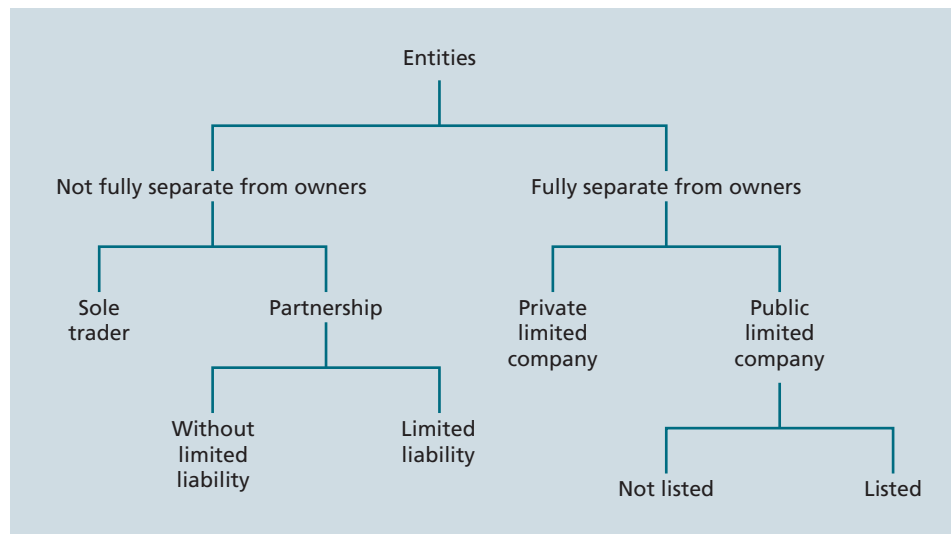
Figure 1.1 Four types of entity

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 listed. 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.