David Alexander, Anne Britton, Ann Jorissen,
Martin Hoogendoorn and Carien van Mourik

INTERNATIONAL FINANCIAL

REPORTING AND ANALYSIS

sixth edition

David Alexander, Anne Britton, Ann Jorissen, Martin Hoogendoorn and Carien van Mourik

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CENGAGE Learning

International Financial Reporting and Analysis, 6th Edition

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Publishing Director: Linden Harris

Publisher: Andrew Ashwin

Development Editor: Abigail Jones

Production Editor: Beverley Copland

Manufacturing Buyer: Elaine Willis

Marketing Manager: Amanda Cheung

Typesetter: Cenveo Publisher Services

Cover design: Adam Renvoize

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British Library Cataloguing-in-Publication Data
A catalogue record for this book is available from the British Library.

ISBN: 978-1-4080-7501-2

Cengage Learning EMEA
Cheriton House, North Way, Andover, Hampshire, SP10 5BE
United Kingdom

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Printed in China by RR Donnelley
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PREFACE

WHY THIS BOOK?

Financial reporting is changing. Accounting has always been a reactive service, changing and developing to meet the practical needs created by the environment in which it operates. This process of change can be illustrated by both time considerations and place considerations. In particular, in the days when most business operations were largely organized within national boundaries, accounting thought, practices and regulation grew up in significantly different ways in different countries, consistent with national environments and characteristics, a process discussed in more detail in Chapter 2.

Now, however, big business is international, and the process and its implications are moving at a very fast rate. Big business is global in its operations; the demand for finance is global and the supply of finance is global. The provision of information, the oil which lubricates any working market, is global in its reach and instantaneous in its transmission. Financial reporting must of necessity be global too. From slow beginnings, the International Accounting Standards Board (IASB) is now poised to become the generally accepted regulator at this international level. From 2005, every listed EU company (and also in Australia) has been required to produce its group financial statements in accordance with International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). Many countries followed this example and now require IFRS compliance for their listed companies (e.g. Argentina, Brazil, Canada, South Korea). Other countries, as diverse as the USA and China, are seeking close convergence, at minimum, with IASB requirements. The USA allows IFRS accounts without reconciliations for US stock exchange listing for foreign registrants.

The effects on accounting and reporting for business entities operating at a national or local level, many of them of the small and medium-sized enterprises (SME) size, are unclear, and are likely to differ in different places. Two points are very clear to us, however. First, national needs, characteristics and ways of thinking will remain significant

at the SME level. Second, the application of agreed IAS, a subjective process of necessity, will continue to be influenced by the context and environment in which the application takes place.

This book is written to reflect this situation and its implications. A knowledge of the requirements of the IFRS is now essential to anyone studying financial accounting and reporting, whether the aim is the preparer focus implied by a desire to enter the accounting professions or the user focus implied by finance, business or MBA-type programmes aimed at management or the educated public.

But, of course, knowledge is not enough. A critical understanding of issues and alternatives, of the whys and wherefores, is also required. The author team has been carefully constructed to contain significant academic, pedagogic and writing experience and to reflect the diversity of European and international thought and experience. Our approach is to expose the reader to the issues by a carefully developed sequence of exposition, student-centred activity and constructive feedback. This process provides a framework with which the reader can assimilate, understand and appraise the exposition of international requirements that follows. Only with such an overall understanding, enhancing both depth and breadth, will the reader be able to follow, and hopefully to take an active part in, the future development of financial accounting and reporting as the process of international change continues.

It is important to be clear that our emphasis is on the IASB requirements, and on a full understanding thereof. How those requirements will actually be applied in detailed practice in the many different countries and cultures involved has to be largely outside our scope. As already indicated, we certainly believe that there will continue to be material differences in the practical interpretation and application of international standards. We give a full justification and explanation of that belief, and provide a framework for analyzing its implications. Nevertheless, it has to be up to the individual reader and/or teacher, situated in a 'local' context, to explore what the implications of that local context may be.

The discussion of all standards has been updated for this sixth edition and brought in line with the latest developments in the IFRS standard-setting programme of the IASB. This implies that at the time of writing, attention has been paid to current evolutions and possible changes in the standards taking place in the near future. For this new edition we have included extracts from company reports from a variety of international corporations to provide students with real-life insight into financial accounting and have introduced a new chapter (Chapter 8) on fair value accounting.

STRUCTURE AND PEDAGOGY

The broad structure of the book is as follows: Part One provides the essential conceptual and contextual background. Parts Two and Three explore the detailed issues and problems of financial reporting both in general and through the specific regulatory requirements of the International Accounting Standards Board – for individual company issues in Part Two and for group and multinational issues in Part Three. Part Four provides a summation by an in-depth consideration of financial statement analysis within a dynamic international context.

Each chapter follows a similar pattern in terms of pedagogic structure. Learning objectives set out what the student should be aiming to achieve, with an introduction to put the chapter in context. There are frequent activities throughout the chapter, with immediate feedback so that students can work through practical examples and reflect on the points being made. The chapter closes with a summary and exercises. Answers to some of the exercises can be found on our dedicated CourseMate, the remainder on the Instructor online support resources.

SUPPLEMENTARY MATERIALS

Students have access to the following resources on Cengage's interactive 'CourseMate' platform via the printed access card in the front of the book, which contains access details and a unique access code:

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- Sample chapter – Chapter 24 on Statements of cash flows
- Online chapters on industry-specific IFRSs – mineral resources exploration and agriculture
- A glossary of Accounting and Finance definitions
- Related links

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- Answers to students' exercises
- Answers to instructors' exercises
- PowerPoint slides
- Online chapters on industry-specific IFRSs – mineral resources exploration and agriculture

TARGET AUDIENCE

This is not a book for those with no prior exposure to accounting. A one-year introductory course in accounting and a basic understanding of the principles of double-entry, or some practical business exposure, are assumed. However, we recognize that such earlier work may have taken any of a wide variety of different forms, have approached the subject from any of several different directions, and indeed may well not have been studied in the English language. The book will be particularly suitable for the middle and advanced years of undergraduate three- or four-year degree programmes, for post-graduate programmes requiring an internationalization of prior studies of a national system and for MBA-type programmes where a true understanding of the issues and the implication of accounting subjectivity and diversity is required.

LIST OF REVIEWERS

The publishers would like to thank the following academics for their insightful feedback and suggestions which helped shape the sixth edition:

Simon Brook, Sheffield Hallam University, UK
Stefano de Cesaris, City University, UK
Jing Li, University of Bradford, UK
T.A. Marra, Groningen University, The Netherlands
Wendy Mason Burdon, Northumbria University, UK
Dirk Swagerman, Groningen University, The Netherlands

OFFICIAL EXAM QUESTIONS

We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer bank have been prepared by us, unless otherwise stated.

We are also grateful to the Chartered Institute of Management Accountants (CIMA) for granting permission to reproduce past examination questions and answers.

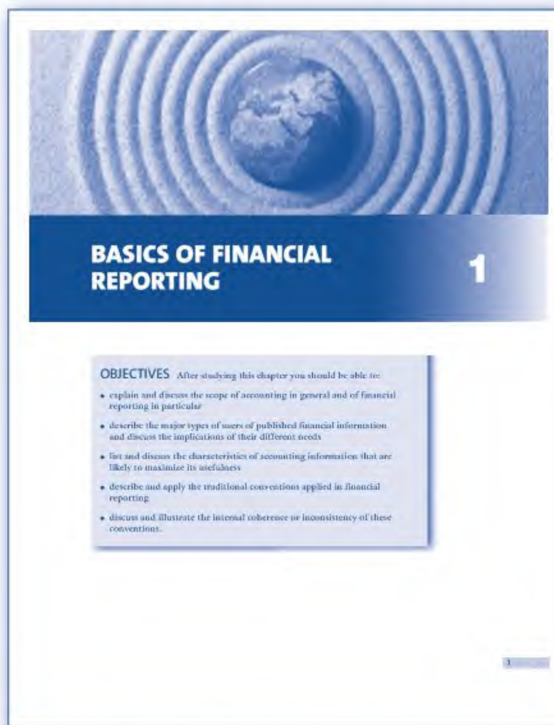
ACKNOWLEDGEMENTS

We are grateful for constructive help and support from several quarters. First of all the authors are indebted to Christoph Muller (Air Lingus, formerly CEO Sabena) for the assistance given and the insight into the airline industry derived from discussion with him. Further, the authors want to thank Leo van der Tas (Tilburg University and Ernst & Young) for his comments on Chapter 2. We are especially grateful to Karel van Hulle for providing many helpful comments to us regarding earlier editions. For the 6th edition we are grateful to George Georgiou for contributing Chapter 29 to this edition. Five spouses and their offspring have coped with the conflicting demands on our time and thoughts. Now, perhaps, it is your turn to help us, or to help us to help you. Suggestions for further development and improvement would be gratefully received by authors or publisher.

Finally, to come back to where we started, we hope that you, the reader, will be interested and stimulated. The internationalization of accounting is an unstoppable force, which will create new and demanding challenges. We believe that participation in this process will be a fascinating and rewarding experience. We hope that you will agree when you have finished studying this book.

David Alexander, University of Birmingham
Anne Britton, Formerly of Leeds Metropolitan University
Ann Jorissen, University of Antwerp
Martin Hoogendoorn, Erasmus University Rotterdam
Carien Van Mourik, Open University – United Kingdom

WALK THROUGH TOUR



Learning Objectives These appear at the start of each chapter to help you monitor your understanding and progress through each chapter. Learning objectives are followed by an introduction which puts the chapter's content in context.

Chapter Summary Each chapter ends with a comprehensive summary that provides a thorough re-cap of the issues in each chapter, helping you to assess your understanding and revise key content.

Activity (and Activity Feedback) With immediate feedback, these activities provide an opportunity to work through practical examples and reflect on the points being made.

Annual Reports Extracts from company reports from a variety of international corporations provide students with real-life insight into financial accounting.

Illustrations and Real World Illustrations Providing an example of a detailed, practical application, the illustrations work through core concepts to aid understanding.

Exercises Appearing at the end of each chapter, these help reinforce and test your knowledge and understanding, and provide a basis for group discussions and activities. Answers to questions marked with ✓ are available in the students' area of CourseMate and the remainder in the instructors' area.

References Comprehensive references at the end of the book allow you to explore the subject further, and act as a starting point for projects and assignments.

Figures Throughout the chapters, figures and tables help explain the subject by giving a visual representation of key concepts or data.

DIGITAL SUPPORT RESOURCES

Dedicated Instructor Resources

To discover the dedicated instructor online support resources accompanying this textbook, instructors should register here for access:
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- Instructor's Manual
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- Solutions to selected exercises
- Interactive eBook
- A glossary of Accounting and Finance definitions
- Links to useful websites

PART ONE

FRAMEWORK, THEORY AND REGULATION

In this first part we look at what financial reporting is all about – what it is trying to achieve and how the accountant sets about achieving it. We explore the international context, reasons for national differences in accounting practice and tradition and the developing international regulatory system designed to achieve greater harmonization.

BASICS OF FINANCIAL REPORTING

1

OBJECTIVES

After studying this chapter you should be able to:

- explain and discuss the scope of accounting in general and of financial reporting in particular
- describe the major types of users of published financial information and discuss the implications of their different needs
- list and discuss the characteristics of accounting information that are likely to maximize its usefulness
- describe and apply the traditional conventions applied in financial reporting
- discuss and illustrate the internal coherence or inconsistency of these conventions.

INTRODUCTION

At its simplest level, accounting is about the provision of figures to people about their resources. It is to tell them such things as:

1. what they have got
2. what they used to have
3. the change in what they have got
4. what they may get in the future.

You may have done quite a lot of 'accounting' already. In many cases this will have consisted largely of technical manipulation – writing up ledger accounts, preparing profit and loss accounts and balance sheets, and so on. Much of the emphasis is likely to have been on 'doing things with numbers'. Given a figure to start with, you can probably record it in a proper double-entry manner and see its effect through onto a balance sheet that actually balances.

But this is only part of the story. Suppose you are not 'given a figure'. Suppose you are given, or have available, a whole variety of figures all related to a particular item or transaction. Which figure or figures should you actually put into the double-entry system? More fundamentally, *how* are you going to decide which ones to put in? In very general terms, we can answer this question by going back to our original simple definition of accounting. Namely, that it concerns the provision of figures to people about their resources. Presumably, therefore, the figures that we as accountants should provide to people are the figures that they need to know for their own particular purpose.

So the key question is: What do people want to know about their resources? Or, what use do they wish to make of the figures we as accountants provide? Once we have answered this question, we can go on to say that the figure we should put into our double-entry system is the one likely to be *most useful to the user of our accounting reports.*

Accounting therefore needs:

- an effective and efficient data handling and recording system
- the ability to use that system to provide something useful to somebody.

This book is essentially concerned with the second of these needs. We have to consider three fundamental issues:

1. Who are the users of accounting statements?
2. What is the purpose for which each particular type of user requires the information?
3. How can we provide the user with the information best suited to their needs?

However, we have also to remember that the accountant and the user themselves have to operate within, and under the control of, the community at large. There is, therefore, an element of *regulation* that has to be taken into account.

USERS OF FINANCIAL REPORTS

As readers will be aware, accounting can be divided into management accounting and financial accounting. Very broadly, management accounting is designed for the management user, i.e. for internal decision making, and financial accounting is designed

for all other users. The theoretical distinction is that management, by definition, can obtain whatever information it needs from within the organization. External users, however, have to rely on negotiation or regulation in order to obtain information. Financial reporting is only concerned with external users and so is this book.

ACTIVITY 1.1

Nine user groups can be suggested for financial reporting, as follows:

1. The equity investor group, including existing and potential shareholders and holders of convertible securities, options or warrants.
2. The loan creditor group, including existing and potential holders of debentures and loan stock and providers of short-term secured and unsecured loans and finance.
3. The employee group, including existing, potential and past employees.
4. The analyst-adviser group, including financial analysts and journalists, economists, statisticians, researchers, trade unions, stockbrokers and other providers of advisory services, such as credit-rating agencies.
5. Suppliers and trade creditors – past, present and potential.
6. Customers – also past, present and potential.
7. Competitors and business rivals.
8. The government, including tax authorities, departments and agencies concerned with the supervision of commerce and industry, and local authorities.
9. The public, including taxpayers, consumers and other community and special interest groups, such as political parties, consumer and environmental protection societies and regional pressure groups.

Taking each of these groups one at a time, consider first the sorts of decisions that they are likely to wish to make using accounting information and, second, the implications from this as to what information they might need.

Activity feedback

The equity investor group

Essentially, this group consists of existing and potential shareholders. This group is considering whether or not to invest in a business: to buy shares or to buy more shares; or, alternatively, whether or not to disinvest, to sell shares in the business. Equity investors look for one or a combination of two things: income, a money return by way of dividend, or capital gain, a money return by way of selling shares at more than their purchase price. It should be apparent that these two are closely related. Indeed, the only difference is the timescale. However, the simple theory is made immensely more complex in practice by the effects on share prices of other equity investors' expectations.

For example, share prices for a company may rise because higher dividends are expected to be announced by the company. Alternatively they may rise because other people believe *dividends will increase. A buys some shares in expectation of 'good news'. This causes prices to rise. B then buys some shares in expectation of the price rise continuing. This causes the price to rise again – a self-fulfilling prophecy – which brings in C as a buyer too. The original hope of 'good news' is soon forgotten. If, however, at a later date the news arrives and turns out to be bad, everyone involved – A, B and C – may want to sell and the price will come crashing down.*

The motivational and psychological arguments involved here are well beyond the scope of this book. It is the information requirements that concern us. If the investor is taking a short-term view then current dividends may be a major factor. As the time horizon of our investor lengthens, then future dividends become more important and future dividends are affected crucially by present and future earnings. *The focus then is on profits, which both determine future dividends and influence the share price.*

One obvious point is that investors, both existing and potential, need information about future *profits. The emphasis in published accounting information is almost wholly on past or more or less present profits. These may or may not be a good guide to the future. The need to make the past results useful for estimating (guessing) the future is an important influence on some of the detailed disclosure requirements we shall explore later. The general trend is to make reported accounting statements as suitable as possible for investors to make their own estimations. We should note an alternative possibility, however. This is that the company itself – through either the management or possibly through the auditors – should make a forecast. After all, the management and the*

(Continued)

ACTIVITY 1.1 (*Continued*)

auditor have a much greater insight into possibilities and risks than the external shareholder.

The loan creditor group

This group consists of long-, medium- or short-term lenders of money. The crucial question an existing or potential loan creditor wishes to consider is obvious: Will he or she get their money back? A short-term loan creditor will primarily be interested, therefore, in the amount of cash a business has got or will very soon get. As a safeguard, they will also be interested in the net realizable value (NRV) of all the assets and the priority of the various claims, other than their own, on the available resources. Longer-term lenders will clearly need a correspondingly longer-term view of the firm's future cash position. Their needs are thus similar to the needs of the equity investor group – they need to estimate the overall strength and position of the business some way into the future.

The employee group

Employees or their representatives need financial information about the business for two main reasons:

1. *fair and open collective bargaining (i.e. wage negotiations)*
2. *assessment of present and future job security.*

In these respects they also need to be able to assess the economic stability and vulnerability of the business into the future.

The employees, actual or potential, will also have additional requirements, however:

1. *They will often need detailed information at 'local' level, i.e. about one particular part of the business or one particular factory.*
2. *They will need information in a clear and simple non-technical way.*
3. *They will need other information that is inherently non-financial. They will want to know, for instance, about management attitudes to staff involvement in decision making, about 'conditions of service' generally, promotion prospects and so on. It can thus be seen that the employee group may require particular statements for its own use and that it may require information not traditionally regarded as 'financial' at all.*

The analyst-adviser group

In one sense this is not a separate group. It is a collection of experts who advise other groups. Stockbrokers and investment analysts will advise shareholders, trade union advisers will advise employees, government statisticians will advise the government and so on. The needs of the analyst-adviser group are obviously essentially the needs of the particular group they are advising. However, being advisers, and presumably experts, they will need more detail and more sophistication in the information presented to them.

Suppliers and trade creditors

Suppliers and trade creditors need similar information to that required by short-term loan creditors. But they will also need to form a longer-term impression of the business's future. Regular suppliers are often dependent on the continuation of the relationship. They may wish to consider increasing capacity specifically for one particular purchaser. They will therefore need to appraise the future of their potential customers both in terms of financial viability and in terms of sales volume and market share.

Customers

Customers will wish to assess the reliability of the business both in the short-term sense (will I get my goods on time and in good condition?) and in the long-term sense (can I be sure of after-sales service and an effective guarantee?). Where long-term contracts are involved, the customer will need to be particularly on his or her guard to ensure that the business appears able to complete the contract successfully.

Competitors

Competitors and business rivals will wish to increase their own effectiveness and efficiency by finding out as much as possible about the financial, technical and marketing structure of the business. The business itself will naturally not be keen for this information to become generally available within the industry and it is generally recognized that businesses have a reasonable right to keep the causes of their own competitive advantage secret. Competitors may also wish to consider a merger or an amalgamation or a straight takeover bid. For this purpose they need all this information, plus the information required by the equity investor group. They also need information about what they – the bidders – could do with the business. In other words, they need to be able to form an opinion on both:

- *what the existing management is likely to achieve*
- *and what new management could achieve with different policies.*

(*Continued*)

ACTIVITY 1.1 (*Continued*)

The government

Everybody is aware that governments require financial information for purposes of taxation. This may be the most obviously apparent use by governments, but it is not necessarily the most important. Governments also need information for decision-making purposes. Governments today take many decisions affecting particular firms or particular industries, both in a control sense and in its capacity as purchaser or creditor. Also, governments need information on which to base their economic decisions regarding the economy as a whole. This information is likely to need to be very detailed and to go well beyond the normal historic information included in the usual published accounting reports. Again, there is an obvious need for future-oriented information.

The public

Economic entities, i.e. businesses in the broadest and most general sense, do not exist in isolation. They are part of society at large and they react and interact with society at every level. At the local level, there will be concern at such things as employment, pollution, and health and safety. At the wider level, there may be interest in, for example, pollution and 'green' issues, energy usage, effective use of subsidies, dealings with foreign governments and contributions to charities in money or kind. Much of this information is non-financial. Indeed, some of it cannot be effectively measured at all. Whether it is accounting information is an open question. But it is certainly useful information about businesses.

Summary of user needs

Several general points emerge from the preceding discussion:

1. Many, although not all, of the information requirements are essentially forward looking.
2. Different users, with different purposes, may require *different* information about the *same* items.
3. Different users will require (and be able to understand) different degrees of complexity and depth.
4. Not all the information required is likely to be included in financial accounts.

CHARACTERISTICS OF USEFUL INFORMATION

ACTIVITY 1.2

Make a list of the desirable attributes or characteristics (such as relevance, for example) that financial information should have if it is likely to be useful.

Activity feedback

Seven general ideas occur to us, as follows.

Relevance

This sounds obvious, but on reflection it is difficult to define and therefore to achieve. A report must give the user what he or she wants. As already indicated, this presupposes that we, the accountants preparing the report, know:

1. *who the user is*
2. *what their purpose is*
3. *what information he or she requires for this purpose.*

Clearly these requirements may change as time progresses.

Understandability

Different users will obviously have different levels of ability as regards understanding accounting information. Understandability does not necessarily mean simplicity. It means that the reports must be geared to the abilities and knowledge of the users concerned. Complex economic

(*Continued*)

ACTIVITY 1.2 (*Continued*)

activities being reported to an expert user may well require extremely complicated reports. Simple aspects being reported to users with little or no background knowledge will need to be very simple. The problems really arise when we have the task of reporting on complex activities to the non-expert user.

Reliability

The user should be able to have a high degree of confidence in the information presented to him or her. This does not necessarily mean that the information has to be factually correct, but it should be as credible, as believable, as possible. Preferably it should be independently verified, for example by an independent, qualified auditor. However, unverified – or unverifiable – information may be better than no information at all.

Completeness

The user should be given a total picture of the reporting business as far as possible. This is a tall order. It implies large and complex collections of information. It may also imply problems of understandability.

Objectivity

The information presented should be objective or unbiased in that it should meet all proper user needs, and be neutral in that the perception of the measurer should not be biased towards the interest of any one user group. Objectivity is a confused notion, with several different possible meanings. We shall consider the problems in more detail later. The present proposition is that reports should not be biased by the personal perception, the personal opinion, of the preparer of those reports. The stated need is not for reports with no personal opinion, but for reports with unbiased *personal opinion.*

Timeliness

Essentially, this means that information should be provided to the user in time for use to be made of it. Information presented should be as up to date as possible. Approximate information, made available in time to assist with some decision or action, is likely to be more useful than precise and accurate information presented after the decision has already been made.

Comparability

Information about any one business for any one period should be presented so that:

1. *it can be easily compared with information about the same business for a different period*
2. *it can be easily compared with information about a different business for the same, or even a different, period.*

Clearly, consistency of treatment is very important here – the application of generally accepted standards (and generally accepted regulatory standards).

NEED FOR COMMUNICATION

So we have some idea of the various characteristics of useful information. But, more fundamentally, what is information? Remember our earlier suggestion that accounting is about the 'provision of useful figures to people about their resources'. The accountant has to provide figures to the user. But 'provide' does not just mean 'send'. It is not enough to send, to deliver, sheets of paper or electronic documents with words and figures. There has to be *communication*, there has to be *understanding* by the user. The point about communication, the point about information, is that the receiver is genuinely informed. He or she must become mentally and personally aware.

If effective communication is to take place, the language used must be such that the signs employed evoke in others the same response as if those others were to see the object represented instead of the signs. This is, of course, an idealistic position. A television news film can never really put the viewer in the same position in every respect as if they were physically present at the actual event filmed. Even less successful is a verbal description by 'someone who was present'. In accounting, the means of communication is essentially a few numbers, usually prepared by someone who was not actually involved in the financial events supposedly being portrayed anyway. But it is a useful idea to bear in mind, however impossible to achieve.

Another problem is the likely ignorance of the intended receiver of the information. Accounting 'signs' are highly 'coded'. The accountant knows what he or she means, but does anybody else? And how is the user requiring the information to specify exactly what is wanted from the accountant if they cannot 'speak the language'? Clearly, when we think about it, the accountant has to communicate the main features of the reports in non-accounting terms.

Financial accounting conventions

We have looked at some of the possible things that financial accountants could do in order to provide useful figures to people about their resources. We have looked at who the users are and what sort of information they might need. In this and the following chapters we look at what accountants usually *do* do. Many different words are used in textbooks, articles and statements to describe these ideas – concepts, conventions, assumptions, postulates, for example. Some of them are described as being more 'fundamental' than the others. In this chapter we shall simply refer to all of them as 'conventions'. Later we shall look at how international bodies define and divide them, but here we concentrate on the ideas themselves.

We shall consider 12 separate conventions, as follows: business entity, duality, monetary measurement, cost, accounting period, continuity (going concern), conservatism (prudence), consistency, materiality, objectivity, realization of revenue and matching.

Business entity

This states that the business has an identity and existence distinct from its owners. To the accountant, whatever the legal position, the business and the owner(s) are considered completely separately. Thus the accountant can always speak of the business owing the owner money, borrowing money from the owner, owing profits to the owner and so on. Think of the basic business balance sheet:

Non-current assets	Capital
Current assets	Liabilities
Total	Total

As we know, a properly prepared balance sheet can always be relied on to balance. Why is this? The simple answer is because capital is the balancing figure. Capital is the amount of wealth invested in the business by the owner, the amount of money borrowed by the business from the owner or the amount the business owes the owner. None of these three statements could be made unless the accountant is treating the business as separate from, and distinct from, the owner. The accountant usually prepares the accounts of, i.e. the balance sheet of, the business. Transactions of the business are recorded as they affect the business, not as they affect the owner. In principle, another balance sheet always exists, namely for the owner as an individual. This will contain the owner's investment in the business, shown as one of his or her assets.

Duality

This may be regarded as a formalization of the basis of double-entry. It states that in relation to any one economic event, two aspects are recorded in the accounts, namely:

1. the source of wealth
2. the form it takes (i.e. its application).

In the simplest of terms, 1 is 'where it comes from' and 2 is 'what we have done with it'. The source it came from will have a claim back on it. Thus, again in balance sheet terms, we can say that the balance sheet shows the array of resources at a point in time (assets) and the claims on those resources (liabilities); it shows the application of what was available (assets) and the source of what is available (liabilities or claims).

Monetary measurement

Accountants regard their job as dealing with financial information. This convention states that the accountant only records those facts that are expressed in money terms. Any facts, however relevant they may be to the user of the information, are ignored by the accountant if they cannot conveniently be expressed in money terms. It is often said that the greatest asset an effective and efficient business possesses is its workforce. So why does the workforce never appear on a business balance sheet? The short answer is that it would be extremely difficult to 'put a figure on' the workforce, i.e. to express this asset, this resource, in money terms. So the accountant does not even bother to try. Facts and outcomes that cannot be expressed in money terms are ignored. This convention and its limitations are sometimes queried.

Cost

This convention states simply that resources acquired by the business are recorded at their original purchase price. It follows on from the previous convention in that it tells us how that item is actually to be measured. This is the well-known historical cost (HC) convention. It does not now receive the near universal support of earlier years.

Accounting period

This very simple convention recognizes that profit occurs over time and we cannot usefully speak of the profit 'for a period' until we define the length of the period. The maximum length of period normally used is one year. This is supported by legislation normally requiring the preparation of full audited accounts annually. This does not, of course, preclude the preparation of accounts for shorter periods as well. But the formal 'published accounts' period is nearly always one year.

Continuity (going concern)

This important convention states that in the absence of evidence to the contrary it is assumed that the business will continue into the indefinite future. This convention has a major influence on the assumptions made when evaluating particular items in the balance sheet. For example, the convention allows us to assume that inventory will eventually be sold in the normal course of business, i.e. at normal selling prices. Perhaps even more obviously it allows for the principle of depreciation. If we depreciate an item of plant over ten years, then we are assuming that the plant will have a useful life to the business (not necessarily a useful total *physical* life) of ten years. This assumption can only be made if we are first assuming that the business will continue – or keep going – for at least ten years. Notice, incidentally, that the going concern assumption does not say that the business is going to keep being profitable into the indefinite future. It merely assumes that the business will manage not to collapse altogether.

Conservatism (prudence)

This convention refers to the accounting practice of recognizing all possible losses, but not anticipating possible gains. This will tend to lead to an understatement of profits – to an understatement of asset values with no corresponding understatement of liability.

The accounts are in essence trying to give an indication of the current position (the balance sheet) and of the degree of success achieved through the accounting period (the profit and loss (P&L) account). This convention requires the accountant to attempt to ensure that the position or the degree of success is not overstated. Recognizing that absolute accuracy is not possible, the accountants, according to this convention, should ensure the avoidance of overstatement by deliberately setting out to achieve a degree of understatement. This requires that similar items, some of which are favourable and some of which are unfavourable, should not be treated identically or symmetrically.

ACTIVITY 1.3

Give some examples of regular non-symmetrical treatment of favourable and unfavourable aspects of otherwise similar items.

Activity feedback

There are many examples to choose from. Two examples are:

1. *the treatment of inventory, which is usually shown at cost or NRV if lower (but not at NRV if higher) – see Chapter 17*
2. *the whole approach to contingent items – see Chapter 20.*

Consistency

This is the practice of applying the same accounting rules, methods or procedures in each similar case. This convention should:

1. avoid short-term manipulation of reported results
2. facilitate comparisons within the firm over different accounting periods (intra-firm comparisons)
3. facilitate comparison between different entities (inter-firm comparisons).

Consistency can, of course, never overrule the requirements of proper and useful reporting. But the convention does certainly support the argument that where several alternative treatments or approaches are acceptable, the business should make a decision and then stick to it year by year for all similar items.

Materiality

This is a statistical concept that, in its application to accounting, implies that insignificant items should not be given the same emphasis as significant items. The insignificant items are, by definition, unlikely to influence decisions or provide useful information to decision makers, but they may well cause complication and confusion to the user of accounts. Their detailed treatment may also involve a great deal of time and effort – and therefore of money – for no useful purpose. Many firms, for example, treat smallish