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# 2 Perspectives surrounding book entries

## 2.1 Introduction

The integrity of information presented in the financial statements has to be of a high level and it is the purpose of this research to show that this goal is often compromised by the application of certain accounting practices (e.g. creative accounting). One way in which these practices precipitate in financial statements is through the use of the so-called book entry, to be defined in section 2.3.3 below. However, such practices are not recent developments, but have a legacy in the history of accounting. Furthermore, in order to discuss these historical milestones, some definitions are needed. Hence this chapter has a twofold purpose, namely, to present a historical account of the use of book entries to alter the information portrayed in the financial statements and to introduce a number of critical definitions. In particular, the history of the book entry, as well as an account of the early treatment of depreciation are presented. This is followed by the history of the cash flow statement and some definitions of concepts related to this research, together with an analysis of these definitions. A summary concludes the chapter.

## 2.2 The history of book entries

A book entry may be looked upon as a tool used by an accountant or financial manager to induce non-events (non-cash transactions) into financial statements. General accounting roots may be traced back as far as 4500 BC in Mesopotamia, what is today Iraq, with small parts in Iran and Syria (Keister 1978). The double book entry is the main theme addressed in the majority of material concerned with the history of accounting (Yamey 1978; Murray 1978). Unfortunately, references to the history of book entries are rather limited. A particular book entry that comes under the spotlight is depreciation, addressed in the article entitled “Illustrations of the early treatment of depreciation” by Mason (1978). As far as the author is aware, this is the only book entry that is treated

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so comprehensively in the literature and to which a whole article is dedicated.

Although the book entry is a very important tool in the accountant's toolbox, the author could not find any *formal definition* of a 'book entry' in the literature. Examples of book entries are, however, abundant in the literature (Cushing 1989). Deferred taxation, depreciation as well as research and development costs, are all examples of book entries to name a few. These concepts are all based on timing differences. In addition, book entries are often not based on transactions and events, but are instead seen as based on proposed happenings (Goldberg 2001). Hence, other than events and transactions that are based on the past and the present, book entries are based on certain proposed future happenings. Researching the history of book entries is a rather challenging task, because of the lack of a proper definition.

### 2.2.1 Early treatment of depreciation

Depreciation is one of the book entries on which the analytical part of this research is based, hence a historical account of depreciation is in order. A chronological discussion of the history of depreciation, distilled from a historical presentation given by Mason (1978), appears below. In each case the year is followed by a description of the event:

(1) 1744. An entry to write down the value of household furniture, was formulated.

(2) 1757. A book called '*Book-keeping Methodiz'd*' (5$^{th}$ edition) was published by John Mair. There was no illustration of depreciation in Mair's book, but the method described for handling fixed asset accounts appeared in most of published texts at that time and for more than 100 years thereafter. This lent itself to the recording of depreciation by what might be called the inventory or revaluation method.

(3) 1801. A book called '*Book-keeping in the true Italian form*', by Wm. Jackson was published. In this book a credit is shown in a "ship" account "By Profit and Loss, for

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Wearing, Age, etc.". and the balance forward was called a "present value".

(4) 1838. In August 1835, a ship called the "Lord William Bentinck", despite it having been in the water for sixteen months, was hauled up into a dry dock and no signs of corrosion were visible. Following this discovery, 20 years were confidently assumed for the duration of an iron vessel. The annual depreciation, on both a vessel and the engine was therefore fixed at 5 percent (using what is nowadays called the straight-line method), with 20 percent on the boilers.

(5) 1839. In some analysis of costs in the *American Railroad Journal*, the computation of depreciation as a percentage of the cost was indicated.

(6) 1841. One of the earliest hints at the creation of a fund somewhat related to the idea of an internal fund to replace fixed assets was made in the 10th annual report of a company called "The Boston & Worcester Railroad". In this report a "reserved fund for decay and wear beyond repairs" was not deducted from the total construction cost as had been the practice, but was simply shown as a special item in the report. For example, in a group of "expenditures (text omitted) exclusive of the amount charged to construction", the following item appeared:

*For repairs of engines and cars, of which, taken from reserved fund for new cars, $9,900, .....$25,286.46*

(7) 1843. A plea for the creation of an internal fund to replace fixed assets was also made at this time by Charles Ellet Jr. in the *American Railroad Journal*. He wrote the following:

To those companies whose works are now new, and who seem to be making money, I would suggest the timely formation of a contingent fund, to prepare them for a

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contingency which will as surely reach them as the next new year. It is bad policy to divide the annual expenses as if they were real profits; the money that is earned at the expense of the rails, cars and machinery, should be hoarded to replace those things, and not distributed, as if they were to last for ever. It can be shown that every company should annually store away, in times of prosperity, while their work is new, at least 6 cents for every mile travelled by their engines, 1 cent for every ton conveyed one mile, and 200 dollars for every mile of road, to replace decayed materials, and injured iron and machinery. (Mason 1978)

The case presented above was a further call for putting in place a mechanism for the painless replacement of fixed assets.

(8) 1844 – 1846. By this time a definite policy seems to have been worked out for handling depreciation. It was the early practice of directors to make an annual allowance for the deterioration of a fixed asset when the expenditures for repairs were not deemed the same as the waste incurred by normal wear and tear of such assets. A fund was created to meet expenditures of succeeding years whenever these expenses should exceed the average cost of the necessary repairs in a given year.

(9) 1848. A further account of a call to create an internal fund is reported on in the *American Railroad Journal*. A speech was made by a certain Mr. Glyn at a general meeting of the London & North Western shareholders. In this speech Glyn stated that replacements had been charged against revenue. He proposed that new capital was required because of the capitalisation of the cost of the increased weight of rails, and made a request for the creation of a replacement fund viz.: "... your directors have thought fit, not only to take the usual course in regard to the relaying of the rails (part omitted) but conceiving that, in the course of some fifteen or twenty years, the existing rails will, from the working upon them, require necessarily, to be replaced by others, [and] they have thought it their duty to call

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upon you to sanction the annual appropriation of £15,000 for the purpose of forming a fund to meet that contingency from time to time".

(10) 1849 – 1867. During this period companies experimented extensively with ways in which to present depreciation data. For example, although there was no evidence of a change in depreciation policy, figures were seldom presented in exactly the same way for more than two or three years in succession.

Currently, it is the practice when compiling a balance sheet, to deduct accumulated depreciation from the cost of a fixed asset. The net or book value is then shown as a combined figure in the balance sheet. Sprague (1920:51) regards depreciation not as a liability, but rather as an offset to an asset: "It is sometimes desirable for some special reason to separate the account of an asset, of a liability or of a proprietor into two accounts, usually in order to present two different valuations". For example, machinery was bought a year ago for R100 000 and it is estimated that this machinery will be worthless in five years' time. The depreciation rate is estimated at 20 percent per year or R20 000. If, for some reason, it is necessary to keep a record of the original cost, R100 000, and at the same time of the book value, R80 000, this may be done by using two accounts on opposite sides of the ledger:

| Machinery at cost | R100 000 | Depreciation | R20 000 |
|---|---|---|---|

It is argued that it is often less expensive to replace a fixed asset from an internal fund rather than an external fund, hence depreciation is also investigated from a viewpoint of being a source of internal funds for the replacement of assets in the future, rather than a liability or an offset to an asset. Maintaining an internal fund for the replacement of fixed assets forces an accountant to keep track of such replacement costs from year to year, other than the alternative of losing track of such replacement costs over the years, only to be surprised by unbudgeted, escalating costs when the asset has to be

replaced eventually.

In the accounting literature of 1976, an internal fund created from the depreciation provision, was described as a “Depreciation fund investments at cost” and “Leasehold depreciation fund” (Wimble and Cairns 1976). The reason that this practice was stopped is not entirely clear. One could speculate that making use of a company’s own internal funds suggested that they did not have confidence in the management of their own liquidity because their internal rate of return was lower than the outside market. The use of a provision for internal funds had certain benefits since lost by modern accounting practices, for example, as suggested above, the replacement of a fixed asset might be funded more economically from an internal fund than an external fund.

Historical evidence suggests that the provision for depreciation was not accepted without problems. According to Most (1982) the American railroads opposed this depreciation and delayed the imposition of mandatory depreciation from 1923 to 1932. They called the provision for depreciation “unnecessary”, “deceptive” and “impossible” to calculate accurately. When the depression started, the mandatory provision for depreciation was suspended immediately. Hence, depreciation has been an item of great controversy through the years and only came into force in 1943. A book entry that was so heavily criticised may indicate that the integrity of the information created by this book entry is not the same as the integrity of information created by real transactions. In Chapter 7 of this dissertation it is shown that depreciation affects the integrity of information.

### 2.2.2 History of other book entries

As stated earlier, although many examples of book entries are discussed in the literature no formal definition could be found. A book entry is the vehicle used to allocate costs and revenue, to classify accounts, to valuate intangible assets, to provide for depreciation, depletion, amortisation and bad debts. Yamey (1982:133) gives an

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example from the 1920's of the allocation of fixed costs that nearly cost someone by the name of Thomas J. Kreps his job: Too many costs over which Kreps had no control were allocated to his division. As a result his division was no longer cost effective and he was in real danger of being retrenched. Fortunately, a superior who spotted Kreps' talents, changed the basis of this cost allocation where after his division became economically more viable, not through a change in operational efficiency, but simply by representing the information about his division differently. Subsequently Kreps' job was thereby secured. As Yamey (1982:133) argues that:

> We need to know how common or uncommon such or similar cases of unintentional misinformation have been before we can answer important questions, and assess, for example, the significance, since the rise of large scale enterprise, of financial accounting and cost accounting in matters such as the quality of entrepreneurial decisions, the determination of the volume and allocation of investable funds, and the course of business cycles – to take three evidently important subjects of wide economic interest.

The allocation of common fixed costs mentioned above brought about through the use of book entries. Yamey called the allocation of fixed costs based on the wrong criteria, misinformation. When allocating fixed costs, an accountant needs to be very careful to use the correct allocation criteria. Using the wrong criteria may lead to information of a lesser integrity. An expense cannot be allocated to revenue that has little or no bearing on the expense when adhering to the matching principle. It is the experience of the author that in many companies expenses are allocated to various cost centres which did not benefit from the income which is matched with the expenses.

The provision for doubtful debtors is another book entry described in the history of accounting. A list of debtors' individual amounts appears at the end of the opening inventory in *Peele's Pathe waye*. There are no total and the amount of the list of debtors is not included in the calculation of the owner's capital (Yamey 1982). Therefore, if an

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accountant is uncertain about whether a debt is going to realise or not, it might be a good idea to omit it from the calculation of the owners capital – rather understate the capital and include the debt later, only after certainty regarding the realisation of the debt has been achieved.

Intangible assets, for instance goodwill and patents, are items that are brought about by book entries. Capital may be impaired by the use of book entries and therefore influence the integrity of the information. Sprague (1920:53) has the following to say about impaired capital: "Almost universally the assets are hoisted to meet the exigency, or the deficiency is represented as an asset. This receives some euphemistic title such as Good Will, Franchises, Patents. This may not be with any fraudulent intent, but from a feeling that the latent personal assets, spoken of in Articles 84 and 101 as 'non-ledger' assets, make the concern worth at least par as a revenue producer. There is a natural reluctance to admit the fact of overcapitalization or 'watering'".

### 2.2.3 History of the cash flow statement

Depreciation, one of the book entries examined in this research, has no cash consequences. For this reason, as early as 1902, the US Steel company and their subsidiaries added back depreciation after beginning with the net profit in a funds statement (Donleavy 1994:61). Following this principle, it can be said that depreciation should not be seen as an item with cash consequences and should therefore be added back in the cash flow statement so as to show the real cash events or transactions. It becomes evident that in order to generate information based on real transactions, depreciation, a non-event is added back. The effect is to remove a non-event from the net profit, resulting in real transactions which may enhance the integrity of the information.

Donleavy (1994:62–63) reports that the funds statement was historically often viewed as an excellent vehicle to test a student's knowledge on the accrual basis of accounting.

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"Specifically, the working capital format was a better testing device than the 'changes in all balance sheet accounts' at this time, because the former eliminated the effects of many 'intra-entity' bookkeeping entries, and its definition of funds approximated accrual accounting concepts". These so-called 'intra-entity bookkeeping entries' are synonymous to *book entries*. Cash represents a real transaction and since a book entry does not represent cash, a book entry ought to be excluded from the funds statement, leading to the observation that information created by book entries may be of a different integrity than that of real transactions (e.g. cash).

The information from which a cashflow statement is drawn up, is based on different types of transactions. This was emphasised by Hooper and Page in 1979 when they proposed to adjust the cash flow at three levels (Donleavy 1974).

**Table 2.1:** A three-level cash flow adjustment

| Level | Adjustment | Distinguished as |
|---|---|---|
| 1 | Receipts and payments on capital account, broadly the same as financing and investing activities | Real transaction's |
| 2 | Accruals and prepayments including sales not yet paid | Judgmental transactions |
| 3 | Includes depreciation, profit or loss on asset disposals, undistributed subsidiary earnings and deferred tax | Accounting allocations |

(Donleavy - adapted)

The accounting allocations in Table 2.1 are book entries in today's terms, that is, accounting allocations (book entries at level 3) were regarded as artificial transactions in contrast to the real transactions at level one.

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## 2.3 Critical analysis of definitions

Definitions are an essential part of any research and in this section definitions are presented for a number of concepts presented below. These concepts are all related to the area of this research in the sense that concepts (2) to (6) all fall under the umbrella of item (1), namely accounting, while items (2) and (3) may be used in an argument for introducing (4) in a company. Also, concepts (2) and (3) may affect the integrity (i.e. item (6)) of information which is item (5).

(1) Accounting
(2) transactions, events and occurrences
(3) book entries
(4) internal funds
(5) information
(6) integrity.

### 2.3.1 Accounting

Accounting may be defined as 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" (Kam 1990:33). Goldberg (2001) claims that the word accounting signifies a set of activities which are carried out by people. These activities reflect relationships between people and are presumed to be intended to be of benefit to stakeholders. The term accounting is a further conceptualisation of the word account, in the sense that it "stores information, which are human artifacts and not natural phenomena" (Goldberg 2001). The accountant may get some 'pictures' of what is happening in a social unit and then communicate these pictures to the relevant stakeholders, helping them to make decisions.

Another definition of accounting is also provided by Plank and Blensly (1989) in that

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they define accounting as a service activity which function is to provide qualitative information that is largely of a financial nature and about economic entities, intended to facilitate the making of economic decisions. Such information furthermore allows a decision maker to make reasoned choices among alternatives.

### 2.3.2 Transactions, events and occurrences

The above definition of accounting makes use of two concepts, namely, *transactions* and *events*, hence definitions of these concepts are called for.

A *transaction* usually refers to an activity that arises between two interrelated parties. This activity is subsequently recorded in the financial statements (Goldberg 2001). A business transaction can be described as a "piece of business" (Hornby 1981:918). A transaction or event is based on economic circumstances and quite naturally, therefore, the accounting definition for a transaction is "an event of a financial nature that must be recorded in the organisations' *accounts*" (Thompson 2003). An event has to be of a financial nature to form part of accounting.

Another accounting definition of a transaction is "an identifiable operation carried out by or through an organization that transforms or converts an asset" (Accounting dictionary 2003). A book entry does not have the ability to transform an asset; such transformation is achieved only through a real transaction. "A transaction makes a stranger part of the value chain and as such a stakeholder. However, a book entry does not make a stranger part of the value chain and represents internal fund movements. A stakeholder can only be created by a transaction but not by a book entry" (Gouws 2003a). Therefore it may be difficult for an outside party to verify a book entry, thereby influencing the integrity of the information displayed in the financial statements.

Whenever a normal transaction takes place, an exchange of money, goods or services takes place. When a debtor pays a creditor, the transaction is complete. According to

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Most (1982) for a transaction to occur, the earning process must be complete, and an exchange must take place. When a book entry takes place, there is no exchange.

Owing to the inherent ambiguity of natural languages (Meyer 1985) the word *event* can be interpreted in different ways and therefore some problems or questions may arise (Kam 1990). For example, when a contract is signed, does an event take place at signing or not? Both parties have rights to future performance, but these must meet the definition of an asset before the event is recorded. A business event may be seen as a happening and, in particular, an economic happening. A business event is any activity that can be controlled, planned or evaluated by management and provides value to an organisation (BYU Junior Core Faculty 2003). In this description of an event, a book entry rather than a transaction is portrayed. A book entry may also be controlled, planned and evaluated by management and therefore book entries may influence the integrity of information.

In order for an event to have an economic nature, a value must be allocated to the event. Sorter and Ijiri are two researchers who aimed to overcome a number of ‘valuation problems’ in conventional accounting which resulted in limited information for users. Cushing (1989) did similar research but restricted his attention to events having direct financial implications. He pointed out that there are certain non-events (non-financial in nature) included in corporate accounting that may be viewed as relevant (Goldberg 2001). Non-events are seen as book entries because they are based on future happenings and they do not have direct financial implications.

Occurrence is derived from the word ‘occur’, and if something occurs then it means it takes place or happens (Hornby 1981:579). An occurrence is further defined as a happening or an event, a fact or a process of occurring (Hornby 1981). Goldberg (2001) sees what accountants deal with as occurrences expressive of, or representing purposive activities. If an occurrence can be expressed in financial terms, the

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occurrence can be used in financial statements, and if a suitable method of expression can be found, one can account for intention as well as for the actual activity of such occurrence. As soon as intentions are used, information becomes subjective and the integrity of information gets affected or even influenced. Some non-events may be seen as purposive occurrences that express or represent a change in circumstances. These non-events include depreciation, accruals and cost and revenue allocations (Goldberg 2001). If non-events are seen as purposive occurrences, and non-events are seen as book entries, it follows that the integrity of the information must be different to the integrity of the information generated by real transactions.

### 2.3.3 Book entries

Examples of book entries are described by Most (1982) as phenomena that do not represent real transactions because no exchange of goods or services has taken place. If a book entry does not represent a real transaction then a book entry may represent an artificial transaction. Book entries are based on quasi- or semi- information, meaning that such entries are based on “make believe” information. Quasi also means partly, almost, it appears to be something but it is not really so (Hornby 1998).

One of the research questions in the questionnaire requires a definition of a book entry and one of the respondents answered as follows: “An entry that does not have a real (eventual) cash effect on assets or liabilities of the entity and is subject to reversal in certain instances. Examples are provisions (depreciation, bad debts, future costs, warranty, and write-offs on inventories), revenue recognition, amortisation, etc.” – courtesy of Mr. E.E. Strauss from Grintek Telecom. This is a good attempt at a definition of a book entry since the most important characteristic of a book entry is that a book entry does not have cash consequences.

Until the Industrial Revolution, cash recording was used to portray a company’s net financial result. Accrual accounting was developed to solve inadequacies in cash

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accounting and is responsible for the origin of some book entries, such as depreciation and amortisation (Goldberg 2001). These occurrences had financial implications but did not have cash flow consequences and so may be seen as subjective entries, which influence the integrity of information on which managers have to base their decisions. The book entries or occurrences are not based on real transactions (cash transactions) but rather on the perception of an observer of a proposed happening. The effect is that these book entries are often based on a subjective observation made by the observer, possibly leading to subjective information on which further subjective decisions may be made by stakeholders. A further discussion on observation (amongst other topics) is presented in Chapter 3.

#### 2.3.3.1 Examples of book entries

Accounting is often divided into events and certain non-events. Book entries are based on non-events which include (Cushing 1989):

- accruals
- cost or revenue allocations
- depreciation, depletion and amortisation
- account classifications
- valuations of intangible assets
- financial statement consolidations
- judgements regarding future values of bad debts, natural resource reserves, liabilities under warranties and other contingencies
- changes in value, such as those associated with the lower-of-cost-or-market method.

It is the experience of the author that the majority of the above book entries are normally recorded at a financial year-end which is an artificial cut-off point in the life cycle of a company. A discussion of some of the above non-events follows below.

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Intangible assets, as the word suggests, are assets that cannot be touched. These represent abstract nouns and cannot be measured, for instance, a good reputation (Hornby 1981). Plank and Blensly (1989:84) define intangible assets as “a group of long-term assets that do not have physical existence or tangible form, but are considered to have a value to the entity”. Furthermore, goodwill and asset write-offs are considered bookkeeping adjustments that typically do not coincide with any changes in tangible assets or cashflows (Hirschey and Richardson 2002). Book entries may be seen as bookkeeping adjustments. A book entry does not have any cash flow consequences, hence goodwill write-offs may be seen as book entries. If an asset cannot be touched and cannot be measured, it follows that the integrity of information created with the use of book entries may not be the same as information based on measurable and touchable assets. Again information content flowing from such book entries may influence managers to make incorrect (long-term) decisions.

Most companies are faced with contingencies at some stage of their operating life. A contingency is defined as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more events occur or fail to occur” (Plank and Blensly 1989:105). When a transaction takes place there is little uncertainty owing to its character, but with a future happening like a contingency there may be a substantial amount of uncertainty. Furthermore, because a contingency is a future happening, the provision for a contingency is created through the use of a book entry and may therefore influence the integrity of the company’s financial information and subsequently any decisions based on such information.

Manufacturing companies make use of research and development provisions to provide for the development of new products. Research and development provisions are based on predictions and artificial information. As Plank and Blensly (1989:85) put it:

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> *Research* is planned search or critical investigation aimed at the discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service or a new process or technique or in bringing about a significant improvement to an existing product or process. *Development* is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use.

Research and development provisions are based on what is going to happen in the future and are therefore classified under book entries. Since the outcome of a research effort is often based on hope and prediction, it follows that the information created on hope and prediction may not have the same integrity as information based on reality, again influencing any future decision based on the character of such information.

Additional definitions regarding book entries, derived from the questionnaire, are discussed in Chapter 7.

### 2.3.4 Internal funds

When a company wants to acquire assets, they may use either internal or external funds available to the company. Internal funds are funds that are raised within a company. For example, income after taxes and non-cash expenses such as depreciation adds to the funds of a company to obtain or acquire investments and fixed assets. Other funds that are available are loans from banks and the sale of additional shares (Xrefer 2002). Donleavy (1994) makes the point that, although for most people the term funds means cash, in accounting the term funds has a restricted meaning and is used to refer to net working capital.

Internal funds are hidden in the working capital and instead of being earmarked for the purpose these were intended for, they are often used to fund the normal operating activities of a company. In the income statement depreciation is deducted as an

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expense even though depreciation does not represent an outflow of cash (unlike other kinds of expenses which do decrease the amount in the bank). The current assets are overstated in the working capital with the amount of accumulated depreciation since the amount reflected by the bank includes the amount earmarked for the future replacement of the asset. Since this "extra amount" is not reflected in a separate internal fund, managers may often tend to forget about the surplus amount and they simply spend the surplus amount on the normal operating activities of a company.

The spirit of this dissertation is to provide justification for the argument that an internal fund should be classified separately from the working capital and that such funds should be used for the replacement of fixed assets (Refer to section 4.4.1). According to Wilson (1974:248) "... the sum of depreciation and retained earnings (i.e. the *cash flow*) is an important source of finance. (Part omitted). If depreciation allowances exceed the current level of capital expenditure, they may add to working capital, and eliminate the need for short-term borrowing. On the other hand, if depreciation allowances are exceeded by capital outlays, it may have the effect of depleting working capital, or requiring the company to borrow". The creation of internal funds through the depreciation provision, therefore, appears to be one of the best ways to fund the replacement of fixed assets.

The earmarking of funds for the replacement of fixed assets through the provision for depreciation, is seen as one way of creating internal funds within a company. This view is shared by Correia, Flynn, Uliana and Wormald (2003:7-15): "EPS is calculated from the accounting income after such items as depreciation and deferred taxation have been deducted. These expenses do not, however, constitute a flow of funds out of the company. What happens to actual funds represented by such items as depreciation? The assumption is that they are used to replace existing assets". The reality of depreciation may have the effect of generating an internal fund for the replacement of fixed assets at the end of their lifespan. However, Glautier and Underdown (1997:122)

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claim that "depreciation accounting itself does not provide funds for the replacement of depreciable assets, but the charging of depreciation ensures the maintenance intact of the original money capital of the entity. Indeed, a provision for depreciation is not identified with cash or any specific asset or assets". The above claim certainly holds, because currently the cause of the relevant book entry (the depreciation provision) is brought into account but not its effect, namely the creation of the internal fund reserve.

The depreciation provision decreases the profit for the year under reporting and the company actually saves on taxes. Depreciation does not have cash consequences for the company, that is the bank balance is not affected by the book entry as is the case with other expenses in the income statement. "Depreciation, therefore, is effectively a cash refund from the current earnings off part of the original investment in the business" (Ezybusiness 2001). When a company provides for depreciation, an internal fund reserve should be created. For example, when depreciation is written off over a ten-year period (10% per year), the company enjoys the benefit of a lower profit and thereby less taxation. The retained earnings are decreased as well as the shareholders' interest. After 10 years the company has to replace the asset using the funds in the reserve. However, if no reserve for replacement (i.e. no internal fund reserve) has been maintained during this period, the company is faced with the reality of making use of external funding which may turn out to be an expensive venture. But if an internal fund is in place, and it is cheaper to replace the asset from this fund, rather than the external fund, the company would benefit.

### 2.3.5 Accounting and accounting information

Accounting information may be divided into two categories, namely, financial accounting and managerial accounting. According to Plank and Blensly (1989) the information created by financial accounting is for users of financial statements including creditors, stockholders, financial analysts, etc., while the information created by managerial accounting is primarily for internal control purposes for example to ensure efficiency,

productivity, proper pricing decisions and so forth. It follows that the integrity of information in both instances must be of a high level in order to make the correct decisions.

Information is portrayed in the financial statements of a company and is used to make long-, medium- and short-term economic decisions. According to Hemus *et al.* (2000), the four qualitative characteristics of financial statements (prescribed by AC000) that make accounting information useful to the users of that information are:

- understandability
  The information should be comprehensible to those users of the financial statements who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence. Users must, however, be willing to learn how to use the information properly.

- relevance
  The information portrayed in the financial statements must be relevant to the decision-making needs of the users. When a user can use the information to formulate predictions and assess past predictions, the relevance quality of the information is good.

- reliability
  Useful information has to be reliable. Information is reliable when the information is free from material error and bias, that is, when users can depend on the information.

- comparability
  The information is useful if the information can be compared with previous periods and with similar information from other companies.

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If any of the above characteristics are not being met in the information supplied in the financial statements of a company, then stakeholders may make important decisions based on information of which the integrity has been influenced either positively or negatively.

Information is described as “news or knowledge given” (Hornby 1981:437). It is the responsibility of the accountant to give “news” about a company to the relevant users. Clearly, information has different definitions and understanding in different disciplines. According to the new science, “information is unique as a resource because it can generate itself” (Wheatley 1999:97). Accountants cannot create information but of course they may observe information. “Information in itself is neutral, neither relevant nor irrelevant” (Goldberg 2001:174). Observers attach their own (subjective) semantics and perceptions to the information. The relevance of information can only be judged if the purpose is known and taken into consideration (Goldberg 2001). It is difficult to judge the relevance of the subjective information created by book entries because the purposes of these entries are unknown to the users of the financial statements. Book entries are used as a strategic tool by management; only management knows their purpose and this may influence the integrity of the information portrayed in the financial statements and subsequently any decisions based on such information.

### 2.3.6 Integrity

The word ‘integrity’ has two meanings. According to Hornby (1981:444) the first definition is the “quality of being honest and upright in character” and the second definition, which is also the meaning attached to integrity in this research, is a “state or condition of being complete”. Under corporate governance, transparency and accountability are not enough to build public trust, all depends on people of integrity. According to DiPiazza and Eccles (2002), users can only trust reported information if the information is firmly embedded in a foundation of personal integrity. Book entries may be used or even misused by management depending on their personal integrity

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which, in turn, may influence the integrity of the information being reported and hence any future decisions based on such information.

Users and other stakeholders make decisions using the financial information contained in the financial statements. As emphasised by DiPiazza and Eccles (2002), users are ultimately accountable for their own decisions, but ethically users may be held accountable for such decisions only if the information they use to make decisions is prepared, approved and audited by people of integrity, in a spirit of transparency. DiPiazza and Eccles (2002) furthermore state that companies without integrity destroy shareholder value and undermine public trust. When book entries are used to reach certain strategic goals, based on the personal integrity of management, it may be possible that the integrity of the information created by book entries, is influenced.

## 2.4 Summary and conclusion

This chapter presented a brief history of book entries and gave definitions of a number of important accounting concepts to be used.

An important point that emerges from this chapter is that there is a difference between the integrity of information created by *real transactions* and the integrity of information created by *book entries*. Reliance on the integrity of information supplied in the financial statements of a company is one aspect about which stakeholders cannot afford to be uncertain.

In Chapter 3, a new information perspective from the new science, will be discussed.