

Accounting and Finance

A FIRM FOUNDATION

THIRD EDITION

ALAN PIZZEY

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Accounting and Finance *a firm foundation*

Third Edition

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Preface to Third Edition

The purpose of this book has not altered since the second edition appeared six years ago, but I hope that the changes which I have incorporated within the third edition will improve the work, and help to achieve its purpose. There have been considerable developments in accounting since 1984, which I have introduced into this edition. There are five major alterations to the text.

1. In the preface to the first edition I commented that an introductory textbook was not the proper medium for a detailed explanation of Standard Accounting Practices. I still hold this view but nevertheless I have increased the coverage of SSAPs where they are relevant to the text. In some cases a standard expresses the basic principle governing the accounting treatment of an item, and it is right that students should understand such principles from an early stage in their education. The operation of the Accounting Standards Committee (ASC) has been the cause of much recent debate, and I have added a chapter on standard setting to incorporate the criticisms levelled at the ASC, and some of the suggestions made to remedy the situation.
2. I have deepened the section on accounting theory. My intention here is to meet the requirement of introductory courses for an explanation of basic ideas, and their relationship to practical accounting techniques. Since the publication of the second edition, methods suggested to guide accountants in a period of changing prices, and in the treatment of goodwill, have suffered sharp criticism, which is reflected in the text.
3. The section on finance has been strengthened. In my view some introductory courses concentrate on accounting techniques at the expense of discussion covering the management of the finance used to fund a large proportion of the assets which figure in the accounting statements.
4. The technique for drafting funds flow statements has changed in recent years to follow the format specified in SSAP 10. I have converted most of the examples in the textbook to reflect this form, although it is true to say that, in practice, a variety of forms can be found by comparing the published accounts of companies. This standard practice has suffered criticism, both academic and practical, which is covered in the text.

5. At the time of writing a Companies Bill is before Parliament, which in the course of time will emerge as yet another Companies Act. Whilst it is unlikely that this Act will usher in basic changes of such significance that they may affect an introductory course, I have included points from the Bill which are relevant to chapters in the book.

As before, the text includes tutorial questions at the end of each chapter, and, where relevant, seminar exercises with solutions in an appendix at the end of the book. There are also review questions at the end of many chapters. The solutions to these problems are contained in a Teachers' Manual which I trust colleagues will find helpful.

I would like to thank Diana Russell and Justin Vaughan for their assistance and encouragement in the preparation of this third edition.

ALAN PIZZEY

Preface to First Edition

The purpose of this book is to help students who are commencing their studies in accounting, by ensuring that the basic techniques are mastered and principal ideas understood at an early stage. Once a firm foundation is laid the young accountant can proceed to more complex matters without the disadvantage of misconceptions which might hamper his or her progress.

The book sets out to introduce the techniques of financial accounting, to discover why one method is preferred to others, and to demonstrate how to use the accounting statements which are produced. A discussion of the elements of finance follows naturally from chapters which consider the work of the financial accountant, and also acts as a prelude to the interpretation of accounting statements. In a practical subject such as accounting, the techniques are important for the student, but they must not be allowed to dominate a course or a book to the exclusion of other matters. Concepts are important to underpin the choice of technique, and to provide a basis of comprehension on which the interpretation and use of accounting statements can rest. In this book I have attempted to blend theory with practice by mixing methodology with explanation, in the hope that students will not only learn how to account, but also develop an ability to discuss their work. To this end the text includes comment of a theoretical nature alongside explanation of accounting methods. Most chapters have suggestions for discussion topics, as well as accounting exercises (with solutions) which will provide practice in applying techniques. A workbook is to be published to accompany this volume which will provide the student with further opportunities to practise the techniques discussed here.

This book has developed from the first year undergraduate course taught at Trent Polytechnic [now Nottingham Polytechnic], and represents the lecture notes, seminar problems and tutorial discussion topics built up by a team of accounting teachers over the last seven years.

I am indebted to my colleagues for their helpful suggestions, and to past students whose requirements have encouraged me in the preparation of this work. In my view tutorial discussion is an important element in an accounting course, enabling students to marshal their ideas, present them in logical form in discussion, develop the ability to make constructive criticism and use judgement to decide the relative strengths of conflicting views. Resources are scarce, however, and it is not always possible to teach in small groups where a meaningful discussion can take place. However, teachers can still inject an element of critical appraisal into a course by including some discussions in the accounting exercises. For this reason many of the

exercises in the book contain discussion questions. Solutions are provided to enable students to check the mechanics of their answers, but in general suggested answers to discussion questions have not been provided, in order to encourage students to think out their own solutions.

At the present time accounting must be seen against a background of unstable economic conditions, which have promoted much discussion and not a few changes to the subject. This atmosphere of argument and development, although stimulating to the academic, is bewildering to students just starting their accounting career. I have therefore tried to explain some of the current discussions in as simple a way as possible in the hope that students will begin to appreciate the efforts made by our profession to solve the problems with which it is faced. For this reason Accounting Standards are mentioned where they fit into the text, but this is considered too early a stage for a detailed study of the standards. Ideally we need to train young people to enter the accounting profession with open minds, a capacity for independent thought and the ability to test doctrinaire views before accepting them.

One difficulty encountered in the production of an introductory textbook on accounting is that the student has little or no practical experience of the subject, and therefore terms have to be explained as they are introduced. I have tried in this book to set the subject in context with other disciplines such as law and economics, and on the practical side to introduce the systems which are necessary to provide the basic data which the accountant uses. No doubt some introductory accounting courses will include matters which I have omitted, while some teachers may not consider all the items I have covered as appropriate for their courses. Although auditing and taxation are separate subjects, in my view they need to be introduced at this early stage to familiarize students with them and to demonstrate how they stem from the more general work of the financial accountant.

The textbook *Financial Accounting Techniques* (1982) by Alan Pizzey and Alan Jennings which accompanies this text is designed to reinforce and extend the coverage of accounting techniques for students who need the practice, and for those whose course is aimed at a syllabus which contains a greater proportion of practical work.

I would like to thank B. D. Coleman, D. Hewitt and Ian A. Wright, whose comments were very useful. Also sincere thanks to Tom Perlmutter, whose encouragement and advice have proved most helpful.

ALAN PIZZEY

To Barbara, Jonathan and Joscelin

WITHOUT WHOSE FORBEARANCE AND ENCOURAGEMENT
THIS BOOK WOULD NEVER HAVE BEEN COMPLETED

‘Complacency is the enemy of study.’

MAO TSE TUNG.

‘They should have . . . a supercilious knowledge of accounts.’

MRS MALAPROP.

*‘Receive before thou wryte, and wryte before thou paye;
Thus wilt thou well assured be, thy counte will never decay.’*

FROM THE TOMB OF AN OLD BURGHER IN CHESTER
CATHEDRAL.

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PART
ONE

Basic Principles and Techniques

1 | Accounting: The Provision of Financial Information and Its Use

THE WORK OF THE ACCOUNTANT

The work of the accountant is diverse in its nature, but basically it deals with the recording, planning and control of financial transactions, whether income or expenditure. In every organization money will be spent on administration, and thus there will be a need for an accountant. Broadly speaking, accountants can be divided into two classes: those in professional practice and executive accountants who work for organizations.

Accountants in practice have a number of clients for whom they provide a service. This service takes the form of auditing, accounting, taxation work, acting as liquidator and giving general financial advice. Auditing involves checking that the accounts of a business, which have been prepared by accountants within the business, show a true and fair view. Although the term 'true and fair' has been enshrined in company law since 1948, it has never been defined. The Companies Act 1985 states that the need to provide a true and fair view in accounts is of paramount importance, and if the strict application of rules in the Act inhibits the production of a true and fair view, such rules may be 'overridden'. The auditor must ensure:

- a. that the accounts have been properly drawn up according to best accounting practice, as expressed in Statements of Standard Accounting Practice (SSAPs) approved by the professional accounting bodies;
- b. that legal requirements concerning limited companies have been complied with;
- c. that no fraud has taken place;
- d. that the system of accounting operated by the business is such that fraud is discouraged.

A second task often undertaken by the accountant in practice is to prepare a taxation computation to translate the accounting profit into a taxable profit by applying the rules embodied in the tax laws. Some companies are large enough to employ a permanent tax specialist, but in most cases the practising accountant with special taxation expertise will undertake this work. The practitioner may find himself involved with tax planning, advising his clients, both companies and individuals, on how best to reduce the burden of taxation. He might also act as a liquidator when a company ceases trading and is wound up. Incomplete records work is important in practice, since it involves producing accounts for small firms where proper books of

account have not been maintained and the basic records may be difficult to assemble. Many small businesses receive advice as to how to finance their operations from the practitioner who undertakes their accounting, auditing and tax work. This accountant may draft a statement of future cash flows for the business, and then negotiate overdraft or loan facilities with his client's bank.

Some practising accountants have joined together to form large worldwide practices. It is now a common feature of such practices to operate a financial consultancy division as a limited company (see Table 1).

Table 1. Statistics for Large Accountancy Practices

This table demonstrates the size to which some large international accountancy practices can grow, and the relative importance for each firm of the four major activities: Accounting and Auditing (A/A), Tax work, Management Consultancy (M/C) and Insurance (INS).

	UK fee income £m	Growth %	% Practice devoted to discipline				Partners	£ per partner earnings ratio
			A/A	Tax	M/C	INS		
Peat Marwick McLintock	315.6	20.2	63	18	15	4	514	614 007
Coopers and Lybrand	225.0	30.8	45	17	29	9	391	575 447
Price Waterhouse	222.0	24.4	45	24	26	4	363	611 570
Deloitte Haskins & Sells	188.8	25.0	51	26	18	5	246	767 480
Ernst and Whinney	148.4	22.7	56	22	16	6	226	656 637
Arthur Anderson	144.1	27.0	30	24	42	4	153	941 830
Touche Ross	141.8	21.6	50	20	23	7	237	598 312
Arthur Young	135.5	25.5	46	30	13	7	215	630 232
BDO Binder Hamlyn	89.0	21.6	56	31	5	3	238	373 949
Grant Thornton	86.0	14.7	47	28	5	12	253	339 921
Spicer and Oppenheim	83.2	22.2	49	25	18	8	174	478 161

(Source—*Accountancy Age*)

The current trend is for mergers among the larger firms. Prospective partners are: Price Waterhouse/Andersons; Deloitte and Touche; Ernst and Young. This would change the order at the top of the table. Price Waterhouse/Andersons could have a worldwide annual revenue of nearly £5 billion.

The type of work done by executive accountants who work for a company or some other organization, e.g. local authority, hospital board or a charity, can be further subdivided. First, there are financial accountants, whose main job is to record transactions. They are responsible for maintaining accurate records of what their company owns (its assets), and what it owes (its liabilities). They are concerned with the system of book-keeping used to record sales and purchases, the payment and receipt of cash, and keeping an accurate account of stocks, debts, and fixed or long-term assets of the company. Financial accountants act as stewards, showing the financial effect of the actions of the managers to the owners of the business. One way this effect is revealed is through accounting statements such as the balance sheet and the profit and loss account. The financial accountant drafts the published accounts which are later checked by the auditor. Such accounts provided for shareholders and available to the public are produced within the strict disclosure rules of the Companies Acts, and SSAPs. Other duties of a financial accountant may be company secretarial work dealing with insurance, pension funds, share transfers and statutory

meetings, or the general management of office procedures, business systems and computerized methods of recording transactions. Some companies have an internal audit section which liaises with the external auditors, checks systems and protects the assets of the business.

The second type of executive accountant is the management accountant, whose job it is to use his expertise in any way he can to help the management of the company in the administration of the organization and the formulation of decisions. Management accountants prepare financial reports and statements which give information about the subject of a decision or show up what has happened in the recent past. In this way managers are better able to plan the future operations of the business and allocate scarce resources between alternatives, and are made more aware of the financial effect of transactions which have taken place so that they can act quickly to control a situation where, for example, losses are being incurred. Cost analysis and budgetary control are important tools for the management accountant.

THE HISTORICAL DEVELOPMENT OF ACCOUNTING

Merchants and others have kept records of their transactions from very early times. However, it was not until an Italian monk, Luca Pacioli, wrote an appendix to his mathematics book in 1494 that the system of accounting which had evolved among the merchants of Italy was formulated. Pacioli's description of the 'Italian method' is a simple one, and probably more sophisticated systems than that outlined by Pacioli existed in larger firms of merchants and manufacturers of the time. The rudiments of double-entry book-keeping had developed, as had the practice of showing a position statement for the business rather than for the individuals who owned it and the practice of accounting at regular intervals so that the profits could be computed and divided among the owners of the business. The idea of accounting once a year had not yet been adopted, since in those days businessmen tended to account for each venture as an entity, irrespective of how long it took to complete.

After Pacioli came a steady development of accounting, with the emergence of a need to account in a common monetary unit and for a set period of time, and to enable the creditworthiness of a firm to be established. Estate owners, merchant bankers and manufacturers began to operate standardized systems to reduce fraud within their large enterprises. In 1605 a Dutchman, Simon Stevin, advocated that the profit and loss account should be produced at yearly intervals, and by 1655 Jaques Savary was suggesting that the balance sheet should be drawn up at certain stated intervals. In 1673 the Code of Commerce produced in France recommended that all businesses produce a balance sheet at least every two years.

The industrial revolution increased the scale of businesses and the complexity of their transactions. The organization of finance on a large scale, the separation of loan and venture capital, the principle of limited liability, and the emergence of joint stock banks created a demand for more sophisticated methods of accounting.

The emergence of a profession of accountants with a code of ethics and standards of performance was followed by the formation of professional accounting bodies. In 1854 a Royal Charter was granted to a society of accountants in Scotland, in 1880 the Institute of Chartered Accountants in England and Wales was formed and in 1887 the Association of Public Accountants was launched in the USA.

Even at this time, however, the accounts kept by many businesses consisted of little more than the recording of cash movements in and out. Dividends were often paid before the existence of a profit had been established, and fixed assets were bought and used without providing for depreciation. As the scale of industrialization increased, however, there was a gradual divorce of management and ownership, and it became obvious that management needed accounting information of a different type from that required by shareholders and lenders. The accounting profession therefore enlarged its scope to cater for this need, and over the last forty years the provision of information to management has become the most important function of the accountant, who has in fact become a member of the management team, managing the finances of the business and providing other managers with information to help with their tasks of planning, control, and decision-making.

THE PROFESSIONAL ACCOUNTING BODIES IN GREAT BRITAIN AND IRELAND

At present there are in the UK and Ireland six separate major organizations for accountants. Each of the professional bodies possesses a charter from which its authority is derived and each gives a professional qualification with its own designatory letters. The first three are the Institutes of Chartered Accountants in England and Wales, Scotland and Ireland. These are quite separate from one another, each one having its own membership, rules, governing council, examination syllabus, and student members. The one rule which unites them is that all student members must serve a fixed period under a training contract with a member of the Institute, so that they gain the appropriate experience before they qualify. Chartered accountants dominate the practising side of accounting, although many who have qualified and have gained experience with a practising accountant then leave the practice to work in industry and commerce.

The fourth body of accountants is the Chartered Association of Certified Accountants, whose members are found mainly in industry and commerce, although there are a significant number in practice. Members of the Association, as well as members of the Institutes, are recognized by the Department of Trade and Industry and can act as auditors to public companies. The students of the Association must undergo a period of training to gain experience before they qualify, but this period may be spent either as a clerk to a practising accountant or in an accounting office in industry, commerce, nationalized industry or local authority.

The fifth body of accountants is the Chartered Institute of Management Accountants. As the name implies, the members of this body work mainly in industry or commerce, and students of this Institute must gain their experience, prior to qualifying, by training as a management accountant.

The sixth and last body of accountants is the Chartered Institute of Public Finance Accountants. Members of this body work for local authorities and Government agencies, and it is in this type of organization that the student members of this Institute gain their experience.

From time to time attempts are made to unite all or parts of our fragmented profession but so far little has been achieved. The Consultative Committee of Accountancy Bodies (CCAB) has been established by the six major bodies to