Introduction to

FINANCIAL ACCOUNTING

Christopher Nobes

Introduction to duction Accounting

by

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London
GEORGE ALLEN & UNWIN
Boston Sydney

First published in 1980

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GEORGE ALLEN & UNWIN LTD
40 Museum Street, London WC1A 1LU

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British Library Cataloguing in Publication Data

Nobes, Christopher
Introduction to financial accounting.
1. Accounting
I. Title
657'.48 HF5635 79-41500

ISBN 0-04-332071-6
ISBN 0-04-332072-4 Pbk

Typeset in IBM Press Roman 10 on 12pt by Katerprint Co. Ltd., Oxford
and printed in Great Britain
by Billing and Sons Ltd, Guildford, London and Worcester

PREFACE

This introductory textbook in financial accounting is intended primarily for undergraduate students in universities and polytechnics and for students reading for such qualifications as the Higher National Diploma or Diploma in Management Studies. However, it is hoped that part of it may also be appropriate for use with other books for other academic or professional courses.

There are several matters relating to the structure and content of introductory textbooks on which the opinions of academic accountants differ. First, the scope of first-year courses and books varies considerably. This book deals mainly with financial accounting and those parts of business finance and management accounting which fit most closely with it. There are many good introductory textbooks on these latter two areas that could be used with this book for courses that cover a wider area than financial accounting.

The degree to which double entry bookkeeping is covered varies greatly too. This book does not *base* its explanation of accounting on double entry, as some do, but it does provide a fairly lengthy outline of it, after the nature of asset valuation and income measurement have been fully introduced.

A further difference between introductory textbooks concerns the extent to which practice is discussed. This book discusses accounting standards at appropriate points and in several places quotes figures from surveys of accounting practice. Because accounting for changing prices is now not only an important area of research but also has significant practical effects on published financial statements, this area is examined at some length. It no longer seems possible to cover adequately an introduction to accountancy without doing so.

In trying to determine the appropriate balance on the above issues I have gratefully received much assistance from a number of colleagues and students who have read various drafts of some or all of this book. Of particular help have been Professor Dick Briston, Pat Kirkman, Graeme Macdonald, Tony Mahoney, Eammon Murray and Professor Bob Parker. These readers have also made detailed comments, and many changes have been made as a result. I cannot claim about the writing, then, that it is all my own, but I can make such a claim about any remaining unfortunate biases, mistakes or obscurities. Also, I am grateful to several typists who have laboured long, particularly Mrs Elvy Ibbotson, and to Associated Paper Industries Ltd for allowing me to reproduce excerpts from their published accounts.

CHRISTOPHER NOBES
Exeter, March 1979

To the Exeter Accountancy Studies Graduates
of 1978, who were the first to encourage
(and survive) my introductory teaching

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CONTENTS

Preface *page* ix

1 *Introduction* 1
- 1.1 Accounting functions
- 1.2 Accounting theory
- 1.3 Accountants

Part One *THE ACCOUNTING METHOD*

2 *Value and Profit* 7
- 2.1 Value
- 2.2 Profit
- 2.3 Summary

3 *The Balance Sheet* 12
- 3.1 The business entity
- 3.2 Types of asset
- 3.3 Valuation conventions
- 3.4 Liabilities
- 3.5 Capital
- 3.6 Summary

4 *Revenues and Expenses* 23
- 4.1 Accounting periods
- 4.2 The accruals convention (revenues)
- 4.3 The accruals convention (expenses)
- 4.4 Debtors and bad debts
- 4.5 Profit measurement conventions
- 4.6 The accounting equation
- 4.7 Profit, drawings and cash
- 4.8 Summary

5 *Depreciation* 35
- 5.1 The traditional concept
- 5.2 Methods of depreciation
- 5.3 Practice
- 5.4 Practical problems
- 5.5 Replacement
- 5.6 Further considerations
- 5.7 Summary

6 *Stock* page 51
6.1 Profit measurement
6.2 The count
6.3 Valuation
6.4 Historic cost as an input value
6.5 Current replacement cost as an input value
6.6 Practice under historic cost accounting
6.7 Current value accounting
6.8 Long term contracts
6.9 Summary

7 *The 'Italian Method'* 65
7.1 History
7.2 Double entry: explanation and justification
7.3 The advantages of double entry
7.4 The trading account: gross profit
7.5 The profit and loss account
7.6 Stock, accruals and prepayments
7.7 Provisions
7.8 The balance sheet
7.9 Summary

8 *Accounting Techniques* 84
8.1 Books and ledgers
8.2 Control accounts
8.3 The trial balance
8.4 The journal
8.5 Incomplete records
8.6 Machine and computer accounting
8.7 Summary
Appendix 8A An example of the application of computers to accounting

Part Two *ACCOUNTING FOR BUSINESS ENTITIES*

9 *Partnerships* 107
9.1 The partnership form
9.2 Taxation and disclosure
9.3 Accounting implications
9.4 Summary

10 *Companies: Legal and Tax Aspects* 114
10.1 The need for capital
10.2 The corporate entity
10.3 Types of capital
10.4 The separation of ownership from management
10.5 Taxation
10.6 Summary

11 *Companies: Capital Raising* page 126
11.1 The context of the choice
11.2 Self-finance
11.3 External finance and gearing
11.4 Issues
11.5 Financial adjustments
11.6 Summary

12 *Companies: Stewardship* 135
12.1 Objectives of company reports
12.2 Disclosure in annual reports
12.3 Published accounts
12.4 Groups
12.5 Auditing
12.6 Dividend policy
12.7 Summary

13 *Accounting under Inflation: Introduction* 153
13.1 Inflation
13.2 Effects on accounting
13.3 General or specific adjustment
13.4 Summary

14 *Accounting under Inflation: Proposed Systems* 163
14.1 Partial adjustments
14.2 Current purchasing power systems
14.3 Current value accounting
14.4 Current cost accounting
14.5 Effects on profit
14.6 International comparisons
14.7 Summary

15 *International Financial Accounting* 177
15.1 Background factors
15.2 Forms of business organisation
15.3 Published accounts
15.4 Accounting rules
15.5 Harmonisation
15.6 Summary

Part Three INTERPRETATION OF FINANCIAL INFORMATION

16 *Profitability* *page* 190
16.1 Definitions of accounting aggregates
16.2 Asset ratios and gearing
16.3 Profitability ratios
16.4 Profit and sales ratios
16.5 Summary

17 *Liquidity* 201
17.1 The cash flow cycle
17.2 Cash flow statements
17.3 Funds flow statements
17.4 The measurement of liquidity
17.5 The reasons for, and cost of, holding current items
17.6 Cash forecasts and budgets
17.7 Summary

18 *Valuation of the Business* 218
18.1 Balance sheet assets
18.2 Other assets
18.3 Valuation by expectations
18.4 Market valuations
18.5 Summary

Appendix 228
Excerpts from the Annual Report and
Accounts of Associated Paper Industries Ltd, 1978

Index 242

1 Introduction

Accounting is a very ancient art. Archaeological investigation shows that, wherever a sophisticated and organised society has developed, some form of accounting has been present. In many cases records of expenditure or taxation are the most important relics of a once mighty civilisation. 'Keeping account' has always been part of an ordered society, 'giving account' has always been the duty of chancellors and stewards and 'auditing' (or hearing) of these accounts has been a requirement of kings and barons (of the realm and later of industry). This need to keep and give account was an important stimulus in the development of writing and arithmetic.

The essential purpose of accounting is therefore to communicate relevant financial information to interested persons. The original nature of accounting was concerned with explaining what *had* happened - how stewards had collected and used their lords' money. This *accountability* or *stewardship* role now applies as much to directors and shareholders as it did to stewards and lords. However, other uses for financial information have also become important. The owners of businesses may wish to compare their success with that of other businesses, and they may wish to use financial information to make decisions about the future. Other parties (e.g. lenders, employees and revenue authorities) have other uses for financial information.

This chapter looks at the different functions of accounting and outlines the structure within which this book will discuss them. There are also sections on the nature of accounting theory and the accountancy profession.

1.1 Accounting functions

The central concerns of accounting are with the valuation of assets and the measurement of profit. There are many difficult problems of definition in these areas, some of which will be discussed in the early chapters of this book. Having already identified the main function of accounting as the communication of financial information, it is clear that a subsidiary

function of capturing the relevant data is necessary. This recording or memory function of accounting developed into the 'Italian method' of *double entry bookkeeping* by the early fourteenth century. This method is still used in a very similar manner today. However, the method of book-keeping used is not fundamental to the definitions of value and profit. It does not determine the accounting conventions used. That is why, contrary to the layout of some books and courses, this book will discuss the fundamental accounting-measurement problems before this, out of the context of any particular method of bookkeeping, which is just the initial recording of the relevant economic events that can be quantified in money terms.

However, the information on double entry bookkeeping in Chapters 7 and 8 should prove useful in understanding the rest of accounting, which now covers a much larger area. Some of this larger area is the province of Parts Two and Three.

Part Two will deal with the presentation and publication of accounting information. Chapter 9 will look at accounting for partnerships, Chapters 10–12 at accounting for companies. The three chapters on companies will discuss the relevant law, taxation matters, the types of owners and capital raising, as well as the publication and audit of financial statements. If accounting information is to be used for decision-making rather than for stewardship-reporting, it needs to be based on current costs and prices. Whole new underlying frameworks for accounting have been suggested to take account of inflation and relative price changes. These will be examined in Chapters 13 and 14.

All the matters of Part Two can be looked at again on a comparative international basis. This is useful in that it puts UK accounting into perspective, opens the door for further study and provides indications of the direction of future changes. Chapter 15 will look at the influences that have caused international diversity, the nature of the differences in accounting and reporting, and the progress of harmonisation.

Another function of accounting is to assist in the interpretation of financial statements. This is necessary before economic decisions can be made. Part Three will look at measures of profitability (Chapter 16), liquidity (Chapter 17) and the worth of a business (Chapter 18).

An area of accounting that has developed particularly rapidly in the twentieth century is management accounting. This concerns the use of accounting data to aid decision-making by managers about the allocation and management of the resources of a business. Accounting can provide information for planning and control, for investment appraisal, and so on. Management accounting is different from financial accounting in many

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important ways. It is concerned with providing information to insiders (not outsiders), it looks forward (not backwards), it must rely on estimates (not historical facts), and it is largely a product of twentieth-century America (not Renaissance Italy and later European development). This large area of accounting is not covered in this book. Good introductions to management accounting are available elsewhere (e.g. Sizer, 1969).

1.2 Accounting theory

The word 'theory' in accounting is sometimes used to express a concept that occupies a very different place from theory in the natural sciences, or even from its place in such a social science as economics. In a natural science a theory is developed to explain how things *are* and why they behave as they do. In accounting, theory can be *positive* in this way, but it can mean something *normative* (e.g. the body of invented conventions that have evolved over centuries and are now used to determine what behaviour *should be*). To a large extent accounting practice does not follow one consistent underlying normative theory of how assets should be valued, how income should be measured, and so on. However, academic accountants and others have criticised this weakness and made suggestions for such a framework. Theoretical research and experimentation in this area have been particularly concerned with whole new underlying frameworks for accounting, which have been suggested to take account of inflation and relative price changes.

There is also a practical scientific side to accountancy research. Research is carried out using analytical and empirical methods to discover and explain the behaviour of companies, investors and managers, the way in which accounting practices have developed and the effects of different practices. For these purposes theories and models are proposed and tested in a similar way to other scientific research.

1.3 Accountants

The diversity in the work performed by accountants reflects the wide range of functions of accounting discussed above. There are about 100 000 qualified accountants in the United Kingdom. By international standards this is a high proportion of the population (see Chapter 15). Accountants are engaged in the preparation of accounts for all types of businesses and

public institutions, auditing the accounts of companies and public authorities, advising about and calculating personal and corporate taxation, preparing accounting information for managers, acting as management consultants and teaching and researching in accounting.

An important divide between accountants is that some are in private professional practice as members of firms of accountants who work for clients, and others are in the direct employment of organisations that require accounting services.

There are six important professional accountancy bodies in the United Kingdom and Ireland. These are the three Institutes of Chartered Accountants - that in England and Wales (ICAEW), that of Scotland and that in Ireland - the Association of Certified Accountants, the Institute of Cost and Management Accountants and the Chartered Institute of Public Finance and Accountancy (Renshall, 1977). These bodies act together on a number of matters through the Consultative Committee for the Accountancy Bodies (CCAB). This body liaises with the government, the Inland Revenue, the EEC Commission, and so on.

One very important function of the CCAB concerns the setting of Standards through its committees: the Accounting Standards Committee (ASC) and the Auditing Practices Committee (APC). The ASC began work in 1970 following mounting criticism about the lack of accounting rules and the unreliability of profit statements. The ASC publishes Exposure Drafts (ED) for comment and then recommends Statements of Standard Accounting Practice (SSAP) for promulgation by the accountancy bodies, which require their members to observe them. Reference will be made to relevant SSAPs throughout this book. The APC is a newer body; auditing standards were not launched until 1978. There is also the International Accounting Standards Committee (IASC), which publishes Standards (for further details, see Chapter 15).

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Further reading

Henderson, S. and Pierson, G., *An Introduction to Financial Accounting Theory* (Melbourne: Longman, 1977).

Part One
The Accounting Method

This first part of the book discusses 'the accounting method', whereby financial information is selected and processed in order to present valuations of assets and measurements of income. Chapter 2 will introduce the different ways of valuing and measuring. Chapters 3 and 4 will discuss in greater detail the conventions that accountants use for these purposes and the way in which value is linked with profit. Chapters 5 and 6 will examine two of the most important problems that affect both asset valuation and profit measurement: the valuation of stocks and the measurement of depreciation.

Chapters 7 and 8 will look at how transactions are recorded by the double entry system in order to supply the raw material for the calculation and presentation of financial information about value and profit.

2 Value and Profit

As may be seen from the discussion of accounting functions in Chapter 1, two of the fundamental problems facing accountants are the measurement of value and the measurement of profit. We shall see that there are many ways of making these measurements. Some have much to recommend them; all may be sensibly criticised. The difficulty is to find methods of measurement that are theoretically sound, produce useful and verifiable information and are practicable given the time and expertise that are available to a business. A further consideration is that there are several different parties interested in such accounting information who might prefer different methods of measurement. These problems are explored in an introductory way in this chapter.

2.1 Value

If we temporarily ignore practical problems, the most acceptable way of measuring the value of a business is to add together all future net benefits that the owner will receive from it. For example, if a business were to yield £1000 this year, £1500 next year and £2000 the year after that, and so on, its owner could add together these expected future flows to obtain a valuation. Before adding the amounts account would need to be taken of the fact that money *now* is preferable to money in the future, for various reasons, which will be discussed later (see section 18.3). Adjusting the future flows for this factor is called *discounting*. The sum of the discounted amounts is called the *present value*, because the discounting adjustment leads to the value today of the future flows.

This present value may be considered by the owner and by buyers in the event of a proposed sale. It is a forward-looking value. It values the business as a whole;and if it can be performed accurately, is very useful for decision-making. However, many of the estimates involved must be regarded as vague and uncertain. Therefore, it is difficult for different accountants to agree on the same figure; in other words there is a lack of *objectivity*. This is the main reason why this method is not used by accountants under

normal circumstances for valuing a whole business.

Alternative methods of valuing a business start by identifying the individual *assets* (i.e. things owned; see more detailed definition in section 3.2) and *liabilities* (i.e. money owed) of the business. A statement of the assets and liabilities of a business at a particular moment is called a *balance sheet*. As will be seen, accountants use a number of conventions to decide which assets and liabilities to include and how to value them. For example, one of the conventions is objectivity (mentioned above). This means that, since it is very difficult to reach an agreed measure for the value of the loyalty of customers, it is usually omitted. The same applies to the value of a skilled and hard-working management team.

There are two main categories into which methods of valuing assets may be put: *historic cost* and *current value*. The historic cost system leads to valuations that rest upon recordable facts about prices paid for assets in the past or amounts agreed to be owing to, or owed by, a business. There are some problems in defining when assets have been bought or sold or when they can be agreed to have risen in value, but these are usually resolved by relying on the evidence of actual external transactions. This way of adding up the assets has been used with variations over the past centuries, because it is simple, objective and prudent.

Current value accounting is much more recent and much more complicated. However, it solves many of the problems associated with historic cost accounting, particularly in times of inflation. Current value accounting has recently become of great importance to accountants, to such an extent that it is now impossible to teach accounting satisfactorily by concentrating only on historic cost accounting.

The main asset-valuation bases used within current value accounting are *replacement cost*, *net realisable value* (i.e. expected sale receipts *less* costs involved in a sale) and *economic value* (i.e. the net present value of the particular asset). Depending on the circumstances, a choice must be made concerning which base to use for valuing a particular asset at its current value. A useful method of doing this is to consider what the *deprival value* of the asset is. The value to the business of any asset may reasonably be said to be the maximum amount that the business would lose if it lost the asset - in other words the deprival value of the asset. The precise meaning given to deprival value and the ways in which the three bases of valuation are chosen will depend on which system of current value accounting is chosen.

It can easily be seen that, although these values may be more relevant and current than past values, they involve much more subjectivity than historic cost valuations. In practice, as we shall see, it is possible to intro-

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