Christopher Nobes

ACCOUNTING

A Very Short Introduction

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Chapter 1
Introduction

Purpose of the book

If you read the business pages of a newspaper or if you listen to the financial news on the television or radio, you will often hear terms such as 'liability', 'balance sheet', or 'earnings'. These terms turn up in non-financial contexts as well: 'he was more of a liability than an asset'. If you invest in shares, have a building society account, or sit on a committee of a property company which owns your apartment block, you will receive financial statements every year. If you are a manager in a company, a hospital, or a school, you will see accounting information often. This book is designed for you: the intelligent non-specialist.

This book will not turn you into an accountant but it will help you to understand and use accounting information. You will no longer need to feel out-of-depth in conversations that include 'debits', 'pre-tax income', or 'goodwill'. The book will also be a useful introduction to academic or professional study of accounting. The book explains terms when they first appear but, if you get stuck, you can look at the Glossary which explains the key terms.

Importance of accounting

Wherever archaeologists uncover early remains which contain writing or numerals, what they have found are nearly always accounting records. Research shows that the need to keep account was the key driver in the invention of writing and numbers (see Figure 1).

Civilization requires some form of government; which provides roads, defence, order. Government cannot function without tax revenues. Tax cannot work without accounting. So, civilization depends on accounting. Conclusion so far: accounting is important.

In the modern world, prosperity depends on good accounting. The information prepared by accountants is used when making decisions, such as: What price should Tesco or Walmart put on a particular product? Should General Motors build its cars in Michigan or in Malaysia? Should I buy shares in Citibank, HSBC, both, or neither? As a shareholder or a member of a club, should I vote to re-appoint the existing directors?

1. A clay tablet from Sumer, used for numerical records

According to the present rules, how much tax should a company or a person pay this year? What level of dividends should Nokia pay to its shareholders this year?

If these decisions are made badly, the world will be worse off. There will eventually be less money for important things such as hospitals, bridges, Mozart, and champagne.

Types of accounting

Activities in accounting can be divided into several types, as now explained.

Bookkeeping

Whatever the eventual use of accounting information, the raw data first needs to be collected. Each time a shop sells something, a bank lends money or a manufacturer pays the wages, a record must be kept. The process of recording all the transactions is called bookkeeping. It used to be done in a series of pieces of paper (journals) and large books (ledgers), but is now generally done by computer. Either way, the technique used is nearly always 'double-entry bookkeeping', which is an Italian invention of the thirteenth century. It is famous for its debits and credits.

Financial accounting

Financial accounting is the use of accounting data in order to calculate and report the cash flows, profit and financial position of an entity. The word 'entity' is used here in order to include all types of private-sector and public-sector organizations. Financial accounting information is prepared in summarized form for people outside of the entity, such as shareholders. The process of sending such information is called financial reporting. To take the example of shareholders in a company, the financial reporting helps them to assess the success of their company and its managers, and it helps them to make investment decisions. The financial reports include an income statement and a balance sheet.

Auditing

In many entities, especially large ones, most of the owners are not the day-to-day managers. This is why financial reporting is necessary. However, there is a horrible risk that the managers (including the accountants in the company) will overstate success or hide problems when they report to outsiders. This is why independent experts are needed to check on the information reported by the managers. Many accountants work in the field of auditing.

Management accounting

The information collected by the bookkeepers can also be used to present detailed information about individual products, factories, or managers. This is used by managers inside the company in order to make decisions about prices, volumes of production, locations for expansion, and who to promote. It is also used to control the company.

Management accounting can be divided into several types of activity, including cost accounting (which concentrates on finding out the cost of particular units or types of production) and budgetary control (which identifies inputs and outputs with particular managers in order to help them to make operational decisions).

Accountancy bodies and accountancy firms

As in many other fields of work, accountants have formed societies to advance their interests. An early example of a body of accountants was the Collegio dei Rasonati in Venice from 1581. The ship-building works at the Arsenale were so vital to the success of Venice that the state founded this body of auditors to control the costs and detect any mismanagement. However, the earliest private-sector accountancy bodies were founded in the UK in the nineteenth century, for reasons to be examined in Chapter 2. Table 1 shows some examples of these bodies around the world.

Table 1. Examples of accountancy bodies, age, and size

Country	Body	Founding date[a]	Approx. number of members (1000s), 2010
Australia	CPA Australia	1952 (1886)	132
	Institute of Chartered Accountants in Australia	1928 (1885)	54
Canada	Canadian Institute of Chartered Accountants	1902 (1880)	78
China	Chinese Institute of Certified Public Accountants	1988	140
France	Ordre des Experts Comptables	1942	19
Germany	Institut der Wirtschaftsprüfer	1932	13
Japan	Japanese Institute of Certified Public Accountants	1948 (1927)	20
Netherlands	Nederlands Instituut van Registeraccountants	1967 (1895)	14
New Zealand	New Zealand Society of Accountants	1909 (1894)	32

(continued)

Table 1. Continued

Country	Body	Founding date[a]	Approx. number of members (1000s), 2010
Sweden	Föreningen Auktoriserade Revisorer; Svenska Revisorsamfundet	2006 (1899)	6
United Kingdom and Ireland	Institute of Chartered Accountants in England and Wales	1880 (1870)	136
	Institute of Chartered Accountants of Scotland	1951 (1854)	19
	Association of Chartered Certified Accountants	1939 (1891)	140
	Chartered Accountants Ireland	1888	20
United States	American Institute of Certified Public Accountants	1887	348

Note: [a] Dates of earliest predecessor bodies in brackets

International comparisons of statistics, as in many fields, are fraught with difficulty. For example, the German body in Table 1 only has practising auditors as members, whereas the UK's Chartered Institute of Management Accountants has very few auditors (and only if they are also members of another body). Nevertheless, it is clear that accountants are a speciality of the English-speaking world. In extreme cases, such as Australia, New Zealand, and the UK, accountants are very numerous (e.g. nearly 1 per cent of the population in New Zealand). The big accountancy firms (see later) are the largest employers of new university graduates in these places. Accountancy is the most common background for chief executives of companies in these countries, and several accountants are members of parliament. At the other extreme (e.g. Germany), even the head of accounting in BMW or Lufthansa is unlikely to be a trained accountant but will be a business graduate or engineer instead.

Some accountants who offer professional services (in fields such as insolvency, audit, and tax) operate alone, but others have joined together in partnerships. The four famous accountancy firms can all trace their earliest origins to the UK, although they are all now larger in the USA. In alphabetical order, these firms are: Deloitte, Ernst & Young, KPMG, and PwC.

The components of their names are as follows:

- Deloitte is legally 'Deloitte Touche Tohmatsu Limited', a UK company. The 'Deloitte' comes from a Londoner (William Deloitte), the 'Touche' from the Edinburgh born George Touche, and the 'Tohmatsu' from a Japanese auditor.
- A. C. Ernst worked in Cleveland; Arthur Young worked first in Glasgow and then New York. The global executive office of Ernst & Young is in London.
- KPMG once stood for Klynveld (Dutch), Peat (London), Marwick (Glasgow, then New York), and Goerdeler (German). For legal and tax reasons, KPMG is based in Switzerland.

- PwC resulted from various mergers of firms named after 'Price', 'Waterhouse', and the four 'Cooper' brothers (all from London).

Rules

Some areas of accounting work do not need rules to govern them. In particular, management accounting is done inside an organization, and can be arranged exactly to suit its particular circumstances. However, financial reporting is used by many investors and others, so there are advantages in its being regulated. In much of the world, various forms of law impose 'accounting standards' on companies, particularly on listed companies. The standards are written by committees of accountants; the most important being the International Accounting Standards Board (IASB).

Related subject areas

The core work of the accountancy firms is audit, but the UK firms first specialized in insolvency work (the rescuing or winding up of businesses), and still carry this out. It is now euphemistically called 'corporate recovery'; and audit is part of 'assurance'. Throughout the world, the accountancy firms also have many staff working on tax. In some countries (e.g. Germany and Italy), tax and accounting are very closely linked, so that expertise in one field automatically implies expertise in the other. In other countries (e.g. the USA and the UK), the main purpose of accounting is to give useful financial reports to investors. So, accounting is not primarily designed for tax calculations. Although some accounting numbers in these latter countries are used for tax, there are many adjustments to make, which are based on tax law. In the USA, tax is more the province of lawyers than of accountants.

Many employees of the accountancy firms (including many qualified accountants) work in consultancy, although frequently this is connected to accounting numbers. Another field related to accounting is finance, which is concerned with the raising of money and how to best use it. Finance addresses such questions as: If a company wishes to expand, should it borrow money or should it get more money from its owners? If a company has spare money, should it invest in new projects, pay dividends to the shareholders, buy back its own shares, or pay off its debts? How much does a company's share price move when it announces a particular level of profit? What strategy should investors in stocks and bonds use in order to out-perform the general stock market?

This book focusses on the central areas of accounting (financial reporting and management accounting) and does not have space to examine the areas of insolvency, tax, consultancy, and finance.

The reporting entity

At one extreme, a business can be run by a single person with no other owners and no organization which is legally separate from the person. This business might be called a 'sole trader'. The trader has unlimited liability for the debts of the business and pays personal income tax on the profits. If the business is to be sold, then the trader must sell the individual assets and liabilities because there is no separate legal entity to sell. Nevertheless, the trader keeps the accounts for the business distinct from other personal activities. Otherwise, the success of the business and the basis for calculating tax will be unclear.

As the business becomes larger, it may be useful to have some joint owners (partners) who can contribute skills and money. The business then becomes a partnership, which is formalized by a contract between the partners which specifies their rights and duties. In common law countries, such as the United States, Australia and England (though not Scotland), a partnership does not have separate legal existence for most purposes. So, the partners are legally responsible for its assets and liabilities, and they pay tax on their share of the profits. Nevertheless, it is possible to set up a 'limited liability partnership' (LLP) and, for example, many accountancy firms have done so. The purpose of this is to seek to protect the partners from some part of the liabilities of the partnership in the event of a legal case being brought against it. In Roman law countries (such as most countries in continental Europe, in South America and Japan), some forms of partnership do have separate legal status, although generally the partners still pay the business's tax.

The complete legal separation of owners from their business is achieved by setting up a company, usually with limited liability for the owners. The ownership of the company is denoted by shares, which can be transferred from one owner (a shareholder) to another without affecting the company's existence. A company is a separate legal entity from its owners. The company can buy and sell assets, and it pays tax on its own profit.

In many jurisdictions, including the whole of the EU and South Africa, companies can be either private or public. A private company is not allowed to create a public market in its shares, so they have to be exchanged by private agreement between the owners and the company. Many small businesses are set up as private companies. By contrast, public companies are allowed to have their shares traded on markets. Some designations of companies are shown in Table 2. Public companies have to comply with some extra rules because they can offer shares to the public but these rules vary by country and are of no importance for our purposes.

The biggest form of market for shares is a stock exchange. Companies that are listed (quoted) on a stock exchange have extra rules to obey coming from stock exchanges, regulators of stock exchanges or other sources.

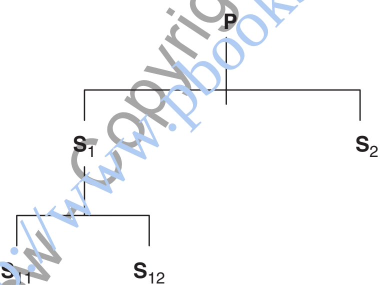
There are some linguistic problems here. First, the English word 'company' has no exact equivalent in some other languages. For example, the French *société* and the German *Gesellschaft* are

Table 2. Some EU company names

	Private	**Public**
Belgium, France, Luxembourg	Société à responsabilité limitée (Sarl)	Société anonyme (SA)
Denmark	Anpartsselskab (ApS)	Aktieselskab (AS)
Finland	Osakeyhtiö yksityinen (Oy)	Osakeyhtiö julkinen (Oyj)
Germany, Austria	Gesellschaft mit beschränkter Haftung (GmbH)	Aktiengesellschaft (AG)
Greece	Etairia periorismenis efthynis (EPE)	Anonymos etairia (AE)
Italy	Società a responsabilità limitata (SRL)	Società per azioni (SpA)
Netherlands, Belgium	Besloten vennootschap (BV)	Naamloze vennootschap (NV)
Norway	Aksjeselskap (AS)	Almennaksjeselskap (ASA)
Portugal	Sociedade por quotas (Lda)	Sociedade anónima (SA)
Spain	Sociedad de responsabilidad limitada (SRL)	Sociedad anónima (SA)
Sweden	Aktiebolag-privat	Aktiebolag-publikt
United Kingdom, Ireland	Private limited company (Ltd)	Public limited company (plc)

broader terms, also covering partnerships. Another problem is that the term 'public company' tends to be used, particularly in the United States, to mean *listed* company. It is true that only public limited companies in the UK (and their equivalents elsewhere in Europe) are *allowed* to be listed, but most such companies choose not to be. So, most UK public companies are not listed.

In practice, nearly all the world's important companies are really groups of entities which operate together. Let us take the example of Nokia, the Finnish telephone company. The public can buy shares in a company called Nokia Oy. It is a legal entity, and it transacts business in its own right. However, much of the activity goes on in subsidiary legal entities in Finland and many other countries. For example, there are major manufacturing subsidiaries in seven countries. These subsidiaries are legal entities. They pay taxes locally. They pay dividends up to the top parent company.



2. A simple group

A simplified example is shown as Figure 2. There are five legal entities: one parent (P), two direct subsidiaries (S_1 and S_2) and two subsidiaries of subsidiary S_1. A subsidiary entity is one controlled by a parent entity. The parent and the subsidiaries therefore act together as a group. Accountants prepare 'consolidated' financial statements for the group as a whole. Approximately speaking, this involves adding together the financial statements of all the group members, e.g. the five companies in Figure 2.