Accounting in Business

R. J. BULL

BSc (Econ), FCCA

Head of School of Accounting
and Applied Economics
Leeds Polytechnic

FIFTH EDITION

BUTTERWORTHS
London Boston Durban Singapore Sydney Toronto Wellington

First published 1969
  Reprinted 1970, 1971
Second edition 1972
Third edition 1976
  Reprinted 1977
Fourth edition 1980
  Reprinted 1982
Fifth edition 1984

British Library Cataloguing in Publication Data

Bull, Roger John
Accounting in business.—5th ed.
1. Managerial accounting
I. Title
658.1'511 HF5635

ISBN 0-408-01486-5

Library of Congress Cataloguing in Publication Data

Bull, R. J. (Roger John), 1940-
  Accounting in business.

  Includes bibliographies and index.
  1. Accounting. I. Title.
HF5635.B9655 1984 658.1'511 84-3248
ISBN 0-408-01486-5

Printed and bound in Great Britain by
The Garden City Press Ltd, Letchworth, Herts.

Preface

The basic objective of this book is to enable the reader to acquire a broad perspective of business accounting based upon a sound conceptual framework. Much of the enthusiasm for writing the original text in 1969 was generated as a result of my year's research for the Department of Education and Science and the Institute of Chartered Accountants in England and Wales which culminated in the report entitled 'Accounting for the Non-Specialist' which became the basis for the accounting guide syllabuses for ONC and HNC issued by the Joint Committee for Business Studies (now the Business Education Council). During that research year I became convinced that the traditional introductory studies to accounting which focused exclusive attention upon the detailed mechanics of bookkeeping failed both to provide an adequate conceptual framework for accounting and to present accounting as an important tool of management.

Considerable emphasis, therefore, has been placed on the integration of the theory with the application, seeking to stimulate independent thought on the part of the reader. This book is not intended to be a reference manual which can provide ready-made solutions to all problems; it does attempt to identify principles which the reader can apply and adapt to meet the needs of fresh and challenging situations. In writing this text, I have striven to present accounting concepts as simply and directly as possible, bearing in mind the needs of different groups of readers.

At the end of each chapter is a list of suggested additional reading on specific topics, designed to extend and deepen the reader's knowledge of the areas introduced by the chapter. No doubt some very excellent references have been omitted either because of the author's ignorance of their existence or because of the sheer wealth of material in a particular area. For this, I apologise, but would hope that these lists will be useful in providing a starting point for further investigation.

Since the publication of the first edition, it is evident that this book has provided, and will continue to provide, a suitable foundation for students pursuing a variety of courses—the Foundation Course, the first part of degree courses, the Business Education Council Higher National Certificate and Diploma Courses, and a range of professional accounting and finance studies. The increasing acceptance of a conceptual and broader approach to accounting is one measure of the profound change which has taken place in accounting education in the last two decades.

The fifth edition builds on the substantial extension and restructuring of the fourth edition, and, apart from minor changes made to update and improve clarity, incorporates several important changes and extensions:

(i) Chapters 10 and 11, which examine aspects of the limited company, have been extensively amended and extended to incorporate the effects of the Companies Act 1981;
(ii) Chapter 13, Value and Income Measurement, now incorporates SSAP 16—Current Cost Accounting, and subsequent criticisms;
(iii) Short-term decision-making (Chapter 18) includes the consideration of limiting factors;
(iv) Business income taxation is no longer a separate chapter, but the effects of taxation on financial accounting and decision-making have been incorporated into the text;
(v) Question material has been reviewed and amended and—by popular request—suggested solutions to numerical questions or parts of questions have been included at the end of the book.

My thanks are due to the Association of Certified Accountants for permission to reproduce some of the questions from their recent foundation examination papers—some of which I myself set during a period as examiner—and also to many of my colleagues at Leeds Polytechnic who have provided through our 'question data bank' some of the other question material.

My thanks must also go to my wife who has so patiently and carefully interpreted my inadequate handwriting, and turned it into legible typescript, quite apart from her willing acceptance of the many hours of work I have spent in preparing the book.

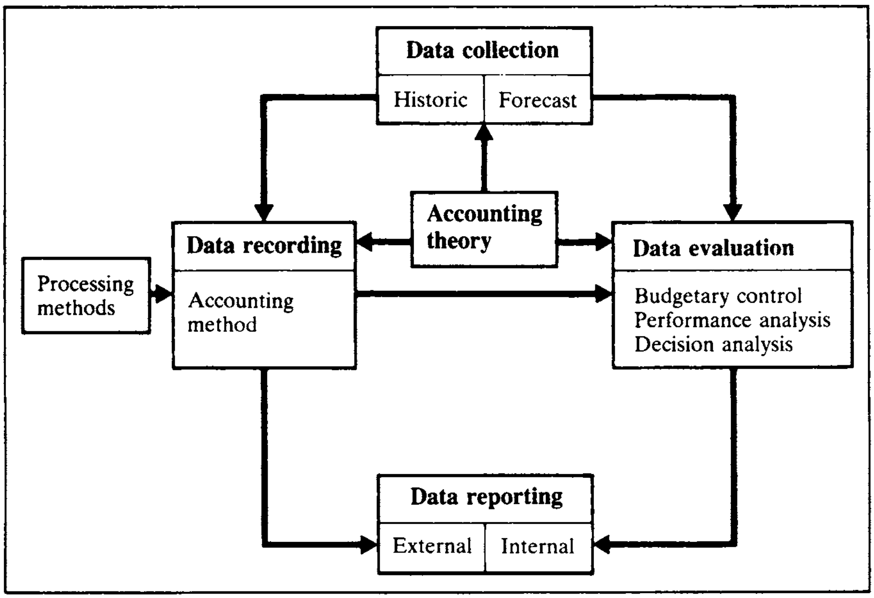
JOHN BULL

Part I

The accounting environment

This introductory chapter reviews the nature and scope of accounting, setting it in its historical perspective and examining the environment which helps to shape, constrain and develop accounting concepts and practices.

1 The scope and environment of business accounting



External environment

If a survey were conducted in which people were asked to say what they understood by accounting, the majority would be able to produce some sort of answer. For most people, accounting is 'something to do with figures, working out profits and the like'; perhaps the very vagueness of such answers is indicative of the fact that those concerned with accounting are more adept at explaining what they do, rather than what accounting is, or what are the foundations and uses of their art. In this book we will be concerned with laying the theoretical foundation of accounting and the uses to which accounting can be put in the business world; the methods of accounting, and in particular, that method called bookkeeping, will be treated as a means to an end, rather than an end in itself.

Accounting is in a period of rapid transition, and the changing environment has given rise to changing and ever-widening definitions of accounting. Many of today's definitions would be unacceptable—and almost unrecognizable—to the accountant of a century ago. Even with the past 40 years, definitions of accounting have markedly broadened. According to a 1953 definition:

> 'The central purpose of accounting is to make possible the period matching of costs and revenues.'

By 1966, the American Accounting Association interpreted accounting as:

> '. . . the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by the users of the information.'

For our purpose we will adopt the following definition:

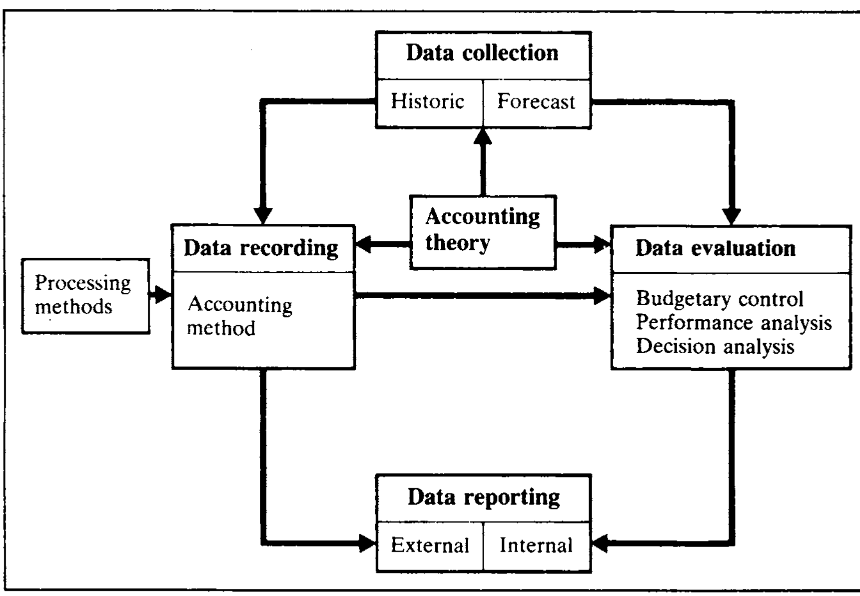
> 'Accounting is concerned with the quantification of economic events in money terms in order to collect, record, evaluate and communicate the results of past events and to aid in decision-making.'

This definition does not confine itself to business accounting; it also embraces national income accounting and local government accounting. While these other areas of accounting are important, we will concern ourselves solely with that part of accounting related to the modern business world.

The scope of business accounting

It is useful to present our definition of accounting in diagrammatic form and then to examine each element a little more closely.

Business accounting



External environment

We use the term 'data' to mean those events affecting the business which are capable of being expressed in monetary terms. Later in this chapter, when we are examining the environment in which accounting operates, we will have to recognize that while the use of 'money terms' is probably essential, it does place important limitations on accounting information.

'Data collection' is the area of activities which provide the raw material of accounting. The data collected is 'historic' in the sense that it refers to events which have already taken place. Until 60 years ago accounting was largely an 'historic' art, concerning itself with what had happened, rather than making any attempt to predict and prepare for the future. The collection of forecast data is the firm's attempt to estimate the likely course of future events.

We must make an important observation here. Historic accounting attempts to describe events in money terms; the money terms are therefore secondary to the event. In other words, although accounting is sometimes said to be central to all business activities—the language of business—it is dependent upon the other functions of business, such as selling and production, to generate the 'event'. In this sense, historic accounting may be regarded as a 'service' function. Where accounting is employed as a controlling or predictive aid, however, it is a prelude to the event, serving the other functions by advising them on the course of action to take.

The historic data, once collected, is recorded in a manner which is in accordance with general accounting theory. The *method* of recording is provided by double entry bookkeeping rules. It is essential that we do not confuse bookkeeping with accounting—unfortunately an all too common misconception. Within our definition of accounting, bookkeeping occupies a small—though important—part. In the diagram, connected with 'data recording' is 'processing methods'. The days of writing the books of account with the aid of a quill pen are long since gone. Manual methods have given way to the mechanical, and, in the larger firms, the electronic computer is the modern equivalent of the ledger clerk.

'Data evaluation' is the most important area of accounting in the modern business. In the diagram we have divided this into three: budgetary control, performance analysis and decision analysis. Budgetary control necessitates the comparison of forecast information with the actual results, with an examination of any variance between the two. Performance analysis investigates the success of the business by testing its profitability, its liquidity—the ability to meet obligations as they fall due, its solvency—the ability to meet interest costs and repayments associated with long-term obligations, and its return on investment. We include in such analysis the use of flow of funds statements—the description of the sources of additional funds available to the business in a given period of time, and the uses to which these funds were put.

Decision analysis is of considerable importance to the business, and will be even more important in the future. It is here that the art of the accountant, the skill of the mathematician and insight of the economist are linked to provide a sound basis for decisions which affect the future of the business. In this book we will examine such issues as pricing, investment in long-lived assets, choosing among alternative course of action, and the relationship between volume of output, costs and profit.

'Data reporting' consists of two parts—internal and external. External reporting refers to the communication of financial information about the business to outside parties—the shareholders, Inland Revenue and various government bodies. Internal reporting highlights the need to communicate the results of financial analysis to management and others in an effective and comprehensible manner.

Accounting does not exist in a vacuum; it reflects the activities of the business which reacts and interacts with the external environment shaped by many different forces—political, social, economic, legal and technological. Traditionally, accounting has particularly related to the economic implications of business activity but now, with a growing awareness of a business's social responsibilities for the environment, for the use of scarce resources, for the provision of employment opportunity, accounting is beginning to reflect a new social awareness—a dimension which promises many exciting developments in the future.

In the centre of the diagram is 'accounting theory'—the foundation stone for the art of accounting. It is important for us that we understand the nature and origins of this theory, and the place which it is to occupy in the practice of accounting.

The nature and place of accounting theory

Accounting has sometimes been defined as 'what accountants do', and this rather inadequate tautology might help us to appreciate why accounting theory was virtually non-existent 50 years ago, and is today the source of much debate and controversy. Theories are conventionally described as either 'positive' or 'normative'. A positive theory is one which attempts to explain or describe what is, and a normative theory is concerned with what ought to be. Theory, in the natural sciences, is expressed in positive terms, because, for example, there is no need to make any value judgements about the boiling point of liquids—it exists as a fact. In the social sciences, however, theories are normative because they take as a starting point a value judgement of what ought to be.

If accounting is 'what accountants do' and we were to take this activity as having some absolute, unchanging basis in fact, then it would be possible to evolve a positive theory of accounting. But accounting, as we have defined it, is concerned with making judgements about the social and economic consequences of business activity, and the central problem of valuation and income measurement depends upon the way in which terms such as 'value' and 'income' are defined. Hence, in accounting, we are seeking to establish a normative theory, a theory by which we can evaluate and guide existing and proposed practices.

We will refer to the particular statements of accounting theory as 'postulates'—sometimes these are also referred to as principles or fundamental accounting concepts. The use of the word 'postulate' is quite deliberate; it means 'a law or rule adopted as a guide to action which rests on general acceptance rather than some basic undeniable truth'. Two words in this definition must be particularly stressed; a postulate is *general* and it offers a *guide*. Accounting postulates do not prescribe *exactly* how economic events affecting the business should be collected, recorded and evaluated; there is an infinite number of possible events, and no rules could hope to prescribe for every eventuality.

In the 'positive' physical sciences it is frequently possible to devise experiments to test any given theory. In the social sciences this is seldom possible, or, at least, it cannot be done in so rigorous a manner, because we cannot control, as in a scientific laboratory experiment, all of the complex variables which influence human and business behaviour. Because we cannot verify accounting postulates in any absolute sense, their acceptance is a process of evolution dependent upon three criteria—utility, feasibility and objectivity. A postulate is *useful* to the extent that it results in meaningful information to those concerned with the business; it is *feasible* to the extent that it can be implemented without unnecessary complication and without excessive cost; and it is *objective* to the extent that the resultant information is not the product of personal bias.

Very often these three criteria are in conflict with one another. For example, the postulates which are the most useful for the purposes of income measurement and decision-making are not those which are the most feasible or objective. The postulates which are currently accepted are those which strike a balance between the three tests. It is useful to bear this in mind, for much of the criticism levelled against accounting postulates attacks their usefulness and ignores completely the two other factors.

Accounting in historical perspective

Acceptance of postulates demands general consent, and the obtaining of general consent is a lengthy, time-consuming process. Contrary to much popular belief, accounting is not the product of the past 100 years but has a long and noble ancestry. It is useful for us, as we begin our exploration of modern business accounting, to spare a moment to place accounting in the context of its historical development.

The earliest attempts to record financial information date back to the Assyria of 3500 BC when it was thought necessary to record the payments made to the armies of the king. The payments, of course, were not in terms of money, but by means of cattle and precious stones. The Egyptian civilization, too, has left us fragments of detailed records relating to the building of the pyramids; the records of one overseer even detail the cost of nails needed to make the slaves' shoes. The records of these early civilizations are erratic in their form, but this is only to be expected in the absence of both an adequate numerical system and money. In any case, trade was not sufficiently developed to necessitate more than a cursory attempt to list some of the transactions which took place.

The Greek and the Roman periods show some advances in the art of record-keeping. The adoption of money as the normal medium of valuation and exchange in the sixth to fifth centuries BC made it possible for transactions to be recorded not as so many slaves, so many bushels of grain or the exchange of so many casks of wine against so many pounds of silver, but in terms of a particular system of currency. Apart from the use of money, however, improvements in methods of accounting were not consistently maintained and were confined to isolated examples. There is no evidence to indicate that there was any use made of what we would call 'double entry' bookkeeping; lists of receipts and payments are often given in narrative form, and even when the figures are clearly segregated from the text there is only occasionally segregation of the receipts from the payments.

It was the Arab traders of the seventh to eleventh centuries AD who provided the stimulus necessary to the eventual use of a double entry system of accounting. The traders who often visited India recognized the merit of a numerical system derived by the Hindus. The system is, of course, our own 'Arabic' notation, or, more properly, 'Hindu-Arabic', which made it possible to add lists of figures in a way which earlier civilizations had found impossible. Once figures began to be disposed in a single column instead of being scattered all over the page, the advantages of having *two* clearly separated columns to facilitate computation would slowly have been realized.

The first double entry bookkeeping records appeared in Italy in the fourteenth century, and the first accounting text appeared in 1494 under the authorship of one Luca Pacioli. His famous 'De Summa' was primarily a treatise on mathematics, but it included one important section on bookkeeping. The ideas expressed in it gradually gained acceptance and slowly became more sophisticated; for example, the practice of ascertaining profit at the end of each year rather than at the end of each trading venture was first proposed in 1605.

The nineteenth century saw a series of economic and social events which gave rise to a tremendous expansion of trade, providing the impetus for the development of a system of bookkeeping into a field of accounting. The extended system of ownership (by means of shares in a limited company) necessitated government legislation to provide for some minimum standards of accounting. Rapid industrialization, with the accompanying heavy investment in plant and machinery and associated complex manufacturing processes, gave rise to the development and expansion of that part of accounting normally referred to as 'cost accounting'.

The formation of the professional accounting bodies in the late nineteenth and early twentieth centuries provided for minimum standards of professional competence; it was not until 1942, however, that a series of statements called 'Recommendations on Accounting Principles' was inaugurated by the Institute of Chartered Accountants in England and Wales. These are intended to be statements of the best practice—and as such they are of great value and importance—but only recently has there been any systematic attempt in this country to develop more definitive statements of practice. The process of establishing accounting standards began in this country in 1969 when the Institute of Chartered Accountants in England

and Wales issued a 'Statement of Intent on Accounting Standards in the 1970s' in which the Institute announced its intention to advance accounting standards by:

(i) narrowing the areas of difference and variety in accounting practice;
(ii) requiring businesses to disclose the accounting bases on which their published accounts are founded;
(iii) requiring businesses to disclose any departure from established definitive accounting standards; and
(iv) inviting comment from appropriate bodies on any draft proposals for standards.

To give effect to this proposal, the Institute formed in 1970 the Accounting Standards Committee, which by 1976 had been extended to embrace the six major accounting bodies in the UK, being reconstituted as the Consultative Council of Accounting Bodies (CCAB). This new body extended the scope of its activities beyond the development of accounting standards to involve such matters as commenting on company and revenue law changes, and acting as co-ordinators for the UK bodies with respect to international accounting matters. To date, this committee has issued nineteen 'Statements of Standard Accounting Practice' (SSAP) together with a number of 'Exposure Drafts' (ED) which invite comment and criticism before producing a definite statement. It is arguable, however, that these 'standards' are simply rules governing accounting practice rather than any attempt to provide a theoretical framework for accounting. Perhaps their value is more in the debates they engender than in the particular practice which they seek to encourage.

In a wider context, the CCAB is a member of the EEC 'Group d'études des experts comptables' which puts forward the profession's views on proposed EEC legislation which has particular bearing on fiscal matters. The most important example of this is the work on the 'Fourth Directive' much of which has found its way into the 1981 Companies Act. Still broader, is the International Accounting Standards Committee (formed in 1973) which had as its primary objective:

> 'To formulate and publish in the public interest, standards to be observed in the presentation of audited financial statements and to promote their world wide acceptance and observance.'

Although acceptance of IASC standards are not obligatory in the UK, the CCAB now seeks to incorporate relevant standards within the UK standards.

The years since the last war have seen an increasing emphasis on the provision of accounting information for management. Greater analysis and better presentation of historic financial data has been encouraged, and far more attention has been paid to accounting as a predictive device. Record-keeping, the art prescribed by Pacioli, is being placed in its perspective as an essential means to the end of providing management with information to check the results of decisions and predictions.

Increasing, too, is the recognition that business decisions have profound social as well as economic consequences, and businesses are being held to account for the almost endless social implications of their activities. An obvious example is the impact of the business on the environment—pollution, resource depletion, aesthetic qualities—or the extent to which employment opportunities are provided. If this social dimension is important, then it is undeniable that conventional accounting information and reports totally fail to reflect this 'social responsibility' of the business. This area of concern takes us to what some accountants believe to be one of the most exciting frontiers of accounting theory and practice.

References and further reading

AMERICAN ACCOUNTING ASSOCIATION (1966), *A Statement of Basic Accounting Theory.*

ASHTON (1983), UK Financial Accounting Standards. Woodhead-Faulkner.

BROMWICH and HOPWOOD (1983), 'Accounting Standard Setting: An International Perspective', 1983.

BUCKLEY, KIRCHER and MATHEWS (1968), 'Methodology in Accounting Theory', *Accounting Review*, April 1968.

CHAMBERS (1966), *Accounting, Evaluation and Economic Behaviour.* Law Book Co.

ESTER (1973), *Accounting and Society.* Melville Publishing Co.

HARVEY and KEER (1984), *Financial Accounting Theory.* Prentice-Hall.

IJIRI (1967), *The Foundations of Accounting Measurement.* Prentice-Hall.

LITTLETON and YAMEY (1956), *Studies in the History of Accounting.* Sweet and Maxwell.

LITTLETON and ZIMMERMAN (1962), *Accounting Theory: Continuity and Change.* Prentice-Hall.

POPOFF (1972), 'Postulates, Principles and Rules', *Accounting and Business Research*, Summer 1972.

STERLING (1970), 'Theory Construction and Verification', *Accounting Review*, July 1970.

TERLECKYJ (1973), 'Measuring Progress Towards Social Goals', *Management Science*, August 1973.

TINKER, MERINO and NEINMARK (1982), 'The normative origins of positive theories; ideology and accounting thought'. Accounting Organisations and Society, 1982.

WATTS and ZIMMERMAN (1979), 'The Demand and Supply of Accounting Theories: The Market for Excuses'. *Accounting Review*, April 1979.

Questions for discussion

1 Examine a series of job advertisements for accountants, and try to deduce what accounting is from the descriptions.
2 Find a number of different definitions of accounting, and consider the extent to which they coincide or diverge.
3 Normative accounting theories need to be 'generally acceptable' to be

of use. Discuss the extent to which the criteria for acceptability can be in conflict.

4 Outline the major influences on the development of accounting practices from the earliest times to the present day.

5 To what extent should accounting information reflect the impact the business has on the social as well as the economic environment?

6 Accounting is not an end in itself, but aims to help people make decisions. What different groups may need accounting information, and for what purposes?

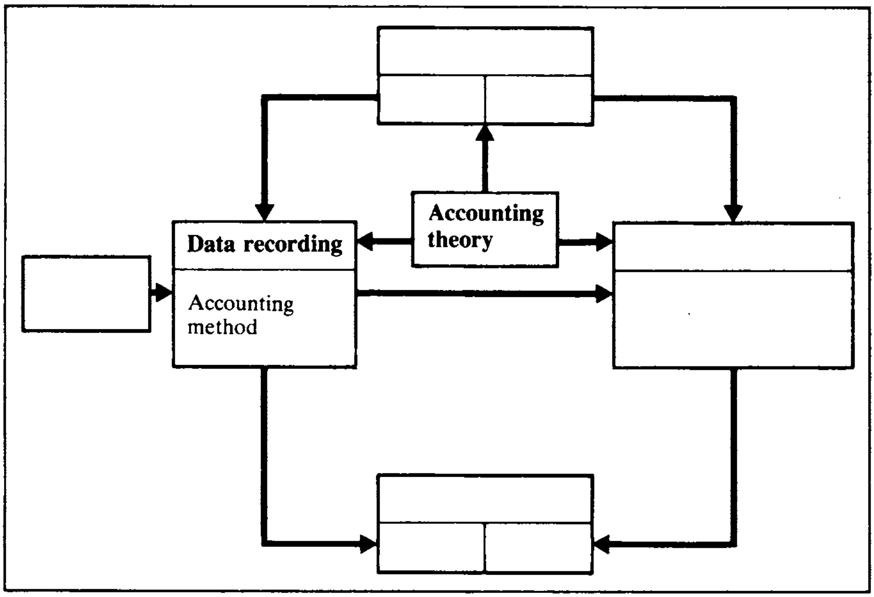
7 Accounting theory is variously described as setting out 'principles', 'postulates', 'concepts', 'rules' or 'practices'. Is there any difference between these terms, or is this just a matter of semantics?

Part II

Financial accounting theory and practice

Chapters 2–4 explain the basic principles of income measurement and valuation in accounting, and the preparation of income statements and balance sheets. Chapter 5 and, later, Chapter 8 consider the formal bookkeeping used to reflect these concepts. Two major problems in accounting—depreciation and the valuation of stock and other assets—are explored in Chapters 6 and 7, and then the basic concepts and procedures of these early chapters (Chapters 2–8) are extended to partnership accounting (Chapter 9) and company finance, accounting and reporting (Chapters 10 and 11). The section concludes (Chapter 12) with a critical summary of accounting and economic concepts of value and income, leading to a review of the conceptual and operational problems of accounting for inflation.

2 The balance sheet



The accounting environment

The environment of the economic, legal, social and political world has provided the general framework for the development of accounting. The boundaries of accounting have been largely prescribed by the varying stages of economic development through which mankind has passed. The economies of the early civilizations depended to a large extent on barter—the exchange of one commodity for another; hence accounting was limited to such things as inventories of the possessions of kings and princes. The feudal system of Europe demanded a check on payments made by way of rent and tithe; accounting was accordingly developed to a stage sufficient to meet this need. The growth of trade in twelfth and thirteenth century Italy saw the birth of double entry accounting; the manorial system of England necessitated the keeping of household accounts; the growth of large industrial complexes in the nineteenth century accelerated the rise of cost accounting. There are many more examples which could be quoted, but perhaps these are sufficient to illustrate how accounting has responded to the needs of the economy, and also helps to explain why the ideas of accounting and economics bear a close relationship to each other.

Accounting, however, is also influenced and constrained by legal considerations in the form of judicial decision and statute law. We may illustrate this point in relation to the limited company, where statute law in the form of the Companies Acts prescribes the keeping of adequate books and accounts, and lays down certain minimum standards in relation to the disclosure of information to shareholders. Judicial decision and statute law has indicated, for example, when the profits of a company shall be available, if so desired, for the payment of dividends.

The influence of taxation legislation has been primarily indirect in nature so far as the larger businesses are concerned. For the small business, however, there is little question that the main use of accounting has been in the preparation of the income tax return—a very restricted use indeed. There are many differences between tax and financial accounting, partly as a result of the use of differing income concepts, and partly because taxation is also used as an instrument of government policy to effect social reform or grant relief to specific industries, or industries in certain geographic areas.

The environmental postulates

The objective of the environmental postulates of accounting is to draw from the broader environment those aspects which are particularly relevant and necessary to the development of accounting. In one sense, these postulates can be no more than general descriptions of parts of our economic environment; however, the very fact that they are *selected* from a range of possibilities means that accounting considers them to be of particular importance. For our purpose we will identify three such postulates:

(1) Economic agents
(2) Business entity
(3) Money measurement.

(1) Economic agents

An obvious fact about business organizations is that they consist of human beings. Anything that the business achieves is the result of human action, figures in themselves accomplishing nothing. Two firms with identical accounting systems can achieve entirely different results if, in the one, management ignores the information, and, in the other, management utilizes it.

Figure evidence, too, is only partial evidence; no system can describe in terms of numbers all the consequences of human action taken or planned. The postulate of economic agents is an assertion of the human factor which we must be careful not to ignore. It states, in essence, that humans exist, or in more precise terms, that economic agents are 'natural persons engaged in the economic activities of producing, owning, managing, storing, transferring, lending, borrowing and consuming commodities and services'.

(2) Business entity

The business is an institution which may own and owe economic resources, and which may itself be owned by one or more agents. In accounting, all the records are kept from the viewpoint of the business rather than from that of the owner. In recording data in the accounts the important question is—how does it affect the business? For example, if the owner of a shop were to take cash from the till and put it into his pocket, the accounts would show that the cash had been reduced, even though the owner is himself no worse off.

The business entity postulate states that a distinction can be drawn between business and owner, and therefore that all transactions can be recorded as they affect the business as distinct from the owner. The distinction can be easily maintained in the case of the limited company because the law accords to the business a personality all of its own whereby it can sue and be sued in its own name instead of in the name of all its owners, the shareholders. Distinction is more difficult in the case of a partnership, and even more so in the case of the one-man business—the sole trader. Here, in a very real sense, the man is the business, but, nevertheless, accounting still maintains the separation of business and owner. This means that all the owner's personal affairs—his house mortgage, his expenditure on food, clothing and heating—will not appear in his books of account.

The idea of business entity has a close connection with that of stewardship. The owner is seen as entrusting the business and those who manage its affairs with his funds for which the business must account, that is, act as a steward. The stewardship idea is perhaps rather a narrow view of accounting, for many of the reports prepared are of more use to management than to the owners. Nevertheless, the stewardship idea does help to explain in part the greater emphasis which has been placed on accounting for outside parties.

(3) Money measurement

In accounting, only those facts which can be expressed in terms of money are recorded, simply because money is accepted both as a store of value and a medium of exchange. The advantage is that a number of widely differing facts can be expressed in terms of a common denominator: what other easily understood means is there of adding together two buildings, ten machines and four vans?

Although money is probably the only practical common denominator, we must observe that there are two major limitations of this unit. In the first place there are a great many facts of vital concern to the business which cannot be expressed in money terms. For example, accounting cannot reveal that the managing director is unwell, or that the chief accountant and the production director are not on speaking terms, or that a strike is about to begin, or that a competitor has recently taken over the best customer.

Secondly, the use of money as a common denominator implies a homogeneity—that one pound is like any other pound. Most modern economies are in inflationary conditions with prices rising. This means that the £1 of 1984 is not worth the same as the £1 of 1955. In general, accounting assumes the problem away (*see* Chapter 4), and only makes any allowance for changing price levels (*see* Chapter 12) in statements supplementary to the conventional records.

Business entity

The second of the environmental postulates was that of business entity. The concept was seen to be related to the idea of stewardship, namely, that the business is entrusted with funds by the owner for which it must account, that is, act as steward. Given that the distinction between business and owner can be maintained in logic—if not in reality—it follows that what a business owes must necessarily equate with what it owns. In accounting what a buiness owes is referred to as its liabilities, and what it owns as its assets. The statement of a business's assets and liabilities at a particular moment in time is called the balance sheet.

The balance sheet

Before the assets and liabilities of a business can be recorded in the books of account, one further postulate is necessary. The postulate is that of duality, which states that any economic transaction must necessarily affect two aspects within the accounts. For example, if John Smith were to invest his life savings of £15,000 in a new business venture of, say, a bookshop of which he will be the sole owner and manager, then, from Mr Smith's point of view, he still has his £15,000. However, if we view this situation from the standpoint of the business, which has assumed a fictional life and identity quite separate from that of Mr Smith, the owner, then the result from the accounting point of view will be

John Smith, Bookseller
Balance Sheet as at 1 January 1984

Capital	£15,000	Cash at bank	£15,000

The business has an *asset* (cash at bank) of £15,000 which is exactly matched by its *liability* to the owner—the capital—of £15,000.