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# Accounting in a Nutshell*

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*Christopher Nobes:*
*Accounting – A Very Short Introduction*
*Oxford University Press, 2014, pp. 137*
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The British author Christopher Nobes is a professor of accounting at several universities (London, Oslo, Sydney), who has participated in the development of international accounting standards and is a member of the editorial board of several accounting journals. His book ("*Accounting – A Very Short Introduction*") was published in 2014 as part of the educational book series (*Very Short Introduction Series*) of the Oxford University Press, started decades ago, covering hundreds of subjects.

Accounting is a very large special subject, and its history is almost of the same age as writing. Companies in the private sector and public institutions use accounting statements for internal purposes at a daily level, whereas tens of thousands of public limited companies are obliged to publish accounting statements several times a year. At the time of writing the book, the IFRS[1] (containing the international standards of accounting) is more than 3,600 pages long (and continuously increasing), whereas the American equivalent of this, US GAAP,[2] is much longer. Thus, the objective of the author, i.e. to introduce the history and framework of accounting and present in clear language its main concepts and notions and their practical applications in a relatively short book, is rather ambitious. The targeted audience is not accounting experts, but intelligent non-specialists who wish to obtain a better understanding of accounting.

The historical antecedents of accounting date back very far. When archaeologists excavate remains from ancient times and find writing or numbers, they are usually part of the accounting records of that age. Incomes, i.e. taxes, are necessary for the establishment and maintenance of the government power maintaining social order.

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[1] IFRS: International Financial Reporting Standard
[2] US GAAP: United States Generally Accepted Accounting Principles

Taxation requires accounting records. Thus, modern civilisation does not operate efficiently without accounting records.

The economic decisions of the modern world are also based on basic accounting information (e.g. How should Tesco or Walmart price a product? In which country should General Motors build a new factory? Can the stocks of Citibank or HSBC be considered as better investment? How much tax has to be paid in the given year? What level of dividends per share can be paid?). If we make good decisions on the basis of high quality accounting information, it may lead to economic prosperity with better opportunities. By contrast, in the case of bad decisions, less money can be spent on important things such as health care, transport infrastructure and culture.

Within accounting, the author presents the essence of bookkeeping, financial accounting, auditing and management accounting. We also learn that accounting experts also establish organisations in order to protect their interests and enforce their objectives. The first professional organisations were established by the state, e.g. the Collegio dei Rasonati in Venice in 1581, so that the accounting experts could exercise control over the budgets of building warships. The first professional accounting organisation established on a private basis was founded in the United Kingdom in the 19th century.

There are vast national differences as regards accounting experts. Accounting has greater prestige and plays a larger cultural role in Anglo-Saxon countries (Great Britain, Australia, New Zealand) than in other countries.[3] Whereas among the senior executives of American companies one finds a significant ratio with an accounting degree, in the case of the German companies BMW and Lufthansa even the head of accounting is not a trained accountant, and they have a business or engineering degree instead.

Some accounting experts work alone and specialise on certain areas, whereas others provide a wider area of services by organising themselves into larger units. In terms of the latter, the author underlines and examines the four large global auditing firms (the so-called Big4: Deloitte, Ernst & Young, KPMG, PwC). The main profile of the larger companies dealing with accounting is auditing, but several related areas have been developed as well, e.g. in the United Kingdom many accounting experts work on insolvency procedures (*corporate recovery*). In many countries, accounting experts handle taxation issues as well (e.g. in Germany and Italy), whereas elsewhere (e.g. in the US) taxation is typically the domain of lawyers. After some time, the large auditing companies have also launched other, related business lines (e.g. consulting).

[3] Almost 1 per cent of the population of New Zealand has an accounting degree, whereas this ratio is much lower in the non-Anglo-Saxon countries.

The author starts the presentation of the development and evolution of accounting with historical precedents. Ancient Romans already developed accounting statements for measuring the effectiveness of farm management, whereas in India and in the Arab world they used more sophisticated accounting records. At the beginning of the 13th century, the traders of Venice already kept rudimentary records (still using Roman numerals!), preparing an entry for each transaction, with *single-entry bookkeeping*. After some time, however, business relations became more complex (e.g. foreign branches, trading in multiple currencies, projects of several merchants performed in partnership), which required more detailed records. This was done in *double-entry bookkeeping* which appeared in Italy. This system prepares two entries for each transaction (debit and credit) and the debit and credit sides are always in balance.

Thanks to its advantages, double-entry bookkeeping spread quickly among Italian traders and then among the traders of other cities as well (e.g. in Provence from 1299 and in London from 1305). By the 1340s, some cities (e.g. Genoa) also switched to double-entry bookkeeping. Two systems of double-entry bookkeeping caught on: the Tuscan and the Venetian. Today's double-entry bookkeeping is based on the latter. A great role in the spread of double-entry bookkeeping was played by the publication of the textbook (*Summa De Arithmetica, Geometria, Proportioni et Proportionalita*) of Franciscan friar and professor of mathematics Luca Pacioli, published in 1494 in Venice, which he wrote not in Latin, but in Italian, and thus it quickly became popular among merchants, and it was soon translated into Flemish, French and English. The French started to regulate accounting with legal tools in the 17th century. The formation of the rich trader layer and colonisation led to the development that funds had to be collected publicly for the major projects in 17th century Amsterdam, and public companies with separate legal entity were developed. Later, the industrial revolution further increased the need for the collection of funds and the foundation of such companies.

After the industrial revolution and the victories of Admiral Nelson and General Wellington, Great Britain became the 'top nation' in terms of military and trade. In 1844, the regulation related to public limited companies was eased in order to facilitate the collection of funds for companies. In parallel with this, the publicity of the accounting data of such companies was introduced, thereby also decreasing the likelihood of abuses and promoting the control of owners. Despite this, the enormous collapse of some companies (e.g. that of the City of Glasgow Bank in 1878) resulted in the tightening of regulation: the application of external auditors was prescribed for banks and, from 1900, for other companies as well. Thus, with the gradual separation of the role of owners and management in 19th century Great Britain, the demand for auditing appeared in order to exercise external control over management in the interest of the (often layman) owners. Scotland played an outstanding role in the development of the auditing profession.

In the beginning, there were no bookkeeping and auditing provisions whatsoever in the US for publicly traded companies: the 1929 stock exchange crisis clearly underlined that this was an untenable situation. The Federal Securities and Exchange Commission (SEC) was established in 1934. The American accounting profession started the development of accounting standards, and for this activity the Financial Accounting Standards Board (FASB) was established in 1973. Currently, the Generally Accepted Accounting Principles (US GAAP) are constituted by the accounting standards submitted by the FASB and accepted by the SEC. Germany standardised financial reports at the beginning of the 20th century, the US developed the system of consolidated financial reports, and the United Kingdom introduced the requirement of "*true and fair view*" for financial reports, which is a basic requirement of today's accounting in several countries. Japan introduced significant innovations in the area of management accounting and accounting controls.

Accounting remained in national frameworks until the 1970s, but with the development of large international companies, globalisation spread to the area of accounting as well. The accounting framework systems operating within national boundaries could no longer ensure the ability to compare various companies globally. Thus, the harmonisation of the national systems became necessary. First, attempts were made for the harmonisation of rules within the European Community. But British accounting experts lobbied against this, as they did not want other (e.g. German and French) governments to have a major influence on their accounting system. And so, in 1973, when the United Kingdom joined the European Community, the London-based International Accounting Standards Committee (IASC) was established with the professional organisations of nine countries. In the first 20 years only a few companies followed the International Accounting Standards (IAS) of the IASC, and then German companies started to use it from 1994. In 2001, the IASC was succeeded by the International Accounting Standards Board (IASB), which issues standards as the International Financial Reporting Standards (IFRS). Upon its establishment, the IASB assumed all previous IAS's, therefore the IFRS and IAS standards exist in parallel in the current system, until the IFRS prepared for the given subject replaces the IAS dealing with the same subject. At the time of writing the book, the use of IFRS was already a requirement in the majority of the countries of the world (e.g. EU, Australia, Canada, Brazil), and it was allowed in other countries (e.g. Japan, Switzerland).

The IFRS is built on basic principles (*principle-based system*) and it often provides several possible options for users. By contrast, US GAAP establishes very detailed rules (*rule-based system*) and provides only few options for companies in relation to a given issue.

After the historical part, the book presents the foundations of *financial accounting* via the presentation of the balance sheet, the profit and loss statement and the cash flow statement. Moreover, a separate chapter is devoted to the financial statements of listed companies prepared on the basis of IFRS and US GAAP, and the accounting indicators related to profitability, liquidity and leverage calculated on the basis of the financial statements. According to the author, financial statements and accounting indicators must be handled with care, since their producers are interested in giving a better impression about themselves and they often 'manipulate' the numbers to this end. In the case of the 2001 Enron scandal, the main problem was the fraudulent evaluation of financial contracts and hiding losses in off-balance-sheet structures; whereas in the 2003 Parmalat scandal, EUR 4 billion of stated deposits were not on the accounts and the debt of EUR 14 billion was eight times the amount that the company stated in the financial statements.

The main task and responsibility of the auditor is to provide an *opinion* in its report about the contents of the annual report prepared by the board of directors that the financial report is reliable and provides a realistic picture about the financial situation and economic processes of the company. The development of global standards can be observed in the area of auditing as well, in the form of the International Standards of Auditing (ISAs). The independence of the auditor provides authenticity to its opinion on the financial report, and therefore both the external rules and the internal provisions of auditors include requirements related to achieving and maintaining independence. The breach of independence of the auditor may have serious consequences, e.g. the 2001 fall of Enron also resulted in the termination of the audit activity of its auditor, Arthur Andersen, which belonged to the five largest global (Big5) auditing firms at that time.

The book presents in detail the phases of the auditor's activity and the topics related to the audit (e.g. the role of accounting systems, estimates and internal control processes in auditing; the IT support of the audit; and to what extent the exploration of accounting abuses is the task and responsibility of the auditor). In the beginning the work of the auditors was very seasonal and adjusted to the preparation of the annual report. Later, auditors' work also related to the semi-annual and quarterly reports of listed companies, and thus for example the auditors of Shell have work continuously throughout the year. Nowadays, special examinations are also entrusted to auditors (e.g. in the United Kingdom it is customary to order both a prominent auditor and a prominent lawyer for the examination of corporate scandals, with respect to their complementary expertise), and in the case of legal disputes they also perform expert activity for any of the parties or for decision-makers.

Separate chapters present management accounting and the control function of accounting. This part of the book presents how managers can use accounting to increase the efficiency and profitability of control over the institution they manage (e.g. budget planning, cash flow forecast, rate of return analyses, calculation of standard cost for work and production processes and monitoring the deviations from these).

In the epilogue, the author mentions several issues in connection with accounting, arising in the literature and in public life: e.g. how exact a science is accounting; are financial reports nearly as good as they could be; why is the modernisation of management accounting necessary; and what was the role of accounting and auditors in the global financial crisis?