The measurement of wealth

In Chapter 1 we discussed the objectives of accounting reports and the influences of users on financial reporting. We also discussed the limitations of accounting information and the role of accounting in business, its effect on business and some of the factors which influence accounting. In Chapter 2 we examined some possible approaches to income measurement from the point of view both of the economist and of the accountant. We shall now look more specifically at the ways in which accountants measure wealth and income.

We suggested that the problem facing accountants is that of finding an appropriate basis for the measurement of wealth. There is also the additional problem that with the complexity involved in the real world a system that only measures wealth and derives income from it will not be able to cope with the complexity of present-day enterprises. Consider a large retailing group such as Sainsbury: should they have to carry out a valuation of all their premises, vehicles, stocks etc. on one day of the year? The costs of such an operation would make it prohibitively expensive, even if it was logistically possible. For companies such as Hanson Trust, where operations are carried out on a worldwide basis, these logistical problems would be even greater. Such a system would also lead to problems because management or the owners would not be able to make decisions on a day-to-day basis as they would only have information at hand once a year. Because of these problems with annual valuation systems we need to find separate ways of measuring wealth and income.

The measurement of income will be dealt with in detail in Chapter 4. In this chapter we concentrate on the problem of the measurement of wealth and the way in which accounting approaches that problem. We shall look in some detail at the use of the balance sheet as the measure of wealth, at its component parts such as assets and liabilities, and finally at the format in which the balance sheet is presented and the way in which that is influenced by the type of organization, the environment and the needs of the users.

The measurement of wealth

In the case of an individual, we have said that wealth can be found by simply listing the items you own, assuming of course that you do not owe
anybody money as this will clearly reduce your wealth. To some extent the same can be said for an enterprise, although the level of complexity will, of course, be greater. The way in which this is done for an enterprise is similar to that for an individual but the resulting statement is called a balance sheet. You should note that the balance sheet relates to a position at a point in time. It is because of this that the analogy with a snapshot is often found in accounting textbooks.

The balance sheet is a statement, at one point in time, which shows all the items (assets) owned by the enterprise and all the amounts owed by the enterprise (liabilities).

The definition is not intended to be comprehensive – it merely provides us with a basic idea of what we are referring to. Before looking at the balance sheet in more detail it is important to appreciate that, although an enterprise does not exist in the same way as a person, for accounting and for some legal purposes an enterprise is presumed to exist in its own right. It is therefore treated as a separate entity from the person or persons who own or operate it. In broad terms it is possible to account for any unit which has a separate and distinct existence. It may be that this is a hotel, for example, or a group of hotels or a more complex organization such as Trust House Forte. This idea of a separate entity is often referred to in accounting literature as the business entity principle. It applies equally to organizations that are not commonly referred to as businesses such as charitable organizations, clubs and societies. The question of whether the entity should be accounted for separately is related not only to the legal situation but also to the question of whether it can be seen to have a separate existence.

The business entity principle states that transactions, assets and liabilities that relate to the enterprise are accounted for separately. It applies to all types of enterprise irrespective of the fact that the enterprise may not be recognized as a separate legal or taxable entity.

Whilst the application of this principle and the reasons for it are fairly self-evident when we are looking at large public companies such as ICI or Shell, they are less clear with smaller enterprises such as the corner newsagents or a second-hand car business. If, for example, you decided to set yourself up as a car dealer, for accounting purposes the cars purchased as a car dealer and the money earned as a result of that activity would be treated separately from your own personal car and money. This allows the tax authority to tax you separately on the profits from your business and it also helps you to arrive at the value of your business should you wish at