

Value and Profit

The measurement methods used in financial accounting affect our perception of the value and performance of businesses by determining the amount of the reported profit or loss and the resources of the business. Thus, measurement affects shareholders and other stakeholders in the business. It has even been suggested that the Global Financial Crisis of 2007–10 was partly due to the mismeasurement of financial instruments.

Inflation Accounting, Geoffrey Whittington provides a unique survey of the theory and practice of measurement in financial accounts. It seeks to define and illustrate alternative methods, using simple numerical examples, and to analyse their theoretical properties. Also, it summarises extensive empirical evidence and the historical development of ideas and practice. It is essential reading for advanced undergraduate and postgraduate students studying financial accounting, as well as practitioners and policy makers concerned with accounting standards.

GEOFFREY WHITTINGTON is a Senior Research Associate of the Cambridge Centre for Finance, Judge Business School, and a founding member of the International Accounting Standards Board (2001–6). He is the author of numerous publications and essays on financial accounting, including *The Elements of Accounting* (Cambridge University Press, 1992) and *The Debate on Inflation Accounting* (with David Tweedie, Cambridge University Press, 1984).

Value and Profit

An Introduction to Measurement in Financial Reporting

Second Edition

GEOFFREY WHITTINGTON

Judge Business School, Cambridge University



CAMBRIDGE
UNIVERSITY PRESS

Cambridge University Press
978-0-521-19097-8 — Value and Profit
Geoffrey Whittington
Frontmatter
[More Information](#)

CAMBRIDGE UNIVERSITY PRESS

University Printing House, Cambridge CB2 8BS, United Kingdom

Cambridge University Press is part of the University of Cambridge.

It furthers the University's mission by disseminating knowledge in the pursuit of education, learning and research at the highest international levels of excellence.

www.cambridge.org

Information on this title: www.cambridge.org/9780521155885

DOI: 10.1017/9781139022378

© Geoffrey Whittington 2017

This publication is in copyright. Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press.

First published 2017

Printed in the United Kingdom by Clays, Ltd.

A catalogue record for this publication is available from the British Library

Library of Congress Cataloging-in-Publication data

Names: Whittington, Geoffrey, author.

Title: Value and profit : an introduction to measurement in financial reporting / Geoffrey Whittington, Judge Business School, Cambridge University.

Description: Cambridge, United Kingdom : Cambridge University Press, 2017. |

Includes bibliographical references and index.

Identifiers: LCCN 2017006036 | ISBN 9780521190978 (hbk : alk. paper) |

ISBN 9780521155885 (paperback)

Subjects: LCSH: Accounting. | Valuation. | Profit.

Classification: LCC HF5636 .W593 2017 | DDC 658.15/12 – dc23 LC record available at <https://lcn.loc.gov/2017006036>

ISBN 978-0-521-19097-8 Hardback

ISBN 978-0-521-15588-5 Paperback

Cambridge University Press has no responsibility for the persistence or accuracy of URLs for external or third-party internet websites referred to in this publication, and does not guarantee that any content on such websites is, or will remain, accurate or appropriate.

Cambridge University Press
978-0-521-19097-8 — Value and Profit
Geoffrey Whittington
Frontmatter
[More Information](#)

To Caspar, Hamish and Xander

Contents

Preface	page ix
List of Abbreviations	xiii
1 An Introduction to the Measurement Problem in Financial Accounting	1
2 Fundamentals	32
<i>Appendix: A Numerical Example</i>	51
3 Historical Cost Accounting	60
<i>Appendix: A Numerical Example</i>	76
4 Current Value Accounting 1: Valuation	92
<i>Appendix A: Some Empirical Studies of Current Value Accounting</i>	141
<i>Appendix B: A Numerical Illustration of Current Value Accounting</i>	149
5 Inflation and the General Price Level	165
<i>Appendix A: Select Bibliography on Constant Purchasing Power Accounting</i>	207
<i>Appendix B: A Numerical Example of Constant Purchasing Power Accounting</i>	212
<i>Appendix C: Some Empirical Studies</i>	225
6 Current Value Accounting 2: Capital Maintenance Concepts and Real Terms Accounting	234
<i>Appendix A: A Numerical Illustration of Alternative Capital Maintenance Concepts</i>	264

viii CONTENTS

	<i>Appendix B: Empirical Evidence Relating to Alternative Capital Maintenance Concepts</i>	280
7	Review	288
	Bibliography	315
	Index	341

Preface

In 1983, I published *Inflation Accounting: An Introduction to the Debate*, on which this book is based. This earlier book was intended to introduce the basic framework of inflation accounting as a preparation for reading the study of the inflation accounting debate which David Tweedie and I published in 1984. However, it was also intended to stand on its own as an introduction to the measurement concepts underlying financial accounting as it is currently practiced, which are extremely important in determining economic decisions. Such issues as how profit is measured in the profit and loss account and how assets and liabilities are measured in the balance sheet affect our perception of the performance of businesses and, increasingly, of other entities, including public-sector bodies. This became alarmingly obvious during the Financial Crisis of 2007 onwards.

When the original book was written, inflation was a major economic concern throughout the world economy, so the book emphasised inflation accounting, whilst acknowledging that inflation is only one aspect of the measurement problem: individual prices typically change relative to one another even when inflation (the change in the general price level) is negligible. Since that time, the world economy has changed in a way that emphasises the importance of specific, rather than general, price changes. Notably, the recession following the Financial Crisis has been characterised by low inflation accompanied by some large changes in the prices of some goods and commodities, such as oil.

This book reflects this shift of emphasis from inflation to individual price changes, although it is based on the earlier one and, in particular, uses the same fundamental framework of accounting

X PREFACE

identities and numerical examples. The text has been re-written and re-ordered to emphasise specific rather than general price changes, and in particular, the detailed discussion of inflation is now deferred until Chapter 5. It also attempts to reflect the enormous amount of relevant research that has been published since the original book appeared. Much of this research is empirical, whereas the framework of this book is essentially theoretical, focusing on how accounting statements are, or might be, constructed rather than on what methods are actually adopted and how they are received by users of accounts. The style of the book may therefore seem to be a little old-fashioned. I make no apology for this, because theory and empirical studies must surely be essential companions rather than competitors: empirical studies cannot yield sensible answers if they are not based on theoretically sensible questions, and, of course, policy choices involve choosing between theoretical models on the basis of their empirical feasibility and consequences. My perception (despite having started academic life as an empirical researcher working on a large database of company accounts) is that the welcome expansion of empirical accounting research has started to crowd out theory to an unhealthy extent. As a result of this, there is a serious danger that knowledge gained in the past will be lost and will have to be rediscovered when it becomes relevant in the future. Therefore, if I can persuade a few accounting researchers to work through my simple, but fundamental, accounting identities and numerical examples, I will be more satisfied than if I had written a more popular survey of recent empirical work alone.

That is not to say that the book is aimed solely at accounting researchers. I have tried to make it readable and accessible, but the reader's task will be helped by having a basic knowledge of accounting, such as might be obtained from an introductory course. Beyond that, the stronger the readers' background in accounting and finance, the more they are likely to understand, but understanding is relative. Even as the author, I cannot claim to understand fully all of the apparently simple but often subtle problems posed by the

subject. That is why I am still attempting to explain it to myself, a third of a century after the original book was published.

It is a pleasure to acknowledge and thank all those who have helped me in the long process of writing this book. Apart from those acknowledged in the preface to the original book, I have benefitted from the support and comments of friends and colleagues too numerous to list here. However, special thanks should be accorded to Richard Barker and Geoff Meeks, professors at Oxford and Cambridge, respectively (and my PhD students long ago), each of whom gave very helpful comments on the penultimate draft. Also, thanks to Dr William Peterson of Christ's College, Cambridge, who made some astute comments on the treatment of index numbers in Chapter 5 and saved me from at least one foolish error. Needless to say, I retain sole responsibility for the remaining errors and deficiencies. Finally, since I left the International Accounting Standards Board in 2006, my work has been supported by the research facilities provided by the Cambridge Endowment for Research in Finance (CERF) at the Judge Business School, and I wish to thank its trustees for their support and its successive directors, Professors John Eatwell and Bart Lambrecht, for their unfailing encouragement.

It is a mark of the passage of time that I dedicated the original book to my children, Alan and Richard, who were then both under ten years old. The present book is dedicated to my grandchildren, who, by the time the book appears in print, will each be at least ten years old. If somebody in their generation reads the book, the effort of writing it will have been worthwhile.

Abbreviations

INSTITUTIONS

AARF	Australian Accounting Research Foundation
AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board (predecessor of the FASB in the US)
ASB	Accounting Standards Board (the UK standard-setting body since 1990)
ASC	Accounting Standards Committee (previously, until 1975, the ASSC; the professional standard-setting body in the UK until 1990)
ASR	Accounting Series Release (a statement on accounting published by the SEC)
ASSC	Accounting Standards Steering Committee (became the ASC in 1975)
CCAB	Consultative Committee on Accountancy Bodies (a committee of professional institutes which supervised the ASC in the UK)
ED	Exposure Draft (a draft accounting standard, issued for discussion)
FAS	Financial Accounting Standard (issued by the FASB)
FASB	Financial Accounting Standards Board (the private-sector standard-setting body in the US)
FRC	Financial Reporting Council (the UK body overseeing the Accounting Standards Board and, latterly, the Accounting Council)
IAS	International Accounting Standard (issued by the IASC)

xiv LIST OF ABBREVIATIONS

IASB	International Accounting Standards Board (replaced the IASC in 2001)
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IFRS	International Financial Reporting Standard (issued by the IASB)
IPSASB	International Public Sector Accounting Standards Board
PSSAP	Provisional Statement of Standard Accounting Practice (issued by the ASSC)
SEC	Securities and Exchange Commission (the US government agency responsible for supervising securities markets and financial information disclosure)
SSAP	Statement of Standard Accounting Practice (issued by the ASC)

TECHNICAL

ARR	accounting rate of return
CCA	current cost accounting
CoCoA	continuously contemporary accounting
CPI	Consumer Price Index (compiled by the UK Office of National Statistics)
CPP	constant (or current) purchasing power accounting
DV	deprival value (also known as VTB)
FV	fair value
GNP	gross national product
HC	historical cost
IRR	internal rate of return
MCRV	Making Corporate Reports Valuable (a proposal by ICAS)
MWCA	monetary working capital adjustment
NRV	net realisable value
PV	present value

Cambridge University Press
978-0-521-19097-8 — Value and Profit
Geoffrey Whittington
Frontmatter
[More Information](#)

LIST OF ABBREVIATIONS XV

RC	replacement cost
RPI	Retail Price Index (compiled by the UK Office of National Statistics)
VTB	value to the business (also known as DV)