Paper C02
Fundamentals of Financial Accounting

CIMA students may be pleased to know that management accounting has been around for a significantly longer time than financial accounting – as the following brief history of the profession shows. By Grahame Steven

Accounting has been with us since the advent of human economic activity, enabling people to operate in a barter economy (“I traded one cow for eight sheep”) and keep track of their possessions (“do I have the same number of animals as I did yesterday?”)

The introduction of monetary systems was a big milestone for accounting, as people started to express their wealth in units of currency. This increased the demand for accounting and led to the development of financial services such as banking, since these aided economic activity. The next key development – double-entry bookkeeping – occurred in the 15th century. It arose from the trade missions pursued by Marco Polo and his contemporaries between the Italian city states and China. Their expeditions were complex ventures, involving large sums of money, since:

- Many investors provided the finance.
- The expeditions lasted several years.
- Many people had to be employed.
- Many goods had to be purchased for each expedition to China.
- Goods from China were sold in Europe.
- A profit needed to be determined for each expedition and then, if there was one, be distributed among the investors.

Double-entry bookkeeping enabled more accurate financial records to be maintained and allowed investors to scrutinise the costs and revenues of the expeditions. It still provides the basis for today’s accounting systems, be they computerised or manual.

The first book on accounting was published in 1494. The Collected Knowledge of Arithmetic, Geometry, Proportions and Proportionality was written by an Italian monk named Luca Pacioli. His motto was “no person should go to bed until the debits equal the credits” – advice worth remembering.

The new steam-based technologies developed in the industrial revolution of the late 1700s led to mass production and distribution systems (factories and railways). Firms could grow by reinvesting profits or securing finance from third parties. But in the 18th century it was hard to bring money, most of which was held by the landed gentry, and entrepreneurs together owing to the lack of a legal framework for business. Perhaps the key question for potential investors at that time was: what would my financial position be if this venture were to fail – ie, could the firm’s creditors obtain redress from me for their losses? The concept of limited liability – whereby a shareholder’s liability is restricted to the sum they have invested – was developed to address this issue. Investors became more willing to fund ventures, since they knew the extent of the risk they were taking. This model has been adopted in most countries, as it has been successful in bringing capital and ideas together.

Stocks and scandals
Before the 19th century, businesses tended to have few shareholders and were largely owned by their managers. But, owing to the rise of limited companies and the growing number of individuals and institutions holding shares in such firms, ownership became increasingly divorced from management. Shareholders not involved with the running of a company became increasingly concerned about the quality of financial information they were receiving from its managers, since they relied on this to make their investment decisions. Then, as now, financial scandals also created pressure for change. The UK Joint Stock Companies Act 1844 was the first legislation requiring directors to provide an annual balance sheet to shareholders and give an auditor access to company records. The requirement for audits was repealed in 1856, since it was considered onerous, but the scandals kept coming.

By re-establishing compulsory audits and setting out standard reporting formats, the Companies Act 1900 eventually laid the foundations for modern financial accounting.

Two distinct wings of the discipline were emerging: financial accounting and management accounting. The main purpose of the former is to provide information – ie, the annual report – to a firm’s shareholders. This public document can be read by anyone – other users will include employees, potential investors, competitors, lenders, suppliers, customers, government agencies and researchers. Conversely, information produced by a company’s management accounting system is private, although a firm may occasionally publish some of its management accounting information when raising finance from a public share issue.

If a firm were required to provide comprehensive reports on an ad-hoc basis to its shareholders, instead of only once a year, it would have less time to get on with its main task of making a return for them. Management accounting information, on the other hand, is provided whenever it’s required: daily (eg, sales orders), weekly (eg, production-line data), monthly (eg, sales by customer) and quarterly (eg, internal accounts). There are no rules as to when it should be provided; this depends on the users’ needs, which will change over time as a business develops.

Financial accounting reports what has happened. Management accounting also reports the past, but it also provides information about the future for the purposes of forecasting, planning, budgeting, control and decision-making.

While annual reports may contain some segmental information – by country or product range, for example – they principally report information about the whole company. Management accounting must report on the parts – activities, departments, divisions, subsidiaries – in addition to the whole business, since such detailed information is required to monitor and manage an organisation.
The two wings of accounting compared

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Statute and generally accepted accounting practice (Gaap) largely determines what financial information should be included in an annual report, but a company may publish extra material. This is normally done if it’s in the firm’s interests to do this – eg, to reassure the markets about its prospects. When it comes to internal reporting, a company is free to decide what and how it reports.

Annual reports largely use financial data. While management accounting also makes significant use of information, there has been a growing awareness in recent years of the importance of non-financial information. In simple terms, financial figures report what has happened – ie, they are lagging indicators. But non-financial information can indicate what might happen – ie, it’s a leading indicator. One example of a non-financial leading indicator is the number of faulty goods returned by customers. If this keeps increasing, it’s clearly not a good sign for the firm’s future. The balanced scorecard, designed by Robert Kaplan and David Norton, uses financial and non-financial measures to provide a holistic view of a company. This is covered in detail by higher-level papers.

While annual reports are based on information obtained internally, management accounting reports will use external information where appropriate.

A company’s marketing manager, for instance, needs data on its rivals – eg, estimated sales by competitors to the firm’s current and potential customers. Most companies will benchmark their performance against that of their rivals to ascertain their strengths and weaknesses. While annual reports are an important source, they do not provide enough data for such an analysis on their own. Companies obtain such information from their trade associations, which collect large amounts of data from their members. The first entrepreneur to fully appreciate the significance of this type of information for competitor analysis was Andrew Carnegie, who built a steel empire in the US in the late 19th century.

Most accountants working for limited companies produce both financial and management accounting information. It is therefore important to appreciate the differences between the two types in order to ensure that what you provide is fit for its intended purpose. But always remember that management accounting pre-dates financial accounting – it is the senior service.

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