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Introduction to Accounting

This chapter introduces accounting and provides a short history of management accounting. It describes the early role of the management accountant and recent developments that have influenced the role of non-financial managers in relation to the use of financial information. The chapter concludes with a critical perspective on accounting history.

Accounting, accountability and the account

Businesses exist to provide goods or services to customers in exchange for a financial reward. Public-sector and not-for-profit organizations also provide services, although their funding comes not from customers but from government or charitable donations. While this book is primarily concerned with profit-oriented businesses, most of the principles are equally applicable to the public and not-for-profit sectors. Business is not about accounting. It is about markets, people and operations (the delivery of products or services), although accounting is implicated in all of these decisions because it is the financial representation of business activity.

The American Accounting Association defined accounting in 1966 as:

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

This is an important definition because:

- it recognizes that accounting is a process: that process is concerned with capturing business events, recording their financial effect, summarizing and reporting the result of those effects, and interpreting those results (we cover this in Chapter 3);
- it is concerned with economic information: while this is predominantly financial, it also allows for non-financial information (which is covered in Chapter 4);
- its purpose is to support 'informed judgements and decisions' by users: this emphasizes the decision usefulness of accounting information and the broad spectrum of 'users' of that information. While the primary concern of this book is the use of accounting information for decision-making, the book takes a

stakeholder perspective that users of accounting information include all those who may have an interest in the survival, profitability and growth of a business: shareholders, employees, customers, suppliers, financiers, government and society as a whole.

The notion of accounting for a narrow (shareholders and financiers) or a broad (societal) group of users is an important philosophical debate to which we will return throughout this book. This debate derives from questions of accountability: to whom is the business accountable and for what, and what is the role of accounting in that accountability?

Boland and Schultze (1996) defined accountability as:

> The capacity and willingness to give explanations for conduct, stating how one has discharged one's responsibilities, an explaining of conduct with a credible story of what happened, and a calculation and balancing of competing obligations, including moral ones. (p. 62)

Hoskin (1996) suggested that accountability is:

> more total and insistent ... [it] ranges more freely over space and time, focusing as much on future potential as past accomplishment. (p. 265)

Boland and Schultze argued that accountability entails both a narration of what transpired and a reckoning of money, both meanings deriving from the original meanings of the word *account*.

Accounting is a collection of systems and processes used to record, report and interpret business transactions. Accounting provides an **account** – *an explanation or report in financial terms* – about the transactions of an organization. It enables managers to satisfy the *stakeholders* in the organization (owners, government, financiers, suppliers, customers, employees etc.) that they have acted in the best interests of stakeholders rather than themselves. This is the notion of **accountability** to others, a result of the *stewardship* function of managers that takes place through the process of accounting. Stewardship is an important concept because in all but very small businesses, the owners of businesses are not the same as the managers. This separation of ownership from control makes accounting particularly influential due to the emphasis given to increasing shareholder wealth (or shareholder value). Accountability results in the production of financial statements, primarily for those interested parties who are external to the business. This function is called **financial accounting**.

Accounting is traditionally seen as fulfilling three functions:

- *Scorekeeping*: capturing, recording, summarizing and reporting financial performance.
- *Attention-directing*: drawing the attention of managers to, and assisting in the interpretation of, business performance, particularly in terms of the comparison between actual and planned performance.
- *Problem-solving*: identifying the best choice from a range of alternative actions.

In this book, we acknowledge the role of the scorekeeping function in Chapters 6 and 7, while emphasizing attention-directing and problem-solving as taking place through three inter-related functions, all part of the role of functional as well as financial managers:

- *Planning*: establishing goals and strategies to achieve those goals.
- *Decision-making*: using financial information to make decisions consistent with those goals and strategies.
- *Control*: using financial information to maintain performance as close as possible to plan, or using the information to modify the plan itself.

Planning, decision-making and control are particularly relevant as increasingly businesses have been decentralized into many business units, where much of the planning, decision-making and control is focused. Managers need financial and non-financial information to develop and implement strategy by planning for the future (budgeting); making decisions about products, services, prices and what costs to incur (decision-making using cost information); and ensuring that plans are put into action and are achieved (control). This function is called **management accounting**.

This book is primarily concerned with the planning, decision-making and control aspects, i.e. management accounting. However, it begins by setting the role of the manager and the use of accounting information in the context of financial accounting.

A short history of accounting

The history of accounting is intertwined with the development of trade between tribes and there are records of commercial transactions on stone tablets dating back to 3600 BC (Stone, 1969). The early accountants were 'scribes' who also practised law. Stone (1969) noted:

> In ancient Egypt in the pharaoh's central finance department . . . scribes prepared records of receipts and disbursements of silver, corn and other commodities. One recorded on papyrus the amount brought to the warehouse and another checked the emptying of the containers on the roof as it was poured into the storage building. Audit was performed by a third scribe who compared these two records. (p. 284)

However, accounting as we know it today began in the fourteenth century in the Italian city-states of Florence, Genoa and Venice as a result of the growth of maritime trade and banking institutions. The first bank with customer facilities opened in Venice in 1149. The Lombards were Italian merchants who were established as moneylenders in England at the end of the twelfth century.

Balance sheets were evident from around 1400 and the Medici family (who were Lombards) had accounting records of 'cloth manufactured and sold'. The first treatise on accounting (although it was contained within a book on mathematics) was the work of a monk, Luca Pacioli, in 1494. The first professional accounting body was formed in Venice in 1581.

Much of the language of accounting is derived from Latin roots. 'Debtor' comes from the Latin *debitum*, something that is owed; 'assets' from the Latin *ad* + *satis*, to enough, i.e. to pay obligations; 'liability' from *ligare*, to bind; 'capital' from *caput*, a head (of wealth). Even 'account' derives initially from the Latin *computare*, to count, while 'profit' comes from *profectus*, advance or progress. 'Sterling' and 'shilling' came from the Italian *sterlino* and *scellino*, while the pre-decimal currency abbreviation 'LSD' (pounds, shillings and pence) stood for *lire, soldi, denarii*.

Chandler (1990) traced the development of the modern industrial enterprise from its agricultural and commercial roots as a result of the Industrial Revolution in the last half of the nineteenth century. By 1870, the leading industrial nations – the United States, Great Britain and Germany – accounted for two-thirds of the world's industrial output. One of the consequences of growth was the separation of ownership from management. Although the corporation, as distinct from its owners, had been in existence in Britain since 1650, the separation of ownership and control was enabled by the first British Companies Act, which formalized the law in relation to 'joint stock companies' and introduced the limited liability of shareholders during the 1850s. The London Stock Exchange had been formed earlier in 1773 by stockbrokers, who had previously worked from coffee houses.

The second consequence of growth was the creation of new organizational forms. Based on his extensive historical analysis, Chandler (1962) found that in large firms structure followed strategy and strategic growth and diversification led to the creation of decentralized, multidivisional corporations like General Motors, where remotely located managers made decisions on behalf of absent owners and central head office functions. Ansoff (1988) emphasized that success in the first 30 years of the mass-production era went to firms that had the lowest prices. However, in the 1930s General Motors 'triggered a shift from production to a market focus' (p. 11).

In large firms such as General Motors, budgets were developed to co-ordinate diverse activities. In the first decades of the twentieth century, the DuPont company developed a model to measure the return on investment (ROI). ROI (see Chapters 7, 12 and 13) was used to make capital investment decisions and to evaluate the performance of business units, including the managerial responsibility to use capital efficiently.

The role of management accounting

The advent of mechanized production following the Industrial Revolution increased the size and complexity of production processes, which employed more people and required larger sums of capital to finance machinery. Accounting historians suggest that the increase in the number of limited companies that led to the separation of ownership from control caused the attention of cost accounting to shift from determining cost to exercising control by absent owners over their managers.

The predecessor of management accounting, 'cost accounting', was reflected in the earlier title of management accountants as cost or works accountants. Typically situated in factories, these accountants tended to know the business and advise non-financial managers in relation to operational decisions. Cost accounting was concerned with determining the cost of an object, whether a product, an activity, a division of the organization or market segment. The first book on cost accounting is believed to be Garcke and Fell's *Factory Accounts*, which was published in 1897.

Historians have argued that the new corporate structures that were developed in the twentieth century – multidivisional organizations, conglomerates and multinationals – placed increased demands on accounting. These demands included divisional performance evaluation and budgeting. It has also been suggested that developments in cost accounting were driven by government demands for cost information during both World Wars. It appears that 'management accounting' is a term used only after the Second World War.

In their acclaimed book *Relevance Lost*, Johnson and Kaplan (1987) traced the development of management accounting from its origins in the Industrial Revolution supporting process-type industries such as textile and steel conversion, transportation and distribution. These systems were concerned with evaluating the efficiency of internal processes, rather than measuring organizational profitability. Financial reports were produced using a separate transactions-based system that reported financial performance. Johnson and Kaplan (1987) argued that by 1925 'virtually all management accounting practices used today had been developed' (p. 12).

They also described how the early manufacturing firms attempted to improve performance via economies of scale by reducing unit cost through increasing the volume of output. This led to a concern with measuring the efficiency of the production process. Calculating the cost of different products was unnecessary because the product range was homogeneous.

Over time, the product range expanded and businesses sought economies of scope through producing two or more products in a single facility. This led to the need for better information about how the mix of products could improve total profits. However, after 1900 the production of accounting information was largely for external reporting to shareholders and not to assist managerial decision-making.

Johnson and Kaplan (1987) described how

> a management accounting system must provide timely and accurate information to facilitate efforts to control costs, to measure and improve productivity, and to devise improved production processes. The management accounting system must also report accurate product costs so that pricing decisions, introduction of new products, abandonment of obsolete products, and response to rival products can be made. (p. 4)

The Chartered Institute of Management Accountants' definition of the core activities of management accounting includes:

- participation in the planning process at both strategic and operational levels, involving the establishment of policies and the formulation of budgets;
- the initiation of and provision of guidance for management decisions, involving the generation, analysis, presentation and interpretation of relevant information;
- contributing to the monitoring and control of performance through the provision of reports including comparisons of actual with budgeted performance, and their analysis and interpretation.

One of the earliest writers on management accounting described 'different costs for different purposes' (Clark, 1923). This theme was developed by one of the earliest texts on management accounting (Vatter, 1950). Vatter distinguished the information needs of managers from those of external shareholders and emphasized that it was preferable to get less precise data to managers quickly than complete information too late to influence decision-making. Johnson and Kaplan (1987) commented that even today, organizations

> with access to far more computational power . . . rarely distinguish between information needed promptly for managerial control and information provided periodically for summary financial statements. (p. 161)

They argued that the developments in accounting theory in the first decades of the twentieth century came about by academics who

> emphasized simple decision-making models in highly simplified firms – those producing one or only a few products, usually in a one-stage production process. The academics developed their ideas by logic and deductive reasoning. They did not attempt to study the problems actually faced by managers of organizations producing hundreds or thousands of products in complex production processes. (p. 175)

They concluded:

> Not surprisingly, in this situation actual management accounting systems provided few benefits to organizations. In some instances, the information reported by existing management accounting systems not only inhibited good decision-making by managers, it might actually have encouraged bad decisions. (p. 177)

Johnson and Kaplan (1987) described how the global competition that has taken place since the 1980s has left management accounting behind in terms of its decision usefulness. Developments such as total quality management, just-in-time inventory, computer-integrated manufacturing, shorter product life cycles (see Chapter 9) and the decline of manufacturing and rise of service industries have led to the need for 'accurate knowledge of product costs, excellent cost control, and coherent performance measurement' (p. 220). And 'the challenge for today's competitive environment is to develop new and more flexible approaches to the design of effective cost accounting, management control, and performance measurement systems' (p. 224).

Recent developments in management accounting

Partly as a result of the stimulus of *Relevance Lost* but perhaps more so as a consequence of rapidly changing business conditions, management accounting has moved beyond its traditional concern with a narrow range of numbers to incorporate wider issues of performance measurement and management. Management accounting is now implicated, to greater or lesser degrees in different organizations, with:

- value-based management;
- non-financial performance measurement systems;
- quality management approaches;
- activity-based management; and
- strategic management accounting.

Value-based management is more fully described in Chapter 2, but is in brief a concern with improving the value of the business to its shareholders. Management accounting is implicated in this, as a fundamental role of non-financial managers is to make decisions that contribute to increasing the value of the business.

The limitations of accounting information, particularly as a lagging indicator of performance, have led to an increasing emphasis on non-financial performance measures, which are described more fully in Chapter 4. Non-financial measures are a major concern of both accountants and non-financial managers, as they tend to be leading indicators of the financial performance that will be reported at some future time.

Improving the quality of products and services is also a major concern, since advances in production technology and the need to improve performance by reducing waste have led to management tools such as total quality management (TQM), just-in-time (JIT), business process re-engineering (BPR) and continuous improvement processes such as Six Sigma and the Business Excellence model. Management accounting has a role to play in these techniques (introduced in Chapters 9 and 15) and non-financial managers need to understand the relationships between accounting and new management techniques.

Activity-based management is an approach that emphasizes the underlying business processes that are required to produce goods and services and the need to identify the drivers or causes of those activities in order to be able to budget for and control costs more effectively. Activity-based approaches are introduced throughout Part II.

Strategic management accounting, which is described more fully in Chapter 4, is an attempt to shift the perceptions of accountants and non-financial managers from an inward-looking to an outward-looking one, recognizing the need to look beyond the business along the value chain to its suppliers and customers and to seek ways of achieving and maintaining competitive advantage.

These changes to the narrow view of accountants, from 'bean-counters' to more active participants in formulating and implementing business strategy, have been accompanied by a shift in the collection, reporting and analysis of routine financial information from accountants to non-financial line managers. This decentring of accounting is evidenced by the delegation of responsibility for budgets and cost control to line managers and is the underlying reason that non-financial managers need a better understanding of accounting information and how that information can be used in decision-making.

A critical perspective

Although the concepts and assumptions underlying accounting are yet to be introduced, having begun this book with an introduction to accounting history it is worthwhile considering a contrasting viewpoint. While this viewpoint is one that may not be accepted by many practising managers, it is worth knowing, because it does lie at the very basis of the capitalist economic system in which we live, and in which accounting plays such an important role.

The Marxist historian Hobsbawm (1962) argued that colonialism had been created by the cotton industry that dominated the UK economy, and this resulted in a shift from domestic production to factory production. Sales increased but profits shrank, so labour (which was three times the cost of materials) was replaced by mechanization during the Industrial Revolution.

Entrepreneurs started with borrowings and small items of machinery and growth was largely financed by borrowings. The Industrial Revolution produced 'such vast quantities and at such rapidly diminishing cost, as to be no longer dependent on existing demand, but to create its own market' (Hobsbawm, 1962: 32).

Advances in mass production followed the development of the assembly line, supported by railways and shipping to transport goods, and communications through the electric telegraph. At the same time, agriculture diminished in importance. Due to the appetite of the railways for iron and steel, coal, heavy machinery, labour and capital investment, 'the comfortable and rich classes accumulated income so fast and in such vast quantities as to exceed all available possibilities of spending and investment' (Hobsbawm, 1962, p. 45).

While the rich accumulated profits, labour was exploited with wages at subsistence levels. Labour had to learn how to work, unlike agriculture or craft industries, in a manner suited to industry, and the result was a draconian master/servant relationship. In the 1840s a depression led to unemployment and high food prices and 1848 saw the rise of the labouring poor in European cities, who threatened both the weak and obsolete regimes and the rich.

This resulted in a clash between the political (French) and industrial (British) revolutions, the 'triumph of bourgeois-liberal capitalism' and the domination of the globe by a few western regimes, especially the British in the mid-nineteenth century, which became a 'world hegemony' (Hobsbawm, 1962).

This 'global triumph' of capitalism in the 1850s (Hobsbawm, 1975) was a consequence of the combination of cheap capital and rising prices. Stability and prosperity overtook political questions about the legitimacy of existing dynasties and technology cheapened manufactured products. There was high demand but the cost of living did not fall, so labour became dominated by the interests of the new owners of the means of production. 'Economic liberalism' became the recipe for economic growth as the market ruled labour and helped national economic expansion. Industrialization made wealth and industrial capacity decisive in international power, especially in the US, Japan and Germany.

This 'British' capitalist system was exported throughout the world, not least with the support of a colonial expansionist Empire that lent large sums of money in return for adopting the British system. This system has since been taken over by multinational corporations, largely based in the United States.

Armstrong (1987) traced the historical factors behind the comparative (in relation to other professions) pre-eminence of accountants in British management hierarchies and the emphasis on financial control. He concluded that accounting controls were installed by accountants as a result of their power base in global capital markets, which was achieved through their role in the allocation of the profit surplus to shareholders. Armstrong argued that mergers led to control problems that were tackled by

> American management consultants who tended to recommend the multi-divisional form of organization . . . [which] entirely divorce headquarters management from operations. Functional departments and their managers are subjected to a battery of financial indicators and budgetary controls . . . [and] a subordination of operational to financial decision-making and a major influx of accountants into senior management positions. (p. 433)

Roberts (1996) suggested that organizational accounting embodies the separation of instrumental and moral consequences, which is questionable. He argued:

> The mystification of accounting information helps to fix, elevate and then impose upon others its own particular instrumental interests, without regard to the wider social and environmental consequences of the pursuit of such interests. Accounting thus serves as a vehicle whereby others are called to account, while the interests it embodies escape such accountability. (p. 59)

This is a more critical perspective than that associated with the traditional notion of accounting as a report to shareholders and managers, which is a result of the historical development of capitalism in the West.

Conclusion

While this book is designed to help non-financial managers understand the tools and techniques of accounting, it is also intended to make readers think critically about the role of accounting and the limitations of accounting, some of which have been historically defined. One intention is to reinforce to readers that:

accounting information provides a window through which the real activities of the organization may be monitored, but it should be noted also that other windows are used that do not rely upon accounting information. (Otley and Berry, 1994, p. 46)

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