

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 managership. 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

	Financial accounts	Management accounts
Target user	Shareholders	Managers
Availability	Universal	Restricted
Frequency	Annual	Whenever required
Time covered	Past	Past and future
Viewpoint	Whole company	Whole and parts
Content and format	Defined by statute/Gaap	Defined by the user
Information type	Financial	Financial and non-financial
Data source(s)	Internal (company)	Internal and external

Statute and generally accepted accounting practice (Gaap) largely determine 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 such 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 predates financial accounting – it is the senior service.

Grahame Steven is a lecturer and teaching fellow in accounting at Edinburgh Napier University.

GLOBAL CONTACT DETAILS

CIMA corporate centre

26 Chapter Street,
London SW1P 4NP
T: +44 (0)20 8849 2251
E: cima.contact@
cimaglobal.com
www.cimaglobal.com

CIMA Australia

5 Hunter Street, Sydney,
NSW 2000
T: +61 (0)2 9376 9902
E: sydney@cimaglobal.com

CIMA Bangladesh

Suite 309, RM Center,
(3rd Floor), 101 Gulshan
Avenue, Dhaka-1212
T: +8802 881 5724
E: zareef.matin@
cimaglobal.com

CIMA Botswana

Plot 50374, Block 3, 1st Floor,
Southern Wing, Fairgrounds
Financial Centre, Gaborone
T: +267 395 2362
E: gaborone@cimaglobal.com

CIMA China: head office

Unit 1508A, 15th Floor, Azia
Center, 1233 Lujiazui Ring
Road, Pudong, Shanghai
200120
T: +86 (0)21 6160 1558
E: infochina@cimaglobal.com

CIMA China: Beijing

Room 605, 6/F Guangming
Hotel, 42 Liangmaqiao Road,
Chaoyang District, Beijing
100004
T: +86 (0)10 8441 8811
E: beijing@cimaglobal.com

CIMA China: Chongqing

Room 2107, Tower 4,
Chongqing Tiandi, No 56,
Ruitian Road, Hua Long Qiao,
Yuzhong District,
Chongqing 400010
T: +86 (0)23 6371 3538
E: infochina@cimaglobal.com

CIMA China: Shenzhen

Room 1121, Tower A,
International Chamber of
Commerce, Fuhua Yi Lu,
Futian District,
Shenzhen 518048
T: +86 (0)755 8923 1445
E: shenzhen@cimaglobal.com

CIMA Ghana

3rd Floor, Ayele Building,
IPS/Attraco Road,
Madina, Accra
T: +233 (0)30 2543283
E: accra@cimaglobal.com

CIMA Hong Kong

Suite 2005, 20th Floor,
Tower One, Times Square,

1 Matheson Street,
Causeway Bay, Hong Kong
T: +852 (0)2511 2003
E: hongkong@cimaglobal.com

CIMA India

Unit 1-A-1, 3rd Floor, Vibgyor
Towers, C-62, G Block, Bandra
Kurla Complex, Bandra (East),
Mumbai 400051
T: +91 (0) 22 4237 0100
E: india@cimaglobal.com

CIMA Ireland

5th Floor, Block E, Iveagh
Court, Harcourt Road, Dublin 2
T: +353 (0)1 643 0400
E: cima.ireland@
cimaglobal.com

CIMA Malaysia: head office

CIMA Malaysia, Lot 1.05,
Level 1, KPMG Tower,
8 First Avenue, Bandar Utama,
47800 Petaling Jaya,
Selangor Darul Ehsan
T: +60 (0)3 77230230/232
E: seasia@cimaglobal.com

CIMA Malaysia: Penang

Suite 12-04A, 12th Floor,
Menara Boustead Penang,
39 Jalan Sultan Ahmad Shah,
10050 Penang
T: +60 (0)4 226 7488/8488
E: penang@cimaglobal.com

CIMA Middle East

804, 8th floor, Liberty
House, DIFC, Dubai,

United Arab Emirates

T: +9714 4347370
E: middleeast@cimaglobal.com

CIMA Nigeria

Landmark Virtual Office,
5th Floor, Mulliner Towers,
39 Alfred Rewane Road,
Ikoyi, Lagos
T: +234 1 463 8353 (ext 518)
E: lagos@cimaglobal.com

CIMA Pakistan

201, 2nd Floor, Business
Arcade, Plot 27-A, Block 6,
PECHS, Shakra-e-faisal,
Karachi
T: +92 21 3432 2387/89
E: pakistan@cimaglobal.com

CIMA Pakistan: Islamabad

1st Floor, Rehman Chambers,
Fazal-e-Haq Road, Blue Area,
Islamabad
T: +92 51 260 5701-6

CIMA Pakistan: Lahore

Flat 1, 2, 1st Floor,
Front Block 3, Awami Complex
at I-4 Usman Block,
New Garden Town, Lahore
T: +92 42 3594 0311-16

CIMA Poland

Warsaw Financial Centre,
11th Floor, ul Emilii Plater 53,
00-113 Warsaw
T: +48 22 528 6651
E: poland@cimaglobal.com

CIMA Russia

E: cis@cimaglobal.com

CIMA Singapore

3 Phillip Street, Level 19,
Royal Group Building,
Singapore 048693
T: +65 68248252

E: singapore@cimaglobal.com

CIMA South Africa

1st Floor, 198 Oxford Road,
Illovo 2196

T: +27 11 788 8723

E: johannesburg@
cimaglobal.com

CIMA Sri Lanka

356 Elvitigala, Mawatha,
Colombo 5

T: +94 (0)11 250 3880

E: colombo@cimaglobal.com

CIMA Sri Lanka: Kandy

229 Peradeniya Road, Kandy

T: +94 (0)81 222 7883

E: kandy@cimaglobal.com

CIMA UK

26 Chapter Street,
London SW1P 4NP
T: +44 (0)20 8849 2251

E: cima.contact@
cimaglobal.com

CIMA Zambia

6053 Sibweni Road,
Northmead, Lusaka

T: +260 (211) 290219

E: lusaka@cimaglobal.com