

Evolution of financial accounting assignment



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Evolution of Financial Accounting Introduction Accountancy is the art of communicating financial information of a business entity to its stakeholders. It is the branch of mathematical science that assists in discovering the causes of success and failure in a business. The American Institute of Certified Public Accountants (AICPA) defines accountancy as “ The art of recording, classifying, and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character, and interpreting the results thereof. Earliest accounting records, which date back more than 7000 years, were found in ancient Mesopotamia. The people of that time relied on primitive accounting methods to record the growth of crops and herds. Accounting evolved, improving over the years and advancing as business advanced. Double-entry bookkeeping first emerged in Italy in the 14th century. Later with the development of joint stock companies wider audiences were created for accounting information, as investors relied on accounts to provide information on the profitability of their investments.

This development resulted in a split of accounting systems for internal – management accounting and external – financial accounting purposes. Some argue that accounting developed purely in response to the needs of the time, brought about by the changes in the environment and societal demands. Others claim that the development of the science of accounting has itself driven the evolution of commerce, since it was only through the use of more precise accounting methods that modern business was able to grow, flourish and respond to the needs of its owners and the public.

Either way the history of accounting throws a light on economic and business history and may help us better predict what is on the horizon as the pace of global business evolution escalates. Accounting in Ancient Mesopotamia, circa 3500 B. C Five thousand years before the appearance of double entry, the Assyrian, Babylonian and Sumerian civilizations were flourishing in the Mesopotamian Valley, producing some of the oldest known records of commerce. The people at that time relied on primitive accounting methods to record the growth of crops and herds.

This made it easier to count and determine whether a surplus had been gained following the natural season of farming and herding. The Mesopotamian equivalent of today's accountant was the scribe. His duties were similar, but even more extensive. In addition to writing up the transaction, he ensured that the agreements complied with the detailed code requirements for scribes, and it was considered a prestigious profession. Accounting records were made on clay. As clay was plentiful in this region.

These clay tokens found amongst the ruins of ancient Mesopotamian civilization are the earliest accounting records found, which date back more than 7000 years. 2 Accounting in Other Ancient Civilizations Egypt

Accounting in ancient Egypt linked to a network of Royal Storehouses in which the tax payments were kept. Book keepers associated with each of the storehouses maintained records, which were verified by the royal audits. Any irregularities in records were punishable by fine, mutilation and death. The use of papyrus rather than clay tablets allowed more detailed records to be kept easily.

However the Egyptian Accounting did not progress beyond simple list-making in its thousands of years of existence. Greece The introduction of coined money in Greece around 600 BC was an important contribution for the evolution of accounting practices. In the 5th century BC Greece used “ public accountants” to allow its citizenry to maintain authority and control over the government finances. Members of the Athens Popular Assembly legislated on financial matters and controlled receipt and expenditure of public money through the oversight of 10 state accountants, chosen by lot. Rome Roman citizens were required to submit regular statements of assets and liabilities, used as a basis for taxation and even determination of civil rights. For this purpose records of household transactions were maintained by the heads of the families. The daily entry of household receipts and payments were kept in an Adversaria, this was similar to a modern daybook. From where the monthly postings were made to Codex Accepti et Expensi, which was similar to a cash book. It consisted of a series of double pages, Debit (Acceptum) and Credit (Expensum).

All receipts were recorded on debit side and expenses on credit. Only cash transactions were recorded. Among Roman accounting innovations was the use of an annual budget, which attempted to coordinate expenditures and revenues for the empire. Medieval Accounting With the development of the feudal system, the task of accounting in medieval era was to allow the government and the property owners to monitor those in the lower portions of the socio-economic pyramid. When William the Conqueror invaded England, he took possession of all property in the name of the king.

In 1086, he conducted a survey of all real estate and the taxes due on them, known as the Domesday Book. The oldest surviving accounting record in the English language is the Pipe Roll, or Great Roll of the Exchequer, which provides an annual description of rents, fines and axes due the King of England, from 1130 AD to 1833 AD. Compiled from valuations in the the Pipe Roll was the final record on parchment of a proffer system which extensively used wooden tally sticks as a basis of account-keeping.

Figure 1 – Pipe roll page from the 1194 roll 5 Twice a year, at Easter and Michaelmas, the various county sheriffs were called before the Exchequer (Tax collection authority) at Westminster. At Easter, a sheriff would pay about half of the total annual assessments his county owed. In accepting a sheriffs payment the treasurer would have a wooden tally stick prepared and cut as record of the transaction. Used even before the introduction of the Pipe Roll, the tally stick was a nine-inch long, narrow, Hazelwood stick, cut with notches of varying size to indicate the amount received.

A cut the size of a human hand – 1, 000 pounds
A cut the size of a thumb's width – 100 pounds
A cut the thickness of a grain or ripe barley – 1 pound
A notch – 1 shilling
After the amount of the sheriffs proffer had been carved, a diagonal cross cut was made an inch or two from the thicker end of the tally, and the whole stick was split down the middle into two identically notched parts of unequal length – the foil and the stock.

The flat sides of both pieces were inscribed in Latin to show that they related to the same debt, and as additional protection, the cross cuts were made at various angles on different tallies, so that no foil or shorter piece could

possibly be fitted to any stock but its own. The sheriff then departed with the stock as his receipt for payments rendered, and the foil was kept by the treasurer. At Michaelmas, each sheriff returns for the final accounting, at which he pays the whole year's revenue. The treasurer reads the amount due from the Pipe Roll. The sheriffs tally stock with the Exchequer's foil to demonstrate that the notches and cuttings correspond.

Figure 2 – Ancient wooden tally sticks

6 Italian Renaissance: Birth of Double Entry Bookkeeping

The Italian Renaissance was the earliest manifestation of the general European Renaissance, a period of great cultural change and achievement that began in Italy around the end of the 13th century and lasted until the 16th century, marking the transition between Medieval and Early Modern Europe. The innovative Italians of the Renaissance are widely acknowledged to be the fathers of modern accounting.

In attempting to explain why double entry bookkeeping developed in 14th century Italy instead of ancient Greece or Rome, seven key ingredients can be identified.

- Private property** The private ownership of property and the power to change the ownership was important in the development of bookkeeping as bookkeeping is concerned recording the facts about property and property rights.
- Capital Wealth** was productively employed. This led trade and commerce to new levels, and better means of profit.
- Commerce** Trade was developed on a widespread level creating the need to the development of an organized system to replace the existing methods of record-keeping.
- Credit** The necessity of a new mechanism to maintain records of credit transactions.
- Renaissance** resulted in improving literacy and developing a common language for the records to be kept.
- Money Use**

of money resulted in developing a common exchange intermediary. Hence transactions were limited to a set of monetary values, making record keeping easier.) Arithmetic Although Arabic numerals were introduced long before, it was during this period that the Italians became the first to use them regularly in tracking business transactions – an improvement over Roman numerals. Many of these factors did exist in ancient times. But they were not found together in a form and strength necessary to push man to the innovation of a systematic accounting mechanism. Under the renaissance the trade and commerce prospered, the use of capital and credit was developed on a larger scale resulting in better means of profit.

Extensive business records were kept, Trending towards the evolutionary double entry bookkeeping. 8 Luca Pacioli and the Double Entry System Double-entry bookkeeping system was developed taking into consideration the dual nature of a transaction, where each transaction was recorded by both a Debit and a Credit entry. As opposed to the Single Entry system where only one entry was made for a transaction, either Credit or Debit based on the cash flow. The earliest evidence of double-entry bookkeeping is the Farolfi ledger of 1299-1300. Giovanni Farolfi & Company was a firm of Florentine merchants who also acted as moneylenders.

The oldest discovered record of a complete double-entry system is the Messari (Italian: Treasurer) accounts of the city of Genoa in 1340. The Messari accounts contain debits and credits Journalized in a bilateral form, and contains balances carried forward from the preceding year, and therefore can be recognized s a double-entry system. Luca Pacioli's " Summa de Arithmetica, Geometria, Proportioni et Proportionalit?????" (Review of <https://assignbuster.com/evolution-of-financial-accounting-assignment/>

Arithmetic, Geometry, Ratio and Proportion) published in 1494 was a digest and a guide to existing mathematical knowledge – Bookkeeping was one of five topics covered.

The Summa's 36 short chapters on bookkeeping and Scripturis (Details of Calculation and Recording). Although Luca Pacioli did not invent double-entry bookkeeping, his 27-page treatise on bookkeeping contained the first known published work on the topic, and is said to have laid the foundation for double-entry bookkeeping as it is practiced today. Figure 3 – Luca Pacioli (1445-1517) 9 Pacioli's System of Accounting: The Method of Venice De Computis begins with some basic instructions for trade.

Pacioli declares that the successful merchant needs three things; sufficient cash or credit, good bookkeepers and an accounting system which allows him to view his finances at a glance. Before commencing business one should prepare an inventory listing all business and personal assets and debts. This inventory must be completed within one day, and property should be appraised at current market values and arranged according to mobility and value, with cash and other valuables listed first since they are most easily lost.

The Memoriale (Memorandum), was Pacioli's equivalent of a daybook for the recording of business transactions as they occurred. The transaction could be entered in any of the various monetary units in use in the Italian city-states of the time, with conversion to a common currency for double entry left for later. The Giornale (Journal) was the merchant's private account book. Entries consisted of a narrative debit-credit and explanation in one

continuous paragraph. The Journal had only one column, which was not totaled. There were no compound entries.

Pacioli's *Quaderno* (Ledger) was, of his three books the most like its modern equivalent. The money and date columns were almost identical to those in modern ledgers, with entries consisting of brief paragraphs, debits on the left side of a double page (*deve dare*) and credits on the right (*deve avere*). The bookkeeper posts "cash in hand" as a debit on page one of the ledger, just as it was entered first in the Journal. As ledger postings are made, two diagonal lines are drawn through each Journal entry, one from left to right when the debit is posted and the other from right to left when the credit is posted. The first 16 chapters describe this basic system of books and accounts, while the remaining 20 are devoted to specialized accounting issues of merchants. These include bank deposits and withdrawals, brokered purchases, drafts, barter transactions, joint venture trading, expense disbursements and closing and The *Summa Summarium* (Trial Balance) is the end of Pacioli's accounting cycle. Debit amounts from the ledger are listed on the left side of the balance sheet and credits on the right. If the two totals are equal, the ledger is considered balanced.

If not, says Pacioli, "That would indicate a mistake in your Ledger, which mistake you will have to look for diligently with the industry and intelligence god gave you." Figure 4 – *Summa de Arithmetica, Geometria*, Figure 5 – *De Computis et Scripturis* (27 page *Proportioni et Proportionalit????* (1523) treatise on bookkeeping titled under the *Summa*) First edition 1494 11

Beyond *Summa* In the first century after its publication, the *Summa* was translated into five languages, and numerous other books on double entry

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bookkeeping appeared in Dutch, German, English and Italian whose descriptions were mainly lifted from De

Computis. This helped the widespread of the Method of Venice throughout Europe. Perhaps most surprising is how little bookkeeping methods have changed since Pacioli. Both the sequence of events in the accounting cycle and the special procedures he described in De Computis are familiar to modern accountants. In fact, the primary differences between current bookkeeping practices and the Method of Venice are additions and revisions brought about by the needs of a larger scale of business operation.

The small proprietorships of 15th century Italy had no need for specialized Journals, subsidiary ledgers, controlling accounts, formal audit systems, cost accounting or budgeting. But numerous tiny details of bookkeeping techniques set forth by Pacioli were followed in the profession for at least the next four centuries. 12 Birth of Financial Statements Pacioli's accounting cycle ended with the Trial Balance. Prepared mainly to discover the errors in preparation of the ledger.

These accounting records never served the modern accounting purpose of providing information to all interested parties. They the development of the Joint Stock Companies the need to communicate the accounting records to a wider community came into being. Joint Stock Companies are the early interpretation of the modern day corporations. Company was owned by many shareholders where each shareholder owned a portion of the company in proportion to his or her ownership of the company's shares.

However up to the 1800s, investing had been either a game of knowledge or one of luck. People acquired stock in companies with which they were familiar, either by knowing the industry or knowing the owners, or they blindly invested where their relatives and friends encouraged them to. There were no sources of information available to determine the profitability of investing in a corporation or business that investors knew nothing about. Hence the higher risk involved in investing made it an activity for the wealthy – a rich man’s sport with the taint of gambling.

Eager to attract more capital to expand their operations, Corporations began to publish their financials in the form of balance sheets, income statements and cash flow statements to communicate the performance of the company to the investors in order to encourage their investments. 13 Development of Cost Accounting and Auditing Cost accounting originated during the Industrial Revolution. The complexities of running a large scale business led to the development of systems for recording and tracking costs to help business owners and managers to make decisions on how best to make their businesses as cost efficient as possible.

Josiah Wedgwood, the owner of the famous English pottery factory, was among the first to use cost accounting to understand what his company’s money was being spent on and to eliminate unnecessary spending. While financial accounting served the purpose of providing information to the outside parties, Cost accounting provided the necessary information to the internal management for their decision making. Cost accounting, in later years led to the rise of Management Accounting. However the increase in the

flow of investments raised the pressure on the management to please the shareholders.

The shareholders were unable to completely trust the management. Hence the need for independent financial review of a company's operations became apparent. 14 Emergence of Corporate Disclosure Requirements During 1841 a committee was appointed in Great Britain to inquire the state of the laws regarding Joint Stock Companies with a view of enhancing security of the recommendations; " The periodical holding of meetings, the periodical balancing, audit and publication of accounts, (would make) the Directors and officers more immediately responsible to the shareholders. " Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud and illegality. " " It is expedient that the accounts of every such Company be open to the inspection of the shareholders: and that the annual balance-sheet, together with the reports of the auditors thereon, be registered. This report marked the beginning of the attempts to enforce proper disclosure of the corporate affairs – the birth of the modern accountancy. The 1844 Report was followed by the first general Companies Act, The Joint Stock Companies Act 1844 which provided for the preparation and delivery of " full and fair" audited balance sheets and the auditor's reports to all shareholders. In United States, the progress on corporate disclosure followed the standards set in England. However even as late as 1920s many irregularities could be found in disclosure practices.

It was after the Great Depression of 1929 that substantial changes were brought in, Supported by President Franklin Roosevelt's policy, which championed full disclosure as the preferable remedy to the malaise of American financial markets at the time. 15 Establishment of Accounting Standards Even as late as 1932, the New York Stock Exchange expressed concern about the wide variety of accounting and reporting methods used by companies. A committee of the American Institute of Accountants under the chairmanship of George May was appointed to formulate improved accounting standards which could then be enforced through listing requirements.

The committee's final report contained five recommendations: 1 . To promote consistency, corporations were asked to adhere to certain broad accounting principles, within this framework, each firm could adopt the accounting methods it preferred. 2. Each listed company would prepare a summary of accounting methods used in its statements. This summary would be formally approved by the firm's board of directors, would be filed with the exchange, and would be available on request to any stockholder. The procedures listed in this summary would be consistently followed from year to year and would not be changed without prior notice to the Stock Exchange and to the company's investors. 4. Financial statements were to be the representations of management. The auditor's task was to inform stockholders whether the methods adopted by each company were actually being used, whether they were compatible with " generally accepted" principles of accounting, and whether they were being applied consistently. 5. The officials draw up an authoritative list of accounting principles to help corporations in preparing their own lists of procedures. 6 In 1938 the Haskins

and Sells Foundation commissioned three educators, T H Sanders (Harvard), H R Hatfield (Berkeley) and Underhill Moore (Yale Law School) to formulate a code of accounting principles which would be useful in the clarification and improvement of corporate accounting and of financial reports issued to the public. In preparing “ A Statement of Accounting Principles” they interviewed both makers and users of accounting data, reviewed the periodical literature, and studied laws, court decisions, and current corporate reports.

A seminal document in the evolution of the universalization of accounting principles was Paton and Littleton’s “ An Introduction to Corporate Accounting Standards” (1940), the most coherent statement of principles to emerge from this period. This document set the tone for much of the subsequent evolution of corporate financial disclosure practices in the decades to follow. The last fifty years have seen greater flesh being added to this skeleton of financial reporting that evolved in the mid 1930s and 40s – through introduction of Generally Accepted Accounting Principles (GAAP) and The International Financial Reporting

Standards (IFRS) 17 International Accounting Standards & International Financial Reporting Standards The history of international accounting standards begins in 1966, with the proposal to establish an International Study Group comprising the Institute of Chartered Accountants of England & Wales (ICAEW), American Institute of Certified Public Accountants (AICPA) and Canadian Institute of Chartered Accountants (CICA). In February 1967 this resulted in the foundation of the Accountants International Study Group (AISG), which began to publish papers on important topics every few months and created an appetite for change.

Many of these papers led the way for the standards that followed, when in March 1973 it was finally agreed to establish an international body writing accounting standards for international use. In June 1973 the International Accounting Standards Committee (IASC) came into existence. Between 1973 and 2000 the International Accounting Standards Committee (IASC) released a series of standards called International Accounting Standards ('AS) in a numerical sequence that began with IAS 1 and ended with IAS 41 Agriculture which was published in December 2000. The IASC restructured their organisation at the end of the twentieth century, which