WHY ACCOUNTING? QUESTIONS AND THE EVOLUTION OF ACCOUNTING CONCEPTS…

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Once upon a time, long, long ago, accounting began to reduce events to numbers to capture and bring meaning to data and it was good. Concepts were agreed upon and accounting techniques evolved to analyze and resolve business issues. This article is about why concepts came first and are foundational to understanding accounting, especially managerial accounting.

A key question for business has always been, "How much does it cost?" To answer that question managers and businesspersons throughout history had to agree about what "it" is, what its costs are, and how to classify these costs in meaningful ways for decision making. In other words, the underlying accounting concepts of cost measurement, cost recognition, and cost classification. Without these concepts, businesses could not communicate internally or externally nor make informed decisions.

"It" traditionally has been defined as a product or service. In earlier times, product or service costs included only traceable costs, meaning a causal relationship existed between the cost and the production of the product or service. Direct material and direct labor are examples of traceable costs. Over time in pursuit of answering what is the full cost of a product or service, managers added in costs that were only indirectly linked to the product or service. Examples include overhead costs, infrastructure costs, and other indirect costs that support the production of the product or service. By considering both the direct and indirect costs, managers utilized the concept of relevance to make their decisions more predictive and pertinent.

More recently, managers have defined "it" as activities the business engages in. By measuring which activities add value and which do not, managers are able to focus their efforts on those tasks, customers, and product or service activities that yield the greatest return to their business. By classifying costs by activities, manager increase the likelihood of another underlying concept, reliability that cost data is complete, neutral, and free from error.

During the industrial revolution, managers discovered that if they could also classify product or service costs by behavior: fixed, variable, mixed, these classifications allowed managers to better manage their business. As Josiah Wedgewood noted in 1772, "you will see the vast consequence in most manufactures of making the greatest quantity possible in a given time." Thus, by understanding cost behavior, managers were able to make better decisions. Over time this understanding has led to the development of cost-volume-profit analysis as a management planning tool.

Another key question for business has always been, "How can a business maximize profit?" Profit maximization is the logical result of another fundamental accounting concept, cost-benefit. Cost-benefit holds that the benefits to be gained should be greater than its costs. A business' income statement compares a business' revenues (or the benefit of being in business) with its expenses (or the costs of being in business) for the period of time. This matching of revenues and expenses results in a net income or net loss for the period and provides managers with a performance measurement. The cost-benefit concept is also used for short-run and capital investment decisions. Short-run decisions about products and services such as make or buy, sell or process further, special orders, product mix, or keep or drop them applies incremental analysis to compare alternatives by focusing on the differences in their projected revenues and costs. Capital investment analysis, sometimes called capital budgeting, uses present value comparisons of benefits and costs between alternative investment options.

Finally, another key question asked by all businesses is, "How should business and management performance be evaluated?" From an external financial standpoint an income statement is the traditional measurement. The income statement as an evaluation tool can be enhanced by adding budget comparisons. A budget identifies, summarizes, and communicates information about a business' future activities. A budget authorizes managers to act to achieve organizational goals. In earlier times a comparison of the budget with actual performance data answered the question. More recently the budget prepared at the beginning of the year has been modified at yearend to improve comparability, relevance, and reliability. The budget is recast at year end into a flexible budget, one that is based on actual output levels. Performance evaluation improves as managers and their organizations actual results can be compared with their budgeted plan of action based on the same activity level instead of beginning of the year output aspirations. Additional performance evaluation is possible by finding and analyzing individual cost variances from the flexible budget. Examples include standard costing's direct material, direct labor, variable overhead, and fixed overhead variances.

In summary, to answer questions about business activities throughout history, managers and businesspersons have had to agree about the meaning of basic accounting concepts before useful accounting techniques could be developed for analysis and decision making. Over time the underlying accounting concepts of cost measurement, cost recognition, cost classification, relevance, reliability, cost-benefit, understandability, and comparability have guided the evolution of meaningful managerial tools so managers could communicate both internally and externally about business. Without these guiding concepts, businesses could not have developed techniques like product costing, cost-volume-profit analysis, budgets, flexible budgets, standard costing, capital budgeting, and short-run decision models to plan, perform, evaluate and communicate about business.