Financial History: The Evolution Of Accounting

By Andrew Beattie

Accounting is the language of business and, by extension, the language of all things financial. In the same way that our senses are needed to translate information about our surroundings into something understood by our brains, accountants are needed to translate the complexities of finance into summary numbers that the public can understand. In this article, we will follow accounting from its roots in ancient times to the modern profession that we now depend on.

The Bookkeepers

Bookkeepers most likely emerged while society was still in the barter and trade system (pre-2000 B.C.) rather than a cash and commerce economy. Ledgers from these times read like narratives with dates and descriptions of trades made or terms for services rendered.

Example - Barter and Trade Bookkeeping

- Monday, May 12 - In exchange for three chickens which I provided today, William Smallwood (laborer) promised a satchel of seed when the harvest is completed in the fall.
- Wednesday, May 14 - Samuel Thomson (craftsman) agreed to make one chest of drawers in exchange for a year\'s worth of eggs. The eggs are to be delivered daily once the chest is finished.

All of these transactions were kept in individual ledgers, and if a dispute arose, they provided proof when matters were brought before magistrates. Although tiresome, this system of detailing every agreement was ideal because long periods of time could pass before transactions were completed.

The New and Improved Ledger - Now With Numbers!

As currencies became available and tradesmen and merchants began to build material wealth, bookkeeping also evolved. Then, as now, business sense and ability with numbers were not always found in one person, so math-phobic merchants would employ bookkeepers to keep a record of what they owed and who owed them. Up until the late 1400s, this information was still arranged in a narrative style with all the numbers in a

single column whether an amount paid, owed or otherwise. This is called single-entry bookkeeping and is similar to what many of us do to keep track of our checkbooks.

Example - Single-Entry Bookkeeping

Date	Item Details	Amount
Monday, May 12	Bought one sack of seeds	-$48.00
Monday, May 12	Sold three chickens	+$48.00
Wednesday, May 14	Bought a chest of drawers	-$900.00
Wednesday, May 14	Sold one year\'s worth of eggs	+$900.00

It was necessary for the bookkeeper to read the description of each entry to decide whether to deduct or add it when calculating something as simple as monthly profit or loss. This was a very time consuming and inefficient way to go about tallying things.

The Mathematical Monk

Continuing in the tradition of monks doing high-level scientific and philosophical research, in the 15th century, Italian monk Luca Pacioli revamped the common bookkeeping structure and laid the groundwork for modern accounting. Pacioli published a textbook in 1494 that showed the benefits of a double-entry system for bookkeeping. The idea was to list an entity's resources separately from any claims upon those resources by other entities. In the simplest form, this meant creating a balance sheet with debits and credits separated. This innovation made bookkeeping more efficient and provided a clearer picture of a company's overall strength. This picture, however, was for the owner who hired the bookkeeper only. The general public didn't get to see these records, at least not yet.

Example - Basic Double-Entry Bookkeeping

-		**Debit**	**Credit**
Sold chickens	Debit cash	$48.00	-
	Credit chickens	-	$48.00
Bought seeds	Debit seeds	$48.00	-
	Credit cash	-	$48.00
Sold eggs	Debit cash	$900.00	-

(daily delivery, for 1 year)	Credit eggs	-	$900.00
Bought chest of drawers	Debit furniture	$900.00	-
	Credit cash	-	$900.00

Coming to America

Bookkeeping migrated to America with the European colonization. Although it was sometimes referred to as accounting, bookkeepers were still doing basic data entry and calculations for business owners. The businesses in question were small enough that the owners were personally involved and aware of the health of their companies. They didn't need accountants to create complex financial statements or cost-benefit analysis.

The American Railroad

The appearance of corporations in the U.S. and the creation of the railroad were the catalysts that transformed bookkeeping into the practice of accounting. Of the two factors, the railroad was by far the most powerful. To get goods and people to their destinations, you need distribution networks, shipping schedules, fare collection, competitive rates and some way to evaluate whether all this is being done in the most efficient way possible. Enter accounting with its cost estimates, financial statements, operating ratios, production reports and a multitude of other metrics to give businesses the data they needed to make informed decisions.

The railroad also shrank the country. Business transactions could be settled in a matter of days rather than months, and information could be passed from city to city at a much greater speed. Even time did not run evenly across the country before the railroad. Previously, each township decided when the day began and ended by a general consensus. This was changed to a uniform system because it was necessary to have goods delivered and unloaded at certain stations at predictable times.

This shrinking of the country and introduction of uniformity encouraged investment, which, in turn, put more focus on accounting. Up to the 1800s, investing had been either a game of knowledge or one of luck. People acquired issues of 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 financials to check if you wanted to invest in a corporation or business that you knew nothing about. The risk of this type of investing made it an activity for the wealthy - a rich man's sport with the taint of gambling. This image has never completely faded.

The First Financials

Corporations, eager to attract more capital to expand their operations, began to publish their financials in the form of a balance sheet, income statement and cash flow statement.

Investment capital from sources outside the company became more important than that provided by the individual owners who had pioneered business. Although bringing in this investment capital increased the range of operations and profits for most corporations, it also increased the pressure on the management to please their new bosses - the shareholders. For their part, the shareholders were unable to completely trust the management, so the need for independent financial review of a company's operations became apparent.

The Birth of a Profession

Accountants were already essential for attracting investors, and they quickly became essential for maintaining investor confidence. The profession of accounting was recognized in 1896 with a law stating that the title of certified public accountant (CPA) would only be given to people who had passed state examinations and had three years of experience in the field. The creation of professional accountants came at an opportune time. Less than 20 years later, the demand for CPAs would skyrocket as the U.S. government, in need of money to fight a war, started charging income tax.

Financial History: The Rise Of Modern Accounting

In 1913, the Sixteenth Amendment was ratified. This meant that, in addition to the corporate taxes that had been passed a few years earlier, there was now a federal income tax to be paid by all individuals working in the United States. Income tax and corporate tax were little understood and heavily resisted in their formative years. As a result, most corporations and individuals were simply not filing or were filing incorrectly. Accountants themselves were not entirely sure of items like depreciation and other tax deductions. The workload and demand for accountants, however, increased in conjunction with tax rates. (Don't miss any of your tax deductions! Check out our Income Tax Guide special feature to find out more.)

New Rules

In 1917, the Federal Reserve published *Uniform Accounting*, a document that attempted to set industry standards for how financials should be organized both for reporting tax and for financial statements. There were no laws to back the standards so they had little effect. The stock market crash of 1929 that launched the Great Depression exposed massive accounting frauds by companies listed on the NYSE. This prompted stricter

measures in 1933, including the independent audit of a company's financial statements by public accountants before being listed on the exchange.

The years 1933 and '34 also saw the Securities Act and the Securities Exchange Act pass in rapid succession. These acts became the groundwork for the Securities and Exchange Commission. The SEC instituted the regular review of financial statements and began a long trend of government regulation over both the practice of accounting and that of investing.

The SEC, in true government fashion, turned around and delegated the responsibility of establishing accounting standards to a succession of committees and boards with an ever-changing array of acronyms: AIA, CAP, AICPA and APB. Finally the current Financial Accounting Standards Board (FASB) came along in 1973. Although these boards issued pages and pages of accounting standards over the years, the final approval has always been left up to the SEC. The SEC rarely interferes, but it has struck down a rule or substituted in another every now and then just to remind the accountants who is boss.

Survival of the Biggest

As reporting regulations tightened and corporations were required to use different firms for audit and non-audit accounting services, the same handful of large accounting firms kept getting more and more of the business. This is mostly because they had the people and experience to get the job done, and there was a sense of prestige that went with using them as they grew larger.

As part of their growth, these firms merged with smaller firms in order to keep up with the increasing workload as more companies went public and regulations (and management) demanded increasingly frequent and stringent reports. By the 1970s, there were eight firms that handled most of the accounting for publicly traded companies. These were Arthur Anderson, Arthur Young & Company, Coopers & Lybrand, Ernst & Whinney, Haskins & Sells, KPMG, Price Waterhouse, and Touche Ross.

Because every corporation had to deal with two accounting firms, one for audit and another for non-audit accounting services, the competition between the main eight accounting firms increased, leading to more mergers. By 1989, the big eight became the big six. In 1998, the big six was reduced to five. This countdown was advanced by one when, in 2002, the Enron scandal dragged Arthur Anderson down. The remaining four firms, Deloitte Touche Tohmatsu (formerly Touche Ross), Ernst & Young, KPMG International, and PricewaterhouseCoopers, bought up what was left of Arthur Anderson. These four firms now have a type of oligopoly because the competition has been significantly reduced while the regulations and reporting needs of corporations have increased. This has resulted in listed companies having to pay more for both their audit and non-audit accounting services.

Despite the fact that these four firms rule the world of corporate accounting, some of the largest employers of CPAs include H&R Block and American Express. Income tax and credit directly affect millions of people that don't even know the FASB exists. Financial reporting may be the limelight of accounting, but the bulk of the accounting industry is built on helping people file their taxes on time.

The Future of Accounting

Accounting, as a practice, has several guiding principles that will likely survive any changes in the future. Corporate accountants have to abide by these rules, including:

- provide information that helps management make informed business decisions,
- provide similar information to others with a stake in the corporation (creditors, investors, employees),
- ensure that the law is being followed,
- verify that the records and reports of a company are accurate,
- indicate areas where efficiency can be improved (investing cash reserves, cutting costs, etc.),
- protect against fraud, embezzlement, and other activities that cost a company money.

One of the biggest changes on the horizon of accounting is the addition of a seventh service: current-value information. Proponents of this type of accounting argue that historical cost financial statements are flawed because they do not provide information on current value, which would be more relevant for investors. As such, this type of accounting may produce balance sheets that are more representative of a company's value, although it is considered by many to be less reliable.

Another change in corporate accounting is the introduction of advertising into the industry. Actively competing with other firms through advertisement was taboo in an industry that used to depend on word-of-mouth recommendations to build clientele. As this competition between only a few firms begins to heat up, the regulations on the industry will also increase to keep firms from offering dishonest services (think Arthur Anderson) to entice clients from their competition. All in all, the future of accounting will be in getting accurate information to managers and investors as soon as possible. In turn, this will ratchet up market efficiency and keep the financial world ticking along happily.