

Title	A reconsideration on the nature of "financial accounting"
Sub Title	
Author	Yamamasu, Tadahiro
Publisher	
Publication year	1963
Jtitle	Keio business review Vol.2, (1963. ) ,p.43- 52
JaLC DOI	
Abstract	
Notes	
Genre	Journal Article
URL	<a href="https://koara.lib.keio.ac.jp/xoonips/modules/xoonips/detail.php?koara_id=AA00260481-19630000-03919623">https://koara.lib.keio.ac.jp/xoonips/modules/xoonips/detail.php?koara_id=AA00260481-19630000-03919623</a>

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# A RECONSIDERATION ON THE NATURE OF "FINANCIAL ACCOUNTING"

by

*Tadahiro Yamamasu*

## ***Foreword***

As I view it, corporate accounting is nothing but a scheme devised for the calculative management of capital movements of unitary and continuous nature in an enterprise, by means of precise grasp and analysis of their processes and clear presentation of their results. Hence, by origin, it ought to be a coordinated entirety as economic computation system.

While corporate accounting as such an unity must be the object of observation, the prevalent and leading mode of approach has been, at least up to now, that presupposes co-existence of "two accountings", namely "financial accounting" and "managerial accounting," still implicitly assuming one of the two.

Since corporate accounting is of unitary nature in itself, it is obvious that such a way of approach, or the intention of separation, should be reexamined and the two accountings be reunited into corporate accounting as an unity. However, I have observed this point of argument in a previous occasion, and so in this article I shall put focus on the character of financial accounting and clarify its implications, as the title indicates.

## ***1***

The origin of the term "financial accounting" does not date in the long past. The attempt to separate corporate accounting into two categories on some basis was initiated only after the turn of the century and the term came into use also at that period, except for a few forerunning and sporadic instances.

The intention to separate the two was derived from the fact that new fields of accounting had been developed coinciding with the growth of management problems regarding production or processing, as the result of enlarged production scale and increased competition. The new areas were such as "factory accounting" or "works account" that were distinct from the traditional accounting, and were developed mainly by personnels such as industrial engineers rather than customary accountants. In connection with such a change

there emerged naturally a distinction between "general accounting" and "factory accounting." Generally the former, the customary area performed in head offices, was particularly expressed by the name of "financial accounting."

However, in this case the basis for the separation or classification has been put, so to speak, on the objects or areas. It is not that both take up the same objects from different viewpoints, nor that their inter-relations constitute whole and part. Rather they relate each other in a simple form of division-of-labor, in which the former, namely general accounting with emphasis on the traditional area, clarifies its character as the calculation concerning external or transaction processes, leaving internal or production processes, that have been growing within capital movements, to the latter, factory accounting.

In this sense, the separation into general and factory accounting has been devised not on the grounds of the traditional area. Rather it means that accounting for the newly born area, corresponding to the extension of capital movements, has been termed factory accounting, while accounting for the traditional area retained the name of general accounting.

At all events, since that time patterns of capital movements, or business activities themselves, have experienced a transformation by the emergence of "production" process; as a result, the dominant pattern of business takes form of financing — purchasing . . . . production . . . . selling — financing, in contrast to previous form of financing — purchasing . . . . selling — financing. Following this change, the division into general and factory accounting has reformed its meaning into a clear differentiation between external and internal accounting, the former concerning calculative grasp of transactions between enterprise and market through financing, purchasing and selling, and the latter concerning calculative following of production processes. Also in this case the former, external accounting, has often been called with the name of financial accounting.

By the way, the attempt to classify corporate accounting has not been stopped at this point. Eventually, also a tendency has been introduced to make a distinction between **Zeitrechnung** and **Stückrechnung (Einheitsrechnung)** from the viewpoint of accounting form or unit. In this case, the former takes up accounting facts for a given period, while the latter performs calculation on the basis of products or units. This tendency might be said to have led to a preconception that financial accounting is only another name of **Zeitrechnung** or **Abrechnung**.

## 2

As outlined above, the expression of financial accounting has been used in this country implying head-office accounting in contrast to factory accounting, like **Zeitrechnung** is used in contrast to **Stückrechnung**, representing the customary accounting pattern that presupposes the traditional area. The term "financial accounting" has become more popular owing to the fact that a new requirement has been put on corporate accounting, in connection with the rise of large scale enterprises and it tended towards separation between owner-

ship and management there. Hence, even though on the ground of the same area, a differentiation has been brought about with respect to them. In other words it became more fashionable to divide financial and managerial accounting in accordance with the differentiation of their functions and requirements.

This development emerged largely after the 1920's when two sorts of requirements were put on corporate accounting; a socio-economic requirement for the protection of outside interests including absentee ownership on the one hand, and a managerial requirement for the establishment of business functions for the sake of internal rationalization on the other hand. Eventually this has introduced even the so-called confrontation of the two accountings, financial and managerial.

Of course, various devices have been made one by one; such tools for calculative management as "standard costing" or "budgetary control" that have contributed to the birth of managerial accounting. Nevertheless, it must be noticed that managerial accounting is an aggregated calculative system comprised under the purpose consciousness of management, rather than a designation for each particular tool. In this sense, the confrontation in the form of financial and managerial accounting, newly coming in the open, is not based on the problem of area as shown above, nor it is simply confined to the problem of tools. Indeed it is a confrontation that reflects the differentiation of functions in corporate accounting itself.

By the way, as to the fundamental functions of accounting, Prof. W. A. Paton has given: (1) *measuring* and arraying economic data; and (2) *communicating* the results of this process to interested parties. Also Prof. M. H. Stans has shown three functions; (1) function of measurement, that is, to contribute to productivity by means of calculative measurement; (2) function as means of communication, that is, to communicate facts about management; and (3) function as social instrument, that is, to offer tools for planning and control of dividing fruits of production. It should be observed that the word "interested group" by Prof. Paton naturally involves management staffs themselves beside outside group, and also by Prof. Stans the presence of managerial function is suggested in the function of measurement and communication.

Thus, in face of such circumstances as the establishment of managerial functions, two accounting systems could exist, coexisting and confronted, with different standpoints or viewpoints corresponding to the objects of communication, although their concerned areas are similar. The one intends to make communication with external interested group, while the other aims at services for management that makes, at least in direct, the function of internal executive. Truly, the two systems, normally called financial accounting and managerial accounting respectively, are the results of quality-differentiation of an original system, and that, they have been born as functional opposites concurrently.

Of course, in this connection, there might be some functions overlapping between them. For instance, even in the system of financial accounting the managerial functions are not wholly ignored as is shown by the so-called "current operating performance theory", while concern about external interested

group is not always neglected in the managerial accounting. However, the two have been repeating repulsions and claiming superiority over each other.

### 3

As described above, since the 1920's, a significant tide is prevalent in the world of corporate accounting that broadly divides financial accounting and managerial accounting, following the differentiations of functions and purposes, and even today, such mode is dominant.

And, thus it is generally conceived that the former holds character of outward-report-accounting, and the latter holds that of inside-report-accounting. Sometimes the former is called by the name of corporate accounting itself, and the latter, to make the distinction clear, is named business calculation or managerial calculation. As for the latter, a tendency is newly emerging that classifies accounting for planning and that for controlling.

Again, conceptionally corporate accounting might be classified into after-accounting, namely settlement accounting, and fore-accounting, namely budget accounting, in respect of timing and direction. Also on this point, the tendency has been toward recognizing that the former corresponds to financial accounting and the latter to managerial accounting.

In other words, financial accounting, which has been formerly treated as a synonym to general accounting, **Zeitrechnung** or external-transaction accounting in contrast to factory accounting or costing, is now simply regarded, by being set against managerial accounting, to imply outward-report-accounting, settlement accounting, or "retrospective" accounting.

Indeed these terms make a series of pair of concepts opposing to each other respectively in a sense, but I wonder whether it is justifiable to set them against each other in such a superficial way, and to link the opposite ones, thus simply identifying financial accounting with general accounting, **Zeitrechnung**, external-transaction accounting, and further, outward-report-accounting and "retrospective" accounting. Synonym is to mean a fixed relationship in which A equals B and B equals A. Isn't it right to say that the case falls under such relationship?

As I shall observe later, truly in the past there have existed occasionally such situations that allow faultless identification of term accounting & etc. with financial accounting and, in turn, financial accounting with term accounting & etc. The converse has held good there, but it tells only an occasional, fortunate relationship that has existed at the time of the birth of costing and managerial accounting. It could not always be given.

For example, budgeting (**Budgetrechnung**) belongs to managerial accounting or "perspective" accounting in the light of the basis of classification as mentioned above, but when it concerns master-budget or **Gesamtbudget** it may be regarded also as term accounting, and so far holds the same character as settlement accounting. Again, costing involves that for after-accounting (actual costing) and that for fore-accounting (standard costing and plan costing), and, moreover, there could be one with character as a link of the chain

of financial accounting and that may be reasonably placed in the system of managerial accounting.

Still more, the separation between, and setting against, financial and managerial accounting have become confused and stale, because recent development of the study has arrived a phase where ways are being searched for that may serve both of the two objects by one costing; namely outward-report that makes one of the necessary requisites for "costing as a institution", or "cost accounting", and internal-report that the group-up costing earnestly asserts.

This article, as I state in the foreword, does not intend to examine the anti-realism contained in the separation consciousness of financial and managerial accounting. Here, following the preceeding, preparatory explanation, my main task is to point out the evil aftermath derived from the use of the term "financial accounting" to denote the opposite against managerial accounting, and further, to trace the original implications of financial accounting.

#### 4

When the historical attributes of the term "financial accounting" are abstracted, and the simple identification of financial accounting and settlement accounting is dominant, the original financial functions immanent in it have been regretfully lost and it has changed itself into a mere token. Problems start from here.

In the first place, why the term financial accounting has been particularly born, and chosen as a pronoun for general accounting and outward-report accounting, even though for the sake of contrasting to factory or managerial accounting? Isn't it that, at some stage, there has been a proper reason for adopting the term to denote customary accounting, in order to set against the newly grown factory or managerial accounting?

Isn't it that there has been a historical ground where general or outward-report accounting is naturally considered as financial accounting, rather than to say that financial accounting is always such accounting? And so far as it is based on such a ground at its initial stage, there has been a circumstance where financial accounting is seemingly overlapping on report accounting, isn't it? To speak more directly, financial accounting has been born originally bearing financial tasks, as the name shows, and it has been recognized as such ever since. By this reason I think it is urgently needed to scrutinize and discover the implications of the word "financial", retrospectively returning back to its beginning.

By the way, it is often said that financial accounting is "aiming at settlement statements". But this definition is too abstract with little meaning. For, even though in fact it is pointing to settlement statements, the essential problem must relate to "why" and "to whom" the statements should be directed. Of course, to the question "to whom" one may immediately answer "to third persons" or "to interested third persons". Then, the next question is why such accounting should be particularly called financial accounting.

In what sense is such outward-report accounting termed financial accounting? Such answer as that it intends compilation of financial statements does not suffice here, for it will lead us to another question why accounting statements for report to third persons are called financial statements.

Anyhow, after putting one question after another in this way, I have come to think of a need to clarify the reason why the accounting for the purpose of reporting to third persons is specifically called financial accounting, and why accounting and settlement statements for the purpose are skillfully named financial statements. This makes a problem of primary significance and two answers are thinkable.

The first answer is that it opens financial positions of enterprise to public and hence deserves to be called as such. The second answer is a claim that, besides opening to public, it contributes through the processes to maintain and secure business finance positively and directly.

By the first answer, the object of opening is laid on the group more or less interested with the enterprise, and the purpose of opening rests on social ones such as adjustment of opposite interests among third persons. In case of the second answer, however, a further, material explanation will be needed to show how such accounting contributes to finance.

It was at the beginning of this century that the custom had grown in the United States to call the traditional accounting "financial accounting" and accounting statements for outside persons "financial statements", corresponding to the development of factory accounting and the rise of managerial accounting, for the comparison of areas and functions. There was an apparent reason, I suppose, why the word "financial" was particularly taken up to qualify and symbolize it. Further, at the period of the birth of "two accountings" an inevitability was supposedly existing that so-called general accounting or outward-report accounting was directly received as financial accounting, and accounting reports as financial statements. Let us study these circumstances to ascertain the nature of financial accounting in the following section.

## 5

So far as the United States is concerned, the term "financial accounting" came into use intentionally in relation to financing (of capital) indeed. When in the latter half of last century, American industrial capital, which was then on the way of growth, intended to introduce British capital, English accountants came to the United States and made close surveys of financial positions and earning powers of the concerned enterprises, thereby marking the dawn of American accounting and audit practices. Since then corporate accounting in the United States had developed gradually in connection with finance.

American corporate accounting had started in the right direction and showed splendid advance from the fall of last century to the 1920's, because in that period new types of financing means such as single-name papers came into popular use in place of the customary ones, requiring thorough credit

inquiry and reasonable accounting.

Since that time, it had become a customary practice that finance credits are rendered after finding ability to repay or to give mortgage, through minute examination of balance sheets that were presented from enterprises to banks, or from buyers to dealing sellers. Being urged by such financing aims, namely compilation of balance sheets, and from just this point, the practices of corporate accounting in this country had made a rapid progress. In short, the practices of accounting in those initial days had developed in connection with creditor's viewpoint and financing purpose. It was, so to speak, esteemed as a tool for finance.

And, as it was also on those days that the newly-born factory or managerial accounting claimed independence from the traditional accounting, the term "financial accounting" naturally became popular to everybody, as a suitable expression for the traditional accounting. Anyhow, at the beginning when the traditional accounting was identified with financial accounting, it was closely tied with the immediate needs for capital financing, and served just as a tool for it.

In view of these historical backgrounds, it may be fairly said that financial accounting is a term that holds a character of financing tool and an accounting for creditor's convenience, laying stress on balance sheet that represents financial position. This interpretation may be ascertained by the presence of an American scholar who seems to characterize the transition from creditor's accounting (that is accounting for creditor) to investor's accounting as a change from the customary financial accounting to a new investor-ownership accounting.

American report accounting, after the 1930's, has turned into that for stockholder's convenience immediately reflecting financial situations, and claiming "accounting for investor" as its slogan. After that, its main theme became profit calculation rather than asset calculation; and to indicate profitability rather than liquidity. However through this transition American report accounting and statements have constantly laid emphasis on contributions to business financing and continued progress, keeping pace with the transformation of finance as its tool.

So long as corporate accounting is an accounting to serve both business and capital, the expression of creditor's accounting or investor's accounting may sound paradoxical. Supposedly this has been derived, for one thing, from the significance that it serves for finance as a tool, communicating most efficiently to creditors or investors who are the sources of finance. In any case financial accounting is not such that confines itself to mere financing for its own sake or simple calculation of profit or loss, but it is always ready to make contribution to business. In other words, although the proper logic of accounting is naturally involved, there lies a clear relationship that financial policies have influences upon it and financial problems define its contents.

Mr. G. O. May has shown five items that have been traditionally tied to financial accounting and considered as its purposes.

- 1) Report concerning stewardship to stockholders.

- 2) Bases for fiscal policies of enterprise.
- 3) Leading principle to judge legality of profit sharing.
- 4) Indices for justifiable profit sharing.
- 5) Bases for crediting.

Broadly speaking, proper tasks of financial accounting may be found in these.

In short, financial accounting is so called not because it aims at reporting financial positions, but it contributes to financial activities by clarifying financial positions.

## 6

Later, however, with the increase in public and social characters of enterprise, such accounting that extends its scope of reporting over the entire public, not being confined to limited group, say, creditors or investors, has been demanded. As this type of accounting, so to speak social open-accounting, is named financial accounting and superficially tied to the traditional trend, there has grown an impression that financial accounting is so called because it intends to compile financial statements. But this accounting does not intend to provide services to financing as its immediate purpose, nor from the viewpoint of business; rather, it aims at adjustment of opposite interests of concerned groups. Hence, it should be called "public accounting" or "financial accounting as public accounting" in contrast to the customary private accounting or financial accountings as private accounting.

In other words, so long as accounting performed by business-management and that demanded by external interested group are of the same sense and contents, few problems arise and there is little room for the differentiation between private and public accounting. But owing to the marked opposition that emerged at that time between public and private, corporate accounting has been obliged to alter the former phase of simple private accounting, and also to provide the functions as public accounting in addition to private ones. It may be noticed here that the so-called "corporate accounting standards" have been originally devised as social, practical basis for the unification of private and public functions.

Particularly there is one thing to be pointed out here. It is that, through such a reform a notion has prevailed that financial accounting deserves to be named so only when it is related to public accounting, and thereby the immanent fundamental functions and substances of financial accounting have been often missed. In fact, in the case of financial accounting that presents itself as being accompanied with public accounting, its contributions to business finance are rather indirect, and it is not linked with finance as much as it ought to be. It is too quick to define the concept of financial accounting by the appearance in such a case.

As we are not satisfied with such superficial observation, we shall proceed to the reasoning that financial accounting should not be limited to those based on the viewpoint of creditor or investor, but should extend itself to management's accounting or inside-report to management, and to recognize the existence of financial function in full. This recognition corresponds to the enlarged and

more intricate process of business financing itself, being in accordance with the transformation of finance and the finding of managerial functions involved.

7

As I have already examined, financial accounting has been, in its initial stage, nothing but an accounting system for capital financing. Verbally the word "finance" means "preparation and procurement of capital" in its origin. Discussions on the theory of corporation finance in the United States also have taken such a view until recently, and regarded finance as one sector of horizontal processes, namely purchasing....stocking....production....stocking...selling, taking as its functions such problems as: (1) capital market as institution to raise capital; (2) stocks, bonds and borrowing as means to raise capital; (3) profit sharing in connection with capital raising; namely problems related to procurement of capital or fund. Under a realization of finance as such, it is understandable that, following the changes in the institutions and means for finance, and in response to the occasional requirements, financial accounting has shown evolutions as creditor's accounting at one phase and as investor's accounting at another.

But, most recently, finance has been regarded to involve not only procurement but also utilization of capital, and its managerial function has been emphasized with the result that the theory on corporation finance has been developed in the form of finance management from the view point of entrepreneur. It is not strange that, once finance is recognized as such, the accounting wanted by business as a tool for financial management is tentatively named financial accounting.

The intention of this article is to point out the current inclination to miss the prominent financial functions immanent in "financial accounting" as the name suggests, and not to try the enlargement of its concept. It tries neither to argue that financial accounting is sufficient for financial management, nor to designate all accountings that are supposedly required for financial management as financial accounting. A proper observation might be that financial accounting has its own limit, while financial management could not achieve full development without considering its tie-up with managerial accounting. What does this mean? Here, we must again take up the term financial accounting in order to examine its immanent financial functions, and further to clarify its limits.

As I have repeatedly emphasized, financial accounting, at its start, has aimed to help capital raising from outside. This is because finance, in its essence, has its ultimate concern upon maintenance of monetary liquidity and sustained balance between payments and receipts. For that purpose preparation of payment means such as cash, deposit, receivable bill is necessary, and, at the same time, procurement of outside capital makes an urgent task in order to strengthen financial foundation. By these reasons the corporation finance has been looked as business financing, naturally with outward sense.

Nevertheless, once activities of capital take their right courses, the source

of capital raising might not be necessarily confined to outside world. Capital fund can be born also by inside the business process through its circulatory movement. Still more reserved profits or depreciation of fixed assets that will give liquidity are often called by the name of self-financing (*Selbstfinanzierung*). It may be apparent from this consideration that the objects of corporation finance do not confine themselves to the processes of procurement and repayment of outside capital nor in-and out-flow of payment measures such as cash and etc., but involve wider range of capital movement.

Financial accounting is just a system of accounting that has quickly constituted itself, presupposing such wider concept of finance and being tied with it. The reason why an accounting that performs coordinated and systematic measurement and communication about the processes of capital activity is particularly called financial accounting nowadays, lies in the fact that it is based on such a wide concept of finance and serves for the calculatory control of financial activities.

However, by the same reason, "financial accounting" is not perfect, but contains some defects, even when it is appreciated as an accounting for finance. Since it presupposes a wide concept of finance and takes up wide range of capital activity as finance, its calculative results are the movements of capital itself, or the abstracted positions of capital increases, rather than the movements of payment means and their propriety. And this provides the foundation for the birth of "fund accounting", beside "financial accounting".

Again, although financial accounting actually has something to serve for "management" of finance, naturally it is not furnished with all of the perspective or planning numerical values necessary for the management. Its contribution to management is no more than a numerical grasp of the details of capital movements, putting them into a given scheme. It is by this reason that financial accounting, being a useful tool for financial management, has not been regarded as the perfect one, and the management accounting has its *raison de être* for business management.

**Supplementary Note:** In this article I have tried a through analysis of the implications of the pre-fixing word "finance", as a means for clarifying the nature of the so-called financial accounting. Various terms affixing "financial" or "finance" such as financial accounting, financial position and financial statements are used in the study of accounting, though examination of its meaning has been almost neglected. I know only a few studies referring to this point. Eiichi Furukawa: *Zaimukanri to Zaimukaikei* (Financial management and accounting), "PR", June, 1955.

Shigeo Aoki: *Zaimukanri ni okeru Zaimukaikei no Chii to Kino no Genkai*, (Positions and limits of functions of financial accounting in financial management) "PR", June, 1955.

Tadahiro Yamamasu: *Zaimukaikei no Zaimuteki Kino*, (Financial functions of financial accounting) "PR", June, 1955.

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