Chapter – 1
Introduction

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1.1 Introduction

1.1.1 Financial accounting

The purpose of accounting is to provide the information that is needed for sound economic decision making. The main purpose of financial accounting is to prepare financial reports that provide information about a firm's performance to external parties such as investors, creditors, and tax authorities. Managerial accounting contrasts with financial accounting in the managerial accounting is for internal decision making and does not have to follow any rules issued by standard-setting bodies. Financial accounting, on the other hand, is performed according to Generally Accepted Accounting Principles (GAAP) guidelines.

The primary accounting professional association in the U.S. is the American Institute of Certified Public Accountants (AICPA). The AICPA prepares the Uniform CPA Examination, which must be completed in order to become a certified public accountant. To be eligible to become a CPA, one needs an undergraduate degree in any major with 150 credit hours of course work. Of these 150 credit hours, a minimum of 36 credit hours must be in accounting. Only about 10% of those taking the CPA exam pass it the first time.

In order that financial statements report financial performance fairly and consistently, they are prepared accounting to widely accepted accounting standards. These standards are referred to as Generally Accepted Accounting Principles, or simply GAAP. Generally Accepted Accounting Principles are those that have “substantial authorities support”.
In the cash basis method, income is recognized when cash is received and expenditure is recognized when cash is paid, the matching of cash receipts and disbursements serves to determine operating results during an accounting period. This method is simple in its application, but in most cases, it does not fully match all the expenses incurred to the incomes generated in a given period. For example, the purpose of equipment or a building is not depreciated over time, but is fully expensed at the moment of purchase.

Cash basis of accounting fails to achieve most of the financial reporting objectives. It is because the timings of cash receipts and cash payments may not coincide with earning of revenues or incurring of expenses. Furthermore, measurement of performance based on cash basis of accounting is susceptible to manipulation through a variation in the timings of cash receipts or payments. For example, postponing the payment of certain bills by a few days can conceal a budgetary deficit. Another major weakness of cash basis of accounting is that no distinction is made between receipts or payments on capital account and those on revenue account. Thus, no distinction is made between expenditure on construction of infrastructural facilities such as roads, water distribution system, bridges etc. and expenditure on routine items such as salaries, rents etc. Similarly, a substantial expenditure on major changes to a building that result in an increase in its life is treated as no different from the revenue expenditure on normal repairs and maintenance. Similarly refundable deposits are treated no differently form charges for service rendered.

The major limitations of cash basis of accounting are:

- Incorrect measurement of income and expenditure
In this system of accounting transactions are recorded when there is actual flow of cash. Revenue is recognized only when it is actually received. Expenditure is recognized only on the outflow of cash. No consideration is given to the “due” fact of the transaction. This system of accounting is simple to understand and as such needs less skill on the part of the account. Its whole focus is on cash management. The recognition trigger is simply the flow of cash. Budgetary and legislative compliance is easier under this system.

1.1.3 Accrual accounting

Accrual accounting recognizes financial transactions when they occur, and not when cash is received or disbursed. The accrual method is founded on the principle that all incomes earned during a given period are matched with the expenses incurred for earning those incomes. In other words, incomes are recorded in the period in which they are generated, and expenses are recognized by measuring the goods and services consumed to generate those incomes; and the multi-year benefits associated with long-lasting assets are matched with the time(s) when they are expected to be used.

The accrual method provides a better measurement of net income because it matches expenses incurred with incomes earned for given period and it reflects income in the period to which they belongs i.e., the period in which they were earned. Net income is thus, clearly shown as the difference between incomes earned and the expenses incurred for generating those incomes; that is, the difference between the results obtained and the efforts expended to achieve those results. Since accrual accounting provides more complete and useful information than the cash based accounting, most
organizations use this form of accounting to support their decision-making and financial reporting.

It is a system of accounting in which transaction are entered in the books of accounts, when they become due. The transactions are recognized as soon as a right to received revenue and/or an obligation to pay a liability is created. The expenses are recognized when the resources are consumed and incomes are booked when they are earned. Therefore, the focus is on the recording of flow of resources i.e. labors, goods, services and capital, the related cash flow may take place after some time (of event) or it may or may not take place in the same accounting period. 

1.2 Limitation of Cash accounting

It does not provide the complete picture of the financial position i.e. information on assets and liabilities are not available for fixed assets (land, building, machineries, defense, heritage assets etc.)

No information about capital work-in-progress like dams, power plants, roads and bridges etc. is available.

It does not give the full information on current assets e.g. accrued income like outstanding royalty, fees, service charges, tax arrears etc.

Comprehensive information is not available about government liabilities (pensioner’s commitments, interest due, bills payable depreciation for replacement of assets etc.)

Unit cost and total cost of services provided by the Government departments like health, education, water supply, transportation etc. is not ascertainable (as description, interest etc. are not apportionable).
It ignores certain transactions by not recording expenditure already incurred but payment not made e.g. supplies made, salary, telephone charges, overdue interest etc. and also revenue earned but cash not received e.g. license fees, services delivered (electricity, water etc.)

It gives a wrong picture of income received, as advance tax receipts are recognized as income.

No weightage is given to the concept of ‘matching’ i.e. expenses of a specific period should be set off against the revenue of the same period.

No disclosure is made about contingent assets and contingent liabilities which may turn into committed ones on account of guarantees given or letter of comforts issued by the government.

No information is provided about existing net liabilities of public enterprises and agencies outside the government, although the latter cannot escape such liabilities.

No disclosures are made about Accounting Policies on the basis of which Financial Statements are prepared.

It provides room for fiscal opportunism e.g. tax revenues can be collected in excess during a particular period followed by high incidence of refunds together with interest, payments can be easily deferred and passed on to the next financial year, revenue due in the future could be compromised by providing for one time payments.

1.3 Advantage of accrual accounting

The system of Accrual Accounting while retaining the advantages of the Cash Accounting System overcome its limitations by inclusion of Cash
Flow Statement in the Financial statement of the entity. The major advantages are as under:-

1) It helps in the assessment of financial performance by correctly reflecting surplus/deficit as all expenses whether paid or not and all income whether received or not are duly accounted for.

2) It gives information on whether income streams are adequate to meet short and long term liabilities so that their early payment keeping in view their payment period (short term and long term) and nature (cheap or costly loan) can be better managed.

3) It provides comprehensive information on expenses which helps in knowing the cost consequences of policies and enable comparison with alternative policies. Also, information about calculation of subsidy can be extracted from the accounts, which helps in its rationalization. This ensures the adoption of best policy, which in turn assures optimal use of scarce resources. It also helps in ascertaining the future sustainability of programs.

4) Liquidity position of the government can be better assessed.

5) It gives comprehensive information on the Financial Position i.e. assets and liabilities of government. In this system of accounting the financial decisions are not seen merely from the point of view of cash outgo or inflow but also from their impact on the asset-liability position of the government, future funding requirements of assets enabling planning of their timely maintenance and replacement.

6) It gives disclosures on account of contingent assets and contingent liabilities so that risk associated with the guarantees issued and letters of comfort given can be better assessed by the user of the financial statements.
7) It bridges the gap leftover by cash accounting by inclusion of accrued expenses and revenues (receivables and payables) physical assets, capital work-in-progress and depreciation, pension liabilities and provisions etc. in the accounting system.

8) It discloses the Accounting Policies used in the preparation of Financial Statements for better understanding and appreciation of the Financial Statements.

9) Accrual accounting provides information on an entity’s overall financial position and current stock of assets and liabilities. Governments need this information they wish to provide;

b) Demonstrate accountability to the public for their management of assets and liabilities recognized in the financial statements;

c) Plan for future funding requirements of assets maintenance and replacement;

d) Plan for the repayment of, or satisfaction of, existing liabilities; and

e) Manage their cash position and financing requirements.

10) Accrual accounting requires organization to maintain complete records of assets and liabilities. It facilitates better management of assets, including better maintenance, more appropriate replacement policies, identification and disposal of surplus assets, and better management of risks such as loss due to theft or damage. The identification of assets and the recognition of depreciation help managers to understand the impact of using fixed assets in the delivery of services, and encourage managers to consider alternative ways of managing costs and delivering services.
11) Accrual accounting provides a consistent framework for the identification of existing liabilities, and potential or contingent liabilities. The recognition of obligations meeting the definition of a liability and the criteria for recognition:

a) Compels governments to acknowledge and plan for the payment of all recognized liabilities, not just borrowings;

b) provides information on the impact of existing liabilities on future resources;

c) Means that it is possible to allocate responsibility for the management of all liabilities; and

d) Provides necessary input for governments to assess whether they can continue to provide current services and the extent to which they can afford new programs and services.

12) Accrual accounting highlights the impact of financing decisions on net asset/equity and may lead governments to take a longer term view when making financing decisions than is generally possible when relying on cash or modified cash reports. Information on net assets/equity also means that governments may be held accountable for the financial impact of their decisions on both current and future net assets/equity. Changes in an entity’s net assets/equity between two reporting dates reflect the increase or decrease in its wealth during the period, under the particular measurement principles adopted and disclosed in the financial statements. Under the accrual basis of accounting, the financial statements will include a Statement of Financial Position which discloses information about assets and liabilities. Where assets and liabilities are equal, a residual figure for net assets/ equity will be reported. Where this figure is positive it will be interpreted as the net resources
that may be applied for the provision of goods or services in the future, and therefore the community’s investment in the reporting entity. Where the figure is negative, it may be viewed as the amount of future taxation or other revenues which are already committed to paying off debt and other liabilities.

Net assets/equity can comprise some or all of the following components:

- contributed capital;
- accumulated surpluses and deficits; and
- Reserves (for example revolution reserve; foreign currency translation reserve).

1.4 Difference between cash basis and accrual basis

The major difference between accrual accounting and accounting based on cash receipts and payment is in the timing of recognition of revenues, expenses, gains and losses. It is possible that cash receipts during a particular period largely reflect the effects of activities of the enterprise in the earlier periods, while many of the cash payments may relate to activities and efforts expected in future periods. Thus, an account showing cash receipts and cash payments of an enterprise for a short period cannot indicate how much of the cash received is the return of investment and how much is the return on investment and thus cannot indicate whether or to what extent the enterprises is successful or unsuccessful.

Cash accounting records the cash effects of a transaction in the period in which they occur. Under this regime moneys paid and received are recorded in the financial statements of an organization.
1.5 Key elements of accrual accounting

1) Income is recorded only when it is due, not when it is received.

2) Expenditure is incurred when due, not when it is paid out.

3) Assets are recorded when they belong to the organization and when a future benefit will be received from holding the asset.

4) All likely liabilities must be included.

5) The question of whether an organization is solvent must be reflected.

1.6 Financial reporting under the cash basis of accounting

Key issues identified from ACCA’s knowledge gained from working with countries adopting the cash accounting standard include the following:

The costs and resources required to implement the standard, the availability of qualified accountants in the public sector and cultural resistance to change are key issues for developing countries. Given that only one country (Malaysia) has fully implemented the IPSAS cash accounting standard suggests that there are continuing problems. Similar issues were also highlighted by participants at an ACCA workshop on the cash accounting standard in Vietnam (June 2009). Also, we have found that the introduction of cash accounting must be supported by a strong audit function and accountants with expertise in financial systems.

A number of countries perceive the adoption of the cash accounting standard as a stepping stone towards the future adoption of accruals based accounting. There is an argument for directly moving to accruals based accounting, particularly if there are a significant number of government entries already reporting on an accruals basis. In the long-term this has the potential to
minimize costs and be less disruptive. Some practical guidance or advice would be helpful to countries faced with this situation.

The UK’s experience of moving from a cash based system to an accruals basis was particularly fraught. A major overhaul of systems and governance arrangements was required. Even today there is further restructuring of governance processes to align disparate reporting and funding mechanisms under the current Government’s “clear line of sight program”. There is still a problem with publishing the ‘whole of government accounts’ because non-central government bodies don’t follow the same systems and deadlines. Lessons should be learnt from the UK’s experience.

Despite the above barriers ACCA has identified some key drivers to help with the implementation of the IPSAS cash accounting standard. These include: having the support and political will of the government, strengthening the standard setting and regulator bodies, building capacity within the profession and having a clear strategy for implementation with clear deadlines. Some countries such as India have undertaken a gap analysis between existing practice and what is needed to move to IPSAS compliance. It provided a roadmap with clearly defined set of actions. Finally, any change in accounting practice needs to be supported with adequate infrastructure and systems to manage the transition together with effective communication and process management.

1.7 Backgrounds of Indian Pharmaceutical Industry

"The Indian pharmaceutical industry is a success story providing employment for millions and ensuring that essential drugs at affordable prices are available to the vast population of this sub-continent"
The Indian pharmaceutical sector has come a long way, being almost non-existent before 1970 to a prominent provider of healthcare products, meeting almost 95 per cent of the country’s pharmaceuticals needs.

The Industry today is in the front rank of India’s science-based industries with wide ranging capabilities in the complex field of drug manufacture and technology. It ranks very high in the third world, in term of technology, quality and range of medicines manufactured. From simple headache pills to sophisticated antibiotics and complex cardiac compounds, almost every type of medicine is now made indigenously.

Playing a key role in promoting and sustaining development in the vital field of medicines, Indian Pharma Industry boats of quality producers and many units approved by regulatory authorities in USA and UK. International companies associated with this sector have stimulated, assisted and per headed this dynamic development in the past 53 years and helped on put India on the pharmaceutical map of the world.

The Indian Pharmaceutical sector is highly fragmented with more than 20,000 registered units with severe price competition and government price control. It has expanded drastically in the last two decades.

There are about 250 large units and control 70 percent of the market with market leader holding nearly 7 percent of the market share and about 8000 Small Scale Units together which form the core of the pharmaceutical industry in India (including 5 Central Public Sector Units). These units produce the complete range of pharmaceutical formulations, i.e., medicines ready for consumption by patients and about 350 bulk drugs, i.e., chemicals
having therapeutic value and used for production of pharmaceutical formulations.

Following the de-licensing of the pharmaceutical industry, industrial licensing for most of the drugs and pharmaceutical products has been done away with. Manufactures are free to produce any drug duly approved by the Drug Control Authority. Technologically strong and totally self-reliant, the pharmaceutical industry in India has low costs of production, low R&D costs, innovative scientific manpower, strength of national laboratories and an increasing balance of trade.

1.8 Backgrounds of Maharashtra Pharmaceutical Industry

The pharmaceutical industry of Maharashtra has successfully established its presence in domestic market with large investments in manufacturing assets and research and development activities. The pharma companies in Maharashtra put up good show during past and captured significant market share in the international area also. The pharma industry in the state is on the fast track by implementing major expansion programmers and playing crucial role in the health care segment. The industry in the state will be on forefront in the challenging business environment with new technological tie-ups, mergers and acquisitions, up gradation of facilities and several important approvals from foreign authorities. Besides, the industry is taking proper care of its investors by offering better returns in the form of dividend and bonus shares. Several scripts on the stock exchanges are moving ahead with higher market capitalization.

Out of top 10 Indian companies, with the net sales above Rs.700 crore, 5 major companies viz., Cipla, Nicholas Primal, Lupin, Sun Pharmaceuticals
and Wockhardt are located in Maharashtra. These five companies put up healthy show during the year 2003-04 and marching ahead strongly. The sales of these five companies touched to Rs. 6100 crore during the year 2003-04 from Rs.5051 crore in the previous year, registering a growth of more than 21 per cent. The net profit has taken a quantum jump of 28 per cent to Rs.992 crore form Rs. 778 crore in the previous year.

Several mid-sized companies are also moving ahead and entering more aggressively in domestic and international markets. These mid-sized companies are in process of launching new molecules and new products in the regulated markets. There are several companies like Glen mark Pharmaceuticals, J B Chemicals, Unichem Laboratories, FDC, RPG Life Sciences, Aarti Drugs, Zandu Pharmaceutical, Elder Pharmaceuticals, Ankur Drugs and Pharma, TAS Pharmaceuticals, Indoco Remedies and Makers Laboratories, have established their manufacturing units in Maharashtra. Recently Indoco Remedies entered into the capital market with public issue of 30 lakh equity shares. The issue received excellent support from investors and was oversubscribed. These mid-size companies are consolidating their business activities to meet future challenges.

The companies are focusing more and more on research and development activities and investing large funds to develop new products for international as well as domestic market. Though the pharmaceutical industry revenues are under pressure during the last year on account of stiff competition, the companies are in the state achieved better working results during 2003-04 and in the first nine months of the current year.
The pharma companies have established excellent brand image by launching research based, cost effective and quality products in the international market. The pharma sector is a net foreign exchange earner adding to country's foreign exchange reserves. The sector is not only exporting products, but also undertaking contract manufacturing from multinational companies in a big way. The pharmacy companies are concentrating on advanced profitable markets like USA and Europe. For instance, export earnings of Cipla went up sharply by 43.5 per cent to Rs. 812 crore during 2003-04 from Rs. 566 crore in the previous year. Similarly, Lupin and Wockhardt achieved exports of Rs. 559 crore and Rs.280 crore which worked out to 47.4 percent and 38.5 per cent of their sales during 2003-04. Sun Pharmaceutical exported products worth Rs.203 crore during 2003-04. IPCA Laboratories is exporting to more than 95 countries and notched up exports of Rs.340 crore as against Rs.266 crore in the preceding year. Sterling Biotech's exports went up by 267 percent to Rs.88 crore. Similarly, Glenmark, a Mumbai based Rs.330 crore plus company, reported a rise of 167 per cent in exports to Rs.48.95 crore during 2003-04.

The companies in the Maharashtra are focusing more on R&D to step up market share. Though Cipla, the second largest company in India after Ranbaxy Laboratories, is not spending on R&D activity, Nicholas Pirmal is planning an investment of Rs.200 crore on R&D an upgradation. Nicholas has set up a new Rs.100 crore and R&D centre at Mumbai to conduct all the stages of drug development, including clinical trials indigenously. To capture international markets, these companies are filling DMFs and ANDA in US and Europe. Lupin is investing Rs.20 crore in Aurangabad for manufacturing anti-
TB products and also planning to launch herbal products. Cipla filed 7 DMFs and sun Pharmaceuticals filed 4 DMFs during 2003-04. Lupin filed 32 patents including 10 finished products. Wockhardt also filed 30 DMFs in US. Thus the companies are moving aggressively in developed market and increasing their market share. The pharma companies are undertaking new molecular research and around 25 to 30 products are in pipeline. The NCE products will be crucial for post-WTO period. Several companies are now looking biotechnology as future growth area.

To increase the presence in the market, Cipla has recently announced a technical collaboration with the California-based Symbiotic Inc to launch treatment for arthritis. The withdrawal of some Cox-2 inhibitors from pharmaceutical market place has created a real need for products that will safely relieve the pain a debilitating effect of arthritis. The Cipla products will likely to fulfill the gap. Further, Cipla has expanded the scope of collaboration with Bangalore based Avesthagen for their ongoing bio-therapeutics development programs. Cipla is also working on developing a dosage for treating AIDS.

Nicholas entered recently into two contract manufacturing deals with multinational pharmaceutical companies, which would translate into sales of more than Rs.150 crore in the current year. Lupin established its herbal division to capture sales of Rs.40 crore. The company is looking forward to export herbal product to Germany and France in near future. The company is also setting up subsidiary in Japan, the world’s second largest pharma market.

The pharma companies in Maharashtra are built up on strong financial position with excellent back of high-tech manufacturing facilities and tie-up
with multinational entities. These companies are distributing handsome rewards to its investors. Cipla paid equity dividend of 150 per cent, which absorbed an amount of Rs.90 crore during 2003-04. Similarly, Nicholas also paid equity dividend of 150 per cent and Lupin paid dividend of 65 per cent. Sun Pharmaceuticals, Glen mark; Unichem, IPCa, FDC and Zandu rewarded their shareholders with liberal bonus issues during last couple of years.

The Companies are set to achieve better performance in the current year also. The aggregate net profit of Maharashtra based top five companies i.e. Cipla, Nicholas, Lupin sun Pharma and IPCa move dup by 30.5 per cent during the nine months period ended December 2004 to Rs.842.96 crore from Rs.645.96 crore in the corresponding period of Rs.4950.42 crore from Rs.4299.72 crore. Wockhardt achieved net profit growth of 56 per cent to Rs.207.80 crore during the year ended December 2004 and declared quality dividend of 100 per cent. Other companies like Glen mark, J B Chemicals, Aarti Drugs, Elder Pharmaceuticals, Ankur Drugs, and TASC Pharma also strengthen their top line and bottom-line during the nine months period of current year.7
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