CHAPTER 1

GENERAL INTRODUCTION

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CHAPTER 1
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1.1 Introduction

Precision in information is vital for making rational decision - this undoubtedly is true in this ever-changing global scenario. Since the beginning of civilization, human beings have been adopting various means to make information available for different purposes. Accounting is one such system used by people to obtain economic Information.

In business world all works are done through various types of organizations i.e. group of people who work together to achieve the pre determined objective or objectives. To achieve the objectives, organization can use men, material, capital etc involving cost. Information is a vital resource for business decision. Acquisition and use of information in an economic activity becomes significant, particularly in the context of perceivable trend towards accounting development. The effective utilization of such resources is the pre-condition for the success of an organization. In case of business, accounting can provide the important information. With the development of business, the number of stakeholder increases. Now in addition to owners, creditors, customers, government, society etc. are associated with the activities
of business. The innovations of corporate forms of business push the owners outside the business. The owner, potential owner and other parties associated with the business have to take some decisions about the business, which must be based on information. These informational needs have been largely discharged by modern forms of accounting. In a widely held company, the annual report can provide all the financial as well as non-financial information about the business to the external users. The external users can take all decision about the business on the basis of such information. Availability of proper information can attract the potential investors to invest. Therefore, accounting information can induce the investor to invest which helps the capital formation for the business and leads for economic development. In the present globalized environment, business can attract capital from all corner of the world and can reduce the cost of capital by making information available. As accounting can make economic information available to users, so development of proper form of accounting and reporting practices can become very important. Therefore, the study of existing accounting and reporting practice is very essential to judge the suitability and availability of informational needs to the users. The availability of reliable and relevant information can attract investors, customers from all corners of the globe and can reap the advantage free market economy.

1.2 Meaning of Accounting:

There is no universally accepted and authoritative definition of accounting. It began as a practical activity in response to perceived needs and most of its development has taken place to meet the demand made on it. Where the needs differ in different countries or environment, it was developed in different ways as response to a
particular environment. ‘At a general level it is at least safe to say that accounting exist to provide service’. However different accounting bodies have provided some definitions over the time. Some of which are reproduced below:-

In 1941, the committee on terminology of American Institute of Certified Public Accountants (AICPA) define accounting 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 a financial character and interpreting the results there of”\(^2\). This definition was widely used for many years.

In 1966, the American Accounting Association (AAA) provided another definition by emphasizing the broader prospective of accounting as “the process of identifying, measuring and communicating economic information to permit inform judgments and decision by users of information”\(^3\)

In 1970, the Accounting Principle Board (APB) of the AICPA, defined accounting with reference to the concept of information and defined “accounting is a service activity. Its function is to provide quantitative information primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making reasonable choices among alternative course of action”\(^4\). This definition has been widely used and covers the basic characteristics of accounting, such as measurement and communication of financial information.

\(^1\)Dvide Alexander & Charistopher Nobes.. Financial Accounting an international introduction. P-1. Prentice Hall 2001

\(^2\) Accounting Terminology Bulletin No1, Review and Resume AICPA 1953, para 9

\(^3\) American Accounting Association, A statement of basic accounting theory, AAA 1966 p-1

\(^4\) Accounting principles board, statement no 4
the economic activities and information to the interested parties. Thus, accounting in brief can be considered as an information system because it has input, processing of input and definite output. It provides (a) operating information (b) financial information and (c) management information.

(a) Operating information: Operating information is micro level information relating to operation of an entity like plant capacity, wages and salaries of staff, cost of raw material etc. Such information helps an organization to determine price of product, wages and salary of employee, evaluation of performance, control of cost, and preparation of future budget etc. Such information provides the basic data of management information and financial information. On the basis of such information, business determines cost of the product, salary and wages of the staff, and takes operating decisions by the management.

(b) Management information: The information that is prepared to aid management is known as management information. This information is prepared by analyzing the operating and financial information for internal use by management. The performance of management functions is based on management information system. The planning and controlling become perfect if it is based on management information.

(c) Financial information: This information reveals the financial position and financial results of an entity. Financial information is the product of operating information, which is prepared by the accountant by using different accounting practice and is largely used by management itself and external users. Based on financial information external users can take various decisions about the business. This information is useful to external users if it is prepared on the basis of some common principles, so that it possesses qualitative characteristics like –
i. Understandability: Accounting information should be readily understandable to users who assumed to have a reasonable knowledge about business, economic activities and accounting and users have willingness to study the information with reasonable diligence. The understandability of information may make wider acceptance and become useful to wide range of users of information. Adequate disclosure and consistent use of standard make financial information more understandable.

ii. Relevance: To be useful the information must be relevant to users so that items reported in information may aid in decision-making. All information may not be relevant to the users. A careful scrutiny is necessary by the experts in the field to present relevant information. There are system analyses which help the internal parties to select relevant information. Relevant information not only helps users to take proper decision in time but also assists in saving time and money of the organization.

iii. Reliability: To be useful the information must be reliable. Information may possess the quality of reliability, when it is free from material error and bias and is prepared based on some logical principle. Reliability can increase confidence of users on the information. Accuracy of presentation and use of principles in making information increase reliability to users of information. Reliability does not mean 100 per cent accuracy of information. Disclosure of limitation attached with information and use of assumptions, assessment of management in the preparation of information and consistent use of same accounting policy increase faithfulness of information.

iv. Comparability: Another important quality of information is comparability. The users of information must be able to compare financial information with similar other information in order to identify trends of performance and financial position. Again, it
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must facilitate users to compare with such information of other entities in order to judge relative financial performance, financial position and changes in financial position. Comparability assists the decision maker to determine relative strengths, weaknesses and prospects for the future between two or more firms or between periods in a single firm. The use of uniform principle and appropriate disclosure with information helps to enhance comparability.

1.3 Accounting as an Information System:

Accounting is often called as a language of business. It is a means of communicating information about the business. An accounting system starts from (a) collection of data and selection of accounting transaction i.e. input of the accounting system, (b) processing of transaction and (c) output. The system flows as given below.

Input ----------> Processing of input--------> Output = Financial statements

The accounting activity starts with the observations of economic activity and collection of data. An accountant observes and records the business transactions, which can be expressed in monetary terms only. The transactions that can take place in accounting records are the inputs of accounting.

Recorded transactions are then classified and summarized by the accountant by using different accounting principles. The summarized data are used to prepare accounting statement. These activities are the processing of input.

Finally, processed data are used to prepare financial statement in concise format to ascertain periodical operating results and financial position of the business in a comprehensive manner to the users who have only limited knowledge. These
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Statements are output of accounting system. Output can assist to accommodate special and complex needs of internal management as well external users. Reports prepared for special needs of management for discharging various needs of management are popularly known as management accounting information and reports prepared for external users are known as financial accounting information.

Management accounting is that branch of accounting, which is concerned with the provision of information useful to management. Such types of accounting can be carried out on the principle that no information needs to be kept secret for commercial reasons and the preparers will have no incentive to disguise the truth. However, in actual practice management cannot disclose all such information publicly due to some strategic reasons and used only by the internal users to discharge management function. So, for external reporting purpose financial accounting becomes the only means by which business communicate financial information to external users.

Financial accounting is that branch where accountants prepare accounting statement to show financial effects of business transactions and these reports are communicated to external users for making economic decision. Conventionally financial accounting gives information about (1) financial position measuring assets, liabilities and equity and (2) operating results, measuring revenue and expenses, by preparing balance sheet and profit and loss account respectively. Public limited companies communicate such information by publishing quarterly reports and annual reports. Contents of the financial accounting reports can be determined by many forces. First, it is influenced purely by a market force. Potential suppliers of fund will be more willing to supply if there is relevant and reliable information about use of investment and the results of such investment. An entity providing good quality and quantity of financial
information having good record of accomplishment will be able to obtain more and cheaper fund. Thus, enterprise has its own market-induced incentive to provide accounting information. Secondly, the state and some statutory body regulate the whole process by which they specify information to be reported, time of report, forms of report etc. considering environment of the country.

Presently, some countries have national Accounting Standards at national level set by Accounting Standard Board of that country considering the basic rules of financial accounting, local environment and tradition of the country. There is an International Accounting Standards (IASs), now known as IFRSs (International Financial Reporting Standards) at international level prescribed by International Accounting Standard Board (IASB), the parent organization of national accounting standard bodies. International Accounting Standard Board has no discretionary power to enforce such standards in any country but they urges to its members either to set own accounting standard in conformity with such standard or to follow such standard for preparation of accounting information to harmonize accounting information.

In India, recognizing the need to harmonize the diverse accounting policy and practices and keeping eyes on international developments in the field of accounting and finance, the council of the Institute of Chartered Accountant of India (ICAI) constituted Accounting Standard Board (ASB) in April 1977. From then, they have been formulating accounting standards for Indian business entities taking into consideration the applicable laws, customs, usages and prevailing business environment. Being the member of International Accounting Standard Board, the Indian Accounting Standard Board tries to maintain conformity with International Accounting Standards but due difference in environment, law of the land and tradition
of the country, there are some differences in Indian Accounting Standards with International Accounting Standards.

Again, some statutory bodies like Department of Company Affairs now Department of Corporate Affairs (DCA), Securities and Exchange Board of India (SEBI), Central Board of Direct Taxes (CBDT), Reserve Bank of India (RBI), Insurance Regulatory Development Authority (IRDA) etc. prescribe some rules by passing relevant Act in the parliament of India. The accountants have to follow such rules at the time of preparation of accounts and disclose the relevant information specified by such Act. All the above factors determine accounting and reporting policy of entities. Accounting and reporting policy refers to the specific accounting principles and methods, which are adopted by the enterprise in the preparation of financial statement. The accounting policy prescribes the accounting practice, which is largely influenced by the environment.

1.4 Accounting and Environment:

Accounting is a social science and operates in a specific environment. The factors of such environment like socio-political, legal, economic etc. has been changing due to passage of time, change in structure of economy and attitude of government. Since accounting 'covers the entire administration / management of information for all socio-economic activities and conditions in both micro and macro economic sectors, covering internal and external information needs of interested group, a clear analysis and assessment of this accounting environment is of prime
important. Therefore, accounting has to tune with such changing environment. The environmental factors that shaped accounting information may be followings:

a) The place of economic activities in the society.

b) The nature of economic activities in individual business enterprise.

c) The methods of measuring economic activities.

d) The diverse needs of users of financial information.

Therefore, study of accounting and reporting practices affected by the changes of economic structure, economic policy in a country is very much important.

During the last decades, economic environment of our country has witnessed much change. The major forces behind such changing environment are:

1. Globalization: Globalization is the process where by economy is made open for world market by attaining competitiveness. In a globalized economy, there are no barriers for investment, collection of capital, flow of labour and goods. All such movements take place considering competitiveness. In India the process of globalization starts after announcement of industrial policy in 1991, that is later more liberalized in subsequent other economic policy statement announced by the government from time to time. As an immediate result many foreign companies started their business either by own or jointly with Indian company. Similarly, many Indian companies also started business across the country and collected capital from investor outside the country by issuing GDRs and ADRs through listing in foreign stock exchange. Now with more flow of capital, labour, and goods the nature of economic activities has been changing.

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5 Accounting education in third world. AAA 1978 p 11
2. **Advancement of information and technology**: Globalizations make the pace of advancement of information and technology rapid. Information and technology reduce the physical distance around the world and make information easily available. Now, it becomes possible get anything more easily with the help of information and technology. Business also started to do their transactions more easily through electronic media. Similarly, there is a growing importance to provide financial information through web to make it accessible to global users. Business has to prepare accounting information in such a manner that can be useful and understandable to global users. As a result, need of uniform accounting and reporting practices becomes the need of the hour both from the viewpoint of providers of information and users of information to minimize the cost of such information.

3. **The development of the knowledge industry**: The development of information and technology emerges as new wealth creating factors. Knowledge and information replaces capital and energy as primary wealth creating factors. Knowledge and information transformed the majority of wealth creating work from physical base into knowledge base. As a result, more research and development is taking place. There is more flow of intangible like know-how, licenses among the business. The importance of tangible assets shifted to intangible assets and intangible assets becomes more in the financial statement of the business.

4. **Rise in corporate governance**: “Globalization throws new challenges to enterprises by exposing them the best. One of them is that management not only needs to be honest, but also open and transparent to shareholders, government and other stakeholders”\(^6\). As a result, corporate governance practice has emerged as an integral

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\(^6\) Dolphy D' Souza: Indian Accounting standard and GAAP. Snow white 2002  p-6.
part of financial reporting, by which business can indicates values, principles, policies and procedures of the corporation inculcated, to build users’ confidence and make information more transparent.

5. **Social consciousness and concept of sustainable development**: The social awareness of stakeholder has been increasing day by day. Different groups are interested to know about for the social contribution of the business put pressure to contribute for the welfare of the society. As a result, now Business should not concern only for profit but also for societal development. Again, due development of the concept of sustainable development, dealings business must have sustainability. A business has to do business without hampering potentialities for development of future generation. It has to maintain environment as well as economic sustainability by using resources at optimum level and regenerating the renewable resources.

As a result, the accounting and reporting practices used earlier needs change or modification to fulfill the needs of external users.

Due to changes of economic environment the immediate challenges faced by accounting are:

A. **Global harmonization**: With the changing environment, business entities increasingly operate across the countries, they encounter the cost of dealing with diversity of financial requirement. To reduce cost, and meet information needs accounting practices should be at par with global accounting and reporting. Therefore, the various constituent bodies have tried to harmonize accounting regulation to reduce diversity. However, difference in economic environment and attitude of different groups to establish their leadership causes the hindrance to global harmonization of accounting.
B. Social and environmental reporting: Another consequence of changing global environment is that, companies now may have the stakeholders in more than one country where companies operate rather than only in their home countries. A company has to disclose the meaning of their existence and highlight their contribution. As a result, there is increasing pressure on the companies to disclose social and environmental liabilities and mode discharge of such liabilities either as per requirement of law or as a pressure from socially conscious investors as well as different social groups. In some developed countries, companies have to publish social responsibility statement and environmental reports as a part of annual report as per legal requirement. Finally, companies with foreign competitors, who provide social and environmental disclosure, feel pressure to provide similar disclosure for competitive and strategic reasons. Thus, with the growth of environmental consciousness and increase in related legislation, social and environmental reporting becomes a new challenge before the accountant.

C. Financial reporting in high technology era: The phenomenal growth of internet, software and technology will no doubt have a significant impact on financial reporting. Technology has minimized the significance of geographical distance. It is entirely possible that investor will demand timely electronic financial reports regardless of nationality or geographical distance of the entities in which they invest. The traditional hard copy of annual report becomes obsolete in present age. Therefore, challenge comes for accounting profession to report in the similar way in the web site of entity for global users.

D. Accounting for price level changes: Inflation can significantly affect the purchasing power of money. Inflation corrodes the purchasing power of money. As a result, the historical cost accounting model that dominates financial reporting practices
in most of the countries is not able to reflect 'true and fair' view of financial position. The failure to provide an indication of the effect of inflation on financial statement creates problem in rational decision-making. Again, different countries have different rate of inflation, the absence of inflation adjustment in financial reports may hamper comparability and relevance of the financial statement. However, in some countries there is a specific standards regarding accounting for inflation considering hyperinflationary economy but changing value of money is the normal character. So, considering decision usefulness of financial reports, needs adjustment of inflation. Accountants have to report at fair value so that it can able to reflect current market price.

In a free market environment, quality of accounting information attracts the investor, which helps the capital formation in the country and leads to economic development. The adoption of the principle of transparency and openness facilitates to gain competitive advantage. Non-financial information and information of intangible plays very important role to bridge the gap between the information available to the management and information available to stakeholders.

Over the past decades, the technology and information revolution has fundamentally changed economic and political relationship between the nations. Opening up of financial market across the globe gives the global investor a wide choice of capital markets to invest. Consequently, the investor must have to access the information about the performance of any company in any market that he or she chooses to invest. However, difference in language, accounting practice and reporting requirement make annual report investor unfriendly.
The strength of a global company lies in its ability to collect high quantity of capital at lowest cost from the global pool of investors. Such company needs to understand needs of global investors and publish financial information in a language and form understood by existing as well as prospective investors. An investor friendly is company committed to highest standard of disclosure. Therefore, time has come to judge our accounting and reporting system and change with the changing environment to take the advantage of free market economy.

In this study, an attempt has been made to have an insight into the prevailing Indian accounting practices, its change and to evaluate its relevancy in the context of changing environment.

1.5 Objectives of the study:

In the view of the above, this study is undertaken with the following objectives:

1. To judge the social and economic changes and its impact on accounting and reporting practices.

2. To study the regulatory framework and its rules in presenting accounting information.

3. To examine the international and Indian accounting standards to find out uniformity in accounting and reporting practices in India.

4. To study the voluntary disclosure practices of Indian corporate entities.

5. To suggest ways and means for the development of future accounting practices.

1.6 Hypothesis to be tested:
In course of the study, the following major hypotheses are formulated to test the objectives of study:

1. Uniformity in accounting practice is not essential for free market economy.
2. Accounting and reporting practices are not the result of change in economic activity.
3. Static accounting theory could not help in establishing proper accounting practices in global economic activities.

1.7 Methodology applied:

The study is undertaken based on both primary and secondary data.

**Primary data:** The primary data for the study of existing accounting and reporting practices and change of accounting practice have been collected from the companies’ published annual reports. For primary data, ten Indian corporate entities have been selected randomly from the list of leading companies of Bombay Stock Exchange (BSE) sensex as sample. The companies have been selected keeping in mind the different nature of business like petroleum and gas, iron and steel, consumer products (FMGC), service etc. The annual reports of such sample companies have been collected for five (5) years starting from financial year 2001-02 to 2005-06. Some other relevant information about accounting practices has also been collected by visiting head offices and regional office of some sample companies. The names of the sample companies are:

1. Indian Oil Corporation Limited.
2. Tata Steel Limited.
Another primary sample data have been collected to judge the suitability of accounting practices. For such data, the opinions of 90 sample respondents have been collected by canvassing the annexed questionnaire among the persons directly related to corporate accounting and auditing practices. Such respondent has been selected randomly. The respondents are classified as public accountant i.e. chartered accountant and corporate accountant.

**Secondary data:** The secondary data for the research have been collected from different books, journal, and circulars. Such data are collected by visiting different libraries, website of some organization.

**Research design:** For the purpose of research, annual reports have been divided as (1) directors’ reports (2) financial statement and (3) other information disclosures. From the information collected, the following areas of accounting and reporting practices have been considered for study.

1. Valuation of inventory.
2. Depreciation policy.
3. Revenue recognition.
4. Accounting for fixed assets.
5. Accounting for intangibles.


7. Other information disclosure.

The above accounting and reporting practices have been selected considering their important implications in accounting information and growing importance in the present environment.

For the purpose of analysis, the opinion of the respondents also divided into three main categories, such as opinions about changes in accounting and reporting practices, present financial reporting system and voluntary disclosures of information.

The collected data has been analyzed by using different statistical techniques.

1.8 Limitations of the study:

The study of accounting and reporting practice, although very important, still has some limitations, which may not be avoided due to constraints of time and money.

The major limitations of the study are-

Firstly, it is not possible to cover all the companies within a specified period. Therefore, only few companies were selected randomly to collect information.

Secondly, due to vastness of subject, the study was limited to only few aspects of accounting and reporting practice.

Thirdly, certain conclusions reached are based on the analysis of information supplied on the questionnaire. The answers to such questions are based on perception of the particular respondent. There is certain amount of subjectivity in the responses where options are involved.

Fourthly, the study does not cover any banking and insurance company, which uses separate form of reporting format as per separate relevant act
1.9 Plan of work:

The present study is divided into the following chapters:-.

1. Introduction: The chapter one is an introductory one, which includes an introduction to the study, the meaning of accounting, accounting as an information system, role of accounting information in decision-making and desired quality of accounting information and the challenge faced by existing accounting reporting system due to changes of economic environment in last decades. This chapter also includes the details of methodology adopted for the study and the limitations of the study.

2. Review of literature: Chapter two is the review of literature in this particular line of study. It includes the history of development of accounting. The development of accounting theories, accounting standards and its present status are also discussed here. In the last part a brief discussion about various existing studies is made and superiority and limitations are discussed.

3. Accounting regulatory framework and its rules: In third chapter, role of various statutory bodies like Department of Company Affairs (now Department of Corporate Affairs), Securities and Exchange Board of India (SEBI) and Accounting Standard Board of India (ASB) is discussed. A detailed discussion is made regarding regulations under each body in presentation of accounting reports. The provision of Indian Accounting Standards in relevant accounting practices is compared with International Accounting Standards to find out difference in Indian Accounting Standards from International Accounting Standards.
4. **Analysis of existing corporate accounting and reporting practice**: Chapter four is the analysis of corporate practice. In this chapter, existing accounting and reporting practices adopted by various corporate entities are analyzed to have an oversight about existing practices and find out the similarity and differences of such practices among the entities.

5. **Data analysis: Analysis of opinion of respondents**: The fifth chapter is the study of the opinion of accountants in different aspects of accounting. In this chapter, primary data collected through questionnaire are analyzed. On the basis of analysis of views of respondents on changes of accounting and reporting practices, possibility of uniform accounting practices and existing disclosure practice, conclusions are drown about the reliability and relevancy of present corporate accounting and reporting system.

6. **Conclusion and suggestions**: The last chapter is the general conclusion about the findings from the research study. On the basis of such findings, some suggestions are made for the future course of action.

The next chapter discusses the history of accounting development and a review of existing literature.