Financial Accounting

Introduction to Financial Accounting

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Learning Objectives

After studying this chapter, you will be able to

- Define accounting and realise its importance
- Distinguish between financial, cost and management accounting
- Relate finance function and accounting
- Understand accounting as an academic discipline and as a profession
- Get an overview of auditing and internal control
- Know ethical issues in accounting
- Relate accounting and corporate governance

Let us Set the Stage . . .

Krishna needs to buy a book urgently. She asks her father for the money. “But”, the father says, “what happened to the money I gave you last week?” She tries to recollect how she spent it but could not remember exact amount of money she spent on various occasions. Her father advises her to record all her expenses in a diary. Recording all incomes and expenses systematically is ‘accounting’ for the money.

Mr Ram Singh is a retail fruit vendor. He records his daily sale and purchase of fruits in a diary. At the end of the day, he counts his stock and plans for next day’s purchase. As his fruit business was doing well, he plans to start a retail shop of fruits in the market. He approaches a microfinance institution in his area and asks for a loan. They ask Mr Ram Singh to produce financial statements. Mr Ram Singh produces a diary stating all daily purchases, sales and stock records. A volunteer explains him that such a dairy is not enough and he has to get proper profit and loss account (stating all expenses and incomes) and balance sheet (stating all assets and liabilities) to obtain a loan.

Accounting plays a very important role in determining the profitability and financial position. This chapter will introduce you to various concepts and set a background for you to get acquainted with the accounting terminologies.

Accounting as an Information System

Decision-making in respect of major business functions, including production, administration and marketing, depends on availability of timely and accurate financial information. All types of organisations, whether business, non-profit or governmental, are required to provide information to outsiders. Thus, financial information is demanded by both external and internal users. Accounting establishes a standardised and systematic process for recording and processing of data, giving out information in the form of financial statements.

Meaning

In simple words, ‘accounting’ refers to recording. Whenever any organisation is operating, one would like to know its performance. In order to be able to do so, it is necessary that as far as possible all the transactions that have taken place should be recorded systematically in monetary terms. The process of accounting involves recording, classifying and summarising past events and transactions of financial nature, with a view to enabling the users of accounting data to interpret the resulting summary.

Accounting is one of the most widely used information processing systems in business. The utility of accounting information increases when this information is compiled in a systematic manner and financial statements are prepared at periodic intervals. For the purpose of compilation, all monetary events are recognised as 'transactions' and are classified into various 'account' heads. An account is a statement that shows all transactions related to a particular asset, liability, income or expense, for instance Cash Account (Cash A/C). The 'account' heads are then summarised under related groups so that interpretation becomes possible. For example, when a travel agent purchases stationery for office use, it is recorded as Stationary A/C, grouped under office expenses. All such expenses are compared with business income to arrive at profit.

There is a small difference between the terms 'accounting' and 'book keeping'. Book keeping is a part of accounting that is concerned with recording; a book keeper normally needs lower academic qualification. Accounting, in its broad sense, extends to financial reporting, taxation compliance, cost analysis, interpretation, and estimation. It is the process of identifying, measuring, recording and communicating economic transactions.

> "Accounting is 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 thereof."
>
> —The American Institute of Certified Public Accountants (AICPA)

Financial accounting consists of creation of financial information and the subsequent use of such information. Accounting entails various steps, namely, recording, classifying and summarising, which are dealt below:

1. *What to record*? All financial transactions affecting the business have to be recorded in accordance with the principles of accountancy. As money is the common unit of measurement, all events that are expressed in monetary terms will be recorded.
2. *When to record*? Accounting is historical in nature because of which the recording is to be effected only after the occurrence of a transaction. Therefore, sale of goods cannot be recorded when the goods are merely intended to be sold but only after such sale is complete and the property in the goods has been transferred to the buyer.
3. *How to record*? Whenever a transaction occurs, it is decided in which account/s it is to be recorded. Accounting concepts, policies guide recording procedure. This will be covered in-depth in Chapter 5, Mechanics of Accounting.
4. *Value at which it is to be recorded*: All the ingredients of the financial statements are to be assigned appropriate values. Money is the scale of measurement in accounting and we can measure only those which can be translated into monetary terms. Different valuation bases are used in accounting, of which, the frequently used are historical cost, current cost, realisable value and present value. Value is determined at the time of recording and at the time of preparation of financial statements.

5. *Preparing statements*: Income statement is prepared to calculate profit or loss during a particular year by summarising all incomes and expenses. Balance sheet is prepared to record assets and liabilities stating financial position of the concern at the end of a particular period. Cash flow statement shows inflow and outflow of cash. The financial statements are prepared at the end of certain period, usually yearly or quarterly.

Evolution of Accounting

Both merchants and governments have been using accounting for keeping records of transactions since times immemorial. India has a very long tradition of maintaining books of accounts known as *chopadis*. These *chopadis* were closed at the end of the year and new set of books were opened. *Lakshmi Poojan (Diwali)* is considered as an auspicious day for worshipping new books (*chopadis*), which are to be started from the next day (*Bali Pratipada*). The concept of accounting period is firmly rooted to the Indian tradition. We also see mention of financial instruments like *hundis* in ancient India. Kautilya, also known as Chanakya or Vishnugupta, a well-known statesman, economist and spiritual guru wrote *Arthshastra* in the fourth century BC, where he has recognised the importance of accounting. He realised that a proper measurement of economic performance was absolutely essential for efficient allocation of resources. He specified a very broad scope for accounting and considered explanation and prediction as its proper objectives. Kautilya developed book-keeping rules to record and classify economic data. He emphasised the critical role of independent periodic audits and proposed the establishment of two important but separate offices—the Treasurer and Comptroller-Auditor—to increase accountability, specialisation, and, above all, to reduce the scope for conflicts of interest. Clarity, consistency and completeness of rules are keys to such enforcement. Kautilya believed that such measures were necessary but not sufficient to eliminate fraudulent accounting. He also emphasised the role of ethics, considering ethical values as the glue which binds society and promotes economic development.

The origin of the organised forms of accounting that we use today can be traced back to Italy. The recognition in record keeping, of the fact of the duality of values—that is, the benefit to the entity on the one hand, and its sacrifice on the other—can be considered to be the crux of the modern accounting system. Luca Pacioli (1445–1515) is usually recognised as the father of modern accounting as he published first text on accounting. Though accounting systems were used much prior to Pacioli's book, the system became a standard for merchants, especially in Europe, only after Pacioli structured and organised it in his book. Accounting methodology, which was developed and used in trade and commerce during the Middle Ages, faced its first serious challenge with the introduction of the modern manufacturing industry, as a result of the Industrial Revolution.

In today's information technology intensive environment, we see that accounting is getting increasingly adapted to the new situation and getting integrated into new software packages. Computerised accounting systems have taken the place of traditional book keeping. They are designed to automate and integrate all the business operations, such as sales, finance, purchase, inventory and manufacturing.

Importance of Accounting

Objective 1
To Define Accounting and Realise its Importance

Accounting plays an important role in the success of any business, social or regulatory organisation. The following are the major points showing importance of accounting:

- It ensures systematic recording of financial transactions.
- It records income and expenses in such a manner that net result of any period can be determined.
- It records assets and liability in such a way that financial position of the entity can be judged.
- It makes tax assessment easy and benefits both business organisations and tax authorities.
- It helps share holders, management and other stakeholders to monitor and evaluate organisations performance.
- It provides reliable and timely information for decision-making.
- It acts as a basis for estimation and projection of financial figures and hence enables preparation of budgets.

Users of Financial Statements

Financial statements are prepared by following proper accounting process. Such financial statements are used by various users for different purposes as follows (see Figure 1.1).

Owners/Investors

The major users of financial statements of business include sole proprietor or partners or shareholders. The financial position of the company is communicated to the shareholders through the financial statements which state the profit gained or loss suffered and the value of its assets and liabilities. Prospective investors also use such information to take decisions about their investments in companies. In case of listed companies, groups like analysts, mutual funds, investment bankers, institutional investors become interested in financial statements.

Management/Board of Directors

In a company form of organisation the owners or the shareholders elect a group of people to manage the day-to-day affairs of the company. Since these directors/managers are

FIGURE 1.1 Users of Financial Statements

ultimately responsible for the financial performance, they must periodically compile and report the financial statements. Financial information are also useful for decision-making function.

Lenders/Bankers

Banks, financial institutions and other lenders would willingly part with their money only if they are assured of the repayment capacity, profitability and long-term solvency of the business to which they are asked to lend. Financial statements are normally used by the lenders to judge for the financial health of the business and to assure themselves of the security available for the monies lent. The financial statements are also used to monitor company's performance on regular basis.

Suppliers/Creditors

Suppliers of raw material or services are primarily interested in the short-term liquidity of the company. The financial statements facilitate the creditors in ascertaining the capacity of the organisation, to pay on time the consideration for the goods/services to be supplied.

Customers

They can determine the strength and reliability of an organisation based on financial performance. Legal obligations associated with guarantees, warranties and after sales service contracts tend to establish long-term relationships between a business and its customers. The financial statements are used by the customers to draw inferences about the long-term viability of the firm.

Employees

Employees have an interest in the continued and profitable operations of the organisation in which they work. Financial statements can be used as an important source for obtaining information regarding the current and future profitability and solvency. Sometimes, contracts tying remunerations to profits or payment of incentives based on certain financial measure would tend to magnify this interest.

Government and Regulatory Agencies

The correct assessment of taxes—income tax, sales tax, excise duty, etc.—takes inputs from the financial statements of an organisation especially to detect tax evasion, if any. Government, as the guardian of public interest, must also keep a close watch over the various business firms to detect profiteering and creation of monopolies. Vital information in this regard can be gathered from a scrutiny of the financial statements of business enterprises. National income accounting used in macroeconomic analysis derives its fundamental inputs from financial statements. The tax payable by the enterprises as well as the compilation of countrywide statistics is discerned using the financial statements. Regulatory authorities like Securities Exchange Board of India (SEBI), Reserve Bank of India (RBI), Registrar of Companies (ROC) also uses the financial information to keep vigilance on the companies.

Financial, Cost and Management Accounting and their Interrelationships

Objective 2
To distinguish between financial, cost and management accounting

Financial accounting deals with recording and preparation of the statements revealing the income and financial position of the business on the basis of events which have happened in a particular period.

The major purpose of financial accounting is to report the position of the entity as on the reporting date, as well as the performance of the entity during the period covered by the previous reporting date and the present reporting date. This reporting is done through various financial statements, important ones being income statement and balance sheet. Financial statements present information on revenues, profits, cash flows, assets, liabilities and so on. Though this information is very important, it does not adequately aid the management in planning, controlling, organising and efficiently conducting the course of the business as a result of which cost accounting and management accounting have emerged.

Cost accounting records, analyses and estimates cost. It also deals with cost computation, cost saving, cost reduction, etc. The costing function provides information that is crucial for profit measurement in financial accounting. The cost of products/services to be considered with respect to the revenues earned is provided by the cost accounting system. Cost accounting is primarily targeted to inside users.

Management accounting deals with the processing of data generated in financial accounting and cost accounting for managerial decision-making. It also uses managerial economic concepts for decision-making. Management accounts facilitate planning and control of activities of organisation to assist in decision-making process.

Cost accounting is indistinguishable from management accounting as the major purposes of providing information for control purpose and for formulating plans and policies, is common to both (see Table 1.1). It should, however, be noted that traditionally, cost accounting was concerned with the determination of product costs and inventory valuation and in this respect; it was an extension of financial accounting. The function of management involves taking decision with respect to day-to-day operations of the entity and strategic planning. Managers depend on the accounting data for guiding their decisions. Management accounting provides relevant information to facilitate decision-making.

Table 1.1 Managerial Accounting and Financial Accounting

	Managerial Accounting	*Financial Accounting*
1.	It is generally targeted to managers within the organisation	It is targeted to various stakeholders including outside the organisation.
2.	Preparing managerial accounting is not mandatory	Maintaining financial accounting records is statutory requirements
3.	It is not regulated as it is intended only for management	It is closely regulated by GAAP, accounting bodies and government authorities
4.	It uses historical data along with projections and estimations	It primarily uses historical data

Finance Function and Accounting

Objective 3
To relate finance function and accounting

Accounting involves the creation of financial records of business transactions, flows of finance, the process of creating wealth in an organisation, and the financial position of a business at a particular moment in time.

Finance is the lifeblood of economy without which business cannot run successfully. Sufficient funds at the required time are the key to success. In terms of Husband and Dockery, "Finance is the agent that directs the flow of economic activity and facilitates its smooth operation."

John J Hampton defined it as the management of the flow of money through an organisation. It involves the proper custody and authorised utilisation of available funds. It is related to procurement of funds as well as their effective utilisation. It covers not only financial planning, financial forecasting, raising finance but optimum use of funds.

Accounting as an Academic Discipline

Objective 4
To understand accounting as an academic discipline and as a profession

An academic discipline, or field of study, is a branch of knowledge that is taught and researched. Disciplines are defined and recognised by the academic journals in which research is published, and the learned societies and academic departments or faculties to which their practitioners belong. Accounting has generally been oriented towards practical knowledge as opposed to theoretical abstractions.

Accounting and Economics

Economics is concerned with rational decision-making regarding efficient use of scarce resources for satisfying human wants and needs. Accounting and economics are related to each other. Both of them consider the effective and efficient use of resources. Accounting deals with provision of accurate, timely and adequate information to the stakeholders, while economics deals with production, distribution, and consumption of goods and services. Accounting and finance are related to each other as accounting is a part of finance. Accounting deals with recording financial transactions on daily basis whereas raising and utilising funds are focus areas in finance activity.

Accounting and Statistics

Statistics is the science of numbers. It is concerned with numerical data as well as various statistical techniques which are used for collection, classification, analysis and interpretation of such data. Accounting has close relation with statistics as numbers of statistical techniques are used for analysis and interpretation of accounting data.

Accounting and Law

A business entity operates within a legal framework. There are laws governing specific entity for instance Companies Act is applicable to Joint Stock Companies and it provides detailed guidelines for preparing accounting statements, the Banking Regulation Act is applicable to banking companies and so on.

Table 1.2 shows some of the major Indian and international research journals in the areas of accounting.

TABLE 1.2 Accounting Research Journals

No.	*Name of Journal*	*Published by*
1	Accounting, Auditing, & Accountability Journal	Emerald
2	The Accounting Review	American Accounting Association
3	The Chartered Accountant	ICAI
4	Journal of Accounting and Economics	Elsevier
5	Journal of Accounting Research	Wiley
6	Abacus	Wiley

ACCOUNTING AS A CAREER AND PROFESSION

Accounting is considered as a profession as it requires specialised knowledge. Each country has its own accounting bodies to regulate the accounting profession.

In India, a qualified accountant must have passed examinations conducted by the Institute of Chartered Accountants of India (ICAI) and should be a member of that Institute. The ICAI is a statutory body established under the Chartered Accountants Act, 1949 for the regulation of the profession of Chartered Accountants in India. During its 63 years of existence, the ICAI has achieved recognition as a premier accounting body not only in the country but also globally, for its contribution in the fields of education, professional development, maintenance of high accounting, auditing and ethical standards.

Apart from the ICAI following professional bodies offer professional qualifications which are also widely accepted in India.

- Institute of Cost and Works Accountants of India (ICWAI) (Established in 1944)
- Institute of Company Secretaries of India (ICSI) (Established in 1980)

Table 1.3 lists out some recognised accounting bodies in some other countries.

Table 1.3 List of Recognised Bodies in other Countries

Institute	*Country*	*No. of Members*
American Institute of Certified Public Accountant (AICPA)	USA	3,70,000
The Institute of Chartered Accountants of India (ICAI)	India	1,61,516
The Chinese Institute of Certified Public Accountants (CICPA)	China	1,40,000
The Institute of Chartered Accountants in England and Wales (ICAEW)	UK	1,36,000
Canada Institute of Chartered Accountants (CICA)	Canada	78,000
The Institute of Chartered Accountants of Australia (ICAA)	Australia	50,000
The Institute of Professional Accountants of Russia (IPAR)	Russia	50,000

These accounting bodies contribute to accounting profession by identifying opportunities for accountants in audit and assurance function, performance measurement services, strategic management, general practice specialisation and servicing global organisations. Such institutes plays important role in providing high quality education and in maintaining professional ethics.

Some other international accounting bodies are discussed below.

The Association of Chartered Certified Accountants (ACCA) is a British accountancy body that offers the Chartered Certified Accountant qualification worldwide. It is one of the world's largest and fastest-growing accountancy bodies with 1,40,000 members in 170 countries.

The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession. The IFAC has 164 members and associates in 124 countries and jurisdictions, representing more than 2.5 million accountants employed in public practice, industry and commerce, government, and academe. The organisation, through its independent standard-setting boards, establishes international standards on ethics, auditing and assurance, accounting education, and public sector accounting. It also issues guidance to encourage high quality performance by professional accountants in business.

The Association of International Accountants (AIA) is a professional accountancy body. It was founded in the UK in 1928 and since then has promoted the concept of "international accounting" to create a global network of accountants in over 85 countries worldwide.

Accounting profession is done by individual accountants or by their partnership firms. Global consultancy business is dominated by certain accounting firms. Table 1.4 provides information about top international accounting/consulting firms for 2011.

Table 1.4 Information about Top International Audit Firms

Audit Firm	*Revenue*	*Employees*	*Headquarters*
Deloitte	$26.578 bn	1,82,000	USA
PwC	$26.569 bn	1,69,000	UK
Ernst & Young	$21.255 bn	1,52,964	UK
KPMG	$20.630 bn	1,38,000	The Netherlands

Source: http://en.wikipedia.org/wiki/Big_Four_%28audit_firms%29, accessed on 17 January 2012

Place of Accounting Officers in the Organisation

In the large organisations, professionals with accounting and finance background are placed at all levels, i.e. higher, middle and lower level.

Figure 1.2 shows a sample organisational chart.

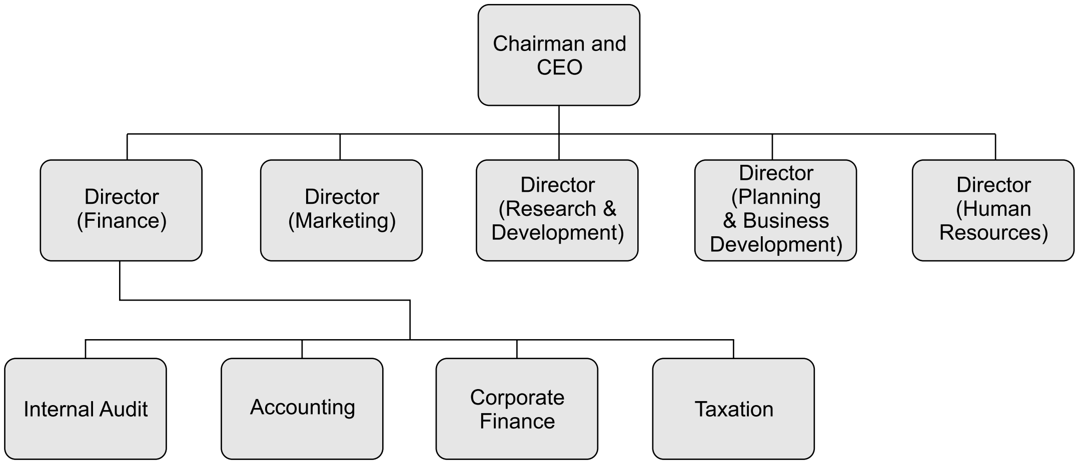

Figure 1.2 Sample Organisational Chart

Auditing and Internal Control

Objective 5
To get an overview of auditing and internal control

The final accounts of business concern are used by various persons such as owners, shareholders, investors, creditors, banks, government, etc., for different purposes. All these users need to be sure that such accounting statements prepared by the management are reliable. An auditor is an independent expert who examines the accounts of business concern and reports whether they present 'true and fair view'.

As per the Standards on Auditing (SA) 200 issued by the ICAI, "Auditing is the independent examination of financial information of any entity, whether profit oriented or not, and irrespective of its size or legal form, when such an examination is conducted with a view to expressing an opinion thereon."

As per the Standards on Auditing (SA) 200 issued by the ICAI, basic principles governing auditing include Integrity, Objectivity and Independence, Confidentiality, Skill and Competence, Planning, Audit evidence, etc.

As per the Indian Companies Act a qualified Chartered Accountant (CA) holding certificate of practice issued by the ICAI is authorised to be appointed as an auditor of the company. Audit report issued by an auditor is opinion of the auditor mainly regarding true and fair view of financial position of the company and compliance with Accounting Standards issued by the ICAI.

Internal control is a process affected by an organisation to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting and compliance with related rules and regulations. Internal control system comprises accounting controls as well as administrative controls. Accounting controls mainly aim at safeguarding assets and ensuring reliability of financial records. It provides reasonable assurance that all the transactions authorised by the management are promptly and properly recorded. Administrative controls are basically regarding improving operational efficiency and adherence to management policies for instance Stores Department can issue materials only against a requisition slip duly authorised.

> A system of internal control comprises the following five elements: Control environment, Entity's risk assessment process, Information system and communication, Control activities, and Monitoring of controls.
>
> —Standard on Internal Audit (SIA) 11-ICAI

Large organisations are required to set up a system of internal audit within the organisation as an integral part of the internal control. Internal audit is review of various operations and records of the company by staff/professionals specifically appointed for this purpose.

> Internal audit is an independent appraisal activity within an enterprise for the review of accounting, financial and other operational controls as basis to service for management.
>
> —Guidelines on Internal Audit by ICAI

Internal audit has always been of immense significance to the corporate world. From being a cross check over the accounts of the organisation, internal audit has, over the years moved to being a strong indispensable control tool in the hands of the management, which can help it to add to the shareholders' value. Internal audit can significantly help the management improve its operational efficiency through improved

(Contd.)

risk management and control systems and strengthening the overall governance mechanism of the entity. Internal audit covers review of all the functional areas of management—HR, Marketing, Production and is not restricted to just Finance and Accounts. With growing competition and increasing expectations of the stakeholders, the importance of internal audit is also gaining importance.

In July 2002, the United States Congress passed the Sarbanes-Oxley Law (SOX). The SOX was primarily designed to restore investor confidence following well-publicised bankruptcies that brought chief executives, audit committees, and the independent auditors under heavy scrutiny. The SOX is applicable to all publicly registered companies under the jurisdiction of the Securities and Exchange Commission (SEC). The SOX is a far reaching legislation, effecting significant changes to laws affecting officers, directors and reporting obligations of public companies, and mandating a myriad of new regulations to prevent securities fraud and other abuses.

The SOX called for the formation of a Public Company Accounting Oversight Board (PCAOB) and specified several requirements that included management's quarterly certification of the financial results and management's annual assertion that internal controls over financial reporting are effective among others. The SOX have extended the reach of the United States' laws to many aspects of the internal affairs and governance regimes of foreign companies and their auditors.

Ethical Issues in Accounting

Objective 6
To know ethical issues in accounting

Accounting involves the systems that gather and transform the information, and involves decision-making about the future based on that information. Accounting has been called 'the language of business' and, because of its pervasiveness, it affects the lives of individuals in all sectors of our society. Accounting requires significant judgements and assumptions. Different accountants, given a complex set of circumstances, will probably arrive at several different income or valuable figures. Considering fiduciary responsibility of an accountant (particularly auditors), their behaviour should be driven by ethical values.

Frauds in financial statements can be of the following types:

1. Recording fictitious revenue—revenues not actually earned
2. Concealment of liabilities and expenses
3. Fraudulent asset valuation
4. False statement of the inventory available
5. Under provisioning for depreciation
6. Showing day-to-day expenses as capital expenditure

7. Paying salary to ghost employees

The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, an American energy company based in Houston, Texas, and the dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganisation in the American history at that time, Enron was attributed as the biggest audit failure. Enron's non-transparent financial statements did not clearly depict its operations and finances with shareholders and analysts. In addition, its complex business model and unethical practices required that the company use accounting limitations to misrepresent earnings and modify the balance sheet to portray a favourable depiction of its performance. Between 1996 and 2000, Enron's revenues increased by more than 750%, rising from $13.3 billion in 1996 to $100.8 billion in 2000. This extensive expansion of 65% per year was unprecedented in any industry, including the energy industry which typically considered growth of 2–3% per year to be respectable. This was as a result of misleading accounting statements.

These malpractices may lead to window dressing, reporting false income, evasion of taxes, and portraying a wrong financial position. According to the Code of Ethics issued by the ICAI, a professional accountant is required to comply with the following fundamental principles:

(a) *Integrity*

A professional accountant should be straightforward and honest in all professional and business relationships.

(b) *Objectivity*

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional judgements.

(c) *Professional Competence and Due Care*

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act diligently and in accordance with applicable technical and professional standards while providing professional services.

(d) *Confidentiality*

A professional accountant should respect the confidentiality of information acquired as a result of professional and employment relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and employment relationships should not be used for the personal advantage of the professional accountant or third parties.

(e) *Professional behaviour*

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Forms of Organisations and Their Effect on Accounting

There are various forms of organisations. The principles of accounting do not change with the form of organisation. However, disclosure requirements may change. In some instances transact recording also changes with the form of organisation. Table 1.5 summarises the various forms of organisations, their essential features and effect on accounting.

Table 1.5 Various Forms of Organisations

Form of Organisation	*Ownership*	*Financial Statements*	*Auditing*	*Regulations on Accounting and Disclosures*	*Suitability*
Sole Proprietorship	Single owner	No specific format	Not compulsory	Minimal	Small Business
Partnership Firm	Minimum: 2 Maximum: 20	No specific format	Not compulsory	Minimal	Small and Medium Business
Limited Liability Partnership (LLP)	Minimum: 2 Maximum: no limit	Specific format	Compulsory	Very less (under Limited Liability Partnership Act, 2008)	Medium Sized Business
Private Company	Minimum: 2 Maximum: 50	Specific format	Compulsory	Minimum regulation (Companies Act, 1956)	Medium and Relatively Large Business
Public Company	Minimum : 7 Maximum: no limit	Specific format	Compulsory	Minimum Regulation (Companies Act, 1956)	Large Business
Listed Public Company	Widespread	Specific format	Compulsory	Stiff Regulation (SEBI and Companies Act, 1956)	Large Business
Banks	Usually widespread	Specific format	Compulsory with stringent norms	Stiff Regulation (RBI and Companies Act, 1956)	Banking Business

(*Contd.*)

Insurance Companies	Not so wide-spread	Specific format	Compulsory with stringent norms	Stiff Regulation (IRDA and Companies Act, 1956)	Insurance Business
Cooperative Society	Minimum: 10 Maximum: no limit	Specific format	Compulsory	Minimum Regulation (Co-operative Societies Act, 1912 or State Cooperative Societies Acts)	Medium Sized Business with social angle
Public Trust or Society	Minimum: 2 Maximum: no limit	Specific format	Compulsory	Minimum Regulation (Societies Registration Act or Indian Public Trust Act or State Public Trust Acts)	Non-business Entities

Accounting and Corporate Governance

Objective 7
To relate accounting and corporate governance

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

—OECD April 1999

The issue of corporate governance has assumed greater significance ever since frauds in multinational and global corporations have come to light. The very purpose of having an entity clothed in separate legal personality in the form of a company is to enable easy and quick mobilisation of money in the form of share capital to take up activities requiring huge financial resources and also to distribute the profits or losses arising out of such ventures. The other reasons are like pooling talent for smooth management of the affairs of the entity, global presence, obtaining loans from banks and financial institutions, etc.

In the Indian context, the need for corporate governance has been highlighted because of the scams occurring frequently since the emergence of the concept of liberalisation in 1991 such as the Enron Corp. Scam (1998), Harshad Mehta Scam

(1992), Ketan Parikh Scam (1995), Satyam Scam (2007), etc. Scams like Satyam may decrease investor confidence about corporate governance and oversight in emerging markets, which are still reeling from the global financial crisis.

Satyam Computers had been one of the major contributors to the IT revolution in India. A company which had been fourth largest Software Company of India came to ground on January 7, 2008 with its chairman Ramalinga Raju conceding that he has systematically fudged the accounts of the company. Cash and bank balance as reflected in the accounts, actually did not exist. According to a rough estimate total fraud was to the tune of around 8,000 crores.

Some Accounting Frauds

CRB Capital Markets (1996)

Amount: Rs 1,200 crore

Chairman Chain Roop Bhansali was accused of using CRB's accounts in SBI to siphon off Rs 12 billion bank funds, claiming that the firm was encashing interest warrants and refund warrants.

ITC-Chitalia's Fera Violation (1996)

Amount: $80 million

ED investigation into export transactions between ITC and EST Fibres of the Chitalia group during 1990 and 1995 revealed violation of FERA provisions.

Home Trade (2002)

Amount: Rs 6,000 crore

Eight cooperative banks, including Valsad People's Cooperative Bank and Navsari Co-operative Bank among others collectively lost over Rs 80 crore.

DSQ Software (2003)

Amount: Rs 595 crore

Dinesh Dalmia's DSQ Software was accused of dubious acquisitions and biased allotments made in 2000 and 2001.

Enron (2001)

Amount: About $50 billion

The company did not report the actual debts and losses in its financial statements.

Arthur Andersen (2001)

In 2002, Andersen was convicted for obstruction of justice for shredding documents related to its audit of Enron. AA.s CPA licences and its right to practise were confiscated by SEC in 2002.

Parmalat (2001)

Amount: $5.7 billion in debt and $6 billion in cash

Tyco (2004)

Amount: $600 million

Former chairman and CEO Dennis Kozlowski and ex-CFO Mark H Swartz were accused of theft of $600 million from the company.

Summary

- Accounting involves recording, classifying and summarising of past events and transactions of financial nature, with a view to enabling the user of accounts to interpret the resulting summary.
- Users of financial statements are management, shareholders, suppliers, creditors, government authorities.
- Accounting entails various steps, namely, Recording, Classifying and Summarising.
- Accounting plays an important role in the success of any business, social or regulatory organisation.
- Accounting involves the creation of financial records of business transactions, flows of finance, the process of creating wealth in an organisation, and the financial position of a business at a particular moment in time.
- Accounting has generally been oriented towards practical knowledge as opposed to theoretical abstractions.
- An auditor is an independent expert who examines the accounts of business concern and reports whether they present "true and fair view".
- Internal control is a process affected by an organisation to provide reasonable assurance regarding the effectiveness and efficiency of operations, reliability of financial reporting and compliance with related rules and regulations.
- Internal audit is an independent appraisal activity within an enterprise for the review of accounting, financial and other operational controls as basis to service for management.

- Accounting is considered as a profession as it requires specialised knowledge. Each country has its own accounting bodies to regulate the accounting profession.
- In the large organisations, professionals with accounting and finance background are placed at all the levels, i.e. higher, middle and lower level.

Multiple Choice Questions*

1. The process of accounting involves
   (a) Recording the transactions
   (b) Classifying the transactions
   (c) Summarising the transactions
   (d) All the above
2. An account is a statement that shows all transactions related to
   (a) A particular asset, liability, income or expense
   (b) Any financial data
   (c) Any business event
   (d) None of the above
3. Who amongst the following is usually recognised as the father of modern accounting?
   (a) Adam Smith
   (b) Karl Marx
   (c) Luca Pacioli
   (d) Chankya
4. Which of the following types of accounting deals with recording and preparation of the statements revealing the income and financial position of the business on the basis of events that have happened in a particular period?
   (a) Financial accounting
   (b) Cost accounting
   (c) Management accounting
   (d) All of the above
5. Which of the following types of accounting deals with recording, analysing and estimating cost and also deals with cost computation, cost saving, cost reduction, etc.?
   (a) Financial accounting
   (b) Cost accounting
   (c) Management accounting
   (d) All of the above

*Answers to Multiple Choice Questions are provided on the website of the book, www.mhhe.com/bapat-raithatha.

6. Which of the following types of accounting deals with the processing of data generated in financial accounting and cost accounting for managerial decision-making?
   (a) Financial accounting
   (b) Cost accounting
   (c) Management accounting
   (d) All of the above
7. In India, a qualified accountant must have passed examinations conducted by
   (a) Institute of Chartered Secretaries of India (ICSI)
   (b) Institute of Chartered Accountants of India (ICAI)
   (c) Institute of Cost and Works Accountants of India (ICWAI)
   (d) All the above
8. Auditing is
   (a) The independent examination of financial information
   (a) Process of recording accounting transactions
   (a) Analysis of financial information
   (a) Interpretation of accounting data
9. Which of the following systems provides the structure through which the objectives of a company are set, and the means of attaining those objectives and monitoring performance?
   (a) Corporate governance
   (b) Auditing
   (c) Internal control
   (d) Accounting
10. Internal control system comprises
    (a) Accounting controls
    (b) Administrative controls
    (c) Both the above
    (d) None of the above

Theory Questions

1. What is accounting? What is its importance?
2. Write a note on evolution of accounting.
3. Who are the users of financial statements? Explain in brief.
4. Distinguish between:
   (a) Financial and cost accounting
   (b) Financial and management accounting
   (c) Cost and management accounting

5. Explain accounting as an academic discipline.
6. Write a note on:
   (a) Finance function and accounting
   (b) Accounting profession as a career
7. Write a note on ethical issues in accounting.
8. Explain relationship between corporate governance and accounting.
9. Explain auditing and internal control.