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CHANGING ENVIRONMENT OF ACCOUNTING

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The ultimate objective of accounting is to communicate financial information to different end users. This paper examines the dynamic relationship between financial accounting and the economic, legal and social environment. The environment of accounting identifies the persons and institutions for whom accounting information is to be compiled and presented in a desired manner. Such information has an impact on decision making at the micro and macro levels.

I

Introduction

Each one of us has to make some type of economic decision in our daily life..As members of families, staff associations, social organisations, as employees and employers, we are confronted with some sort of economic decisions, and this process of decision-making continues throughout our life time. For example, as an ordinary investor, one has to decide whether one should subscribe to the share or debenture issue of a certain joint stock company or as a club member, should we support the proposed operating budget of the club or as a chairman or managing director of a company whether a new factory be set up at Noida, or as union leader should the union demand say a 10 per cent increase in pay or bonus or as a bank manager, should a loan be granted for the construction of a house or purchase of a motor van or as a head of the family whether it is desirable to live in a rented house or to buy a new house and so on. In this way the examples can be multiplied to show the type of economic decision one has to make in real life situations. It is relevant to state that none of the economic decisions cited here can be made without financial information; that is, it is not possible to make economic decisions in a vacuum. Sound economic decisions must be based on relevant financial information communicated in some desirable or meaningful form.

The communication of financial information or data of different users is the ultimate aim of accounting. The term environment literally means the external conditions and surroundings in which people live. In a sense the accountant is associated with social, political and economic organisations such as business, non-profit making entities like hospitals, educational institutions and the religious institutions, chamber of commerce, professional groups (e.g. Institute of Chartered Accountants of India), political parties etc. These organisations constitute the society and in turn are essentials for the working of the society. The major problem facing the society is the allocation of scarce resources

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amongst alternate uses. In fact the society and the various organisations that constitute the society develop in direct proportion to the efficiency with which it allocates the scarce resources – men, materials,services and capital. To accomplish this basic objective, organisations and persons interested in specific organisations need information about how the resources that the organisations control were generated and used. Accounting information is meant to achieve this goal with the help of financial reports. Accounting is responding to the changing needs of the society, and is therefore facing new challenges. In most of the cases accounting has to face business environment over which it has little direct control e.g. changes in the price level. Even then the system of financial accounting is not static but responds to the characteristics of the environment in which it operates. In brief the environment of accounting (financial accounting) is shaped by such factors as

(i) the place of economic activity in the society,
(ii) the nature of economic activity in individual business enterprises,
(iii) the methods or means of measuring economic activity, and
(iv) the diverse needs of many users of financial accounting information.

The foregoing factors may be broadly grouped of classified as

(i) the Economic Environment,
(ii) the Legal Environment, and
(iii) the Social Environment.

II

Economic Environment

The development of accounting has been greatly influenced by changes in economic environment. The origin of double entry book keeping can be associated with the growth of capitalist or market economies and the needs of trade. Similarly the development of cost accounting is attributable to the need to price products produced on a large scale since the advent of industrial revolution. In an economic environment people develop economic systems such as capitalist or socialist for the purpose of production, distribution, exchange and consumption of goods and services. An economic system, therefore, exists to deal with the following basic economic problems.

(i) What type and in what quantities the goods and services shall be produced? This is technically called the production process.
(ii) How the income is to be distributed amongst those engaged in production process? It is achieved by distributing the output (in the form of goods and services) of the production process among four factors of production in the following manner:
   (a) **rent** for the use of land;
   (b) **wages** for labour/human resources;

(c) **interest** for the use of capital; and

(d) **profit** for the owners as reward for risk-taking or entrepreneurship. It may be added that outputs of production process are measured in terms of common unit of exchange, that is, rupees and income is distributed to various factors of production in rupees.

(iii) How are goods and services traded with the help of price mechanism? This is called exchange process.

(iv) How are the goods and services used? This is called the consumption process.

In an economic system people also *save and invest.* Saving takes place when an individual or a group of individuals postpones the consumption of goods and services. If some to today's income is not consumed, the production resources can be directed away from production of more consumer goods. These diverted resources are then utilised to produce capital goods (e.g. machines, plants, public utilities etc.), that is, goods that are not consumed directly but are used to expand the production facilities.

In sum, with increased savings and intelligent investments the health of the nations grows as more machines, factories and tools are produced. The useful accounting information helps to allocate the capital efficiently in the economy. The efficient running of market economy depends to a large extent on the good investment decisions made by people both in the private sector and in Government. **In the capital market, both the receivers and suppliers of capital need relevant and reliable information to decide where to invest or lend and at what price.** As Professor **Paton** put it;

> *"....accounting insofar as it contributes to render effective control of the price system in its direction of economic activity, contributes to general productive efficiency, and has a clear cut social significance, a value to the industrial community as a whole".*

It means that if the accounting information given to investors and creditors is inaccurate or misleading so that incorrect decisions are made, then more investments may be made into inefficient firms or industries. Over a period of time such wrong decisions might lead to disastrous results for the economy.

The economic system has become complex because of increased size of the undertakings and concentration of economic power in the hands of big business enterprises and Government undertakings. The growth in size has made imperative the need for raising finance from external sources. Before the Industrial Revolution, the main source of finance was internal (i.e., proprietor(s)' own resources) and therefore financial statements served the needs of the proprietor(s) only. As the Industrial Revolution progressed and as the internal sources in finance were found inadequate to meet the requirements of large scale industries, external finance became more important. Moreover with the development of joint stock companies, there is a gulf between management and owners (shareholders) and thus financial statements have become an important source for the provision of information to actual and prospective investors. Acquisitions and mergers have further complicated the matters and created a need for consolidated accounts (i.e., accounts of Holding Companies) to report the activities of large business units.

The economic environment, it is clear from the above, affects accounting by placing restrictions upon what accounting can do and what it must do especially in respect of reporting values on financial statements. The economic environment of accounting identifies the persons and institutions for whom financial information is to be made available and determines what type of accounting information is to be made available to them. Accounting information through financial reports has direct economic consequences on the decision-making behaviour of investor-owners, creditors, Government and others. These groups outside the accounting profession show keen interest in the rules and principles followed in the preparation of financial statements. In the past accounting was assumed to be neutral and objective and was not held responsible for the effects it might have on the decisions of users of the accounting information. But now accounting rules can have an impact on the decision of a business unit to buy or not to buy a plant or machine. This decision in turn, can affect the employment, the environment, and the taxes levied by the Government.

The changes in prices levels, an important aspect of economic environment, have led to the development of accounting for price level changes. There has been a serious attempt to incorporate price level changes in the financial statements. The development of current purchasing power accounting and the current cost accounting is a step forward in this direction.

Another important aspect of economic environment in relation to its effect on accounting information is concerned with Informations Economics which is the development beyond the application of quantitative models like cost-volume-inventory planning, production scheduling, capital budgeting and pricing. It is concerned with cost and benefits of accounting data. A good accounting system, to provide useful financial information, is one where benefits of having the data exceed the cost of gathering it and unless the data generated by the system is relevant there should be no effort expended on gathering it. Cost-benefit approach is directly linked to vast theoretical structure of information economics – application of micro-economic theory of uncertainty to questions of buying information. The law of comparative advantage dictates that the tools like budgeting and standard costing prove good investment.

III

The Legal Environment

The legal environment consist of corporate laws, tax laws, the Securities and Exchange Board and other regulatory agencies. Accounting profession has to operate within the rules made by these agencies. Corporate laws all over the world have framed comprehensive rules regarding the preparation of financial statements and disclosure of accounting policies. The measurement of income and presentation of financial position have to be done in accordance with the guidelines and prescribed balance sheet in Schedule VI of the Companies Act 1956. The business units have to prepare the final statements on yearly basis as per legal requirements. the Companies Act prohibits the creation of secret reserves and requires the disclosure of all contingent liabilities. There are rules in respect of the methods and rates of depreciation for different assets depending upon their nature and use.

Special enactments in respect of nationalised Banking and Insurance Companies and also Public utility Undertakings have generally recognised the commercial nature of these 'industries' by requiring their accounts to follow commercial practices. It means that their accounts should contain same kind of information as required by the Companies Act. The tax laws, such as Income Tax Acts, and Central and State Sales Tax Acts require the maintenance of proper books of accounts and records which can conveniently depict information on specified business transactions and other dealings. Failure to comply with the provisions of these statutes has also been punishable. Unlike the corporate laws, these statues do not make it obligatory to publish the said information. The books of accounts can however be inspected by and/or required to be produced before authorised persons or officials only.

The Securities and Exchange Board of India was set up as an administrative body in 1988 and it was given statutory status on 30-1-92. the SEBI has been given the authority to prescribe accounting guidelines for financial reports to be submitted by the companies that sell their shares to the prospective investors. Companies are now required to be fair and honest to the investing public by disclosing all material facts along with the risk involved in their projects to the public. For example SEBI has designed a prospectus format which would provide in clear terms and under specific heads information of interest to the investors. The practice of issuing brochure to the investors along with the application form has been replaced with an an abridged prospectus to be attached to the new issue application form.

It is relevant to state that the legal environment has little influence on the accounting information for internal use. According to Shillinglaw, Gordon and others:

> *"Accounts will not be true and fair unless the information they contain is sufficient in quantity and quality to satisfy the reasonable expectations of the readers to whom they are addressed. On this question the accountants can express informed professional opinion as to what, in current circumstances, the accounts should reasonably contain."*

True and fair view in the context of accounting information thus means that it is measured or compiled on the basis of uniform rules and procedures. For this propose the professional accounting bodies in different countries have set up accounting standards committees or boards. In U.S.A. there is Financial Accounting Standards Board and in the U.K., Accounting Standards Committee. In India, the Institute of Chartered Accountants of India has set up Accounting

Standards Board which, while formulating accounting standards, gives due considerations to the standards issued by International Accounting Standards Committee. The accounting standards by their very nature cannot and do not override the local regulations which govern the preparation and presentation of accounting information. Many of these accounting standards provide only very broad guidelines and accountants must use their judgment in applying them. However the important consideration is that the standards are intended to apply to all business units especially in corporate sector in like situations. It is the duty of the auditors to ensure that accounting standards are implemented in the preparation of financial reports. In the event of any departure from the standards, it is the duty of the auditors to make adequate disclosures in their reports so that the users of the accounting information may be aware of such departures. It is significant to note that accounting standards issued by Accounting Standards Board of Institute of Chartered Accountants of India are proposed to be given statutory recognition by the **Companies Bill 1993,** introduced in the Parliament on 14 May 1993. The relevant **Clause 326** which deals with the form and contents of Financial Statements provides in **Sub Clause (3)** that statement of all significant policies adopted in the preparation of the balance sheet and profit and loss account shall be disclosed in the company's balance sheet. It is further provided that if any of the accounting polices is not in conformity with 'Accounting Standards", the departure form such accounting standard should be disclosed along with reasons for such departure.

IV

The Social Environment

The presentation of accounting information vis-a-vis financial reports is also greatly influenced by the changes in social environment which comprises the diverse needs of the various sections of the society such as shareholders, creditors, trade unions, financial press etc. Accounting information must respond to their requirements accordingly. As stated above, the development of corporate sector has led the emergence of a new group of people namely shareholders (i.e., investor-owners). Management and ownership are divorced and the financial statements have become important documents for the owners. This is technically referred to as **stewardship** function of financial accounting. The considerable increase in scandals and business failures have led to changes in the type and presentation of accounting information. In fact the legislation for the regulation of corporate sector such as the Companies Acts is largely a response to scandals that led to public demand for regulations. The much talked securities scam in India has forced the authorities to insist on greater transparency in the accounting information in respect of Banking Companies.

The most notable effect of social environment on accounting is the development of **social responsibility accounting** that widens the scope of accounting information by taking into account the social effects of business decision. According to **Glautier and Underdown,** the demand for social responsibility accounting stems from an increasing social awareness of undesirable by-products of economic activities and in this connection it is relevant to point out the emphasis on environmental problems over the last few years. Managements are being held responsible not only for the efficient conduct of the business as reflected in the profitability but also for what they do about an endless number of social problems such as

(a) the social costs of air pollution,
(b) the social costs of water pollution,
(c) the social costs of depletion and destruction of animal resources,
(d) the social costs of soil erosion and deforestation, and
(e) the social costs of technological changes.

The society also wants to know what the company is doing for the social security, health and medical facilities of its employees. Although no clear cut format has emerged as yet, the methods adopted by the corporate sector to report the social problems are summarised as under:

(a) **Descriptive reports** which enumerate all corporate social activities. These descriptive reports may form either part of the annual report to the shareholders or separate publications dealing with corporate social responsibility.
(b) **The cost of outlay approach** which states the amount spent on each social activity such as medical benefits, pollution control, sports activities etc. In this way the description of social activities is quantified in money terms.

Social responsibility information is useful both to the management and external users. The management needs social performance report to ensure that it is responsive to social challenges. As a result of growing legal liability the company needs to know in detail what sort of social programmes it is running and what results it is getting. Company managements also need complete information about the effects of business operations and policies on the society – it is more important that they be fully informed as to negative effects since this is where the company will have to defend itself in any legal action against it. Besides, the existing and potential investors, customers, Government departments, professional organisations like customers protection groups also seek social information to evaluate the performance of the business units. There has been an increase in the number of conscious and ethical investors who believe that they should avoid investing in those companies that are believed to be causing social injury or environmental damage of one type or the other e.g., noise pollution, air pollution, water pollution etc. Proper disclosures about social matters mean that all useful information must be disclosed to enable the use of accounting information to make sound investment decisions.

Human Resources Accounting: It is another important aspect of social environment. The idea is that persons employed by a business enterprise should not only be valued but their value must also be reflected in the assets side of the balance sheet. The availability of quantitative data on human resources would show their importance to the company and differentiate it from other similar companies. Human resources accounting is defined as the process of identifying and measuring data about human resources and communicating this information to the interested parties. It thus follows that the business enterprise would be understating its assets if the value of its productive personnel is not reflected in financial statements. Conversely it would be overvaluing its financial position (net worth) if the liabilities created by bad management are not evaluated. Human resources accounting is an exciting concept and its use could enable investors, creditors and the general public to evaluate the potential of a business unit more accurately.

V

Conclusion

To sum the foregoing discussion, it is enough to state that accounting environment cannot remain static and in isolation. Since the accounting works in response to human needs and is associated with the human factor, the accounting environment changes due to changes in social, economic and legal environment.