

An Investigation of Similarities and Differences between Economics and Accounting

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Abstract: Economics is the social science that investigates many subjects in production, distribution, and consumption of goods and services. Accountancy, or accounting, is the process of communicating financial information about a business entity to users such as shareholders and managers. There are some differences and similarities between economics and accounting. The aim of this paper is investigation of differences and similarities between economics and accounting. We have presented these similarities and differences based on prior studies in economic and accounting.

[Masoud Zahedi Avval. **An Investigation of Similarities and Differences between Economics and Accounting.** *Life Sci J* 2013;10(1s):310-314] (ISSN:1097-8135). <http://www.lifesciencesite.com>. 50

Keywords: Economics, Accounting

1. Introduction

Economics is the social science that investigates many subjects in production, distribution, and consumption of goods and services. Economic analysis may be applied throughout society, as in business, finance, health care, and government, but also to such diverse subjects as crime, [Friedman, David D. (2002)] education, [The World Bank (2007)] the family, law, politics, religion, [Iannaccone (1998)] social institutions, war, [Nordhaus, (2002)] and science. [Arthur M. Diamond, Jr. (2008)] At the turn of the 21st century, the expanding domain of economics in the social sciences has been described as economic imperialism. [Lazear (2000)] An increasing number of economists have called for increased emphasis on environmental sustainability; this area of research is known as Ecological economics [<http://www.neweconomics.org/> and Wikipedia]. Accountancy, or accounting, is the process of communicating financial information about a business entity to users such as shareholders and managers. [Elliot, Barry & Elliot, Jamie, 2004] The communication is generally in the form of financial statements that show in money terms the economic resources under the control of management; the art lies in selecting the information that is relevant to the user and is reliable. [Elliot, Barry & Elliot, Jamie, 2004] The principles of accountancy are applied to business entities in three divisions of practical art, named accounting, bookkeeping, and auditing. [Lloyd. 1913]

Peasnell (2006) has reported a number of results concerning the relationship between accounting numbers and economic values and yields. Some of the results have appeared previously in the literature and some are new. They have been collected together in a common analytical framework in order to demonstrate their formal, mathematical

character. It is shown that present value can be obtained by discounting almost any profit numbers; that accounting rates of return define a discount function directly analogous to the term structure and the internal rate of return; and that the internal rate of return can be expressed as a linear weighted sum of accounting rates of return [Peasnell (2006)]. Thompson (1998) has investigated the question of: How have we come to know the economy and the firm? The argument is that it is through forms of visualization (tables, charts, figures, diagrams, pictures and so on) that our knowledge and sense about the firm and the economy are constructed. Accounting and economics texts abound with these visual techniques, which gives them a certain affinity. Common techniques of visualization shared by both accounting and economics are used as a basis for a reflection on the theoretical and practical nature of the “encounter” between these two intellectual domains. The term “encounter” is used instead of the more obvious term “relationship” to indicate the contingent and problematic character of the common use of visual techniques. These encounters are situated within a framework that stresses the epistemic diversity of the forms of visualization and their meaning [Thompson (1998)]. Herath (2005) has examined the role of natural resources accounting in sustainable development. Natural resource accounting is important because the welfare of a nation measured in terms of gross domestic product (GDP) has several weaknesses. It achieves this objective by identifying the present status, the constraints and the challenges for the economics and accounting professions. The main weakness of GDP as a measure of development is that it does not take into account damages to environmental resources. However, the improvement of the concept to include environmental resource use is made difficult because of the difficulties of measuring environmental

damage. The challenge to the economics and accounting profession is to ensure interdisciplinary collaboration, development of a framework to explicitly include the environment, development of credible valuation procedures for the environment, and inclusion of the various ethical positions advanced by various groups on the value of the environment. Some headway has been made on these issues during the last decade but a major challenge still lies ahead in further improving these approaches so that sustainable development becomes an achievable goal [Herath (2005)]. The aim of this paper is considering similarities and differences between Economics and Accounting. This paper is organized by four sections. In the next section, we have investigated differences between Economics and Accounting, section 3 has investigated similarities between Economics and Accounting and in final section will be presented conclusion.

1.1. Differences between Economics and Accounting

There are two ways of measuring profit. The first way is to measure it based on what we actually receive and the other is to trade off what we actually received with what we could have received. Confused? Let me break it down into parts to make this clearer [Kulkarni].

2.1. Understanding Accounting Profit

Now if you are a student of accounts or business, you undoubtedly know what accounting profit is from the bookkeeping results in the balance sheet. But just to make this matter clear, an accounting profit is the excess of business income over the business expenses. The business earns money after selling their goods or services. If the money they earn is more than the money they spend for making/providing the goods/services, it is said that the business has made an accounting profit. Accounting expenses don't only include the tangible money that was spent by the business, but also includes any provision for losses or depreciation that the business makes over an accounting period. So once all these costs are reduced from the total income earned by a business enterprise, if the remaining amount is positive, it is an accounting profit. If the remaining amount is negative, it is known as an accounting loss, which means that the business has spent beyond its earning capacity in the accounting period. Thus we can say that an accounting profit is the excess of accounting income over accounting expenses.[Kulkarni]. Accounting Profit = Total Income - Total Expenses .

3.1. Understanding Economic Profit

So now that we got what is accounting profit out of the way, let us come to what is economic profit. An economic profit is a slightly complicated concept, and I'm going to have to break it down in order to explain it. Let us start with what is an opportunity cost [Kulkarni].

You know that you have only so many resources and so many things you can do with that much money. Suppose you have two investment options. You invest the money in option A and totally forgo option B. The opportunity cost lost, is the return you would get in case you had invested in option B. Suppose both investment options cost \$100,000. Simultaneously you track the progress of option B, although you haven't invested a cent in it. At the end your investment, option A, earns \$150,000 while option B earns \$120,000. [Kulkarni]. The accounting profit formula will tell you that by investing in option A, you have made yourself a tidy profit of $\$150,000 - \$100,000 = \$50,000$. Had you invested in option B, you would have made an accounting profit of $\$120,000 - \$100,000 = \$20,000$. So basically, you have earned some money, but you have forgone the option of investing in B. The \$20,000 which you didn't get is the opportunity lost cost or simply, opportunity cost of not investing in option B. [Kulkarni]. Now I know what you're thinking. You made a larger profit by investing in option A. And quite a large profit at that! \$30,000 now let me come to what is economic profit. It is not just the excess of total accounting income over the total accounting expense. To the cost of an investment, it also adds the opportunity lost cost of another investment option. Thus an economic profit means that not only did you make a profit on your investment, but you made more profit than you would have made otherwise! How much more? $\$30,000$ Economic Profit = Total Income - Total Expenses - Opportunity Lost Cost = $\$150,000 - \$100,000 - \$20,000 = \$30,000$

Conversely, had you invested in option B, you would have made a lesser accounting profit and hence, you would have made an economic loss! You may also take a look at our glossary of accounting terms to understand the details a little better. [Kulkarni].

4.1. Other Differences between Economic and Accounting

Accounting and economics are not the same; they have different objectives, but both are important. The fundamental concepts and application of economic analysis that you should employ are common across economies and organizations. In contrast, the application of accounting varies greatly across economies and even within an economy or

industry. Learning more about accounting and economics and using each separately are important and valuable to the analyst and manager [Groth and Byers (1996)]. The financial manager, analyst, and accountant have an array of issues, practices, and techniques that are important. However, managers should keep several key perspectives in mind [Groth and Byers (1996)].

- Economic income represents the generation of capital measurable in cash flows, the net cash flows representing what is left after covering all costs of the process, taxes, and the cost of capital.
- Capital of all forms has an opportunity cost. Analysis, evaluations, and decisions should take account of the opportunity cost of invested capital.
- The risk associated with cash flows and invested capital must be integral to decisions.
- The creation of value occurs if net economic income is positive after allowing for the timing and risk of realizations, i.e. the present value of economic income is positive after allowing for all costs including the cost of capital.
- Accounting in most economies does not seek to determine economic income—and accounting income will only match an economic measure accidentally.

Accounting practices often are not consistent across firms or economies and do not report economic value. The accounting practices that are employed locally need to be understood.

- Accounting is important. Internally, reliable information on variable costs is a critical input to economic analysis to support decisions. Externally, investors do take a keen interest in certain accounting measures, and in the consistency and reliability of these measures.
- Don't confuse economics with accounting. Make decisions to invest/disinvest capital (human, tangible, and financial) based on economics, not on accounting.
- Make sure in accounting that reporting is diligent [Groth and Byers (1996)]

3. Similarities between Economics and Accounting

Researchers in accounting were customarily concerned about what was achieved in economics but economists remained indifferent to the studies in accounting. As Scapens (1991) put it, the economic framework played the central role when the accounting researchers tried to construct decision making models for the development and reorganization of management accounting. Accounting researchers were therefore interested in analytical tools and theories of economics. A reciprocal interest in accounting was never observed in economics. In the 1950s and 1960s, economists

were proud that their discipline came to the level of an exact science, first among the social sciences. Economics was believed to be complete by itself. So, economics did not learn from accounting, nor from other disciplines. It was believed that exploring the pure logic of economics was the only right way to pursue economic studies. On the other hand, academic researchers in accounting held a complex attitude vis-a-vis economics which propelled them to pursue similar theoretical success to economics. Scapens (1991) argued that this is related to accountants' desires to achieve the academic respectability of management accounting [Shiozawa, Y. (1999)]. This one-sided situation is not unique in the relationships between economics and other social sciences. Despite disciplines' apparent desire for their independence, there has always been a widespread tendency in sociology and political science to import some ideas from economics. In economics, too, there were always some people who claimed the necessity of interdisciplinary collaboration between economics and other social sciences [Shiozawa, Y. (1999)]. But they were only dissidents. Mainstream economists never imagined that there was some theoretical lacuna or deficiency which should be complemented by other social sciences. To repeat, economists believed that economics was complete in itself [Shiozawa, Y. (1999)]. Accounting started as a system of records and reporting. It had in its nature an ex-post character. Even if accounting reports are used for management purposes, they are based on past experience and records. When management accounting started, it was exposed to a special problem which characterizes the driving force of the discipline. This was the contradiction between the ex-post character of accounting and the ex-ante requirement of decision making [Shiozawa, Y. (1999)]. When I insist on the ex-post character of accounting activity, it may sound like blasphemy to accountants and researchers in accounting. I have no such intention. Instead, I want to point out that most useful knowledge is based on past experience. Even in the case of the natural sciences and technologies, the importance of experimentation shows how our knowledge is based on the past experience. Experimentation is a name given for a past experience which is well controlled. Accounting is not an experiment, but it is based on real operations. This is the crucial difference between accounting and economics [Shiozawa, Y. (1999)]. Accounting is based on real experience. Neoclassical economics is only concerned with an imaginary comparison between which alternatives to take. If we take the management cycle into consideration, it becomes evident that neoclassical economics is composed only of the "plan" stage and does not contain the "see and

check" part. One can easily understand why it does not contain the "see and check" part. Let us suppose that general equilibrium theory is valid. Then theory assures that whatever the agents' plan is, it will always be realized in the equilibrium. As a consequence, the "see and check" part of the management cycle is useless, for everything goes as it is planned. It is not by an accident that neoclassical economics does not contain the "see and check" part and offers no explanation about it. That part does not and cannot exist in the neoclassical theory of economics. The absence of "see and check" indicates the presence of a theoretical lacuna in neoclassical economics. In my opinion, this is the reason why management accounting could not make substantial progress under the neoclassical dominance [Shiozawa, Y. (1999)]. It is fair to say that these models in management accounting (and, indeed, in other areas of accounting) are derivative (build on) of economics. The management accounting literature has, however, recast these models, 'fine tuned' them to its purposes and extended their use into a wide range of settings. However, it is fair to say that little of Economic Management Accounting (EMA) has made any major impact on economic theory. This is less true of empirical work. Moderate impacts by management accounting have been made in the information economics area, and some of the work in the analytical control area of management accounting has been used in economics [Chapman, Hopwood, and Shields (2006)]. Economic research is deliberately positive and seeks to improve economic efficiency. The search for efficiency is a major motivator in the economy, and it is to be expected that organized groups of people seeking to make decisions will wish to obtain efficiency whatever their ultimate objectives. Inefficient outcomes will not be sustained by rational groups as some members of the group will propose alternatives with, if necessary, promised side payments to others in the group in order to achieve outcomes that those making side payments will prefer and to which others, including those receiving side payments, are indifferent. However, there may be many actions that satisfy these criteria. Ideally, seeking efficiency will maximise the bundle of outputs available for distribution. Efficiency does not resolve either distribution or ethical issues. Ideally, EMAR seeks to improve the efficiency of organizations. Any attempt to integrate this approach with other approaches to management accounting research must seek to avoid abandoning the positive efficiency orientation of economics-based research. This may be impossible for other approaches that are explicitly normative [Chapman, Hopwood, and Shields (2006)]

4. Discussions

Economics is the social science that investigates many subjects in production, distribution and consumption of goods and services. Accountancy, or accounting, is the process of communicating financial information about a business entity to users such as shareholders and managers. There are some differences and similarities between economics and accounting.

The aim of this paper is investigation of differences and similarities between economics and accounting. We have presented some differences and similarities between economics and accounting based on methodology of research.

Acknowledgements:

Author is grateful to the persons for financial support to carry out this work.

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