

Accounts vs. finance vs. economics

Financial management has a close relationship to economics on the one hand and accounting on the other.

Relationships to Economics: There are two important linkages between economics and finance. The macroeconomic environment defines the setting within which a firm operates and the micro-economic theory provides the conceptual underpinning for the tools of financial decision making.

Key macro-economic factors like the growth rate of the economy, the domestic savings rate, the role of the government in economic affairs, the tax environment, the nature of external economic relationships, the availability of funds to the corporate sector, the rate of inflation, the real rate of interests, and the terms on which the firm can raise finances define the environment in which the firm operates. No finance manager can afford to ignore the key developments in the macro economic sphere and the impact of the same on the firm.

While an understanding of the macro economic developments sensitizes the finance manager to the opportunities and threats in the environment, a firm grounding in micro economic principles sharpens his analysis of decision alternatives. Finance, in essence, is applied micro economics. For example the principle of marginal analysis – a key principle of micro economics according to which a decision should be guided by a comparison of incremental benefits and cost is applicable to a number of managerial decisions in finance.

To sum up, a basic knowledge of macro economics is necessary for understanding the environment in which the firm operates and a good grasp of micro economic principles is helpful in sharpening the tools of financial decision making.

Relationship to Accounting: The finance and accounting functions are closely related and almost invariably fall within the domain of the chief financial officer as shown. Given this affinity, it is not surprising that in popular perception finance and accounting are often considered indistinguishable or at least substantially overlapping. However, as a student of finance you should know how the two differ and how the two relate. The following discussion highlights the difference and relationship between the two.

Score Keeping Vs Value maximizing: Accounting is concerned with score keeping, whereas finance is aimed at value maximizing. The primary objective of accounting is to measure the performance of the performance of the firm, assess its financial condition, and determine the base for tax payment. The principal goal of financial management is to create shareholder value by investing in positive net present value projects and minimizing the cost of financing. Of course, financial decision making requires considerable inputs from accounting.

The accountant's role is to provide consistently developed and easily interpreted data about the firm's past, present and future operations. The financial manager uses these data, either in raw form or after certain adjustments and analyses as an important input to the decision making process.

Accrual Method Vs Cash Flow Method : The accountant prepares the accounting reports based on the accrual method which recognizes revenues when the sale occurs irrespective of whether the cash is realized immediately or not and matches expenses to sales irrespective of

whether cash is paid or not. The focus of the finance manager, however, is on cash flows. He is concerned about the magnitude, timing and risk of cash flows as these are the fundamental determinants of values.

Certainty Vs Uncertainty: Accounting deals primarily with the past, it records what has happened. Hence it is relatively more objective and certain. Finance is concerned mainly with the future. It involves decision making under imperfect information and uncertainty. Hence it is characterized by a high degree of subjectivity.

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