2N1 - Accounting theory and standards

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Accounting theory

The accounting theory^[1] consists of principles, concepts, rules and guidelines developed over a period of time to bring uniformity and consistency to the process of accounting and enhance its utility to different users of accounting information.

Need for the theory: For making the accounting information meaningful to its internal and external users, it is important that such information is reliable as well as comparable. The comparability of information is required both to make inter-firm comparisons, i.e. to see how a firm has performed as compared to the other firms, as well as to make inter-period comparison, i.e. how it has performed as compared to the previous years. This becomes possible only if the information provided by the financial statements is based on consistent accounting policies, principles and practices. Such consistency is required throughout the process of identifying the events and transactions to be accounted for, measuring them, communicating them in the book of accounts, summarising the results thereof and reporting them

[1] Also referred to as the theory base of accounting.

to the interested parties. This calls for developing a proper theory base of accounting.

Principle: The term ‘principle’ has been defined by AICPA as ‘A general law or rule adopted or professed as **a guide to action**, a settled ground or basis of conduct or practice’. The word ‘generally’ means ‘in a general manner’, i.e., pertaining to many persons or cases or occasions. These principles are also referred as concepts and conventions. The term **concept** refers to the necessary assumptions and ideas which are fundamental to accounting practice, and the term **convention** connotes customs or traditions as a guide to the preparation of accounting statements. In practice, the same rules or guidelines have been described by one author as a concept, by another as a postulate and still by another as convention. This at times becomes confusing to the learners. So, attempts have been made by accounting professional bodies to standardise these principles as accounting standards.

GAAP: Generally Accepted Accounting Principles (GAAP) refers to the rules or guidelines adopted for recording and reporting of business transactions, in order to bring uniformity in the preparation and the presentation of financial statements. For example, one of the important rule is to record all transactions on the basis of historical cost, which is verifiable from the documents such as cash receipt for the money paid. This brings in objectivity in the process of recording and makes the accounting statements more acceptable to various users.

Dynamic nature of GAAP: The Generally Accepted Accounting Principles have evolved over a long period of time on the basis of past experiences, usages or customs, statements by individuals and professional bodies and regulations by government agencies and have general acceptability among most accounting professionals. However, the principles of accounting are not static in nature. These are constantly influenced by changes in the legal, social and economic environment as well as the needs of the users.

Principle setting body: In India, the Institute of Chartered Accountants of India and the Institute of Cost Accountants of India has compiled the standards of financial as well as cost accounting as the optimum practices. These are also referred to as GAAP especially in global context to refer the accounting standards and practices of a country such as Indian GAAP or US GAAP.

Accounting Standards

Institute of Chartered Accountants of India crystallises the principles of accounting into accounting standards with respect to financial accounting with the objective of accounting standard is to bring uniformity in different accounting policies in order to eliminate non comparability of financial statements for enhancing reliability of financial statements. These standards provides a set of standard accounting policies, valuation norms and disclosure requirements in addition to improving credibility of accounting data, accounting standard enhances comparability of financial statements, both intra and inter enterprises.

Benefits of Accounting Standards:

1) Accounting standard helps in eliminating variations in accounting treatment to prepare financial statements.

2) Accounting standard may call for disclosures of certain information which may not be required by law, but such

information might be useful for general public, investors and creditors.

3) Accounting standard facilitate comparability between financial statements of inter and intra companies.

Limitations of Accounting Standards:

1) Accounting standard makes choice between different alternate accounting treatments difficult to apply.
2) It is rigidly followed and fails to extend flexibility in applying accounting standards.
3) Accounting standard cannot override the statue. The standards are required to be farmed within the ambit of prevailing status.

Applicability of Accounting Standards: Except the purely charitable organisation which does not have any commercial, industrial and business activity, accounting standard is applicable to:

1) Sole proprietorship unit
2) Partnership firm
3) Societies
4) Trusts
5) Hindu undivided family
6) Association of persons
7) Cooperative societies
8) Companies