

MCM-505

ACCOUNTING THEORY & PRACTICES
UNIT-1 NATURE, SCOPE AND ROLE OF
ACCOUNTING THEORY
(M. COM. SECOND SEMESTER)

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Accounting: Meaning

- In our day to day life, we generally reckon every matter that affects our routine aspects either quantifiable in numbers or expressed in monetary value. The mere tasking of ‘reckoning’ or ‘recounting’ these quantification is accounting.
- **1966** the American Accounting Association (AAA) defined accounting as “the process of identifying, measuring and communicating economic information to permit informed judgments’ and decisions by user of the information.”

Accounting Process

- *Recording*
- *Classifying*
- *Summarizing*

Accounting Theory

- There is always a reason behind each and every action of a human being. A man does not do anything without any sound reason. Regarding Finance, or financial matters, a man is always extra cautious and so, he never makes any financial transaction without any reason. As accounting deals with financial transactions, so every accounting work is also based on reasoning.
- According to **Prof.Hendriksen**, “Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures.”
- Assumptions, methodologies and frameworks used in the study and application of financial principles. The study of accounting theory involves a review of both the historical foundations of accounting practices, as well as the way in which accounting practices are verified and added to the regulatory framework that governs financial statements and financial reporting.
- Accounting theory and Accounting Practices are absolutely closely related. They are so close, as it is very difficult to make them separate. Accounting Theories have developed through observation, analysis, explanation, scrutiny and scanning of the day-to-day accounting practices.

Advantages of Learning Accounting Theory

- By learning accounting theory only one can know the basic reasons behind all accounting practices.
- After learning theory only one can know that practical accounting is not so dull and monotonous as to be the summation of some debits and credits.
- By learning accounting theory only the accountant can perform his work more skillfully and flawlessly.
- an accountant, perfectly equipped with sound knowledge of accounting theory, cannot only understand his job-problems better, but also can make others understand the same in a better way.
- There are many processes of practical accounting. A single process cannot be applicable to all cases.
- There may be many flaws and defects in the accounting system of a concern.
- Present day business is full of diverse Socio-economic problems. So, accounting, now-a-days has become complicated and complete.
- An accountant, fully equipped with the knowledge of accounting theory, can easily help the management in an effective manner by supplying proper accounting information at the proper time.
- Valuation of various assets and liabilities can be more or less accurately if the accountant has the knowledge of accounting theory.

Nature of Accounting

- **Accounting is a process**
- **Accounting is an art**
- **Accounting is means and not an end**
- **Accounting deals with financial information and transactions**
- **Accounting is an information system**

Classifications of Accounting Theory

- **1. Descriptive Theory**
- **2. Normative accounting Theory**
- **3. Evaluative accounting Theory**
- **4. Communicative accounting Theory**
- **5. Inductive accounting Theory**
- **6. Deductive accounting Theory**
- **7. Generally accepted theories**

Accounting Theory vs. Accounting Practices

- Practically speaking, there is no rivalry between accounting theory and accounting practice. One is always dependent on the other. The practice of accounting is always guided and influenced by conventions, doctrines, and various other rules and methods which have been accepted by all. Practice without theory can never be conceived of. Again, there is no utility of any theory when there is no practice. Practice of accounting has developed through customs, usages and conventions which are called theories.

Relation Between Accounting Theory and Accounting Practices

- There is always a reason behind each and every action of a human being. A man does not anything without any sound reason. Regarding Finance, or financial matters, a man is always extra cautious and so, he never makes any financial transaction without any reason. As accounting deals with financial transactions, so every accounting work is also based on reasoning. Accounting Theories always try to explain with reason, the logic underlying a particular practice. Generally Accepted Accounting Principles cannot be changed completely as they are widely and universally accepted but they can be reformed and remodeled to suit the needs of any changed Society or Economy. Accounting Theories point out to the scientific ways of thinking for the solution of any real world accounting problem. According to Prof.Hendriksen, “Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures. To be absolutely able to solve any real world accounting problem, an accountant should have sufficient practical experience aided by adequate theoretical knowledge.

Scope of Accounting

- Accounting has got a very wide scope and area of application. Its use is not confined to the business world alone, but spread over in all the spheres of the society and in all professions. Now-a-days, in any social institution or professional activity, whether that is profit earning or not, financial transactions must take place. So there arises the need for recording and summarizing these transactions when they occur and the necessity of finding out the net result of the same after the expiry of a certain fixed period. Besides, these also the need for interpretation and communication of those information to the appropriate persons. Only accounting use can help overcome these problems.

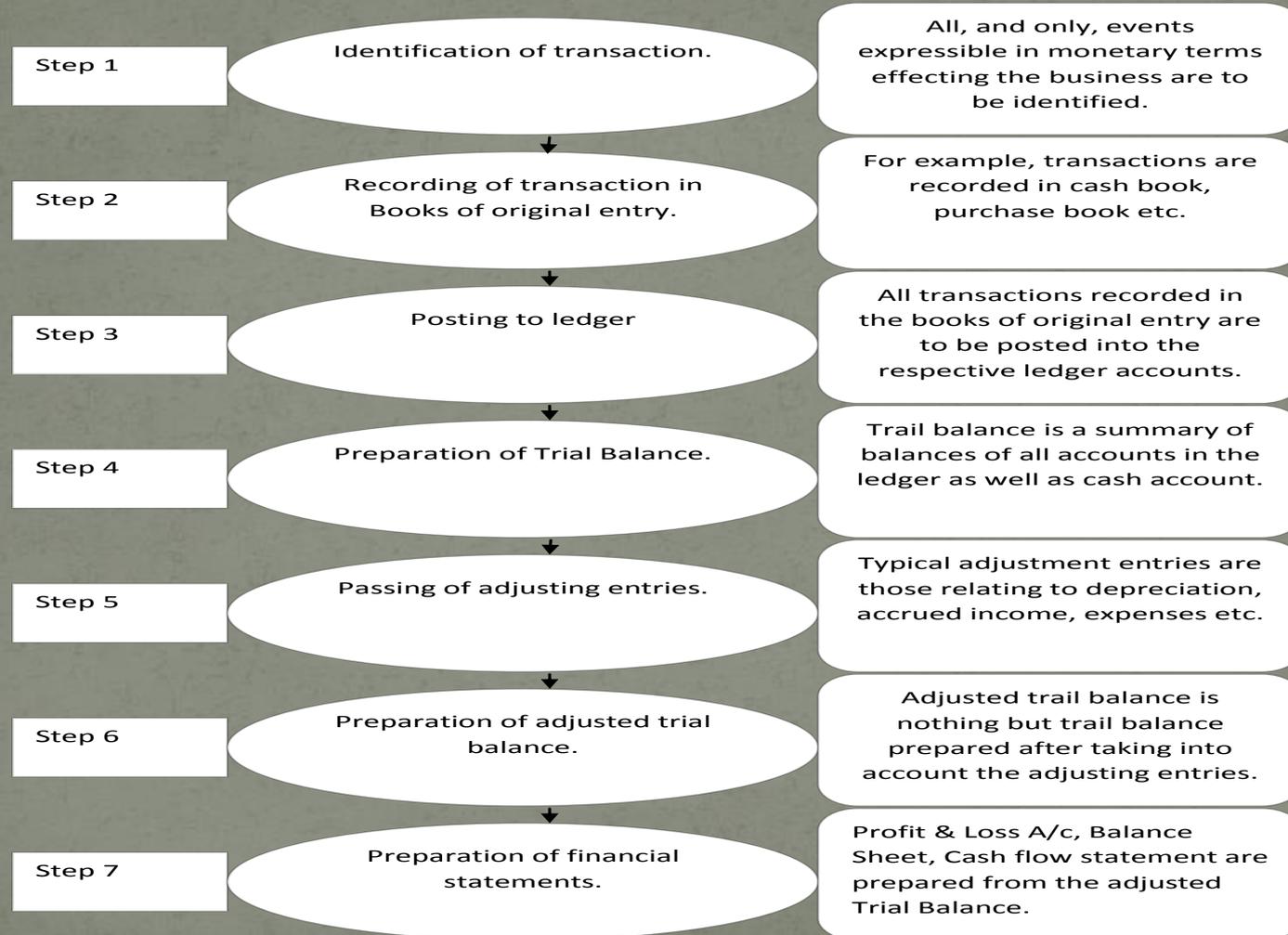
Advantages of Accounting

- **Facilitates to Replace Memory**
- **Facilitates to Comply with Legal Requirements**
- **Facilitates to Ascertain Net Result of Operations**
- **Facilitates a Comparative Study**
- **Assists the Management**
- **Facilitates Control over Assets**
- **Facilitates the Settlement of Tax Liability**
- **Facilitates the Ascertainment of Value of Business**
- **Facilitates Raising Loans**
- **Acts as Legal Evidence**

Limitations of Accounting

- **Ignores the Qualitative Elements**
- **Not Free from Bias**
- **3. Estimated Position and not Real Position**
- **4. Ignores the Price-level Changes in Case of Financial Statements Prepared on Historical Costs**
- **5. Danger of Window Dressing**

The Accounting Process



Financial Accounting: Meaning & Functions

- It deals with recording, classifying and summarizing the financial transactions so as to prepare the Financial Statements viz. Income Statement and Position Statement.
- The American Institute of Certified Public Accountants has defined Financial Accounting as “the art of recording, classifying and summarizing in a significant manner in terms of money transactions and events which are in part at least of a financial character, and interpreting the results thereof”. Accounting is the language effectively employed to communicate the financial information of a business unit of various parties interested in its progress.
- **Functions of Financial Accounting**
 - a) **Recording of Information**
 - b) **Managerial Decision Making**
 - c) **Interpreting Financial Information**
 - d) **Communicating Results**

Limitations of Financial Accounting

- 1) **Historic nature**
- 2) **It records only actual costs**
- 3) **It provides quantitative information**
- 4) **It provides information about the whole concern**
- 5) **Difficulty in price fixation**
- 6) **Appraisal of policies is not possible**
- 7) **It is not helpful in Decision Making**
- 8) **Lack of uniformity in accounting principles**
- 9) **It is not possible to control costs**
- 10) **Possibility of manipulation of accounts**
- 11) **Technological revolution**

‘GENERALLY ACCEPTED ACCOUNTING PRINCIPLES’ (GAAP)

- Generally Accepted Accounting Principles may be defined as those rules of action or conduct which are derived from experience and practice and when they prove useful, they become accepted as principles of accounting. According to the American Institute of Certified Public Accountants (AICPA), the principles which have substantial authoritative support become a part of the generally accepted accounting principles.
- The general acceptance of the accounting principles or practices depends upon how well they meet the following three criteria:
 - **Relevance**
 - **Objectivity**
 - **Feasibility**

Accounting Principles

- 1. Accounting Entity Principle
- 2. Accounting Period Principle
- 3. Money Measurement Principle
- 4. Going Concern Principle
- 5. Consistency Principle
- 6. Prudence Principle (or Conservatism Principle)
- 7. Full Disclosure Principle
- 8. Materiality Principle
- 9. Historical Cost Principle
- 10. Revenue Recognition Principle
- 11. Matching Principle
- 12. Duality Principle
- 13. Objectivity Principle
- 14. Timeliness Principle
- 15. Substance Over Form
- 16. Variation in Accounting Practices
- 17. Cost-Benefit Principle

Summary

- In early days the business organizations and transactions were small and easily manageable by the owners of the business themselves. The businessmen used to remember the transactions by memorizing them. In those days accounting developed as a result of the needs of the business to keep relationship with the outsiders, listing of their assets and liabilities. The advent of industrial revolution and technological changes has widened the market opportunities. Most of the business concerns in these days are run by company type of organization. It is not possible for a human being to keep in memory all the transactions. Therefore, it is necessary to record all these transactions properly to get required financial information. With the help of accounting records the businessman would be able to ascertain the profit or loss and the financial position of his business at the end of a given period and would be able to communicate the results of business operations to various interested parties.
- The accounting information is useful both for the management and the outside agencies. The management needs it for the purpose of planning, controlling and decision making. The outsiders like banks, creditors etc. also require it for assessing the financial solvency of the business and the tax authorities use it for determining the amount of tax liability.

References

- SILM developed by Uttarakhand Open University for MCM-505 (Accounting Theory and Practices), Year 2017,