

ACCOUNTING THEORY: CONCEPT AND IMPORTANCE

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ABSTRACT

Accounting can be regarded as the mathematical science entrusted with the task of observing the financial information; collecting of the financial information; classifying and recording of the financial information under the various hands; summarizing and compiling the financial information in the financial statements in such a way that it can communicate effectively and efficiently the information so collected to the various interested parties; who can later on, can use and draw inferences out of the information provided. Like every subject or language it has its own coherent set of concepts and principles that constitute its theoretical framework based on logic and traditions which helps in, evaluating and explaining existing practices, and also serves as a guide for the development of new practices and procedures. The main objective of this paper is to understand and analyze the available literature about accounting theory and to understand how it has been studied and evaluated by different professionals who have worked on it. This paper also concentrates on understanding the concept and importance of accounting theory and its practices.

Keywords: *Accounting Theory, Accounting Concept, Theoretical Framework, Financial Information.*

INTRODUCTION

Accounting the language of the business is now also considered as the number 1 decision support system of the business. Accounting is regarded as decision support system as no decision in the business can be taken without going through the information provided by the accounting documents. It has come a long way from just a bookkeeper or record maintain to a decision support system with the introduction of new technologies and software's, users of accounting are left with the task of sifting through the data and analyzing the information provided or compiled by the accounting. Accounting has helped the users of accounting to make well-planned, well-organized, well informed and well-coordinated decisions. Accounting is the process aimed at providing financial information to the users of accounting observing, recording, classifying and summarizing the financial transaction or events. It is the process begins with the detection transactions of monitoring nature and ends with information dissemination. It prepares, produces and communicates information to its users which would facilitate quick and sound decision-making. It helps in effective and efficient control of activities of business.

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OBJECTIVES OF THE STUDY

The objective of the present paper is to review the following:

- To know the importance of Accounting Theory.
- To know the importance of Accounting Theory for accounting Professionals and Practitioner.
- To analyze the Concept, Need, Advantages and limitations of Accounting and Accounting Theory.
- To analyze the future aspect of Accounting Theory.

RESEARCH METHODOLOGY

The paper is mainly based on secondary data and information available from books, published works, reports and concern websites.

WHAT IS ACCOUNTING THEORY?

Financial matters are very crucial to any business or a human being thus far business or the human being to make any financial transaction irrationally is just an indication to the end. Accounting theories tries to explain and evaluate the rationales behind the financial decisions or transactions made by the business entity. 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. Perara and Matthew, 1996 opine that Accounting Theory is the logical reasoning in the form of broad principles that provide a general frame of reference to every accountant to evaluate and guide the development of new practices and procedures. It is the rationalization of the rules of accounting which further explains the manner in which accountants gather, record, classify, report and interpret financial data especially when monetary amount is determined in the financial statements. American Accounting Association 1966 described accounting theory as a cohesive set of conceptual, hypothetical and pragmatic proposition explaining and guiding the accountant's actions in identifying, measuring and communicating economic information to users of financial statement.

To sum up it can be said that, accounting theory is a system or set of ideas or concepts or phenomenon which are widely accepted as a justification or explanation to the practices of accounting. Accounting theory mainly aims at explaining the reason behind accounting practice followed that doesn't imply that it is a scientific word but certainly have a logic behind it, for instance wineries generally follow LIFO method of inventory valuation whereas, a fruit vendor would use or prefer FIFO method of inventory valuation, accounting theory should provide explanation regarding such practice of inventory valuation followed whether on the basis of logic or on scientific principles.

CHARACTERISTICS OF ACCOUNTING THEORY

- **Originates and Explains Practices**

Accounting Theory plays a dual role of both of originating and explaining accounting practices. Present practices and problems serve as the basis for the development of new theories similarly; accounting theory also tries out to explain the rationale behind the existing practices.

- **Rationalizes the Accounting Practices**

One of the key aspect of the good accounting theory is to rationalise or provide a logical framework to the accounting practices which would not only serve as general principles of references for evaluating and guiding the existing accounting practices but also developing the new practices arising as a solution to the dynamic environmental problems.

- **Dynamism**

Any theory would not be accepted worldwide or won't flourish unless and until it has dynamism in it. Accounting theories have inbuilt dynamism in their DNA which enables them to cope and develop accounting practices with the changing business environment.

- **Verified and Tested by Practice**

Accounting theories are very verified and tested on evaluated by the accounting practice to check is there a any existence of deviation in the theory and practice are not, if there is the case of deviation then accounting theory is modified, restated or pale the way for a emergence of new phenomena are principles.

- **Systematic Set of Coherent Postulates or Principles**

Accounting theories provides a systematic set of coherent postulates are principles, which are accepted as true in order to provide a basis for logical reasoning to the existing practices.

- **Statement of Systematic Methodologies and principles**

Accounting theories are simply the statement of principles and methodologies to be followed by the accountants.

- **Predictions**

One of the major features or test of a good accounting theory is its inability to predict or govern the accounting events and behavior.

WHY ONE SHOULD ACQUAINT HIMSELF WITH KNOWLEDGE OF ACCOUNTING THEORY?

"Why I should read accounting theory?" "Why am I supposed to do valor of reading such a boredom thing?" These are the questions which would generally come into every readers mind. Well answer to such questions is that, knowledge of accounting theory provides bundle of benefits which would make life of practitioners and readers of accounting easy. The knowledge of accounting theory due to scores of benefits it gives, serve as a deadly weapon in the arsenal of the accountant. The acquaintance to accounting theory gives following benefits:

- It helps in bringing logic in decision-making of accountants.
- It helps in developing better accounting approach among accountants
- It helps in increasing efficiency of accountants.
- It helps in reducing ambiguity in accounting practices.
- It helps in justifying accounting practices with logic.
- It helps in preparation and adherence income tax and at the economic laws.

- Facilitates auditing of accounts easily.
- It helps in framing of accounting policies and procedures.
- It helps in fulfilling various information needs of interested parties in a better way.
- It helps in bringing out accountant from the dilemma of selection of various alternatives.
- It helps in better interpretation and understanding of accounting information provided by accounting documents.

STRUCTURE OF ACCOUNTING THEORIES

There are n numbers of accounting theories floating around. These theories are deferring due to the nature of accounting environment, nature of business environment, nature of economic and political environment and from user to user. Besides, the nature of accounting information and data, sources of information and so on are influencing the accounting theories¹all these aspects serve or provide frame of reference termed as structure of accounting theory. These frame of references or accounting theory structure helps in judging to what extent and accounting theory adequate. The structure of accounting theory has five elements:

- Objectives of Financial Statements
- Accounting Postulates/Assumptions viz Entity Postulate, Going Concern Postulate, Accounting Period Postulate and Unit of Measurement Postulate.
- Theoretical Concepts namely: Proprietary Theory, Entity Theory, Residual Equity Theory, Enterprise Theory and Fund Theory
- Accounting Principles viz Cost Principle, Revenue Principle, Matching Principle, Objectivity Principle, Consistency Principle, Full Disclosure Principle, Conservatism Principle, and Materiality Principle.
- A body of accounting techniques.

CLASSIFICATION OF ACCOUNTING THEORIES

Accounting theories can be classified into three types which are:

- **'Accounting Structure' Theory.**

'Accounting Structure' Theory or Classical Theory or Descriptive Theory or Traditional Theory: Classical Theories tries to answer why an existing practice is followed by the accountant and what he would do in a particular situation. The contributors of the theory would pursue accounting as the mechanical process which begins with the collection of data by observing the financial occurrences and using the data derived from that observation as the input to transform them into valuable output (that is financial statements and financial reports). Classical theorists were mainly focused towards rationalizing and unifying actions of accountants by bringing them under the umbrella of generally accepted principles however, which tends to curtail dynamism of the accounting practices. The essence of the classical theories lied in bringing logic and explaining accounting practices. The classical theorists were highly obsessed with explaining and predicting the behaviour of accountants which resulted in neglectation of real business situation. The classical theorists were more bothered about

¹ American Accounting Association (AAA), 1996, A Statement of the Basic Accounting Theory,

evaluating and explaining the means of producing output (financial statements and financial reporting) instead of bothering about usefulness of the output. In spite of thriving for uniformity in accounting practices classical theories have brought various alternative practices which have led to inconsistency in accounting practices. In the thrust of unifying the accounting practices classical theories restricts the application of judgments and also fails to give meaningful interpretation of accounting practices

- **‘Interpretational’ Theory**

‘Interpretational’ theories are part of the classical accounting theory (model) aimed at giving meaning accounting practices followed. Interpretational theories tries to iron out deviations in interpretations and meaning attached to the information communicated by producers to the users of accounting information as they say, “It is not what you say it is what people understand”. The contributors to the ‘accounting structure theories’ such as Hatfield, Littleton, Paton and Littleton, Sterling and Ijiri were mainly, concerned with bringing out rationale behind traditional accounting practice whereas, the contributors to interpretational theories, were, focused towards finding the consequences of the accounting practices followed by evaluating them. Interpretational theorists tried to make such theories which would help practitioners’ of accounting in resolving accounting issues.

- **‘Decision-Usefulness’ Theory**

The Financial Accounting Standards Board (FASB) has stated that major object of financial reporting is to “provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence.” This opinion is also seconded by, the American Institute of Certified Public Accountants (AICPA) Study Group on the Objectives of Financial Statements, also known as Troubled Report, which categorically states that “the basic objective of financial statements is to provide information useful for making economic decisions.” There is nothing in the business world except accounting which can influence actions and human behaviour in such a drastic manner that it can convert a king into a Knave. Accounting is capable enough to destroy a business empire to a like pack of cards overnight however, the impact of accounting is dependent on the usefulness of the information it provides.

Classical theories as stated earlier were obsessed with giving logic and explaining, and accounting practices on the other hand interpretational theories were analytical in approach and focused towards giving meaning or showcasing the influence of the accounting practices. But, both the theories were not recognizing the crucial fact that is relevance or usefulness of the information provided by accounting documents this very important fact is focus of the ‘decision usefulness’ theories. Staubus emphasized that “accountants should explicitly and continuously recognize an objective or objectives of accounting, and “that a major objective of accounting is to provide quantitative economic information that will be useful in making

investment decisions." 'Decision-Usefulness' theories focuses on measuring and evaluating the impact of accounting procedures and modes of financial reporting on the individual and group behaviour of users of accounting information. The relevance of information being communicated is a subjective concept depends on two things viz, "who are the users of it?", and what are the decision models adopted by the users of information.

LIMITATIONS OF ACCOUNTING THEORY

In spite of number of benefits which knowledge of accounting theory gives to its users, there are varied reasons which limit the acceptability of accounting theory universally. As a student of accounting theory one should keep in mind that the accounting theory though influences the accounting practices but also gets influenced by customs and practices followed in the society, these practices or customs may defer region wise thus it limits accounting theory to get wider acceptability. Government policies and legal requirements also impact the development and acceptance of accounting theory. One of the devastating fact of the accounting theory is that, various conflicting theories and alternative treatment of same items are available, which creates problem of selection for the accountants, these conflicting theories gives rise to inconsistency and ambiguity in accounting practices, which creates a dilemma for both the users and practitioners of accounting.

CONCLUSION

In Spite of overwhelming progress have been achieved in unifying, justifying rationalizing and explaining accounting practices world over yet the gap between theory and practice is quite huge which need to be brought down or even nullified so that accountancy and went its practitioners to cope up with the challenges it is bound to face with the ever-changing business environment. The theories discussed in this research paper are quite different in their exemptions, techniques and methods used for research, problems and issues researched, and inferences drawn on the conclusion arrived at, yet, the writers have failed to justify the superiority of the respective theories over each other this inefficiency. There is no theory or class of theories that explains and predicts all accounting phenomena and that is expected however not desired because accounting theories are simplifications of reality treating/or assuming it to be static but globally things are changing and complex. This doesn't means that accounting fraternity should disregard or abandoned these theories because they might not tick all the boxes but tick most of them.

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