**Application of accounting theory, standards and principles**

**An Overview of accounting theory, accounting concepts and International Financial Reporting Standards**

* **Standards.** International Accounting Standards (IASs) were issued by the IASC from 1973 to 2000. The IASB replaced the IASC in 2001. Since then, the IASB has amended some IASs and has proposed to amend others, has replaced some IASs with new International Financial Reporting Standards (IFRSs), and has adopted or proposed certain new IFRSs on topics for which there was no previous IAS. Through committees, both the IASC and the IASB also have issued [Interpretations of Standards](http://www.iasplus.com/interps/interps.htm).
* **Compliance with Standards.** Financial statements may not be described as complying with IFRSs unless they comply with all of the requirements of each applicable standard and each applicable interpretation.
* **IASB Framework.** While not a standard, the IASB *Framework for the Preparation and Presentation of Financial Statements* serves as a guide to resolving accounting issues that are not addressed directly in a standard. Moreover, in the absence of a standard or an interpretation that specifically applies to a transaction, IAS 8 requires that an entity must use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable. In making that judgement, IAS 8.11 requires management to consider the definitions, recognition criteria and measurement concepts for assets, liabilities, income, and expenses in the *Framework*. The IASB adopted the Framework in April 2001.

International Financial Reporting Standards (IFRSs) are developed through an international consultation process, the "due process", which involves interested individuals and organisations from around the world. The due process comprises six stages, with the Trustees having the opportunity to ensure compliance at various points throughout:

1. [Setting the agenda](http://www.ifrs.org/How+we+develop+standards/Setting+the+agenda.htm)
2. [Planning the project](http://www.ifrs.org/How+we+develop+standards/Project+planning.htm)
3. [Developing and publishing the discussion paper](http://www.ifrs.org/How+we+develop+standards/Development+and+publication.htm)
4. [Developing and publishing the exposure draft](http://www.ifrs.org/How+we+develop+standards/Development+and+publication+of+an+exposure+draft.htm)
5. [Developing and publishing the standard](http://www.ifrs.org/How+we+develop+standards/Development+and+publication+of+an+IFRS.htm)
6. [After the standard is issued](http://www.ifrs.org/How+we+develop+standards/Procedures+after+an+IFRS+is+issued.htm)

**ISSUES IN THE APPLICABILITY OF ACCOUNTING STANDARDS**

1. Are the IASB Standards of Sufficiently High Quality?

When we refer to the need for high quality accounting standards, we mean that the standards must result in relevant, reliable information that is useful for investors, lenders, creditors and others who make capital allocation decisions. To that end, the standards must

1. result in a consistent application that will allow investors to make a meaningful comparison of performance across time periods and among companies;
2. provide for transparency, so that the nature and the accounting treatment of the underlying transactions are apparent to the user; and
3. Provide full disclosure, which includes information that supplements the basic financial statements, puts the presented information in context and facilitates an understanding of the accounting practices applied. Such standards should:
   1. be consistent with an underlying accounting conceptual framework;
   2. result in comparable accounting by registrants for similar transactions, by avoiding or minimizing alternative accounting treatments;
   3. require consistent accounting policies from one period to the next; and
   4. Be clear and unambiguous.

In assessing the quality of the IASB standards, we are applying these criteria on a standard-by-standard basis, as well as to the IASB standards as a whole. Issues that have arisen include:

* the ability to override an IAS where application of the IAS would not result in a "true and fair view" (see IAS 1);
* the option to revalue property, plant and equipment to fair value (see IAS 16);
* transition provisions that permit unrecognized minimum pension and employee benefit obligations (see IAS 19);
* the amortization of negative goodwill to offset restructuring costs (see IAS 22);
* unlimited useful lives for goodwill and other intangibles (see IAS 22 and IAS 38);
* the capitalization of costs related to the development of internally generated intangible assets (see IAS 38);
* the remeasurement of impaired assets at an amount other than fair value (see IAS 36); and

1. The Need for a Financial Reporting Infrastructure

Effective financial reporting begins with management, which is responsible for implementing and applying properly a comprehensive body of accounting principles. Rigorous and consistent application of accounting standards also depends on implementation efforts of the standard-setter, auditors and regulators. There are concerns that current IASB standards may not be rigorously and consistently applied. For example, a recent study authored by IASB identifies non-compliance with IASB standards by a number of the 125 companies surveyed. It also cites examples of auditors who failed to identify properly a lack of compliance with IASB requirements in their reports on an issuer's financial statements.

1. Can the IASB Standards be rigorously Interpreted and Applied?

High quality financial reporting cannot be guaranteed solely by developing accounting standards with the strongest theoretical bases; financial reporting may be weak if conceptually sound standards are not rigorously interpreted and applied. If accounting standards are to satisfy the objective of having similar transactions and events accounted for in similar ways, preparers must recognize their responsibility to apply these standards in a way that is faithful to both the requirements and intent of the standards, and auditors and regulators around the world must insist on rigorous interpretation and application of those standards. Otherwise, the comparability and transparency that are the objectives of common standards will be eroded. In order for any body of standards to be able to be rigorously interpreted and applied, there must be a sufficient level of implementation guidance. The IASB standards provide scant implementation guidance

1. The Interpretive Role of the Standard-Setter

In order for a set of accounting standards to be fully operational, the standard-setter must support reasonably consistent application of its standards. A standard-setter's responsibility for ensuring consistent application of its standards includes providing an effective mechanism for identifying and addressing interpretive questions in an expeditious fashion.

The IASB began addressing interpretive issues in 1997 with the creation of its Standing Interpretations Committee (SIC) and later the International financial standards interpretation committee (IFRIC) to provide resolution of interpretive issues arising in the application of the IASB standards that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance.

In providing this interpretive role, the standards setter should have an independent Board whose members are selected based on technical expertise, with oversight provided by an independent set of Trustees. An effective high quality standard-setter is characterized by:

* An independent decision-making body;
* An active advisory function;
* A sound due process;
* An effective interpretive function;
* Independent oversight representing the public interest; and
* Adequate funding and staffing.

1. Enforceability of standards

The full benefits of a global set of financial reporting standards such as IFRS will be realized only when these standards are consistently enforced. Thus, IFRS consist of only one element of the financial reporting infrastructure. The institutions responsible for enforcing IFRS need to realize that, due to the growing globalization of financial markets, their enforcement efforts often protect both domestic and international investors.

1. Technical issues

Practical implementation of IFRS requires adequate technical capacity among preparers, auditors, users and regulatory authorities. Countries that implement IFRS face a variety of

capacity-related issues, depending on the approach they take.

**IFRS AND IAS SUMMARIES**   
  
[IFRS 1](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ifrs01-sum.pdf) *First-time Adoption of International Financial Reporting Standards*   
[IFRS 2](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ifrs02-sum.pdf) *Share-based Payment*   
[IFRS 3](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ifrs03-sum.pdf) *Business Combinations*   
[IFRS 4](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ifrs04-sum.pdf)  Insurance Contracts

[IFRS 5](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ifrs05-sum.pdf) *Non-current Assets Held for Sale and Discontinued Operations*   
[IAS 1](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias01-sum.pdf) *Presentation of Financial Statements*   
[IAS 2](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias02-sum.pdf) *Inventories*   
[IAS 7](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias07-sum.pdf) *Cash Flow Statements*   
[IAS 8](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias08-sum.pdf) *Accounting Policies, Changes in Accounting Estimates and Errors*   
[IAS 10](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias10-sum.pdf) *Events After the Balance Sheet Date*   
[IAS 11](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias11-sum.pdf) *Construction Contracts*   
[IAS 12](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias12-sum.pdf) *Income Taxes*   
[IAS 14](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias14-sum.pdf) *Segment Reporting*   
[IAS 16](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias16-sum.pdf) *Property, Plant and Equipment*   
[IAS 17](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias17-sum.pdf) *Leases*   
[IAS 18](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias18-sum.pdf) *Revenue*   
[IAS 19](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias19-sum.pdf) *Employee Benefits*   
[IAS 20](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias20-sum.pdf) *Accounting for Government Grants and Disclosure of Government Assistance*   
[IAS 21](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias21-sum.pdf) *The Effects of Changes in Foreign Exchange Rates*   
[IAS 23](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias23-sum.pdf) *Borrowing Costs*   
[IAS 24](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias24-sum.pdf) *Related Party Disclosures*   
[IAS 26](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias26-sum.pdf) *Accounting and Reporting by Retirement Benefit Plans*   
[IAS 27](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias27-sum.pdf) *Consolidated and Separate Financial Statements*   
[IAS 28](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias28-sum.pdf) *Investments in Associates*   
[IAS 29](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias29-sum.pdf) *Financial Reporting in Hyperinflationary Economies*   
[IAS 30](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias30-sum.pdf) *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*   
[IAS 31](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias31-sum.pdf) *Interests in Joint Ventures*   
[IAS 32](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias32-sum.pdf) *Financial Instruments: Disclosure and Presentation*   
[IAS 33](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias33-sum.pdf) *Earnings per Share*   
[IAS 34](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias34-sum.pdf) *Interim Financial Reporting*   
[IAS 36](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias36-sum.pdf) *Impairment of Assets*   
[IAS 37](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias37-sum.pdf) *Provisions, Contingent Liabilities and Contingent Assets*   
[IAS 38](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias38-sum.pdf) *Intangible Assets*   
[IAS 39](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias39-sum.pdf) *Financial Instruments: Recognition and Measurement*.  
[IAS 40](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias40-sum.pdf) *Investment Property*   
[IAS 41](http://archive.iasb.org.uk/uploaded_files/documents/8_63_ias41-sum.pdf) *Agriculture*

**ACCOUNTING THEORY**

The basic concepts of accounting as we understand them today were first published in Italy in 1494 by Luca Pacioli (1445 - 1517.)  He described them in a section of his book on applied mathematics entitled *Summa de Arithmetica, geometria, proportioni et Proportionalita*.  Pacioli was a Franciscan monk whose life and work was dedicated to the glory of God.

**Accounting** is the process of measuring and recording the financial value of the assets and liabilities of a business and monitoring these values as they change with the passage of time.  When we refer to a **business** we could be referring to an individual, a company or any other entity for which accounting records are to be kept (for example a church, club or other non-profit organisation.)

The **assets** of a business are those things that belong to the business that have a positive financial value i.e. items that could be sold by the business in exchange for money.  Examples of assets include land, buildings, vehicles, stock, equipment, rare gold coins, bank accounts with positive balances and money owed to the business by its debtors.

The **liabilities** of a business are those things that belong to the business but unlike assets have a negative financial value i.e. items that will require the payment of money by the business at some point in the future.  Examples of liabilities include unpaid bills, unpaid taxes, unpaid wages, rusty motor vehicles, stock that has passed its use-by date, overdrawn bank accounts and money owed by the business to its creditors.

The **equity** of a business is defined as the value of the assets minus the value of the liabilities.  In other words the equity is the financial value that would be left if all the assets were sold and the money from the sale was used to pay off all the liabilities.  Another way of expressing this is to say that the equity is the amount of money that would be released if the business was to be wound up.

The assets, liabilities and equity of a business are all financial measurements that relate to a particular point in time.  The financial statement that is used to present this information is known as the **balance sheet**.  The balance sheet is a statement of the assets, liabilities and equity of a business as they exist at a particular point in time.

The relationship between the assets, the liabilities and the equity can be represented algebraically by what is commonly known as the **accounting equation**.  If we use the letter A to represent the assets, the letter L to represent the liabilities and the letter P to represent the equity then the accounting equation is

P = A - L

This equation states that the equity is the value of the assets minus the value of the liabilities.  This equation is more commonly written as

A = L + P

This equation states that the value of the assets is equal to the value of the liabilities plus the equity.  This is just another way of saying the same thing.  Because the equity is defined as the value of the assets minus the value of the liabilities then this equation is always true by definition.

A balance sheet is commonly divided into two sections.  One section shows the value of the assets and the other section shows the value of the liabilities and the equity.  Each section will be broken down into more or less detail depending on the intended use of the balance sheet.  Because the accounting equation is always true the totals of each of the two sections of the balance sheet should always be the same i.e. the balance sheet should always be in balance.

The financial measurements we have looked at so far are used to describe the financial position of a business at a particular point in time.  For this reason the balance sheet is also known as the **statement of financial position**.  It presents a summary of the business' financial position at a particular point in time.  However in order to gain a complete financial picture of a business we need to recognise that the financial position of the business is undergoing constant change.

As a business engages in various commercial activities such as buying, selling, manufacturing, maintaining equipment, paying rent and other expenses, borrowing, lending or investing then the value of the assets, liabilities and equity will change and these changes will have an effect on the balance sheet.  The only thing we can be sure about at any point in time is that the accounting equation A = L + P will always apply.  In other words even though the balance sheet is always changing from day to day we can be certain that it will always balance or should do so if it has been prepared correctly.

Recognising that the financial position of a business is constantly changing leads us to the definition of two additional financial measurements that relate to a period of time (unlike assets, liabilities and equity that relate to a particular point in time.)

The **income** of a business is the sum of those things that increase the value of the assets without any corresponding increase in the liabilities or any new investment by the owners of the business.  Examples include revenue from the sale of goods, equipment or services supplied, rent or interest received and capital gains.

The **expenses** of a business are those things that reduce the value of the assets without any corresponding reduction in the liabilities or any capital drawings by the owners.  Examples include the cost of stock and raw materials, rent or interest paid, electricity bills, telephone, wages, taxes, dividends, depreciation and donations to charity.

The income and expenses of a business are financial measurements that relate to a specified period of time rather than a specific point in time.  The financial statement that is used to present this information is known as the **income statement**.  The income statement is a statement of the income and expenses of a business as they occur during a specific period.

If we use the letter I to represent the income over a specified period of time and the letter E to represent the expenses over that same period we can represent the relationship between the assets, the liabilities, the equity, the income and the expenses by using a modified form of the accounting equation as follows

A = L + P + (I - E)

This equation states that the value of the assets is equal to the value of the liabilities plus the equity plus the excess of income over expenses.  Another way of writing this equation is

A + E = L + P + I

This equation states that the value of the assets plus the expenses is equal to the value of the liabilities plus the equity plus the income.  This is just another way of saying the same thing.  However it is helpful to express it in this way when we come to consider the practice of bookkeeping below.

The income statement is commonly divided into two sections in a similar fashion to the balance sheet.  One section shows the total income and the other section shows the total expenses.  Like the balance sheet each section will be broken down into more or less detail depending on its intended use.  However unlike the balance sheet the totals of each of the two sections are unlikely to be the same.  The difference will usually be shown as a separate item at the bottom of the income statement and if the total income exceeds the total expenses it will be given a title such as **retained earnings**, **net profit** or **excess of income over expenditure**.  If the total expenses exceed the total income it will instead be called something like **retained loss**, **net loss** or **excess of expenditure over income**.

Income and expenses are financial measurements that relate to the performance of a business during a specified period of time.  For this reason the income statement is also known as the **statement of financial performance**.  It describes the performance of a business during a specified period.  It is sometimes also referred to as the **profit and loss statement**.

In order to produce a balance sheet or an income statement it is necessary to have a systematic method of recording all the activities or events that have an effect on the financial measurements (A, L, P, I and E) described above.  Traditionally these events were entered by hand into a set of **books** or **accounts**.  More recently it has become common practice to enter these into a computer accounting system.  Each entry is referred to as an **entry** and the practice of maintaining these entries in the accounts is referred to as **bookkeeping**.  The act of placing a particular entry into an account is known as **posting**.  The total of all the entries in an account is known as the **balance** of that account.  The accounts themselves are referred to collectively as **the general ledger** or sometimes just **the ledger**.

Because each business will have different assets, liabilities, income, expenses and equity categories the accounts it uses to record its activities will vary from one business to another.  This set of accounts that a business creates in the general ledger is known as the **chart of accounts**.

Each account in the ledger will be categorised into one of the five types of financial measurements described above (A, L, P, I or E.)  Because the accounting equation

A + E = L + P + I

is always true the total of all the A and E account balances in the ledger must be equal to the total of all the L, P and I account balances if the ledger is to represent a logically correct picture of the finances of the business.  If this is the case then we say that the accounts are **in balance** or that the ledger is in balance.  For the ledger to remain in balance whenever an entry is posted to an account matching account entries must be posted at the same time to ensure that the total of the A and E account balances remain the same as the total of the L, P and I account balances.  For this reason bookkeeping is often referred to as **double-entry bookkeeping**.

Most postings consist of two entries but there is no reason why there cannot be three or more entries posted at the same time provided that the ledger remains in balance.

Traditionally a report was prepared showing the total of the A and E account balances and the total of the L, P and I account balances to ensure that these totals were the same.  This report was known as a **trial balance**.  Because most computer accounting systems will not allow entries to be posted unless the accounts remain in balance this has in many ways obviated the need for a trial balance.

An entry that increases the balance of an A or E account or reduces the balance of an L, P or I account is known as a **debit**.  An entry that reduces the balance of an A or E account or increases the balance of an L, P or I account is referred to as a **credit**.  Traditionally hand-written books were divided into two columns.  Debits were entered into the left-hand column and credits into the right.  In fact the traditional definition of a debit is an entry on the left-hand side of an account.  Conversely a credit was defined as an entry on the right-hand side of an account.  In order for the ledger to remain in balance the total debits must equal the total credits.

It is interesting to note that neither of these definitions of debit and credit are intuitive or immediately obvious.  Neither can they be deduced easily from their commonly understood meanings.  This partly explains why students who are learning accounting for the first time have difficulty understanding the meaning of debits and credits.  The traditional definitions come from the commonly established practice of manual double-entry bookkeeping that puts debits on the left and credits on the right.

It is worthwhile repeating the more precise definitions of debit and credit given above as they are derived from the accounting equation since familiarity with them is essential for a proper application of accounting practice to the process of setting up and maintaining a general ledger.

A **debit** is an entry in a general ledger account that increases its balance if it is an A or E account and reduces its balance if it is an L, P or I account.

A **credit** is an entry in a general ledger account that reduces its balance if it is an A or E account and increases its balance if it is an L, P or I account.