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**CERTIFICATE**

This is to certify that Kansara Kartik U. Has worked and completed her/his Project Work for the degree of MASTER IN COMMERCE in the faculty of COMMERCE in the subject of ACCOUNTANCY on Title of project work to be written “**Role of concepts, conventions and postulates for evaluation of accounting.”** Under my supervision. It is his own work and facts reported by his personal findings and investigations.

**Name & Signature of Guide Date of submission:**

Declaration by student

I the undersigned **Mr. Kansara Kartik U.** here by, declare that this project work entitled **“Role of concepts, conventions and postulates for evaluation of accounting.”** is a result of my own research work and has not been previously submitted to any other University for any other examination.

I hereby further declare that all information of this document has been obtained and presented in accordance with academic rules and ethical conduct.

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CHAPTER 1

Accounting- An Introduction

**Accounting-An Introduction**

Accounting is generally termed as the language of business throughout the world. The language is the means of communication of ideas or feelings by the use of conventionalized signs, gestures, marks and articulated vocal sound. In the same way, the accounting language soaves as a means to communicate matters relating to various aspects of business operations. As the individual business enterprises keep their accounting records separately, the offer to communicate is essentially from a business enterprise to various individuals, groups and institutions that are having interest in the operations and results of that enterprise. Now, although accounting is generally recognized with the business, trade and profession, the business enterprise is not the only kind of organization that makes use of accounting. Legal entities ranging from individual to governments use and prepare accounting to obtain information on the financial condition and performance of the entity in question. Just as the business enterprises (like firms, companies, societies and institutions keep their accounts, so can the nations and even the individual owners of the business and profession entities. It is necessary to have a good knowledge of accounting-grammar (in the shape of construction of accounts, conventions, concepts, postulates, principles, standards etc.) to interpret accounting information for purposes of communication, reporting, decision making or appraisal.

**Definition of Accounting**

The role of accounting then is that of communicating the results of the operations of a business. How does accounting accomplish this? This is best understood by commonly accepted definition of accounting: “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of financial character and interpreting the results thereof. (AICPA) ” The art of recording involves putting into writing or in print the transactions of financial character, reasonably soon after occurrence, in the records maintained by the company e.g. cash book, day books, journals, memoranda books, etc. This part of accounting is essentially concerned

With not only ensuring that all business transactions of financial character are in fact recorded but also that they are recorded in an orderly manner. For example, when a business executive has to travel in connection with his work, he will ask the cashier in the companies accounts department to advance funds for meeting his travel expenses. On receipt of the memo from the executive, the cashier will prepare a voucher, hand over the cash to the executive against his signature acknowledging receipt of the cash advance. This transaction will then be appropriately recorded in the cash book and the “travel advances” account of the ledger. When the executive returns from the business trip, he will prepare a statement of his travel expenses (usually called Travel Allowance Bill or T.A. Bill), get it approved by his superior (if required by the6 Accounting Theory regulations in this regard), and send it on to the accounts department. If he has spent less than the amount originally advanced, he will return the balance amount in cash along with the travel statement. The accounts department, after verification of the statement to ensure that the expenditure is in conformity with prescribed regulations will make appropriate entries in the cash book and other accounting records and suitably adjust the travel advances account. If the amount spent is greater than the original advance, the balance amount will be paid to the executive and the required entries will be made in the accounting records. The art of classifying is concerned with the systematic analysis of the recorded data so that items of like nature are classified under appropriate heads. This accounting classification is usually done by maintaining ledgers with individual account heads under which all financial transactions of a similar nature are collected. For instance, continuing with the earlier illustration, the original advance will be classified by entries in the cash book (or cash account) leading to a reduction of cash held by the company and in the travel advances account in the ledger, thereby increasing the amount of such advances outstanding. On receipt of the travel expenses statement, the balance amount of cash, received from or paid to the executive (as the case may be), will be entered in the cash book the “travel advances” in the ledger will be reduced by adjustment of the accounts rendered and the travelling expenses account in the ledger will be posted with the amount by way of accounting of such expenses incurred in connection with the operations of the enterprise. In the process, the events of the original cash advance and the subsequent incurrence of travel expenses are classified under three relevant heads namely, cash account, travel advances account and travelling expenses account. The art of summarizing in a significant manner consists of presenting the classified data in a manner which is useful to the internal and external end-users of accounting statements. At the end of stipulated periods (usually a month for internal purposes and a year, for external reporting purposes as required by corporation law), the accounts in the ledger will be balanced as at the end of that period. The accountant will check the accuracy of the accounts by preparing a trial balance of all ledger accounts as at the end of that period. This process leads to the preparation of financial statements like the Balance Sheet, Income Statement (or Profit and Loss Account as it is often called), Source and Application of funds statement, cost statements, internal reports to management, etc.

The final function of accounting is the interpretation of the summarized data in such a manner that the and-user can make meaningful judgments about the financial condition or the profitability of the business operations or can use the data in preparing future plans and laying down policies to execute such plans. After the monthly accounting statements for internal purposes have been prepared, the chief accountant or controller will prepare analytical notes appraising the performance of the enterprise and its various units or departments (as reflected in the accounting statements prepared) in relation to the expected performance and highlight areas of shortfall in performance so that management can take appropriate remedial action for overcoming such shortfalls. Similarly, in respect of the annual statutory accounts, the accountant will prepare a note analyzing the results of operations for the year for the consideration of the Board of Directors. Thereafter, the directors will include their comments analyzing the results reported in their report annexed to the final-accounts of the year.

There is no single or unanimously accepted definition of accounting. Why ?

Generally, definition either formally or informally specifies the meaning of a phenomenon or object in question. A definition sets boundaries to a phenomenon or subject indicating not only what it is, but also what it is not. A definition answers questions like, “What are its features ? What is its history or what does it do and how is it related to other phenomenon?” Very often definition depends on our purpose or intention with the given matter. Accordingly, definition of accounting is bound to “come closer to our own interpretation of the scope of accounting, and the manner in which we would like to treat its subject matter. In rapidly changing socio-economic conditions the subject matter of accounting is also changing. Accounting which initially began as the art or science of record-keeping, is moving towards adoption of a dynamic role which also emphasizes its social goal. This is clearly evident from some of the definitions presented below:

**(i) Accounting as an information system**

The definition of the American Accounting Association highlights communication aspect of accounting for decision-making by a wide variety of users. This user-oriented definition of accounting refers to the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information. To Robert Sterling, accounting stands for a measurement communication process. According to him, “Accountants ought to measure something and then communicate the measurement to the people who will make the decisions. Under this interpretation, the outputs of the accounting system are the inputs to decision theories.

**(ii) Accounting as a recordkeeping device**

The definition of the American Institute of Certified Public Accountants highlight record-keeping as an essential attribute of accounting. Accordingly “Accounting is the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof.”

**(iii) Accounting as a service activity**

A later definition of the Accounting Principles Board of the AICPA endorses the views of American Accounting Association about the elements of decision making embedded in accounting: “Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making reasoned choices about the alternative course of action. W.A. Paton, however, attempts to elicit a definition of accounting from the structural viewpoint “Accounting is a synthesis of concepts, rules and techniques designed to facilitate understanding and control of economic activity.”

**(iv) Accounting as a dynamic social science**

According to Gautier and under down, accounting is a social science. They observe that “The history of accounting reflects the evolutionary pattern of social developments and in this respect, illustrates how much accounting is a product of its environment and at the same time a force for changing it. There is, therefore, an evolutionary pattern which reflects changing socio-economic conditions and changing purpose to which accounting is applied.

8 Accounting Theories

The Nature of Accounting

According in its essence is a function that aims to accumulate the communicate information essential to the understanding of the activities of an entity. It is an obstruction of the real world economic events. The distinctive nature that makes accounting a unique system is as follows:

1. **Accounting as a process**

Accounting is a process which involves gathering, compacting, interpreting and disseminating economic information in a systematic way.

1. **Stewardship function** :

Accounting is a stewardship function. Its basic goal is to report on the resources and obligation of the entity to the owners. Through the medium of financial statements it communicates to the interested parties of the contributions and relative rights of the economy segments– the shareholders/owners, creditors and others.

1. **Concepts and conventions**

Since accounting is a process that aims at communicating economic information, it must rely on a set of previously agreed concepts, conventions and rules. These rules and conventions are not discovered but they are contrived and mutually agreed upon.

1. **Accounting as a means to an end**

Although accounting system is characterized by a host of rules, procedures and conventions, they are not the end by themselves. The ultimate end of accounting is to provide external information-communication system by gathering, compacting, interpreting and disseminating economic data which gives a financial representation of the relative economic rights and interests of the economy segments, in order to facilitate judgment formulation and action taking by its users.

1. **Accounting as an art**

Accounting is more of an art than a science; its logical foundation is not deeply embedded in scientific or natural law. It is essentially and fundamentally utilitarian in nature, therefore, its methodologies are primarily based on expediency and upon actual day to day needs of the business community.

**Functions of Accounting**

Accounting being an indispensible part of business system, it is important to delineate precisely its functions. But unfortunately the accountants are not unanimous about the exact functions of accounting, neither is there any authoritative pronouncement that can remove disagreement about the probable functions of accounting. D.R. Scott observed that accounting has three major functions to do. These are record keeping function, the control function and the protection of equities function? Maurice Moonitz, however, defines accounting in terms of five basic functions of accounting. According to him, the function of accounting is

(1) To measure the resources held by specific entities;

(2) To reflect the claims against and the interests in those entities;

(3) To measure the changes in those resources, claims and interests;

(4) To assign the changes to specifiable periods of time; and

(5) To express the foregoing in terms of money as a common denominator.”

A.C. Littleton on the other hand, identifies six areas of “accounting actions. These are: (i) homogenising diverse events; (ii) converting events into entries; (iii) classifying entries into accounts; (iv) reclassifying account data into fiscal periods; (v) summarizing and reporting periodic data; and (vi) reviewing accounting data and processes. Accounting-An Introduction 9 Elsewhere, Littleton states that “accounting has one function–to furnish dependable, relevant information about business enterprise. Although diverse opinions have been expressed above about the functions of accounting, the most common perceptions about the functions of accounting are as follows:

(i) **Recording function**

According is essentially a recordkeeping function of the past, present and future economic events of the business. The recording function involves techniques of information gathering and processing.

(ii) **Summarising role**

The next important function of accounting is summarizing diverse economic data into homogeneous group or unit called account. It is most important function of accounting since just like our language system; accounting communicates economic information to its users through these accounts.

(iii) **Accounting as a medium of communication between the firm and the external parties:**

Accounting is not an end in itself, but it exists to serve a purpose. The purpose is to supply reliable and dependable information about the economic chronicles of the business for the purpose of decision making by the interested parties.

(iv) **Income determination**

Net income determination under the historical cost method lies at the heart of the whole accounting methodology, “says Camp field Income is the basic measure that provides information about the periodic progress of business. It also provides the basic rationale for being in business.

1. **Preparation of balance sheet** :

Balance sheet is very often stated as a statement of financial condition that purports to show the economic resources, obligations and owner’s equities of the business at periodic interval of time. Some views however, consider it as a mere statement of balances of the unallocated costs that has not been assigned to the income statement. Despite difference of opinions about the exact nature of balance sheet, accountants have found its preparation extremely useful.

1. **Control function**

Accounting is a special type of calculative service that comes handy to the management for the purpose of exercising control over many functional areas of business.

1. **Compliance with legal requirements** :

In modern days accounting is not merely an act of prudence to exercise control, but its necessity arises from the need of compliance with many legal requirements. For example, the provisions of the Indian Companies Act make it obligatory for every company to prepare a statement of profit and loss and balance sheet at the end of each accounting period.

**Objectives of Accounting**

Although the terms, definition, function and objective are very often used interchangeably there is presumably a distinction among them. As stated earlier, definition describes what a thing is, while function describes what it does and objective, describes what it intends to do.1 0 Accounting Theory Thus, when we speak of objective, we rationalize the thinking process to formulate a set of attainable goals, with reference to the circumstances, feasibility and constraints. Deciding about the objectives of accounting, therefore, requires perceptions about the environment in which accounting system works. The environment of accounting has a direct bearing on the objectives of accounting and on the logical derivation of principles and rules.”

The accounting environment generally comprises the firm (i.e., the entity which prepares financial statements), different groups of external users and the existing legal and economic environment. The feasibility and constraints imposed by the accounting environment provides the boundary of accounting objectives.

**Evolution of accounting objectives:**

Accounting as we see today was not certainly the same when it began. Its techniques and methodologies have changed through as evolutionary process. The same is true about the objectives of accounting. The system of double entry accounting can be traced back to at least 13th century when it began as an outgrowth of record-keeping function that made possible orderly and organized record of past activities of the business. But over the years it has turned out to be an important mechanism to accumulate and communicate economic information essential to the understanding of the activities of an enterprise in its social set up. Today, accounting is widely regarded as an information system with an objective of effective transmission of information revealing past, present and prospective socio-economic activities of business to a wide spectrum of users. But at the first instance, the basic objective of accounting is to render stewardship services to the owners. This purpose has become all the more important with the diffusion of ownership in corporate business that separated ownership from management. In consequence, stewardship function has become predominant over record-keeping. The managers of the business as steward are responsible for protecting the interests of the owners as well as the assets of the business. The basic objectives of accounting in such cases are :

(i) To measure the resources held by the entity,

(ii) Protection of equities, i.e., to measure the claim against those resources by the owners and out-siders, and

(iii) To measure the results and financial condition of business.

Notwithstanding this, accounting may pursue many other goals that may arise from the specific information needs of the owners/managers for the purpose of management control and meeting legal requirements. Since the middle of the present century, however, a shift of emphasis of accounting objectives have begun. Increasing legal control and wide-spread public interests in corporate business have broadened the scope and objective of accounting. This in clearly manifest in the APB statement No.4 which entails an elaborate list of objectives of accounting. The APB’s list of objectives marks a sustantial departure from the trend of the contemporary accounting literature which had never given significant attention to why accounting was done. APB’s objectives of accounting may be broken into two distinct aspects-the general objectives and the qualitative objectives.

**Users of Accounting Information**

(1) **External Users**

In order to understand the communication process, we might ask ourselves who are the people interested in the operations of a business enterprise. There are several entities outside the business (or in other words, external to it), which are interested in its operations because of their business dealings with the enterprise. There are individuals or organizations who have economic transactions with the business, e.g. suppliers of goods and services on credit, banks or financial institutions lending money either for a short or a long period, buyers of goods and services produced by the enterprise on the basis of stipulated targets, contractors who have undertaken to build plants and buildings and other facilities for the business. They are all interested in varying degrees in the operations of the businesses with which they deal in order to determine whether the enterprise is credit worthy and the terms under which credit can be extended, i.e. the amount of goods or services that can be sold on credit (or the loans that can be advanced), the period of such credit and the likelihood that the debt arising out of the transactions would be repaid in time.

**Internal Users of Accounting Information**

It is not difficult to conclude that the internal people who would be most interested are the owners of the business. The owners are proprietors in proprietary concerns and the partners in partnership businesses, while in the case of a company (or corporation, as it is sometimes called) the legal owners of the company are the shareholders. Shares may be held by individuals or companies or corporations or even the government.

Clearly, the owners would like to know:

(a) Whether the enterprise made any profit during the period reported and if so, what the dividend prospects are ;

(b) whether the financial condition of the enterprise is sound as reflected in its capital to retained earnings ratio, current assets to current liabilities ratio, funds flow statement, etc.;

(c) whether these operations are profitable in terms of return on funds invested or return on assets, profits per rupee of sales, gross margin per unit of sales, etc.;

**Scope of Accounting**

Accounting is a highly organized and integrated discipline, the usefulness of which has been found in diverse areas of socio - economic activities. Although, accounting basically started as a device for recording economic events by the business enterprise in the pursuit of its profit motive, the scope and method of the discipline lend itself to wide social application. The basic orientation of the discipline being information communication it can be applied to the measurement and communication of data revealing past, present and prospective socio-economic activities to improve control methods and decision-making at levels of socio-economic activities. Thus, accounting as the measurement and communication of social data is ubiquitous, always playing a constructive role. The tools and techniques of the discipline can be used in a diverse field of human activities that require some sort of evaluation. It can be used to deal with any organizational unit, whether business, Governments, nations or individuals and it can be concerned equally with the measurement of the flow of socio-economic activities, whether or not expressed in financial terms. It is thus possible to apply the techniques of accounting to the basic areas of social interests such as national income accounting, human resource accounting, to identify and measure data about human resources for the purpose of communication of information to the interested parties, and socio-economic accounting that may encompass community involvement of the business, physical resources and environmental contributions and product and service contribution.

**CHAPTER 2**

The History and Evolution of Accounting Thoughts

**The History and Evolution of Accounting Thoughts**

While accounting appears to have been practiced at least since the beginning of recorded history, accounting theory is of comparatively recent origin. This may be due to the difficult, abstract nature of accounting thought, or perhaps to a gradual change in the scope and methods of accounting, which was thereby rendered more amenable to the formalized type of explanation which we call theory. Possibly there is some other cause; it is a matter for conjecture. In this chapter we will attempt to trace the historical development of accounting thought outside the United States.

**SHORT HISTORY OF ACCOUNTING:**

**THE PRE-CHRISTIAN ERA**

Excavations conducted by archaeologists invariably discover evidence that accounting was a feature of early civilizations. There are respectable hypotheses that both writing and arithmetic originated in the need to keep accounts, and that this first took place at the time of man’s transition from hunter to cultivator. The origins of capital, in the form of a store of food, are also the origins of accounting. Many of the early records which are recognizable accounts, or the raw materials of accounts, lack those systematic attributes of form and content with which we associate accounting today. They consists mostly of inventories, lists of commodities used as payments, contracts of sale or loan, and, morosely, simple journal entries. Nevertheless, ancient accounts were both used and useful; a modern archaeologists, studying the records which were kept by the Chaldean merchant Ea-Nasir nearly five thousand years ago, was able to assert that he was trading at a loss. The force which provided the necessary impetus for the development of modern accounting was the introduction of money as a means of exchange. As with so many other discoveries it appears that the Chinese were the originators of this practice and that they used coined money some two thousand years before it appeared in Europe. Although Western knowledge of Chinese accounting in ancient times is very limited, we do know that sophisticated forms of government accounting, including both historical accounting and budgetary control, existed in China as early as 2000 B.C., accompanied by an audit function performed by a high and independent public official. The coinage of money having a uniform value, therefore, suitable for use as a medium of exchange, first took place in Europe in the seventh century B.C. Greek civilization,

based on the secularization of an economy previously controlled by the priests, possessed a sophisticated system of public administration with accounting and auditing functions, of which details have survived. Banking and other commercial activities were conducted in ancient Greece, and accounting played an important role in them. Management accounting was used in business, as we know from the Zenon papyri. These rolls represent the records of the Egyptian estates of Appolonius, finance minister to the Greek ruler Ptolemy Philadelphus II, which were managed by one Zenon. It is clear2 4 Accounting Theory from them that techniques of accounting control, which we associate with the modern corporate form of business enterprise, were known and understood over two thousand years ago. No accounting records have survived the fall of the Roman civilization, which extended from about 700 B.C. to 400 A.D. This has been attributed to the fact that the Romans kept their accounts on wax tablets, which turned out to be a most perishable material. No doubt the Goths and Visigoths did their part by destroying all remaining physical records. Tantalizing glimpses of Roman accounting occur in the legal codes of Gaius and Justinian, in the orations of Cicero, and in other literary sources. From these it has been surmised that the Romans used the bilateral account form and even that the double-entry system was known fifteen hundred years before Pacioli. We do know that large-scale commercial and industrial operations were a characteristic of the Greek and Roman civilizations, and that they operated complex organizations such as banking, shipping, and insurance. From the Zenon papyri and other records we know that basic principles of accounting, planning and control such as budgeting, the

journal entry, financial reporting, and auditing were used by the Greeks, and therefore probably by the Romans. We are on more certain grounds when we view the modern history of accounting.

**THE RISE OF THE DOUBLE-ENTRY SYSTEM**

The destruction of the Roman and Byzantine civilizations was followed by a period of European history known as the Dark Ages. The feudal system of political organization rescued Europe from chaos and provided the stability necessary for the creation of economic surpluses. These surpluses represented the capital base on which the economic development of the middle Ages was built. The conversion of a subsistence economy into a money economy was effected by the Norman adventurer-kings. The medieval period, therefore, saw the existence of conditions favorable for the development of accounting.

This development took place as several levels: government, business and the medieval manor. Apart from banking, the conduct of business was largely a function of small traders and artisans who kept accounting records of a crude memorandum nature, sufficient for their restricted information needs. Large-scale business operations were carried on by the banks and the church, the latter through the manorial system, and we find the banks using financial accounting based on principles which eventually became double-entry bookkeeping, and the manors using management accounting, based on essentially statistical models. We have mentioned the use of the bilateral account form long before this period. The integration of this form into a system of double-entry accounts appears to have evolved during the twelfth or thirteenth centuries A.D. It may or may not have been an invention of the Italians who at that time dominated banking, trade, and what little manufacturing there was. Largely as a result of the Liber Abacci of Leonardo of Pisa, the Italians adopted Arabic in place of Roman numerals, which was an additional factor favoring the expansion of the concept underlying accounting. Although it is believed that the idea of double-entry was originated by banks, the oldest surviving record which incorporates double-entry principles is the Giovanni Farolfi branch ledger (Salon, France) for the year 1299-1300. More familiar are the double-entry trading accounts of Donald Soranzo and Brothers, merchants of Venice, from the first quarter of the fifteenth. The History and Evolution of Accounting Thoughts 25 century. The method of Venice became the model for the celebrated exposition of double-entry bookkeeping published by Pacioli in 1494. The first professional organization of accountants was founded in Venice in 1581. The method of Venice then spread throughout the world, partly through translations and plagiarisms, partly through being transplanted to other countries by Ventian traders and clerks. Giovanni Farolfi and Company were a firm of Florentine merchants, and it is noteworthy that the banking and manufacturing center of Florence experienced a parallel development of double-entry bookkeeping during the same period as Venice. In fact, Florentine accounting appears to have been more sophisticated than the method of Venice and more comparable with modern accounting systems. Datini (1335-1410) conducted a large-scale international business–what would today be called a multi-national corporation–using a full double-entry system of accounts for the control of foreign as well as domestic operations. The Medicis not only kept complex accounts for their banking operations, but also integrated cost accounting records for textile manufacturing. In these latter records we find the first examples of accounting for depreciation, interest on capital, and cost of production.

**THE SOMBART PROPOSALS**

Werner Sombart, a political economist of some note, was born in 1863 and died in Germany in 1941. He studied law, economics, history, and philosophy at the Universities of Berlin, Rome, and Pisa, eventually becoming a professor of economics in Berlin. His major work, Der Modern Kapitalismus, is a book in praise of capitalism and in it he predicted that capitalism would reach its zenith in the twentieth century. Sombarts theme led him to examine the accounting records of the period during which capitalism developed in Europe, and he identified three casual factors which contributed to the growth of the capitalistic enterprise :

1. The law

2. Business management techniques

3. The market

The law provided a framework for the firm, the capitalistic enterprise as a legal entity, and the market provided a means for it to become a financial entity. Business management techniques relied primarily on accounting, and Sombart put forward four explanations for the role which accounting played in this connection :

(i) By representing the flow of capital through a business. “....... from the capital account to the transaction accounts through the profit and loss account and back into the capital account,” accounting facilitated a concentration on the creation of wealth by means of profits

(ii) By restricting the observations of the entrepreneur to that which could be captured in the accounts, accounting fostered the development of economic rationalism: quod nonest in libris, nonest in mundo. (“Whats not in the book doesn’t exist.”)

(iii) Systematic organization of the affairs of the business was achieved through accounting.

(iv) Double-entry bookkeeping facilitated the separation of management from ownership by rendering the concept of capital objective and by permitting the2 6 Accounting Theory separation of business accounts from household accounts. Winjum has examined these propositions in the light of accounting textbooks and records produced in England during the period 1500-1750 and has concluded that, while some evidence exists in support of all four, the primary advantage of double-entry bookkeeping was the creation of “order from chaos”. The main purpose of accounting revealed by the textbooks and the main use of accounting revealed by the records was the systematic organization of the affairs of the business.

**ACCOUNTING IN ITS ACE OF IMMOBILITY**

Largely as a consequence of the influence which Pacioli’s work had upon the business world of its time, but also partly because that world changed very little between 1494 and 1775, the period which followed the invention of double-entry bookkeeping has become known as accounting’s “age of stagnation”. The principal feature of this period is the extension of the method of Venice to other countries as they came to dominate world trade. Thus, we find double-entry accounting spreading to Germany, the Law Countries (now Belgium and Holland) England, Scotland, Portugal, and Spain during this period.

The emphasis of both literature and practice was on accounting as an aid to the management of a business, rather than as an information source for external users. The owner of a business was expected to keep accounts, and instruction in double-entry bookkeeping was a part of the education of the middle classes. Because the accounts were for one’s own use, we do not find the preparation of financial statements and their audit occupying a central place in the expositions of textbook writers. Nor have we inherited any period income statements or balance sheets of the kind with which we are now familiar. The prevailing practice was to continue the accounts through several years until some event occurred which called for a balance to be drawn up – the merchant’s death, the filling of an account book, the disposal of the business. We know that the accountant businessman sometimes prepared financial statements for specific periods, and the profit and loss account, precursor of the modern income statement, was, as its name implies, a listing of profits and losses on individual ventures or lines of business. Similarly, the balance sheet was listing of balances left over after profits and losses had been closed out to the profit and loss account. Nevertheless, the concepts of capital as the difference between assets and liabilities, and of net profit as the change in capital between two dates (after adjusting for capital contributions and withdrawals) was well established during the age of stagnation.

**THE INDUSTRIAL REVOLUTION AND THE ENGLISH COMPANIES ACTS**

We will restrict ourselves here to a description of the way in which accounting and financial reporting developed in England from about 1775 (although a comparable sequence of events can be noted in other European countries) expanding on the reference to this aspect. The industrial revolution, which is conventionally regarded as beginning in the 1760s with the invention of power machinery, had several consequences of far-reaching importance to the history of accounting. One was the growth of the large-scale enterprise, beyond anything previously known, requiring quantities of capital greater than could be provided by one man or one family. Another was the introduction of the variable time period into production in the two senses of the time period required to amortize machinery and other equipment, and the time period required for production itself. The History and Evolution of Accounting Thoughts 27 The demand for capital involved increasing numbers of savers in investment situations, either directly or through financial intermediaries such as banks and insurance companies. The corporation proved to be the most satisfactory form of business organization from this point of view. As more and more individuals and institutions were involved as stockholders, the financing function became separate from the management function, which has been designated the managerial revolution. In this situation the owners of the business were no longer able to inform themselves by keeping accounts for its operations, because they took no part in the management of the enterprise. To afford these outside investors a measure of protection, the British government introduced a succession of Companies Act. These laws placed certain obligations on the promoters and managers of corporations as part of the price they had to pay for the privilege of incorporation. The 1844 Act required the directors of a company to supply the stockholders with audited balance sheets annually, and the 1865 Act provided a model form of balance sheet for this purpose. This legislation has been progressively supplemented and refined to the present day. It is aimed at providing investors and other financiers with audited information in the form of accounts on which to base their investment and disinvestment decisions and from which to judge the manner in which the directors of the corporation have managed the business. The lengthening of the time period of production had two principal effects. These were the development of business credit, as distinct from investment, and the gradual transfer of attention from the balance sheet to the profit and loss account. Business credit, by its nature short-term and revolving, required decisions for which short-term information about financial position and results was necessary. The need to prepare more frequent financial statements which would reveal profitability and liquidity gave considerable impetus to the development of accounting. In the preparation of financial statements, the analysis of changes in capital became necessary for a variety of operating decisions. This led to the establishment of rules for income statement preparation–in particular,

for calculating depreciation, the valuation of inventories, revenue recognition, and provision for future expenditures arising out of past activities. A by-product of the industrial revolution was the growth and refinement of management accounting. The use of accounting and other quantitative data for purposes of management planning and control has been noted in Ancient Greece, in the medieval manors, and by the traders of the age of stagnation. Some cost accounting was done, varying in sophistication from the ad hoc calculations of individuals to the integrated systems of the Medici factories and the French Royal Wallpaper Manufactory. The complex manufacturing processes and large-scale organization which appeared during and after the industrial revolution required more detailed and systematic analyses of costs of production. Thus, the subject of cost accounting, encompassing the accounts necessary to plan, control, and analyze costs, acquired a separate existence during the second half of the nineteenth century. This separation of cost from financial accounting has persisted to the present, in spite of practical and theoretical efforts to integrate them. For this reason, there appear to be two separate theories of accounting and reporting, an unsatisfactory state of affairs in that it should be possible to present one unified theory of accounting.

**EARLY ATTEMPTS AT ACCOUNTING THEORY**

Historically, there have been three basic approaches to the development of accounting theory. Attention was first directed to the account itself, and attempts were made to2 8 Accounting Theory construct rules for the operation of accounts. This led to the celebrated personification theories (discussed later in this section) in which the account was ascribed the qualities of a person who received and gave. But an account is not a person, and recognition of this fact directed attention to the transactions and events which are in great part the subject-matter of accounts. This led to attempts to formulate rules and standards designed to ensure that objective economic facts were recorded and reported. It then became clear that accounts contained values other than those represented by transactions and events, and that the very concept of value was subjective. Attention is now directed to the user of accounting, and contemporary accounting research is heavily influenced by such questions as : is it useful ? to whom ? Is it used? The transfer of accounting knowledge from one age to another, and from one part of the world to another was accomplished by writing, teaching, and example. Until the twentieth century, however, very little of this involved theoretical explanation separate and distinct from practical instruction. In the absence of an accounting theory, early writers had great difficulty in expressing their objectives, models, and systems. They resorted in most cases to precept and admonition, frequently bolstered by appeals to the deity. A few writers attempted generalizations which would avoid the necessity to memorize many rules and procedures. One of the earliest devices was the personification theory of accounts. This device imputed personalities to accounts for things, so that they were treated as living persons. Personification permitted the formulation of general rules, such as “debit him that receives; credit him that gives”, which appear to have explanatory qualities. Personification took three forms; the attribution of human qualities to inanimate objects, the fiction that each account was a branch of the owner’s personality (e.g. “John Smith his goods”) and the construction that the account representez a clerk, who received and gave up value for the proprietor of the business. Of these, the most useful was the second, for it permitted the accounts of a business to be classified into personal accounts, or accounts of persons outside the business (e.g. debtors, creditors) and impersonal or real accounts, or accounts for objects owned by the owner. The former, of course, would be equal and opposite to the personal accounts kept by others, and must therefore conform to general rules. The latter, being peculiar to the particular business, could be handled in different ways. The rise of the income statement, or profit and loss account, was accompanied by the development of a third class of nominal accounts for revenues and expenses. At this point personification came under severe strain. How does one personify, for example, discounts received or discounts allowed? This, coupled with a growing realization of the artificial nature of the device, led to its abandonment. By the latter part of the nineteenth century explanations were being phrased in terms of transactions. The second generation of theorists was concerned with images of form and structure, and they attempted to explain accounting by demonstrating the effect of accounting entries on these images.

**THE PROBLEM OF CLASSIFICATION**

The problem of classification is fundamental to any science, and early writers on accounting attempted to classify ledger accounts in a logical order. An example of the transition from personalization to some other basis can be found in Abraham de Graefs. The History and Evolution of Accounting Thoughts 29 Instructive van het Italiaans Boekhouden” (“Instruction in Italian Bookkeeping”) published in Amsterdam in 1693. He divided accounts into three groups:

1. Accounts of the merchant as a person: Capital, Profits and Losses, Insurance, Reserves, Housekeeping, Interest.

2. Accounts of other persons: Debtors, Creditors, Participations in Trade Ventures, etc.

3. Accounts for merchandise: Goods in store, Goods in Ships afloat, Cash available for purchases, etc. (the real accounts).

Edmond Degrange in his book La Tenue des Livres Rendue Facile (“Bookkeeping made easy”), published in Paris in 1795, divided these real accounts into five classes: Cash, Goods, Bills (Notes) Receivable, Bills (Notes) Payable and Profits and Losses. It is noteworthy that what was a personal account to do Graef was a real account to Degrange. Followers of Degrange became known as the “Cinquecontistes” or five account school. In Belgium, H. Godefroid attempted to integrate cost and financial accounts for manufacturing concerns; requiring more classes, he borrowed from literary sources and in a textbook published in 1864 Godefroid suggested the use of titles, chapters, and sections for classifying accounts. In this scheme, one of the titles was used for departmental operating accounting, i.e. for cost accounts. Because of its expanded content, Godefroid’s scheme became popular in Europe, and some of his followers decimalized his classification. By the end of the nineteenth century the decimal chart of accounts, based primarily on a classification of balance sheet accounts but including a section for operations, was in widespread use for didactic purposes as well as in actual accounting systems. The first decimal chart of accounts to give equal weight to the income statement was published by Eugen Schmalenbach in 1926. Schmalenbach was a pioneer European accounting theorist and his Dynamische Bilanz (“Dynamic Accounting”), originally published in Germany in 1916, was severely critical of the emphasis on the balance sheet. He argued that the objectives which were generally ascribed to the balance sheet were incapable of realization. The balance sheet could not present the value of the business as a going concern, because that value was different (more or less) from the sum of the individual parts, of which only a selection appeared in the balance sheet.The balance sheet was not a statement of financial position for the same reason and also because the assets and liabilities were not shown at liquidation amounts. Instead of pursuing unattainable objectives with regard to the balance sheet, Schmalenbach argued, accountants should concentrate on improving the profit and loss account (income statement) with the objective of accurately measuring the results of operations. This would relegate the balance sheet to the role of a list of balances in suspense, or “a step between two income statements” as the contemporary phrase has it. An example of a odern chart of accounts derived from Schmalenbach’s classification is reproduced as on Table 2-1. It is noteworthy that more classes are allocated to income statement accounts than to balance sheet accounts but including a section for operations, was in widespread use for didactic purposes as well as in actual accounting systems. The first decimal chart of accounts to give equal weight to the income statement was published by Eugen Schmalenbach in 1926. Schmalenbach was a pioneer European accounting theorist and his Dynamische Bilanz (“Dynamic Accounting”), originally published in Germany in 1916, was severely critical of the emphasis on the balance sheet. He argued that the objectives which were generally ascribed to the balance sheet were incapable of realization. The balance sheet could not present the value of the business as a going concern, because that value was different (more or less) from the sum of the individual parts, of which only a selection appeared in the balance sheet The balance sheet was not a statement of financial position for the same reason and also because the assets and liabilities were not shown at liquidation amounts. Instead of ursuing unattainable objectives with regard to the balance sheet, Schmalenbach argued, accountants should concentrate on improving the profit and loss account (income statement) with the objective of accurately measuring the results of operations. This would relegate the balance sheet to the role of a list of balances in suspense, or “a step between two income statements” as the contemporary phrase has it. An example of a modern chart of accounts derived from Schmalenbach’s classification is reproduced as on Table 2-1. It is noteworthy that more classes are allocated to income statement accounts than to balance sheet accounts.

**THE BASIC EQUATION**

The basic equation appears in the Italian and American literature during the nineteenth century. According to Fabio Besta, one of the Italian users of this equation, the central construct of a business is its capital, a pure abstraction without juridical meaning. It is found by deducting liabilities from assets. The American authors go a step further; they view capital as a representation of proprietorship. Thus, we call this early theory a proprietary theory of accounting. The transactions of a business can now be referred to this equation to explain why we account for them as we do. If the transaction increases assets or decreases liabilities, it increases capital; Besta called this a modifying transaction. Transactions which alter assets or liabilities without modifying capital, he called per mutational transactions. This permits the operation of accounts to be expressed in the form:

As s e t s Liabilitie Capital

Increasing decreasing decreasing increasing decreasing increasing

changes changes changes changes changes changes

The basic equation, being expressed in balance sheet terms, presented difficulties for the explanation of entries for buying and selling and for expenses and other revenues.

It was therefore expanded into the form :

Assets + Expenses = Liabilities + Revenues + Owners’ Equity (Capital)

By cancellation of expenses against revenues, this becomes the basic equation again. The income statement represents the substitution of revenues for expenses, the result of which is net income or loss, an increase of decrease of capital.

One of the advantages of the basic equation is that it also explains the statement of changes in financial position, or funds statement .Cancellation of expenses against revenues in the expanded equation turns it into the following form:

Assets = Liabilities + Owners’ Equity + A Owners’ Equity and

The funds statement can then be expressed as :

AAssets = A Liabilities + A Owners’ Equity.

However, the basic equation still leaves the terms asset, liability, owners’ equity, revenue, and expense undefined.

**LIMITATIONS OF THE OLD MODEL**

The traditional model permits us to explain much of the subject matter of accounting: nevertheless, it is constrained by severe limitations. In the first place, it does not identify all classes of observations which should be included in the scope of accounting. As we saw in Chapter 1, many accountants attempt to define accounting in terms of information. Information is itself defined as purpose-oriented data, that is data which has been selected for a particular purpose, such as, to use in a particular decision model. But selection of data presupposes a surplus of data, and the accountant is concerned first with data and only secondly with information. Since information is a function of the available data, some writers have attempted to identify accounting events as transactions and other changes in states which are perceived and recorded by accountants. But events do not occur labeled “accounting event”, the problem of perception remains. In the second place, the model does not deal explicitly with the question of measurement, which we shall call valuation. Valuation is defined here as the representation of observations in monetary terms, and can be viewed simply as multiplying a quantity by a price. Thus there is a problem of determining quantities and a problem of determining prices; the two problems are frequently combined under the one question: how shall we measure? Reference to Table 2-3 will show that the measurement problem is not one but a succession of problems. Since the transmutation of savings into product goes through a series of stages, the question, how shall we measure, can arise at any one of them. Two accounting theories which have particular relevance to these questions may be mentioned at this time. The proprietary or ownership theory places the owner of the business in the center of the accounting model, so that all observations are made from his viewpoint. This leads to the inclusion of all changes significant to him; assets are things owned, liabilities are debts owed; expenses are losses and revenues, gains; net income is the change in the proprietor’s capital during a period. This theory suggests the inclusion of the owner’s non-business assets, liabilities, revenues, and expenses, and the use of market prices for valuation purposes. Although this theory corresponded well enough with the facts of business accounting preceding the industrial revolution, it failed to explain business accounting following the managerial revolution. The separation of ownership from management and the preparation of financial statements for the owners by the managers imply that personal factors should be omitted from the area of business accounting. The entity theory views the firm as separate from its owners and includes only the assets, liabilities, revenues, and expenses of the firm; net income is still a change in the proprietor’s capital during a period, but the capital is simply an interest in the firm. At the same time, market prices no longer represent appropriate valuations, because the owner cannot dictate market transactions to the firm.

**Development of Accounting Occupation in India**

Without doubting the antiquity of Indian civilization, we can boast of the advanced social system that prevailed in ancient India. When the European civilization was in its embryonic stage, India held high the flag of its science, art and culture. Trade and commerce developed as a spontaneous response to the demand of such a highly developed society.4 0 Accounting Theory The seven preconditions – the art of writing, arithmetic, private property, money as a medium of exchange, credit transactions, commercial activity and owner’s capital investment, identified by Littleton for the emergence of systematic accounting practices were all present in India much before Alexander’s invasion of India in 327 B.C. Arthasastra, which is a complete treatise on state craft and economics, written by Kautilya about 321 B.C., portrays contemporary Indian thinking on state administration, economics and fiscal system. The elaborate and complex tax system devised by Kautilya certainly could not have been possible without accounting. Arthasastra, which contain a specific chapter dealing with the ‘Business of keeping Accounts in the office of Accountants’ bears ample testimony to the existence of not only a complete system of bookkeeping and accounting, but also the existence of the profession of accountant. Some researchers are of the view that Bahi-Khata system of Accounting (known as indigenous accounting system) still practiced in the incorporated enterprises in India which developed prior to the Greek and Roman times might have been the origin of the Italia double entry book-keeping. The history of modern accounting in India, however, can be traced with the arrival of The East India Company in India and its subsequent colonisation by the Britishers in the middle of the 18th century. Thereafter, the development of accounting and accounting profession can be traced on parallel lines with the enactment of several fiscal and companies Acts. The first legislation relating to companies in India was enacted immediately after the Sepoy Mutiny in 1857. The Act did not make elaborate provisions regarding the keeping of accounts or their audit. The Indian Companies Act of 1866 for the first time made elaborate provisions regarding the audit of companies, although no hard and fast rules in respect of the qualification of the company auditor was made in this Act. The question of the qualification of auditor in India became a controversial issue at that time because, unlike England, persons with similar qualifications were difficult to obtain all over India. Therefore, responsibility was vested in the local governments to appoint suitable persons as the auditor of companies. The local governments, in exercise of the powers vested in them, could issue two types of certificates – the Unrestricted Certificates and Restricted Certificates, enabling the holder to act as auditor within the province concerned and in the language specified in the certificates. The holder of Unrestricted Certificates could, however, practice all over British India. The Mumbai Government started a scheme for the training of such auditors which included a qualifying examination known as the Government Diploma in Accounting (G.D.A.). Such auditors were fully recognised by the Indian Companies Act of 1913. From 1930 the powers of the provincial governments to grant licence to the auditors were withdrawn. It then became the privilege of the Central Government which appointed the Indian Accountancy Board for the purpose of granting licence to the auditors. From 1930 to 1948, three Accountancy Boards were set up, the last being set up in 1939. The main purpose behind the setting up of the Accountancy Board was to exercise greater governmental control by consolidating accountancy practice all over India. Because of growing public participation in Joint Stock Companies in India, it seemed to be a right step for the time being although, later on, it was felt that lack of autonomy will impede the growth of accountancy profession in India. The Accountancy Expert Committee which was appointed in May 1948, eventually came out with its recommendations that an autonomous association of accountants should be set up in India and the registeredThe History and Evolution of Accounting Thoughts 4 1 accountants should be designated as “Chartered Accountants”. The council of the associations should be a completely autonomous body free from government control except in certain matters. Following the recommendation of the Accountancy Expert Committee, The Chartered Accountants Bill was laid before the Constituent Assembly for consideration on 9th April, 1949 and it received the assent of the Governor General on Ist May, 1949. Thus, a long cherished desire of the accountants for an autonomous body of accountants was fulfilled and the Institute of Chartered Accountants of India (ICAI) was born. The Institute of Chartered Accountants of India is an important milestone in the history of accounting in India not because of the impetus it provided for the development of accounting profession alone, but also for its efforts to evolve accounting standards that would meet the socio-economic requirements. The Accounting Standard Board which was setup by the Council of the Institute in 1977 has so far brought out Twenty eight Accounting Standards (AS) in important accounting areas.

These are:

**AS 1 : Disclosure of Accounting Policies, 1991/1993**

**AS 2 : Valuation of Inventories (Revised) 1999**

**AS 3 : Change in Financial Position (Cash Flow Statements), (Revised),**

**2001**

**AS 4 : Events Occurring After the Balance Sheet Date, 1996**

**AS 5 : Prior Periods and Extraordinary Items and Change in Accounting**

**Policies (Revised) 1996**

**AS 6 : Depreciation Accounting (Revised), 1995**

**AS 7 : Accounting for Construction Cost, 1995/2003**

**AS 8 : Accounting for Research and Development, 1991/1993**

**AS 9 : Revenue Recognition, 1991/1993**

**AS 10 : Accounting for Fixed Cost, 1991/1993**

**AS 11 : Accounting for the Effects of Change in Foreign Exchange Rate**

**(Revised), 1995**

**AS 12 : Accounting for Government Grants, 1994**

**AS 13 : Accounting for Investment, 1995**

**AS 14 : Accounting for Amalgamations, 1995**

**AS 15 : Accounting for Retiremnt Benefits in the Financial Statements of**

**Employees, 1995**

**AS 16 : Borrowing Cost, 2000**

**AS 17 : Segment Reporting, 2001**

**AS 18 : Related Party Disclosures, 2001**

**AS 19 : Leases, 2001**

**AS 20 : Earnings Per Share, 2001**

**AS 21 : Consolidate Financial Statements, 2001**

**AS 22 : Accounting For Taxes on Income, 2001**

**AS 23 : Accounting For Investments In Associates In Consolidated**

**Financial Statements, 20024 2 Accounting Theory**

**AS 24 : Discounting Operations, 2004-05**

**AS 25 : Interim Financial Reporting, 2002**

**AS 26 : Intangible Assets, 2003-04**

**AS 27 : Financial Reporting of Interests in Joint Ventures, 2002**

**AS 28 : Impairment of Assets, 2004-05.**

**Luca Pacioli and His Contribution**

In the history of modern accounting spanning over five hundred years, no single person had dominated accounting ideas as Luca Pacioli did. Born in 1445 at Borgo San Sepolero, near Florence, Luca Pacioli took orders with the Franciscan Frairs. He started his career as a teacher of mathematics in the university of Perugia. He soon established himself as a distinguished professor of mathematics and Pope Leo X in recognition of his outstanding career appointed him professor of mathematics in ‘Sapienza’ at Rome in 1515 where he ended his career. In between, he also taught in the universities of Milan, Florence, is a and Naples. It is also learnt that before joining teaching, he spent some time as an apprentice to a Florentine merchant. Probably, this exposure to business world in early life prepared the background for his famous work, Suma Arithmetica Geomatria Proportioni et Proportionalita (every thing about Arithmetic, Geometry and Proportion) which was published from Venice in 1494. A section of the book entitled De Computis et Scripturis contained discussions on double entry book-keeping. Historians are unanimous that Suma is the first published work on double book-keeping, though double entry was much in vogue at least two hundred years before Pacioli was born. Some historians, however, argue that mathematics treatise by Benedetto Cotrugli, which also contained a section on double entry, may have been the first book on double entry book-keeping. The manuscript of the book was written in 1458, although it was published much later in 1573. It is, however, not known whether the 1458 manuscript contained the section on book-keeping, since the original manuscript of the book was destroyed by fire.

Despite some controversies about the originality of Pacioli’s work, he is widely acclaimed as the father of modern accounting. And this is not without any reason. The treatise of Pacioli which reaches the students of accounting through the translation of John B. Geij beek and Pietro Crivelli demonstrates ability of Pacioli who combined the skill of an adept mathematician and the prudence of a practical businessman in preparing his work. The book became so popular “that for nearly half a century major book-keeping texts drew heavily on the content of Suma, often dealing with material in the same way and even using similar examples.” It may be remembered that since the time of Luca Pacioli accounting has undergone sea changes and refinements due to the influence of changing socio-economic conditions, but the superstructure of double entry book-keeping provided by Pacioli remains the same even today. “The presentation made by Pacioli was not crude and incorrect but contains the essentials of book-keeping as we know it today. The system of book-keeping, according to Pacioli, was based on three records : The memorandum, the journal and the ledger, though Pacioli recommended that memorandum need not be maintained always, especially when the size of transactions is small. As an essential feature of double entry book-keeping he urged the need for cross referencing of debit and credit entries which is also done in the present days through trial balance.

**Development of Accounting Theory**

One of the interesting aspects of accounting evolution until about the first quarter of the 20th century was that there was very little effort to develop systematic accounting theory. With the development of rail roads and the passage of the first Companies Act in England in the early 19th century there was created new condition for development of accounting profession and professional accounting institutions in England and the USA. But the role of the professional accounting bodies in the early stages were mostly confined to seeking ad hoc solution to the new accounting problems or at best they attempted to “theorize” accounting by compiling existing best accounting practices. They did not in general attempt to build a systematic theory of accounting. While these ad hoc approaches to the new problems facilitated some progress, especially in terms of specific technical problem areas, the lack of appropriate basic theory increasingly made the position of accounting untenable. The need for a basic theory as a frame of reference for the subject or “as a co-herent set of concepts explaining and guiding the accountant’s action in identifying, measuring and communicating economic information” was being increasingly felt.It was, however, not before 1930s that accounting developments focussed on the need for a systematic development of theories. The systematic theoretical approaches to accounting that began to take shape during this period attempted to : (i) develop basic postulates and principles, (ii) broaden the base of accounting by relating to those fundamental disciplines such as Economics, Behavioural Science and Measurement theory, (iii) formalise accounting theory into a more abstract form and (iv) develop conceptual framework for accounting. The impetus for these new developments in the field of accounting came mostly from the research efforts of the leading professional accounting bodies and the contribution of accounting literature.

**AICPA Research**

The AICPA is such a professional accounting body that side by side with the development of accounting practice in the USA devoted itself to the serious business of accounting research to give accounting a much needed theoretical base. The contribution of the AICPA in this respect, compared to its counterparts in the UK and Australia, are large enough to restrict our discussion mostly confined to the AICPA effort of accounting theory development. The major attempt of the AICPA to develop ac counting theory may be discussed under the following distinct phases :

1. Accounting Terminology Bulletins and Accounting Research Bulletins of the committee on accounting procedures from 1938 to 1959,
2. (ii) Accountancy Research Studies of the Accounting Principles Board and its Opinion and Statements from 1959 to 1973, and
3. The conceptual framework project of the Financial Accounting Standard Board after 1973

**(i) Accounting Terminology Bulletins and Accounting Research Bulletins**

The earliest attempt of the AICPA to develop systematic accounting practices in the USA can be evidenced from the establishment of the committee on Terminology in 1920. Till 1959 the committee published four Accounting Terminology Bulletins “in an attempt to promote uniformity in the use of terms in connection with the Business Operations and Financial Statements”. The first of these bulletins definitions of key-terms in connection with the financial statements, i.e., the balance sheet and the income statement. The second and the third considered terms like revenue, income, profit and earnings and book value, respectively, while the fourth defined cost, expenses and losses. The Committee on Accounting Procedures (CAP) established by the AICPA in 1938, before its demise in 1959 published 51 Accounting Research Bulletins. Of the first 42 bulletins, first eight were published in 1953 as Accounting Terminology Bulletin No. 1 and Bulletins No. 44 to 51 were published separately between 1953 and 1959. The other Bulletins were compiled and published as Accounting Research Bulletin No. 43. The most important feature of the Accounting Terminology Bulletins and Accounting Research Bulletins was that they attempted to theorize the practice of accounting by doing not more than defining the basic terms of accounting and developing some ad hoc principles for some related issues. The attempt in general lacked effort to develop coherent set of principles for accounting as a whole.

**ii) Accounting research studies under the auspices of the APB** :

The failure of the CAP to develop systematic principles of accounting led the AICPA to establish another new body, the Accounting Principles Board in 1959. The APB mostly concerned itself to expressing opinions on accounting issues, but it also engaged itself to accounting research project through its Accounting Research Division.

The APB over its entire tenure until 1973, apart from Publishing 31 opinions also published four general statements of accounting :

**APB Statement No. 1 :** As a report on the receipt of Accounting Research studies No. 1 and 3.

**APB Statement No. 2** : Disclosure of Supplementary Financial information by Diversified Companies; issued in 1967.

**APB Statement No. 3** : Financial Statements Restated for General price level change, issued in 1969.

**APB Statement No. 4** : Basic concepts and Accounting principles underlying financial statements by Business Enterprise, issued in 1970.

The effort of the Accountancy Research Division of the APB resulted in the Publication of 15 Accounting Research Studies :

ARS No. 1 : The Basic Postuates of Accouning by Maurice Moonitz, in 1961.

ARS No. 2 : Cash Flow Analysis and the Funds Statement by Parry Masion, in 1961.

ARS No. 3 : A Tentative Set of Broad Accounting Principles for Business Enterprise by Rober Sprouse and Maurice Moonitz, in 1962.

ARS No. 4: Reporting of Lease in financial Statements, by John Myers, in 1962.

ARS No. 5 : A Critical Study Of Accounting For Bussiness Combinations by Arthur Watt, in 1963.

ARS No. 6 : Reporting the Financial Effects of Price Level Changes by the staff of the Accounting Research Division, in 1963.

ARS No. 7 : Inventory of Generally Accepted Accounting Principles for Business Enterprise, by Paul Grady, in 1965.

ARS No. 8 : Accounting for the Cost of Pension Plans by E.L. Hicks, in 1965.

ARS No. 9 : Inter-period Allocation of Corporate Income Taxes by H.A. Black, in 1966.

ARS No. 10 : A c c o u n t i n g f o r G o o d w i l l , b y G e o r g e C a t l e t t a n d Normal Olson, in 1968.

ARS No. 11 : Financial Reporting in Extractive Industries by R.R. Field, in 1970.

ARS No. 12 : Reporting Foreign Operations of U.S. Companies in U.S. Dollars by L. Lorenson, in 1972.

ARS No. 13 : The Accounting Basis of Inventories by H.G. Barden, in 1973.

ARS No. 14 : Accounting for R & D Expenditures, by O.S. Gellein and M.S. Newman, in 1973.

ARS No. 15 : Stockholders’ Equity by B. Melcher, in 1973.

Of these research studies, the first and the third are probably the best examples of APB’s serious intention to develop coherent set of accounting principles. For example, in ARS No. 1, its author enquired into the basic nature of accounting to develop fourteen essential postulates of accounting around the environment (qualification, exchange, entities, time period and unit of measure postulates) the Field (financial statements, market prices, entities and tentativeness postulates) and the imperative of accounting (continuity, objectivity, consistency, stable monetary unit and disclosure postulates). In ARS No. 3, Sprouse and Moonitz went on to enquire the historical cost base of accounting and suggested that it may be necessary to use both general and specific price level changes instead of historical cost accounting. But both these studies were rejected by the APB on the ground that they are too radical to be accepted for implementation. The APB instead preferred to rely on ARS 7, inventory of Generally Accepted Accounting principles for Business enterprise, which was nothing more than a compilation of contemporary accounting practices and the existing APB opinions and Accountancy Research Bulletins. Accordingly, Accounting Research Studies continued to be ad hoc studies without common foundation to support them. The emaining studies reflected the assumption and findings of the individual author who made the study.

**(iii) The FASB conceptual framework project** :

Conceivably, the APB failed in its missinon of developing desired conceptual framework of accounting. The continued existence of alternative accounting treatments for the same economic event coupled with the lack of adequate accounting treatments for new accounting problems unleashed a spate of court cases of fraud and manipulation of accounting results. These were sufficient evidences of APB’ failure in its mission. Amidst this turmoil , AICPA appoint ed two Committee s in 1971 to investigate the situation. The first c ommittee known as the wheat committee, was charged with the task of expediting standard setting process.The report of this committee resulted in the creation of Financial Accounting Standards Boards in 1973 as an independent body, which as of August 1992 issued 110 statements of financial accounting standards as part of its main objective.But AICPA recognised the difficulty of standard setting without agreed statement of concepts and principles. Absence of well defined concepts and principles would cause not only needless waste of time on basic concepts in relation to each individual standard, but it would necessitate a large number of detailed standard on every single issue. The AICPA to lessen the problem of standard setting, set up a second committee in 1971 under the chairmanship of Robert Trueblood, with the specific charge of development of objective of financial statements. The report of this committee provided the FASB the required direction in its conceptual framework project and finally between 1978 and 1985 it published six statements of Financial Accounting Concepts (SFAC) as part of this project:

SFAC No. 1 : Objectives of Financial Reporting by Business Enter- prise, published in Nov. 1978.

SFAC No. 2 : Qualitative Characteristics of Accounting Information,published in May, 1980.

SFAC No. 3 : Elements of Financial Statements of Business Enterprise,published in December, 1980.

SFAC No. 4 : Objective of Financial Repor t ing by Non-business Organisations, published in December, 1980.

SFAC No. 5 : Recognition and Measurement in Financial Statements of Business Enterprise, published in December, 1984.

SFAC No. 6 : Elements of Financial Statements, published in Dec., 1985.

At about the same time of formation of the FASB in the USA as a private standard setting body, institutionally sponsored research studies were also conducted in some other countries on the basic objective and conceptual framework of accounting. Most important of them are, “A statement of Australian Principles”(1970), “Objectives and Concepts of Financial Statements” (1972), and the “Objectives and Basic Concepts of Accounting” (1982) in Australia under the sponsorship of Australian Accountancy Research Foundation, “Corporate Reporting : Its Future Evolution” (1980) in Canada under the sponsorship of the Canadian institute of Chartered Accountants, and the “Corporate Report” (1975) in the U.K. under the sponsorship of the Accounting Standards Sterring Committee.

**Contribution of Accounting Literature in the Development of Accounting Theory**

Much ahead of the institutional efforts, theoretical underpinning of accounting in the iterature began as early as in the beginning of this century. Accounting academics and professionals working on their own sought to develop a general theory of accounting. Charles Sprague in 1907 endeavoured to formulate the “Philosophy of Accounts” where he found an appropriate definition of assets in the “Storage of Services to be Received.Though this definition by itself is not complete, later definition by the APB and FASB are only a shade improvement over Sprague’s definition. Henry Rand Hatfield in 1909 edition of his text book, Modern Accounting introduced the readers with the concept of deprival value, though under different nomenclature.O.G. Ladelle, in English Chartered Accountant, in the November 29, 1890 issue of the ‘Accountant’ magazine made substantial contribution to depreciation theory and convincingly argued that depreciation is a system of cost allocation, not asset valuation. Much later in 1937 Perry Mason published his Principles of Public Utility Depreciation where he espoused the basic principles and concepts underlying depreciation. Henry Sweeney in his book, Stabilized Accounting (1936) propounded a complete discussion of the adjustments of financial statements for price level changes. In the same year, A tentative statement of accounting principles affecting corporate reports was published under the auspices of the American Accounting Association which discussed the “bases upon which accounting standard rest”The ideas expressed in all these works were much more advanced than accounting practices of that time, but they dwelt upon particular areas of accounting theory and are considered only isolated oasis amidst the sands of vague accounting practices. A continuum of systematic accounting ideas was however, first expressed in J.B. Canning’s The Economics of Accountancy which was published in 1929 and where he examined the whole metamorphosis of accounting to develop a comprehensive concept of income, capital value, and asset. A proper appreciation of Canning’s work can not be made unless this fact is known that before Canning there was no cluster of writings on accounting theory, especially, there was “an astonishing lack of discussion on the nature of income.” He thus came to the conclusion that “the accountants have no complete philosophical system of thought about income, nor is there the evidence that they have ever greatly felt the need for one. Their generalisation ........ are too inchoate ........ to permit one to suppose that they have ever seriously put their minds to the philosophical task.” This being the case, there would be little prospect of systematic accounting practice, Canning alliterated. Canning’s work, however, provided the much needed direction to philosophical orientation of accounting as “accountants only few years later began to codify accounting doctrines” formally.

**Developments in the accounting literature from 1940s** **through 1960s**:

In the history of the development of accounting literature 1940 is undoubtedly the watershed year because of the publication of An Introduction to Corporate Accounting Standards by W.A. Paton and A.C. Littleton under the auspices of the American4 8 Accounting Theory Accounting Association. Although, the basic theme of the work was expressed in the earlier AAA publication, ATentative statements of Accounting Principles underlying Corporate Financial Statements in 1936, and some particular aspect of the work can be traced back to Paton’s Ph-D. thesis that was published in 1922 as Accounting Theory : With Special Reference to Corporate Enterprise, the final outcome of Paton and Littleton’s combined work in 1940 “represents the first attempt to elaborate a coherent coordinated, consistent body of doctrines essential to a sound fundamental structure of accounting”. Of the six “basic concepts” of accounting espoused in this work (entity, continuity, measured considerations, cost attach, matching and verifiable objective evidence) they have championed the cause for matching concept, which is still now regarded as the pervasive principle of accounting. The parallels of this fundamental work involving the basic nature of accounting can be found in the works of Mattessich and Chambers in the middle of 1960s (as well as in the works of Moonitz, and Sprouse and Monnitz in ARS No. 1 and ARS No. 3 respectively).Richard Mattessich in the ten chapters and over 500 pages of his book, Accounting and Analytical Methods (1964) extended the frontiers of accounting to such vital interdisciplinary areas like measurement theory, valuation theory, Management and Behavioural Science, as the basis of a general theory of accounting. He formulated the following 18 basic ‘assumptions’, which according to him “might be regarded as necessary and sufficient conditions” for accounting:

**1. Monetary Value**

**2. Time Intervals**

**3. Structure**

**4. Duality**

**5. Aggregation**

**6. Economic objects**

**7. Inequity of monetary claims**

**8. Economic agent**

**9. Entities**

**10. Economic Transactions**

**11. Valuation**

**12. Realization**

**13. Classification**

**14. Data input**

**15. Duration**

**16. Extension**

**17. Materiality**

**18. Allocation**

Close to the heels of Mattessich’s work, R.J. Chambers brought out his significant book Accounting, Evaluation and Economic Behaviour in 1966 where he espoused over 13 postulates and definitions as a part of the general theory of accounting. The other significant accounting works with specific orientation to accounting theory development during the 1960s are : The Theory and Measurement of Business income by E.O. Edward and P.W. Bell in 1961, A Theory of Accounting to Investors by George Stabus in 1961, Accounting Concepts of Profit by Palle Hensen in 1962, Income Determination Theory : An Accounting Framework by Norton M. Bedford in 1965, A Statement of Basic Accounting Theory by AAA in 1966, and The Foundation of Accounting Measurement by Yuji Ijiri in 1967.

**Significant accounting literature during 1970s and 1980s**

The most significant event in the evolution of accounting theory during this time is obviously the formation of FASB and its conceptual framework project that resulted in the issue of six statements of Financial Accounting concepts in an attempt to developThe History and Evolution f Accounting Thoughts 4 9 fully integrated structures of accounting theory upon which standards may be based. The other major areas of accounting research of this time, according to Hendriksen are

(i) The extention of empirical research into the nature of accounting numbers,

(ii) research into the decision making process of the individual,

(iii) research into the implications of efficient capital markets theories for accounting etc. No significant book on basic accounting theory related to this time period can be mentioned except Robert Sterling’s Theory of Measurement of Enterprise income in 1970 and R.M. Skinner’ Accounting Principles : A Canadian Viewpoint in 1972, but most of the works on the above mentioned areas of accounting research had been published in various accounting journal like Accounting Review, Journal of Accounting, Journal of Accounting Research, Accounting and Business Research, Abacus, etc. There was however, significant development of accounting literature on inflation accounting that could be attributed to this time. The major works in this subject published during that time are: Replacement Cost Accounting by Lawrance Revsine and Accounting Values and Inflation by William Baxter in 1975, Current Value Accounting and Price Level Restatement by L.S. Rosen in 1972, Accounting for Changing Prices by James Largay and J.L. Livingstone in 1976 etc.

**Social Accounting: The New Frontiers in Accounting Theory**

While the decades of 1960s through 1980s saw a tremendous outgrowth of accounting literature in the mainstream accounting theory, a wind of change was blowing silently across the horizon of accounting in the late 60s and early 70s. The True Blood Committee Report on the Objectives of Financial Statements in 1973 broke with the traditional orientation of Financial Statements toward reporting on stewardship and instead added socio-economic dimensions to the scope of accounting by stating that “an objective of financial statement is to report on those activities of the enterprise affecting society which can be determined and described or measured and which are important to the role of the enterprise in its social environment”.

The view expressed in the True Blood Report was only a formal recognition of social imperative of accounting, but the role of accounting as an information system concerned with effective transmission of information revealing past, present and prospective socio-economic activities was gaining strong ground since the late 1960s. Such a shift of emphasis as well as extension of accounting function emanated from changes in social attitude which viewed business as a social institution and management as having some social responsibility, to compel accounting goals extends beyond its traditional profit parameters. In fact, it has been widely proclaimed in management literature since the late 1960s that profit motive is no longer the sole motive of many large business enterprises. In consequence, attempts have been made to align profit to other social goals, such as contribution to economic growth, meeting community requirements, public service, human resource development and of late, the concern for environmental disruptions, as a barometer of responsible business behaviour. The outgrowth of accounting literature in the past two decades in the areas of social accounting [c.f. Mobley (1960). AICPA Committee on Social Measurement (1977) Ramanathan (1976), Belkaoui (1976), Spicer (1978), Coopers (1972), Owens (1992) and Roberts (1992), to mention only a few] provide evidence that accountants have demonstrated, their care and concern for upholding social objectives in some critical areas of socio-economic activities.

As a corollary, several proposals have been mooted by the accountants as well as the non-accountants, which suggest that accounting profession should expand the current accounting measurements and disclosure model to encompass corporate social responsibility reporting. The forms and contents of corporate disclosure of such socially oriented data have been made the topic of Committee deliberation and reports by the three major accounting associations in the USA in the recent past-the American Accounting Association in 1974, 1975, and 1976, the National Association of Accounts in 1974, and the AICPA in 1972 and 1977. Social accounting, however, remains an important challenge to the accounting profession since accountants are yet to agree on its scope and methodologies. Further, the nature of the problems confronted by social accounting can not be effectively solved unless it adopts a flexible methodology to break with some of the traditional accounting doctrines, assumptions and conventions

**Accounting Harmonization and the International Accounting Standards**

The emergence of accounting standards in the early 70s is undoubtedly the most significant event in the history of accounting development and corporate financial reporting. Accounting being the language of business, the need for its application in unique sense has been felt as early as the beginning of the present century. The major research efforts in accounting since the early 1930s was, therefore, in search of united frame of accounting principles and consistency in their application. The search for fully authoritative, integrated principles or theory of accounting that could be used to meet the needs of all users at national and global level has, however, not been successful. Instead, a diversity of accounting practices has developed throughout the world depending upon the school of accounting thought and socio-cultural need of different countries. There are conceptual differences on the one hand, and on the other hand, there are differences that stems from the adoption by different countries of different principles in the matter of recognition of accounting events and phenomena, valution of assets and liabilities and computation of profits. The differences that arise from these reasons cannot be simply resolved by developing general principles. In fact, the limitation of attempt to develop such general principle of accounting was observed by Paton and Littleton long ago : “Principles would generally suggest a universality and degree of permanence which can not be exist in a human service institution like accounting”. Accounting being a multiple paradigm discipline, its needs are bound to vary with socio-economic and cultural variables, viz., the level of accountancy education, economic development, development of capital market, prevailing legal system and finally, the specific needs of the industries. organisations in this respect are discussed briefly. The European Community [E.C.] : The E.C. which was formed in 1957 by France, West Germany, Italy, Belgium, Luxemburg and the Netherlands with the objective of free movement of capital, goods and service and personnel, is at present a union of 12 countries, after the accession of the U.K., Ireland, Denmark, Greece, Spain and Portugal. It has attempted to foster accounting harmonisation through its various directives and regulations. Since 1971 it has issued four major directives – The Fourth Directive, Fifth Directive, Seventh Directive and Eighth Directive to be implemented by its members inThe History and Evolution of the area of formats of published financial statements, valuation rules, disclosure requirements, consolidation of financial statements and audit procedures.

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**Association of South East Asian Nations Federation of Accountants (AFA):**

Founded in 1977, by five South Asian Countries – Indonesia, Malaysia, Philippines, Thailand and Singapore, AFA has attempted to harmonise accounting and auditing standards and practices in the ASEAN region. So far the association has issued two standards – one each in respect of accounting and auditing. The accounting standard relates to the fundamental accounting concepts and assumption underlying the financial statements.

**Confederation of Asian and Pacific Accountants (CAPA):**

This is yet another regional association of the accountants in Asia Pacific region which was founded in 1957 by 31 accounting bodies of 22 countries. The association has not so far issued any accounting standard, but as a part of its long term objective of developing a coordinated accounting and auditing practice, has developed eight course teaching materials for the teachers and practitioners of accounting in this region.

**African Accounting Council (AAC)**

AAC was founded in 1979 with membership of government representatives of African countries. The major goal of the council is to promote harmonisation of diverse accounting practices which they have inherited from France and England. So far the AAC has not been able to mandate any accounting standard upon its members.

**The United Nations (UN)**

The UN effort in the area of harmonisation of international accounting practices began as early as the 70s. In 1977 its report on International Standards of Accounting and Reporting for Transnational Corporations”was ublished. The report recommended uniform accounting practices by the TNCS in the area of segment reporting, consolidated financial statements and transfer pricing. In 1979 the Economic and Social Council of the UN appointed an intergovernmental group of experts on Accounting and Reporting Standards. The final report of the group published in 1982 recommended a wide array of disclosure in the basic financial statements of the TNCS.

**Organisation for Economic Cooperation and Development (OECD)**

The OECD effort in the area of harmonisation primarily relates to the accounting and reporting issues by the multi-nationals. In 1976 it developed a voluntary code of conduct for the MNCs relating to the general policies, disclosure of information in financial reports along with a number of social responsibility disclosures. In 1979 a permanent working group on Accounting Standards was set up to review efforts undertaken by its members to reduce diversities in accounting practices.

**The International Federation of Accountants (IFAC)**

The IFAC was founded in 1977. Because of its acceptance as the spokesman of the accounting professionals all over the world, the creation of IFAC is undoubtedly the most significant milestone in the history of accounting harmonisation. The Federation originally started with a membership of 63 accounting bodies from 49 countries, but over the years its membership has swelled into 123 accounting bodies of 87 countries. It is estimated that, together it represents at least 1.7 million of individual accountants from all over the world. So far the IFAC has not attempted to formulate any accounting standard, instead it has upheld the authority of the International Accounting Standards Committee for setting global standards.

**Theory The International Accounting Standards Committee (IASC)**

The IASC was established as a private standard setting body in 1973 by Australia, Canada, France, West Germany, Japan, Mexico. The Netherlands, UK, Ireland and the USA having the Objective to formulate and publish in the public interest, basic standards to be observed in the presentation of financial statements and to promote their worldwide acceptance and observance.” The IASC has a multifarious membership including automatic membership for all the members of IFAC who has agreed to support its standards and ensure their compliance in the preparation of financial statements. It has so far published 32 accounting standards in various fields including a conceptual framework in 1989 to serve as a guide to standard setting process :

**IAS - 1 Disclosure of Accounting policies**

**IAS - 2 Inventories**

**IAS - 3 Consolidated financial statements (Superceded by IAS 27 and 28)**

**IAS - 4 Depreciation Accounting**

**IAS - 5 Information to be disclosed in the financial statements**

**IAS - 6 Accounting responses to changing prices [Superceded by IAS-15]**

**IAS - 7 Cash flow statements**

**IAS - 8 Net profit or loss for the period, fundamental errors and changes in**

**Accounting policies**

**IAS - 9 Research and development costs**

**IAS - 10 Contingencies and events occurring after the balance sheet dates**

**IAS - 11 Accounting for construction contracts**

**IAS - 12 Accounting for Taxes on Income**

**IAS - 13 Presentation of current assets and current liabilities**

**IAS - 14 Reporting financial information by segments**

**IAS - 15 Information reflecting the effects of changing prices**

**IAS - 16 Accounting for property, plant and equipment**

**IAS - 17 Accounting for leases**

**IAS - 18 Revenue recognition**

**IAS - 19 Retirement benefit costs**

**IAS - 20 Accounting for Government grants and disclosure of Government assistance**

**IAS - 21 Accounting for the effects of changes in foreign exchange rates**

**IAS - 22 Accounting for business combinations**

**IAS - 23 Capitalization of borrowing costs**

**IAS - 24 Related party disclosure**

**IAS - 25 Accounting for investments**

**IAS - 26 Accounting and reporting by retirement benefit plans.**

**IAS - 27 Consolidated financial statements and accounting for investment in subsidiaries**

**IAS - 28 Accounting for Investments in Associates**

**IAS - 29 Financial Reporting in hyper inflationary economics**

**IAS - 30 Disclosure in the financial statements of banks and similar financial institutions**

**IAS - 31 Financial reporting of interests in joint ventures**

**IAS - 32 Financial Instruments : Disclosure and presentation.**

With this long list of accounting standards as above in some vital areas of financial reporting, one can reasonably expect that IASC will be able to pave way for harmonisation of global accounting practices. The total commitment of a good number of countries as well as India to the IASC standards corroborates this view. For example, the preface to the Accounting Standards in India clearly states that while formulating accounting standards, the Accounting Standards in India clearly states that while formulating accounting standards, the Accounting Standards Board will give due consideration to IASC standards and try to integrate them, as far as practicable, in the light of the conditions and practices prevailing in India. Not only that, in case of some developing countries like Singapore, Malaysia, Zimbabwe and Sri Lanka, the search for national standards in these countries has ended with word for word acceptance of the IASC standards. IASC’s long march to harmonisation has also gained milage in China, Yugoslavia and erstwhile Soviet Union due to the return of these countries to market economy. IASC’s standards in these countries have acted like a `quick-fix’ to make their accounting system compatible to the requirements of the global investors. There are, of course, some impediments which IASC is facing in the process of harmonisation; the superiority of accounting standards in some developed countries such as the USA the UK and Ireland has created a big hiatus which simply can not be bridged with the present IASC standards.

**CHAPTER 3**

**Approaches to Accounting Theory**

**Introduction**

The students of accounting when enter in their carer after passing graduation or post- graduation in commerce, they believe that there is a solution to every accounting problem. No, it is for away from the truth because there are many issues remain unresolved after having the knowledge of mere accounting. To become of student of accounting in real sense of the business world one should also concentrate on understanding the problems of accounting practice and profession. For this matter and reason, the accounting theory is recommended. The accounting theory provides the knowledge of Generally Accepted Accounting Principles (GAAPs), Contemporary issues and other developments in the field. In this chapter, the students will be introduced with accounting theory and its main issues like “Theory, process of constructing the theory, need of accounting theory”.

**Meaning of Theory**

Our common perception about theory is divided between two notions. One perception of theory is something which is far removed from reality. We then say, it is possible or it exists only in theory, not in practice. Another perception about theory is the cause- effect relationship that exists behind any event or practice. For example, if a man jumps off the New Empire State Building he will descend on earth at a specified time irrespective of his weight. If he survives his first attempt, but repeats it from somewhere near the centre of the earth from the same height, he would be surprised to se that this time he has descended on earth more quickly than before (we hope he has survived this time also). Why ? If he has an inquisitive mind, he may seek explanation which will lead him to the cause-effect relationship. By applying scientific method he may arrive at the theory of the law of gravitation (as Newton did). Then he knows not only the reason of his quick descending, but if he ever wishes to jump off from the same height at another place, he should be able to predict the time of his landing on earth. Our second perception about theory is the employment of scientific method to explain some phenomenon. A scientific method may be defined as a method of explanation that develops and tests hypothesis about how real world, observable phenomena are related. The goal of scientific method is explanation, scientific method strives to develop a systematic body of theory through development of hypothesis. Thus, theory may be described as “a cohesive set of hypothetical, conceptual and pragmatic principles forming a general frame of reference for a field of study.”

**Definition of Theory**

In the field of science, including social science, one may encounter a host of views about ‘Theory’, which has a Greek root, ‘Theoria’ meaning to “behold or view”. A popular definition given by Kerlinger defines theory as “a set of interrelated constructs (concepts), definitions and propositions that present a systematic view of phenomenaApproaches to Accounting Theory 5 7 by specifying relations among variables, with the purpose of explaining and predicting the phenomena”.Arnold Rose’s view is similar to the above statement. He defined theory as “an integrated body of definitions, assumptions and general propositions covering a given subject matter from which a comprehensive and consistent set of specific and testable (principles) can be deduced logically”. There are other views which state theory as “a set of interrelated concepts at a fairly high level of generality”.

**The Process of Theory Construction**

Atheor y, according to the defination of Webster’s Third International Dictionary, provides “general frame of reference for afield of enquiry”. It does not however, give specific prescription for a specific problem. Social Science is not concerned with isolated events, but with the commonality of a series of problem. The process of generalisation is arrived at through the following stages :

**(i) Observation :** There are many disputes over the way in which theories are constructed. But the construction of most of theories, as also the “laws of nature”,begins with observation of the phenomenon. We all know the study behind Newton’s discovery of the law of gravitation. He observed the phenomenon that all objects tossed up come down. This provoked his inquiry which ultimately led to the cause.

**(ii) Defining the problem:** Careful definition of the problem will provide objectivity or a track through which inquiry may be conducted. If identification of problem is wrong or imprecise it would be very difficult to reach meaningful conclusions. It may be observed that the objective or goal of accounting is not rigorously defined. As a result, until now there is no comprehensive theory of accounting.

**(iii) Formulation of hypothesis**: “Science is a method of approach to the entire empirical world, i.e., to the world which is susceptible of experience by man”, that we call a hypothesis. It is the preliminary assumption adopted for the explanation of a phenomenon. It is formulated before empirical evidences or facts are gathered.

**(iv) Experimentation or testing the hypothesis :** A hypothesis established around the preliminary assumption must be tested for probable conclusions. It is important to select the appropriate method for testing the validity of hypothesis.

**(v) Verification**: The final stage in the formulation of theory is generalisation through verification. If the observed phenomenon after repeated trial or experimentation produces the desired result the hypothesis is then said to be confirmed, the logicalconsistency of the hypothesis is generalised to formulate a theory. “Scientific theories provide certain “expectations” or “predictions” about phenomena and when these expectations occur, they are said to “confirm” the theory. When unexpected results occur, they are considered to be anomalies which eventually require a modification of the theory or the construction of a new theory. The purpose of the new theory or the modified theory is to make the unexpected expected, to convert the anomalous occurrence in to an expected and explained occurrence”.

**Characteristics of a Good Theory**

A good theory should fulfil the following criteria :

(i) It should explain or predict phenomena, i.e., they should be empirical.

(ii) Theories should be capable of being tested empirically. Theories which fail tests are not of universal applicability, therefore, must be replaced by better or non refutable theories.

(iii) Theories should be consistent both internally and externally. Internal consistency is present when the analytical properties of theory ensure that the given theory predicts the same outcome in every identical case. External consistency implies that the theory should be consistent with theories in other disciplines.

(iv) A theory should be exhaustive so as to cover the full range of variations relating to the nature of the phenomena is question.

(v) Theory should be helpful in providing guidelines for research into empirical problems.

**Accounting theory and its nature**

Accounting Theory is the organised body of knowledge which deals with order, reasons, relationships, objectives and methods involved in the practice of accounting. Hendriksen, however, used the definition of the Webser’s Third International Dictionary as the basis to define Accounting Theory. Thus, according to Hendriksen, “Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that

(i) provide a general frame of reference by which accounting practices can be evaluated, and (ii) guide the development of new practices and procedure. He further states that accounting theory may be used to explain existing practices to obtain a better understanding of them. Both the definitions of accounting theory given above underpin the use of theory as a guide to accounting practices. But the fact i that there has been a concurrent development in accounting. While accounting was developing as a practical art, it was also evolving a body of theoretical premises. The theoretical evolution of accounting is of recent original, though its practical development can be traced back five hundred years ago. Both the theoretical and practical approaches have contributed to the existing organized body of knowledge, presently known as accounting theory. Their approaches are different, but the purpose is the same : to develop systematic accounting practices. Under the practical approach, accountants have frequently relied on trial and error as a means to improving accounting practices whereas, the theoretical approach relied on logical, conceptual structure to develop meaningful pattern of accounting practices. But both the theoretical approach and practical approach are interested in developing some general principles and procedures for dealing with the same real world phenomena of business transactions and events.

Figure 3.1. is a diagrammatic representation of the development of accounting theory and accounting practices.

**GENERALISATION**

**INDUCTION**

**PROCEDURES**

**PROBLEMS**

**CONCLUSION**

**DEDUCTION**

**ASSUMPTION**

**ABSTRACTION**

**BUSINESS TRANSACTIONS AND EVENTS**

Fig. 3.1. Development of Accounting Theory and Accounting Practices Source : Frank J. Imke, op. cit. The development of accounting practices which employs a problem solving approach is shown in the right hand side of the diagram. As particular problems occurred in dealing with individual business events practicing accountants would look for separate procedures to solve these specific problems. “The history of accounting practice consists of a problem ...... procedure evolution ....... the development of new, or modification of old, procedures as different problems occurred”.In other words, the approach adopted in the development of accounting practice can be epitomised as, “Accounting is what accountants do”.The development of accounting theory, which has taken place concurrently with that of accounting practice is shown in the left hand side of the diagram. The first step in the development of accounting theory is abstraction from the real world of business transactions to make some assumption about them. From these assumptions conclusions can be developed about accounting activities through deductive logic. This procedure would suggest “Accounting is what accountants should be doing”. Descriptive and normative theories : From the foregoing it appears that accounting theory can be extracted from the practice of accounting (i.e., the practical approach) or it can result from a logically derived process through the deductive approach. The difference in not one of purpose, rather the difference is due to adoption of different methodologies. “The divergence of opinions, approaches and values between accounting practice and accounting research have led to the use of two methodologies, one descriptive and the other normative.”

1. **Descriptive theories**: A descriptive theory describes a particular phenomenon as it is, without any value judgment. For example, if you jump from The New Empire State Building, a descriptive theory will tell you when you will descend on earth, it will not tell you whether you are right or wrong in doing so.The practical or conventional approach to accounting theory is essentially descriptive in character. Such descriptive theories are concerned with the behavior of the practicing accountants and what they do. This approach emphasizes accounting practice as the basis from which to develop theory. Under the destructive view, accounting theory, therefore, is “primarily a concentrate distilled from experience”. The prominent examples of descriptive accounting theories are the works of Paul Grady, An Inventory of Generally Accepted Accounting Principles for Business Enterprise, Sanders, Hatfield and Moore, A Statement of Accounting Principles, Stephen Gilman, Accounting Concepts of Profit, A.C. Littleton, Structure of Accounting Theory, and Yuji Ijiri, The Foundations of Accounting Measurement.

**(ii) Normative theories :** The essential feature of Normative Theory is the existence of value judgement. Normative Theories tend to justify what ought to be, rather than what it is. It imposes on the accountants responsibility of determining what should be reported rather than merely reporting what some on else has requested.The outstanding examples of normative accounting theories are the works of J.B. Canning, The Economics of Accountancy, W.A. Paton, Accounting Theory, Henry Sweney, Stablized Accounting, Kenneth McNeal, Truth in Accounting,Edwards and Bell, The Theory and Measurement of Business Income, and Sprouse and Moonitz, A Tentative Set of Broad Accounting Principles for Business Enterprise.

**The roots of accounting theory** : The development in accounting theory has been influenced by the technological changes and advances in knowledge in many other related disciplines. The major disciplines which have influenced such development are:

**1. Decision Theory**

**2. Measurement Theory, and**

**3. Information Theory**

These three disciplines are perceived to be the roots of accounting theory.

**1. Decision theory** : The essence of this theory is that decision-making is not an intuitive process but a conscious evaluation of the possible alternatives that leads to best result or optimises the goal. It is a logical sequence that involves the following

stages :

(i) Recognition of a problem that needs decision,

(ii) Defining all the possible alternative solutions,

(iii) Compiling all the information relevant to these solutions,

(iv) Assessing and ranking the merits of the alternative solution,

(v) Assessing the best alternative solution by selecting that one which is most highly ranked and,

(vi) Valuing the decision by means of information feedback.

Decision theory is both descriptive and normative. As a descriptive process it attempts to explain how decisions are made, while as a normative process it suggests which decision is to be made.

The significance of decision theory as a central construct of modern accounting theory becomes apparent from the FASB objectives and qualities of accounting information and the True Blood Committee Report that came down heavily in favour of decision usefulness of accounting information. But much earlier in 1966, A Statement of Basic Accounting Theory by the AAA foresaw the role of accounting information for such decision usefulness to the managers, creditors and the investors. With decision theory accounting can not be viewed as a discipline with practically no interaction with other operating functions of the business. In fact, accounting functions are intertwined with managerial analysis because, as an information system it provides significant meaningful information about the firm both for internal management use and external financial reporting

**2. Measurement theory :**

There is a clear relationship between accounting and measurement theory. Such relationship has been subjected to extensive analysis by the eminent writers like Chambers, Ijiri and Mattessich. Accordingly, accounting has been defined as a measurement discipline that pertains to “the quantitative description and projection of income circulation and of wealth aggregates” in explicit monetary terms. Thus, although the term measurement has been typically defined as the assignment of numerals to objects or events according to rules in relation to accounting measurement implies financial attributes of economic events that we call accounting valuation

Thus, although the term measurement has been typically defined as the assignment of numerals to objects or events according to rules in relation to accounting measurement implies financial attributes of economic events that we call accounting valuation. Measurement theory is normative in character. Therefore, accounting as a measurement discipline requires specification as to the following :

1. The events or objects to be measured :

This is of paramount importance because, the “identified relationship between accounting and measurement theory would allow .... to convey clearly the objectives of accounting ...” This indicates that the identification of accounting property would allow us to explain more clearly and consistently the urposes, procedure, limitations and theoretical foundation of accounting.

(ii) The standard or scale to be used :

One of the fundamental properties of measurement theory with respect to assigning numerals to objects or events is that they must be related to a common numerical relational system. For example, if we assign 3 ft. to represent the length of an object, we must assign the same common scale to another object so as to make them amenable to addition andsubtraction. This additivity, as Chambers suggests, is the key to accounting measurement. In accounting, money is the most common unit of measure, not because that it is convenient but due to the ability of monetary unit to attach common significance to diverse events and objects which are subjected to accounting measurement.

**3. Information theory :** The dominant nature of accounting lies in an information communication system. More precisely, accounting is an application of the general theory of information to the efficient economic operations. The significance of information theory to accounting lies in the fact that it is a part of the decision-making process that reduces uncertainty and thereby provides a means to improve the quality of decision. Information theory in particular can help accounting to resolve certain important issues such as : What is an information ? What is the relationship between information and data ? What should be an accounting information and what should be the system or systems by which to communicate the information ? The term ‘information’, however, is not easy to define in view of the psychological overtone or personal attitude implied in the term. But accounting being a measurement discipline as well as an information communication system, we can define information as a data that adds to the receiver’s knowledge, reduces uncertainly, and communicates a message to influence the user’s behaviour in his decision-making process. In short,6 2 Accounting Theory when the receiver of a data reacts to it, it is said to carry information. A data is thus distinguished from information. According to Bedford, however, a data becomes accounting information only when it is measured and is bounded by the criteria of relevance, verifiability, freedom from bias and quantifiability. The terms, relevance, verifiability, freedom from bias and quantifiability may be regarded as the attributes that provide internal boundary of the accounting information. Under this theory, information is regarded as a resource, the collection, processing and transmission of which involve a cost. Such costs accelerate with the increase in the volume of information. It is, therefore, important to associate the process of information generation with the economics (i.e., costs) associated with it. Only this criterion can help us to consider the optimal level of information supply by measuring cost of information supply in relation to its benefits to the users.

**Approaches to the formulation of accounting theory**

Richard Mattessich at the beginning of chapter 1 of his magnum opus, Accounting and Analytical Methods makes this observation : “Modern Accounting is a mode of thought, a manifestation of our Charismatic thinking and evaluating, a tool designed to help master our economic struggle. It unfolded in its full breadth during the last hundred years and can not be regarded as having exhausted its potential of technical as well as intellectual growth”.Such intellectual growth of accounting is amply manifested in the numerous approaches that relate to the attempts to accord theoretical support for this discipline. The major such approaches, which range from trivial to sophisticated theories, have been identified to be the traditional approaches, as comprising:

**A. Non-Theoretical (Informal) approach :**

1. Practical

2. Authoritarian

**B. Theoretical (formal) approach) :**

1. Inductive

2. Deductive

3. Ethical

4. Sociological

5. Mathematical (axiomatic)

6. Economic

**C. Eelectic or Combination approach and New approaches Comprising :**

1. The Events Approach

2. The Behavioural Approach, and

3. The Predictive Approach.

**Practical approach**

The practical approach is also referred to as the ‘pragmatic approach’, though it does not fully employ the formal rule of the pragmatic school of logicians. Yet, this approach constitutes an important part of theory in accounting because “it enables the theory to have operational utility, based on an understanding of relations between business phenomena, of constraints on the measurement system, and of the needs of users of accounting information”.Approaches to The practical approach is essentially a problem solving approach. Its primary objective, as can be seen from the most of the “generally accepted accounting principles”, is to find a workable solution to a problem. As a result, any solution obtained through this approach should be viewed as a tentative solution to problems.

**Authoritarian approach**

His approach is sometimes equated with the practical approach because of the common methodology its theoretical grounding based on operational utility under the stamp of approval of the regulatory bodies. “The role of authoritarianism is to discriminate between well-founded but conflicting theories (given on the state of knowledge at the time). A practice which appears appropriate in given circumstances should be authorised for use by practitioners”. A good example of the authoritarian approach is the ARS No. 7 [An inventory of Generally Accepted Accounting Practice for Business Enterprise] of the AICPA, which is nothing more than compilation of contemporary accounting practices in the USA. Inductive approach : The inductive approach is least theoretical in nature because of its basic premise that “accounting is what accountants do, therefore, a theory of accounting may be extracted from the practices of accountants”. This approach in consequence depends on observations to reach conclusions. Here, unlike the deductive approach, the process is “going from the specific to the genralisation”. In other words, some specific observations about financial transactions will be made. If recurring relationships are found among the transactions, genralisation and principles can be formulated

**InDeductive approach:** The inductive approach is least theoretical in nature because of its basic premise that “accounting is what accountants do, therefore, a theory of accounting may be extracted from the practices of accountants”. This approach in consequence depends on observations to reach conclusions. Here, unlike the deductive approach, the process is “going from the specific to the genralisation”. In other words,some specific observations about financial transactions will be made. If recurring relationships are found among the transactions, genralisation and principles can be formulated (See diagram below)

**PROBLEMS**

**PROBLEMS**

**INDUCTION**

**PROCEDURES**

**GENERALISATION**

**PRINCIPLES**

Fig. 3.2. Inductive approach to the formulation of Accounting theory. Inductive approach is backward looking, it depends on the past accounting practices to seek solution for emerging problems. In that sense, this is pragmatic or practical approach, as most of the current “generally accepted accounting principles” are. They have not been derived from the accounting environment, objectives and basic features of financial accounting. The inductive approach is, however, expeditious and utilitarian, but one trouble with this approach is that every solution to emerging problem may not be found in the past accounting practices. Further, the accounting environment on which past practices are built may change due to changing socio economic factors. In this case the utility of the ‘Theory’ would be reduced considerably.

**Deductive approach**: The deductive approach to the development of accounting theory begins with establishing the objective of accounting. Under this approach accounting techniques and practices are linked to the objective of accounting which is derived from the accounting environment. Development of specific accounting practice and techniques would be the last step in the ladder of deductive approach, as shown in diagram below

Postulate

Principles

Standard

Practices

Society

**Instruction Activates**

**Rules Procedures**

**Directives Methods**

Fig. 3.3. Deductive approach to the formulation of Accounting Theory

Source : Frank J. Imke, op. cit.As can be seen from the diagram, in a deductively derived accounting theory, the techniques and procedures of accounting are related to the principles, postulates and objectives in such a logical sequence that if they are true the techniques and procedures must also be true.

The validity of deductive approach, therefore, is dependent on correct identification of accounting objectives related to the accounting environment. Put in other way, to the extent identification of objectives and environment are in error, the conclusions reached will also be in error. The best known examples of deductive methodology of accounting theory are the works of Maurice Moonitz (The Basic postulates of Accounting) and Robert Sprouse and Maurice Moonitz (ATentative set of broad accounting principles for Business Enterprise). Other writers who have used deductive methodology include Cannig, Sweeny, McNeal, Alexandre and Edward and Bell

**Ethical approach**

The ethical approach does not constitute a major theoretical underpinning, though it certainly reflects a paradigmatic change in the accounting objective that were taking place in the USA and elsewhere. During the after the Second World War the erosion of social values brought into focus the ethical need in the objectives of accounting. D.R. Scott, S.C. Yu, J.W. Patillo, F.J. Imke and others saw ethics as the basis of accounting theory, with justice, fairness and truth being the parameters of financial reporting. Imke Opined that “Accounting exists to serve society by recording, interpreting, and otherwise effectively utilizing financial and other economic data.

According to him, accounting, therefore, should be based on the following three criteria:

(i) The practice of accounting must provide equitable treatment of all interests concerned,

(ii) Accounting information must be truthful.

iii) Accounting must reflect an impartial and unbiased representation of the economic facts.

The ethical approach has instantaneous appeal, but the principal limitation of the approach is that though no one would argue against the concepts of truth, fairness and justice as a desirable feature of accounting theory, these are subjective value judgements having no definite yardstick to measure them.

**Sociological approach**

The centre of gravity of the sociological approach to accounting theory is reflected in the proposition that “accounting has the responsibility to “transcend the internal viewpoint of a private firm and develop information which portrays a private firm’s role in and contribution to society”. The plank of this approach is further strengthened by this argument that business being a subsystem of the wider social system, ultimate usefulness of accounting depends on the good it can do to the society and not in the services rendered to individuals.

Sociological approach to the formulation of accounting theory thus calls for an assessment of the accounting techniques and policies vis-a-vis their impact on the society. Its suggested dimensions, among others, include internalizing the social cost and assessment of social benefits arising from the activities of the private firms, disclosure of socially oriented data to assess a firm’s relative role and contribution to the society. In short, under this approach the techniques of accounting should be directed to the development of information for decisions that result in the efficient utilization of resources, the conservation of the environment and equitable allocation of business income as an effective means of maximisation of social well-being.

The sociological approach to the formulation of accounting theory is believed to be the precursor to the evolution of societal or socio-economic accounting, an important subdiscipline of accounting that emerged during the 1960s. The main objective of socio- economic accounting is to assess the impact of the economic activities of the private firms on the society at large by developing indices for the measurement, internalization and disclosure in the financial statements the ultimate social costs which are not included in the traditional cost structure of the firms. The techniques of socio-economic accounting are yet to reach its stage of maturity and the traditional accounting measurements are found insufficient. It has been suggested that to solve the problem, accounting techniques should be flexible and it should encompass other nonmonetary measurements which are presently beyond the scope of traditional accounting

**Mathematical (axiomatic) approach**

The mathematical approach to the formulation of accounting theory culminates in the axiomatic formulation of its contents to grasp the logical structure of accounting. In this approach, “mathematical symbols are given to certain ideas and concepts. The frame work is provided in the form of mathematical models utilizing matrix alzebra on symbolic logic” such that the logical part of the theory can be abstracted and studied in isolation from the empirical part of that theory. In other words, mathematical or axiomatic approach is a variant of the deductive approach that provides techniques for summarising the basic proposition of accounting (posulates,concepts and other observable phenomena) in the abstract language which is amenable to mathematical operations and independent proof.

Example of the use of such axiomatic method are found in the works of Mattessich, Chambers, and to some extent, in the works of Ijiri.

**Financial approach**

While the ethical approach focusses on the concept of fairness and sociological approach on the concept of ‘social welfare’, the economic approach to the formulation of accounting theory emphasises the macro and micro economic welfare of the affected parties arising from the proposed accounting technique. Such considerations were, however, given little attention in the formulation of accounting theory under the traditional approaches discussed above. In fact, accounting techniques in different countries remained neutral to economic impact, although in Sweden attempt is generally made to balance accounting policies with other macro economic goals.

Beginning with 1970, however, increasing attention was being given to the economic consideration while formulating accounting standards.Rappaport, Buckley, Horngren and the FASB investigated the social and the economic effects behind the proposed accounting standards, or more precisely, the economic consequence of Financial Accounting Standards”. It appears that the choice of a particular accounting technique cannot be neutral, but must also consider the economic reality’ and the economic consequence of the proposed accounting technique. In fact, economic consequence is a pervasive consideration which was given due importance in the choice of accounting techniques in the past without any explicit reference to the `Economic Approach’. For example, The widespread use of the LIFO method of inventory valuation by the US companies since 1940s did not emerge out of any theoretical considerations but as a guard against adverse economic effects of FIFO method on corporate earnings in the prevailing inflationary condition. A formal economic approach, however, provided the major theoretical arguments for certain accounting reforms like inflation accounting and replacement cost depreciation that was proposed during the 1970s

**Eclectics or combination approach**

While in a purely deductive approach the objective is to develop a statement of basic accounting theory based on “cohesive set of hypothetical, conceptual and pragmatic principle” to form a general frame of reference for the study and practice of accounting, the inductive approach is characterised by operational utility based on observable relations among isolated economic events as the basis of this theory. Both these approaches have their relative merits and demerits. R.K. Storey thus observes, the practical approach for the formulation of accounting theory has created almost as many problems as they have helped to solve. The exclusive use of conceptual approach, on the other hand, has been equally ineffective. Although this method has fared better than the practical approach from the stand point of internal consistency, it had almost no influence good or bad on accounting practices. Implied in the observation of Storey is the suggestion to use an eclectic approach to the formulation of accounting theory. Eclectic approach does not profess commitment to any particular methodology; it is mainly the result of numerous attempts by individuals, professionals and other agencies [AICPA, AAA and the like] to remove the deficiencies of other approaches. Such an approach is particularly useful in the absence of a universally accepted accounting theory.

**Events approach**:

The events approach to the formulation of accounting theory was first proposed by George Sorter, as an alternative to the value approach to accounting which was endorsed by the majority of the members of the AAA committee that issued “A statement of Basic Accounting theory” in 1966.Approaches to The principal argument used in favour of the events approach is that, due to wide ranging use and heterogenous users of financial statements, accountants should not direct the published financial statements to specified ‘assumed’ group. Furthermore, accounting information on the basis of value approach can contribute little directly to an understanding of the user’s utility preference function, since his goals result from a complex of personal and social values that can not be identified in the financial statement.The tenor of the approach thus suggests that, an event, being defined as an occurrence phenomenon or transaction, has better semantic interpretation than value measurement,and the information need of the great variety of users can be better fulfilled by providing information about the events without having to aggregate the assign weight (i.e., value) to the data generated by the event. The function of aggregating and putting weights to the events should be better left with the users in conformity with their utility function.

Given this argument, the events approach suggests expansion of accounting data in the financial statements.

The limitations of the events approach, however, are the following :

(i) Events approach presupposes that the users are sophisticated enough to be able to classify and aggregate accounting data for their own use.

(ii) Events approach does not explicitly mention which data are to be selected for the financial statements.

(iii) There is definite limit to the amount of data a person can handle at a time. The expansion of data may cause information overload to the users.

**Negotiating approach** :

As a corollary to the measurement and information theory, if we are to define the objective of accounting process to be the production of numbers that possess information content directed to the users, we should also make evaluation of the user’s economic and psychological reaction to the accounting information given under alternative combinations or conditions. This psychological cognate of accounting information, which is amiss in the traditional approaches, have come to be known as the behavioural approach to the formulation of accounting theory. The behavioural approach is concerned with direct evidence of user’s reaction to accounting reports as a basis for descriptive generalisation about the behavoural aspects of particular accounting techniques and problems such as

(1) The adequacy of disclosure,

(2) The usefulness of financial statement data,

(3) Attitudes about corporate reporting practices,

(4) Materiality Judgements and

(5) The decision effects of alternative accounting valuation bases.

The behavioural approach is essentially “descriptive rather than normative and in the usual application does not contemplate changing user behaviour”, it only identifies user’s behaviour.Behavioural approach is relatively new in accounting and is still considered to be at the stage of infancy, but some important empirical research in the area [such as those by Dykman, Gibbins, Swieringa and Horngren] which systematically studied user behavior when they are given alternative accounting procedures in varying combination, have contributed substantially to our knowledge of the effects of such alternatives.

**Prognostic approach**

Under the traditional approach accounting measures are generally used for non predictive purposes e.g., accountability and reporting on stewardship. In the predictive approach however, accounting measures are not just6 8 Accounting Theory considered as post-mortem exercise. In fact, accounting information is decision oriented that permits prediction of future objects or events. This predictive ability of accounting information has been considered by the SFAC No. 2 of the FASB as an explicit criterion of the quality of accounting information. But much earlier in 1968 Bever, Kennelly and Voss had demonstrated the utility of predictive approach in relation to the difficult problem of evaluating alternative accounting measurement. According to them, when confronted with the choice between measurement alternatives, “the measure with the greatest predictive power with respect to a given event is considered to be the ‘best’ method for that particular purpose”. The predictive approach is directly related to the ‘predictive ability’ of financial data and is purported to provide a purposive criterion to relate the function of collecting financial data to the task of decision-making.

**Relationship between accounting theory and accounting practice** :

Accounting theory and accounting practice are not mutually exclusive things, they pertain to the same real world phenomenon of economic transactions. Therefore, conclusions developed from accounting theory should be same as the genralisation developed from the study of accounting practice. Theory is important to the development of accounting because to be meaningful, practice must be based on logic. On the other hand, accounting is an utilitarian device for solving everyday economic problems of business. Therefore, a theory would be judged good in the long run if it improves usefulness of accounting Ideally, a sound practice should always conform to a theory, and at the same time,theory should be based on common sense and relate to the existing business world. In that sense, theory and practice should serve as a check and balance to each other.But unfortunately, present accounting practices are not based on such ideal conditions.

We have already seen that accounting theory and accounting practices are based on different methodologies. Whereas accounting theory is based on logic oriented deductive approach, accounting practices are based upon a process of inductive reasoning which consists of making observations and drawing generalised conclusions from a limited number of observations. This approach emphasises the behaviour of practicing accountants rather than the behaviour of real world phenomena. Since accounting practice is characterised by practical approach, it can not be free from personal bias of the practicing accountants. A good theory, on the other hand, would strive to eliminate such bias. Besides, consistency is another factor that distinguishes accounting practice from theory. As a good number of inconsistencies are noticed in accounting practice, and they are permitted by the “generally accepted accounting practice,they are responsible for significantly divergent reported income. This inconsistency did not escape the attention of Canning who stated that, “Accountants have no complete philosophical system of thought about income, nor is there evidence that they have ever greatly felt the need for one.

The genralisation are too inchoate ..... to permit one to suppose that they have ever seriously put their minds to the philosophical task”.

**A few examples of inconsistency in accounting practice:**

A classic example of inconsistent accounting practice is found in the valuation of inventories. The generally accepted accounting principles regarding inventory valuation is lower of cost or market price, though there is little theoretical justification (from the objectivity points of view). The practice is deeply entrenched into accounting practice “From the desire on the part of creditors for an inventory figure on the position statement reflecting the liquidation value of the assets. Not only this, the meaning of cost has different connotations like LIFO, FIFO. As a result different accountants may adopt different methods showing different income and inventory figures. Other inconsistent accounting practices include varying depreciation methods, treatment of know how expenditure and treatment of gratuity.

In view of the prevalence of such alternative practices Spiller argues that such practices are not logical, nor even internally consistent. Thus, the generalisations that arise out of accounting practices are, in many cases, not descriptive of the whole accounting practice. Spiller describes such generalisation as “poor genralisation .... with little rhyme or reason for the differences”.

Accounting theory in transition : Prof. G.D. Roy observed that the last words about accounting theories have not been said. Neither have we heard the last words about physics, chemistry or medicine. There is continuous developments in all the fields of science. Accounting too, has at least some element of science in it, though its roots are embedded in the practitioners art. But was not all other field of science a toddler at the beginning ? Was not chemistry a vagaries of alchemy or biology a weired collection of errors at the beginning ? Today, nobody would are to dismiss them as a nonsense science.The same can be said of accounting. The scope and methods of accounting are also changing and can be expected to continue to change in future. Such observations were made by many schoars like Bedford and Gluatier and Underdown. At the very beginning of their book, Glauter and Underdown made this observation that, “Accounting is in an age of rapid transition, its environment has undergone vast changes in the last two decades and the accelerating rate of change is in prospect for the future”.The secret of this development lies in the desire of the accounting professionals to see their profession in the ornate discipline of science, encompassing not only economic interests of individual, but also encompassing social behaviour of group of men related to such economic interests. Such integrated approach to accounting can not bypass the great changes which are occurring in measurement techniques, the behavioural science and advances in computer technology. It may be noted that accounting has been already profitably utilizing a great variety of measurement techniques such as computer simulation, statistical analysis and other measurement methods which did not originally belong to its domain.

The developments in the discipline of economics have also greatly influenced accounting. With the introduction of the concept of externalities in the economic literature by Prof. A.C. Pigou in 1960, accountants have attempted to incorporate his concept in their discipline as a new dimension of socio-economic accounting. “The recognition and measurement of external diseconomies, or social costs, and the resulting implications for the accounting profession”. It is highly probable that accounting in future will assume a lead role in measuring social costs for maximisation of social well-being that Pigou saw in resolving the conflict of “divergence between social and private net product”.These developments suggest that accounting will become more of a normative science in future. It is also possible that accounting will merge with other disciplines to create a new information profession. The wind of change which is blowing across the horizon of accounting will undoubtedly call for new structure of accounting theory in future. The dynamic nature of accounting theory in future will include broader scope for accounting to measure and communicate data on past, present and prospective activities of all types in order to improve control methods and decision-making at all levels

**Advantages and limitations of accounting theory** :

The advantages and limitation of accounting theory has been best summed up by Monitz who says that accounting theory “cannot solve all the problems the profession faces anymore than the “laws” of physics can build a bridge, but they can give the frame of reference it must have”. Similarly, it may be observed that a large part of accounting practice depends upon judgement related to particular circumstances. Therefore, a theory with prior determination of objectives or goals may suffer from limitations due to changes in business environment. There seems to be logic both in favour and against theory. Yet, at the risk of over simplification, one way may that theory provides the foundation for practice; theories are constructed to explain and give meaning to practice; without the foundation of theory is like a building standing upon sand. “If we develop accounting with no more foundation than arbitrary assumptions, who will dare rely on it ?” Below is given some of the clearly identified advantages of theory :

**(1) Identification of problem area** :

Accounting Theory narrows the range of problem area by clearly identifying the facts to be studies. It helps select the relevant aspect of a phenomenon.

**(2) Conceptual frame** :Accounting theory provides a conceptual framework or, as put by Hendriksen, it gives a general frame of reference for the study of accounting problems. This frame of reference actually provides the standard with respect to which accounting practice may be evaluated.

(**3) Summarisation** : Accounting theory as an organised body of knowledge summarises concisely what is already known about the subject. As can be seen from the bulletins of the AICPA, many of the current accounting theories are actually summarisation of current accounting practices.

**(4) Uniformity of practice :**

One of the goals of accounting theory is to provide uniformity in practice. The contemporary ‘Generally accepted accounting principles’ are primarily a cluster of current accounting theories on existing practices in the grab of theories. It aims at providing uniformity in accounting practice, the lack of which will greatly reduce credibility of accounting.

**(5) Predictive ability** :

An obvious advantage of accounting theory is its predictive ability. Theoretical generalisations can be used to predict further facts. Due to this predictive ability of accounting theory, a growing body of empirical research has evolved that can be used for decision making by the users. Examples of such predictive model in accounting, among others, include prediction of earnings, corporate failure risk associated with equity or bond, and capital market reactions.

**(6) Development of new practice** :

Accounting operates in a dynamic socio- economic environment. Therefore, with the change in social attitude, economic reality and improvement in information science, it may be necessary to replace the existing practice by new one. For example, requirement of huge capital for fixed assets during the rail road developments in the UK and USA created the need for depreciation accounting based on historical cost. But the economic reality in a persistently inflationary condition has forced the accountants to propose for replacement cost depreciation.

**Limitations of Accounting Theory**

(1) Accounting theory does not explain all its practices. Due to the utilitarian nature of accounting, many of the conventions and principles of accounting have been constructed on the basis of expediency rather than as rules of logic.

(2) Littleton and Zimmerman argued that accounting is not as strongly oriented toward logical argument as towards utilitarian service. It is less concerned with deductive generalisaton than with practical accomplishments.

(3) The concepts and postulates of accounting theory are not rigorously defined. Some of the fundamental assumptions of accounting theory are not realistic, e.g., the assumption about stable value of money.

(4) Unlike the theories of pure science, accounting theory suffers from internal consistency. For example, according to the entity concept, which is a basic postulate of accounting, accounting statements should be prepared to represent the activities of the entity rather than the groups connected with it. But in many cases the tenet of the concept is violated e.g., the net income is defined as net income of the shareholders instead of those to the entity.

(5) The practical nature of accounting does not lend itself to have a general theory of accounting such that a high level of generality makes it possible to the applied to all countries, to all industries and all firms. For example, generally accepted accounting principles in the USA and India are not the same due to different socio economic conditions.

**CLASSIFICATION AND ACCOUNTING THEORY**

A taxonomy is a classification designed to aid the analysis and interpretation of a field of inquiry. A classification of accounting systems should be of value in many ways :

By sharpening the focus of description and analysis

By assembling a mass of data in a form suitable for explanation

By permitting the isolation of critical factors which must be considered in setting accounting standards

By adaptation, a good taxonomy becomes a predictive tool, enabling the analyst to determine probable outcomes of decisions to change a system. More importantly, a taxonomy should lead to the development of models which permit inferences to be drawn from changes in causal and modifying factors to changes in accounting system. Classification in accounting has only recently begun to consider the theoretical implications of taxonomy. The most frequently encountered classification of accounting systems, into financial, tax, managerial, cost, government, and so on, lacks the qualities of an efficient classification in that the classes are not mutually exclusive.

The role of classification in financial accounting appeared to be well understood and generally agreed until recently. In the area of practice there was (and is) widespread use of charts of accounts which reflected the balance sheet and income statement categories underlying the well-known basic equation. In the area of theory, it was frequently pointed out that this was the fundamental process; Mattessich made in the point of departure in his quest for a measurement theory of accounting : “The most basic measurement is classification, a fundamental discriminatory process whereby the various categories can be identified and distinguished through numerals”. The division into classes can be a scale of measurement, and he gives as his example, a chart of accounts. The same proposition is found in such widely different sources as a book on controllership, which identifies the five basic classifications as assets, liabilities, proprietorship, revenues; and expenses, and a contribution to the normative theory of accounting, where the last three were given the names, residual equity, income, and cost.

The area of managerial accounting, however, did not disclose any comparable uniformity of ideas, and the study of different classifications of costs not only threw up the possibility of alternative sub-classes but also revealed a weakness in the basic classification used by financial accountants. This was the observation that a chart of accounts should not be based upon the balance sheet, because many accounts required by a business are eliminated in the preparation of the financial statements, in particular the so-called “clearing accounts”.

By 1969, when Sorter drew attention to the problem, the idea that accounting events were not given in nature had been recognized widely, and attention was being devoted to “economic events” as the phenomena which accountants were attempting to interpret and represent. Unfortunately, this concept led to the identical classification scheme as did accounting events. Sorter postulated that accounts were needed to provide information to be used in decision models, that individual users would develop their own input values, and therefore a financial statement should include all items relevant to any decision model. The starting implications of this observation led Johnson to attempt to design a structure for a financial accounting system of this type.

**Accounting Theory in U.S.A.** :

Until the twentieth century the contribution of the English-speaking world to the development of accounting theory was entirely pragmatic. Even today one can open a book entitled Principles of Accounting and find its author concerned entirely with method. The most virulent controversy before the 1930s was the dispute which centered on the notorious Jones of Bristol, and that one dealt with technical aspects of double-entry book-keeping and the need for the journal.

The twentieth century has seen a radical reversal of roles. During this period the English-speaking world (the United States, the United Kingdom, Australia, Canada, and New Zealand in particular) has become a powerhouse of ideas about accounting : what it is and what it should be. In this chapter and the next we shall trace the course of this transformation, with the spotlight mainly on accounting in the United States.

**THE INDUSTRIAL REVOLUTION**

A major factor was the industrial revolution and the related technological changes of the nineteenth century. The lengthening of the time period of production which characterized these changes produced a need to account for use separately from acquisition and thus directed attention to the cost allocation problem.The processes of mass production may be contrasted with those of an artisanal economyIn the latter, manufacture was accompanied by payments at every stage – for materials when the work was put in hand and for labor as the work was executed, either in the workshop or in the worker’s home. The difference between the money payments and the eventual money receipt when the work was completed was called profit and had to cover the craftsman’s expenses, which were virtually all domestic in nature. The concept of profit is still used by economists, even though it is a pre-industrial one. It underlies the analysis of investment situations in terms of cash flows.

In factory production, however, the nexus between acquisition and use and between production and market was broken. The manufacturer produced for an unknown customer, in advance of demand, and therefore, could not associate the eventual selling price with production. He acquired raw materials, machinery, and often labor in advance of production and therefore could not identify the cost of production without making assumptions about cost flows. The conceptual nature of allocation has been demonstrated by Thomas, who points out the artificially – he calls it arbitrariness – of all accounting allocations. We must also be aware of a semantic problem which exists in the United States because of the use of the word “allocation” to refer to three distinct accounting processes.

The first of these is assignment, the identification of payments with objects. The second is allocation, tracing the use of objects in a production process. The third is absorption, tracing the use of a production process in the production of a product or service. In this section we are contrasting the simplicity of assignment with the complexity of allocation and absorption.The immediate problems raised by the necessity to allocate and absorb costs concerned the calculation of depreciation and depreciation accounting, the valuation of inventories of work in process and finished goods and accounting for cost of goods sold, and accruals and deferrals generally, in relation to uses which preceded or followed acquisitions. In course of time the same necessity has led to a vast area of accounting problems, covering virtually the entire field of accounting, and created what one writer has referred to as explanation strains.

These strains were rendered more acute by the traditional separation of financial and cost accounting. Because of the critical importance of these allocation decisions for pricing policy, they were often retained by the proprietor of the business long after he had delegated accounting for acquisitions to a clerk. Cost accounting went through three stages in the nineteenth century. In the first, it was performed by nonaccounting calculations illustrated by the papers of Josiah Wedgwood and Charles Babage. In the second, the need to create order out of chaos led to the introduction of accounting method and the growth of systems of cost accounts separate from the financial accounts. These separate accounts might be reconciled with the financial accounts, or made to interlock with them through the medium of control accounts a cost ledger control account in the financial books and a general ledger control account in the cost books. Finally, the integration of financial and cost accounts in one accounting system was achieved. It is perhaps significant that the development of modern accounting theory dates from the beginning of this integration. We should not underestimate the important contribution made by industrial engineers in clarifying and sometimes finding solutions for the accounting problems of the industrial revolution.

THE GROWTH OF THE CORPORATION

Corporations are nothing new; the Romans used them, together with elevators, central heating, and divorce. An extensive world trade was conducted from the fifteenth century on by the chartered corporations formed by rulers and entrepreneurs in the mercantilist period. During the nineteenth century, however, and particularly in the United Kingdom and the United States, the number of commercial corporations grew at an accelerating pace, from several hundreds to tens of thousands. Laws were passed to facilitate their formation and administration and to render them accountable to the governments which gave them life

The characteristic features of the corporation are its relatively long life (perpetual succession) and the transferability of its capital. Both of these are the consequence of it being an artificial person, but a legal person nonetheless. Because the corporation does not die, or become sick or insane, it is a convenient device for executing contracts, including contracts to supply capital for industrial undertakings. Because of the transferability of its capital, it is also an attractive device to businessmen and other investors concerned about their future liquidity needs. Add to these the bonus feature of limited liability, and the corporation becomes the irresistible instrument of business growth.

Use of the corporation as a device for channelling savings into business investment effected a separation between capital and its management, formal in the case of the “one man corporation,” but very real in the case of those corporations which raised capital from a number of investors. In order to provide these “anonymous partners”, as the French law called them, with some means of ascertaining what was happening to their investment, a succession of Companies Acts was legislated in the United Kingdom which required corporations to keep records and to render account to their stockholders. Most of the English-speaking world has enacted comparable legislation; only in the United States has it proved impossible to make the states, in whom the power resides, exercise social control over corporate officials. The situation is now changing slightly, as the states se the corporations as taxpayers and legislate for accounts to be kept for the purpose of demonstrating taxable capacity.

Typically, a Companies Act would contain sections requiring accounts to be kept and financial reports to be rendered to stockholders. More important, to protect stockholders from the deception of being paid dividends to keep them quiet while the managers were losing the company’s money, the law would stipulate that dividends may be paid only out of profits. This led of necessity to the preparation of period accounts, or annual financial statements, and to problems of allocation similar to those which were raised by the factory system.

As the manufacturer required information about depreciation, work in process and finished goods, and cost of sales in relation to specific products or services, so the corporation required this type of information in relation to specific periods. The major problems in financial reporting arise from segmenting the life of the firm into artificial lengths only remotely related to the time period of production. As a consequence, we find accountants adopting the going concern assumption, that raw materials acquired will be put into production, that work in process will be completed in the form of saleable finished goods, and that finished goods will be sold at prices higher than their production costs. The going concern assumption also involves a belief that the business will continue to operate in more or less the same way until it has recovered its investments in fixed assets from its customers as part of the selling prices of its products. he going concern assumption, required for asset valuation, also affected profit (income)

measurement, since reduction of asset values must be regarded as a loss. Other assumptions adopted for income statement preparation included the cost assumption, that allocation methods used for cost accounting are useful for financial reporting, and the stable monetary unit assumption, that changes in purchasing power can be disregarded. Another important contribution of the corporation laws was the specification of the capital of the corporation in legal terms. The Companies Acts provided for the registration of corporations to include a description of their capital stock and for the reduction of this capital stock only by legal proceedings, under the mistaken belief that persons dealing with the corporation would be protected in some way by the maintenance of this legal fiction. A variety of ancillary problems were gradually incorporated in the statues how to account for amounts subscribed in excess of par, what could be charged to capital surplus, how surplus could be converted into legal capital. This set of problems combined with the problems involved in preparing period income statements to emphasizethe separation of income from capital, which is a major characteristic of financial accounting. The concept of capital maintenance, of keeping the legal capital of the corporation unimpaired, came in conflict with the concept of keeping its assets in a productive state or maintaining economic capital.In spite of these legal provisions for the protecting of stockholders and creditors, unscrupulous managers nevertheless found ways to make capital look like profits, to pay dividends to one set of shareholders out of capital paid in by another set, and to defraud creditors extent, they always will. One of the objectives of accounting theory is to develop rules of conduct which will make this behavior more difficult. This explains the normative nature of many propositions is accounting; they are attempts to dissuade people from behaving dishonestly.

One fascinating byway of the growth of corporations in the United States is the antitrust law. By the end of the nineteenth century a number of corporations had grown, by retention of profits or by acquisitions, to a size which represented a visible concentration of wealth and a real source of social and economic power. The name for a corporation which grows by acquiring control over other corporations is a holding company. In 1890 the U.S.A Congress passed the Sherman Antitrust Act, to prevent corporations which did not possess powers to own stock in other corporations form acquiring control over such stock by means of a trust instrument. This forced corporations to obtain powers to own stock in other corporations directly, and a number of state corporations laws were amended to permit this. In 1914 the Clayton Act was passed, which made illegal the acquisition of stock of another corporation if this tended to reduce competition. In spite of these and other measures, mergers and acquisitions thrived and the vertical and horizontal integration of industries has been succeeded by the conglomerate, a holding company owning controlling interests in corporations operating in different industries.

The consequence of the combination of corporations was a demand for financial reports which would reveal the combined assets of the group and the combined results of all the corporations of which it consisted. This led to the development of consolidated financial statements as early as 1886, although the first annual report of the United States Steel Corporation in 1902 is usually acknowledged as the prototype of consolidations

THE RAILROADS AND GOVERNMENT REGULATION

The importance of the railroads in the process of identifying accounting problems cannot be exaggerated. They were the first really large-scale enterprises spawned by the industrial revolution. The first capital-intensive enterprises, they presented in unmistakable terms the separation of capital and management, and they provided the first scenario for government regulation of business, including its financial statements. This resulted in large part from the misdeeds of a host of promoters who sold railroad stock and acquired control over railroad assets with no intention other than to enrich themselves. The New York Stock Exchange dates from before the American revolution, but only in 1866 did it prescribe that listed corporations should file their financial statements. Not until 1900 did this influence become effective. One of the principal reasons for the involvement of the New York Stock Exchange was the tremendous fluctuation in the prices of railroad stocks, a consequence of the ignorance of investors as well as the manipulations of the railroad barons.

The railroads were the center of a historical struggle which resulted in the recognition that use should be accounted for, and not merely acquisition. The railroad managers argued that regular maintenance and replacement of worn equipment would cause the permanent way and the rolling stock to last indefinitely. Depreciation was therefore not a relevant concept, and replacements should be charged to expense as incurred. This solution has obvious attractiveness, since it made the expense a discretionary item in good years more and in lean years less or possible none. In 1876 the Railway Commissioners of Massachusetts required railroads to keep accounts, and by 1879 a uniform system of accounting had been adopted nationally on the initiative of the Interstate Commerce Commission (ICC). The Hepburn Act of 1906 authorized the ICC to prescribe railroad accounting, which is did in part by publishing “Classification of Operating Expenses” in 1907 and finally a complete “Accounting Classification for Steam Railroads in 1914.

The 1907 scheme provided for depreciation to be charged to operating expenses on a monthly basis, but gave individual railroads the option not to do so (or to include accrued expenses) if, for example, they were losing money. In 1923 the ICC proposed to make depreciation accounting mandatory; the railroads opposed, using arguments which are still heard today when additional disclosure is sought that it was unnecessary, deceptive, and impossible to calculate with accuracy. The railroads’ opposition delayed the imposition of mandatory depreciation until 1932, when it was immediately suspended because of the depression. It finally came into force in 1943. The omission of depreciation was undoubtedly one of the factors which permitted railroads to operate and attract capital long after obsolescence and inefficiency had made them a burden on the economy.

The outcome of the struggle just described was irrelevant, because of the development of generally accepted accounting principles in the United States, which required railroads to charge depreciation in their published financial statements. The struggle itself is important because it documents the transition from a pre-industrial to an industrial accounting system. Government regulation in the United States has had some of the effects of the Companies Acts in the United Kingdom and elsewhere, in that a number of commissions besides the ICC (the Federal Power Commission, the Federal Communications Commission, the Federal Aviation Authority, etc.), have prescribed accounting systems for the enterprises they regulate. Although some accounting problems have been identified and solutions found through this process, the consensus is that government regulation has had an unfavorable effect on the accounting of regulated enterprises, through discouraging experimentation and innovation. Further, the accounting systems have ceased to be oriented toward disclosure, as in the unregulated sector, and have increasingly become instruments of politics. This is because the commissions have become rate makers, thus taking the pricing function out of the market. One of the principal means for a government to effect a political purpose is by fixing prices. Thus, although a number of accounting issues have been raised by the regulation of public utilities, the can be readily explained in the context of the political problems of rate setting and do not form part of the set of issues which accounting theory seeks to explain.

**THE CORPORATE INCOME TAX**

Perhaps the single most pervasive influence on the growth of accounting has been thecorporate income tax, since it affects all business firms, large or small, incorporated or unincorporated, regulated or unregulated. Here we are concerned with the influence of the corporate income tax on the development of modern accounting theory.

The critical point is that the corporate income tax is a legal structure, and therefore the solutions to tax problems are legal solutions. To the extent that the tax laws recognize accounting solutions, accounting becomes part of the law. There is, for example, no definition of income to be found in the tax code, and the logical tendency of the taxing authority is to tax movements of cash. The first attempts at a corporate income tax in the United States, the 1909 Excise Act and the 1913 Revenue Act, measured net income as cash receipts less cash disbursements, and a battle had to be fought to establish the acceptability of accrual accounting as the basis for income taxation.

A striking illustration of the difference between accounting and taxation is found in the United Kingdom, where the objective is also to tax receipts, and the business accounts are accepted as a point of departure. The tax laws were laid down before the need to charge depreciation was clearly identified, and to this day, depreciation is not deductible in the U.K. However, businessmen were eventually successful in persuading the tax authority that fixed assets may be losing value through time, and the tax laws were amended to introduce capital allowances. These are a quite separate legal system for calculating depreciation for tax purpose, having no connection with accounting depreciation and applicable only to specified classes of depreciable fixed assets; store fixtures and office buildings are excluded. In preparing a business tax return therefore, the U.K. accountant adds back depreciation to net income and deducts a different amount, calculated according to the law.

This illustration serves to remind us that although business net income is a point of departure for arriving at taxable income, the two are essentially distinct concepts. It appears that the original intention of Congress in the United States was to establish a concept of taxable income which corresponded with business net income, but the harmonization of the two has become impossible. In the first place, tax avoidance through technical accounting methods created loopholes which led to legislation forbidding certain tax accounting practices; the valuation of inventories at prime cost, for example, is not permissible, however logical this might be in a specific context. In the second place, use of the income tax laws to effect a redistribution of wealth and to promote political objectives has led to the enactment of a multitude of provisions concerning what is or is not to be included in taxable income, and what may or may not be deducted therefrom. We should not look, therefore, to the corporate income tax as a source of modernaccounting theory.

Its importance lies in :

(1) Extending the need for accounting to many businesses which would not otherwise have prepared financial statements.

(2) Influencing many businesses to adopt tax rules or guidelines for the recognition of items of revenue or expense, because of the complications involved to conventional practices.

(3) Stimulating debate on such questions as depreciation and inventory accounting, accrual and deferral, and asset and liability valuation, by revealing alternatives to conventional practices.

(4) Introducing a new subset of accounting problems, accounting for taxation, which have strained the ability of accountants to explain the application to them of accounting principles developed in a different context.

(5) Distorting accounting to conform with taxation where the tax laws provide that a particular deferral or deduction may be claimed statement treatment. This is the situation in the United States with regard to the use of the LIFO method of determining cost of goods sold. In some countries ( France Germany) many of the items in the financial statements are there because of the requirements of the tax laws.

(6) Providing a false trail for accounting theorists, such as the rule in Eisner v.Macomber, who have been tempted to adopt legal explanations for practices found outside the legal framework

THE ECONOMISTS

Until the early nineteenth century most economists were political economists; their preoccupation with the production and distribution of wealth centered on the source of political power. By the end of the nineteenth century, however, economists had begun to appreciate the role which industry played in the production and distribution of wealth. Such noted economists as Alfred Marshall in England, Bohm-Bawerk in Austria, and J.B. Clark in the United States conducted studies of business enterprises and attempted explanations of concepts such as income, capital, and cost which are the subject of accounting theory also. Sombart pointed out that the ideas of economists on these matters originated in accounting, but the victory of the marginalist school resulted in new definitions which gradually moved economics and accounting further apart.

Nevertheless, the apparent similarity of the subject-matter of economic studies led some early accounting theorists to assume that the disciplines of accounting and economics were essentially one, so that accounting problems could be solved within the framework of economic theory. This assumption pervades much of the contemporary literature on accounting theory, and its origins can be traced to books written in the early years of the twentieth century.

The interests of economists lie primarily in macro-economics, the study of the national income and its generation, and their work in micro-economics, the study of economic behavior at the level of the firm, is designed to support the major field of interest. For this reason, economists have never made the transition from the pre-industrial model of the firm, where acquisitions and uses, and capital and assets, cannot be distinguished, where financial institutions as sources of money can be disregarded, and where time can be reduced to an average or omitted entirely as a significant variable. As we havenoted, this transition was accomplished by accountants in the ninetieth century and resulted in the valuation method we call allocation.

One notable exception to the failure of economists to adapt to the industrial (and indeed, the post-industrial) realities was J.M. Clark. Clark recognized the existence of situations in which economic valuation could not be effected by imputing marginal amounts to production inputs or outputs; he dealt specifically with the nonimputable overhead costs of manufacturing firms. Another American economist who attempted to adapt micro- economics to the industrial scene was Thorstein Veblen. Unfortunately the pioneering work of these theorists proved abortive, as their colleagues were unwilling or unable to abandon the Ricardian inages on which their science was based.

**THE AMERICAN SCHOOL OF ACCOUNTING THEORY**

Much the same sequence of events can be identified in other countries. The situation in the United Kingdom, where the industrial revolution and the corporate income tax originated, can be contrasted with that in the United States, where government regulation played a unique role. The Anglo-American jurisdictions can be contrasted with those jurisdictions which forced financial accounting to conform to tax accounting. Nevertheless, it is noteworthy that the response of accountants in different parts of the world to similar situations was highly comparable. By the beginning of the twentieth century the form and content of financial statements did not differ to any considerable extent throughout the Western world.

From 1930 on, however, special factors have caused the U.S. to act as a trail-blazer in the development of accounting theory.

There is a distinct American School of Accounting Theory.

The characteristics of this school are

1) the involvement of a relatively large number of academics and practitioners in defining, researching, and

debating accounting issues;

2) the existence of institutions which publicize and focus attention on the views of accounting theorists, e.g. the AICPA and the AAA ;

3) the general acceptance of the neo-classical economic theory of investment, as adapted by

scholars in corporation finance ; and

4) an experiment approach to accounting aimed at producing a framework which will justify and explain a more significant social role for the accountant than he has appeared to play in the past.

Because of the absence of a legal framework to which accounting questions could be referred, early American textbook writers displayed a tendency to look for reasons behind their expositions of accounting practices. The prevalence of the proprietary theory approach impelled Beker to attribute its origins to these writers, although we now know this theory to have originated in Europe.

The first author to identify himself clearly as an accounting theorist was Paton, whose seminal work was originally published as a doctoral dissertation in 1916. It was Paton who emphasized the entity theory, which earlier American writers had used and Littleton has identified in nineteenth century European publications. Paton pointed out in the preface to his book that.The conception of the business enterprise as in all cases a distinct entity or personality-an extension of the fiction of the corporate entity-is adopted, although not without important qualifications ...”

**THE ACCEPTANCE OF NEO-CLASSICAL**

**ECONOMIC THEORY**

At the beginning of the period under discussion the primary influence on accounting theory was legal in nature. The modern profession of accountancy owes its origins to the law and has never forgotten the fact-to the bankruptcy and company laws of nineteenth century England and to the taxation and regulatory laws of twentieth century United States. The search for accounting principles was invariably referred to a framework analogous to that of the law; writers contrasted the conventional principles of law and accounting with the immutable principles of the sciences. Beginning with Canning in 1929, however, we find an increasingly explicit effort to establish accounting as a science in the mold of economics. Canning was a disciple of Irving Fisher, whose important work on income and capital theory will be discussed in later on, and attempted to translate Fisher’s ideas into a form useful to accountants. Fisher and Canning taught at Californian universities, and we can identify a “California School” of accounting theorists formed by their views. Maurice Moonitz is the current leader of the California School.

Paton was also exposed to the models of economic theory and taught economics as a young man at the University of Michigan, but he attempted to distinguish accounting from economics rather than to integrate accounting into a framework of economics theory. The second generation of accounting theorists appears to have been more ready to espouse this integration, and from about 1936 until the present day the acceptance of economic theory in its neo-classical form, the form in which it is usually taught in American universities, has become more general. This is not to denigrate Fisherian and Keynesian economics, which have been skillfully interwoven into the neo-classical fabric during the past forty years.

The acceptance of economic theory has had several effects on the development of accounting theory. In the first place, the rigor which characterizes the formulation of economic propositions and the construction of economic models and their use to derive theorems and to deduce principles and rules has been widely accepted as a desirable standard for parallel work in accounting theory. The almost theological tone of previous generational of accounting writers has been replaced by the voice of reason. Secondly, many definitions and concepts used by economists have been taken over by accountants ( as earlier economists adopted accounting terms and ideas ), which has opened up fruitful lines of inquiry and permitted the formulation of new research problems. Examples of this are accountants uses of such economic concepts as marginal cost, sunk cost, present value and uncertainty. Indeed, accounting has at times appeared to be a branch of economics, or vice versa.

Thirdly, and in particular, the development of a theory of corporate finance based on the investment theory of economics has presented accounting theorists with a challenge and an opportunity. It is clear that finance and accounting are inextricably interwoven, and we have pointed out the similarity between the basic equations of the two disciplines. To produce a theory of accounting compatible with the theory of finance would appear to be a useful goal. We shall demonstrate later how this objective underlies APB Statement No. 4, the most comprehensive statement of accounting theory to come from the accountancy profession.

**METHODOLOGY OF ACCOUNTING THEORY**

**FORMULATION**

The view that accounting theory should consist of principles “relatively few in number” was accepted by the AIA’s Joint Committee with the New York Stock Exchange. We may infer that economics provided the inspiration, where the law of demand is deduced from the postulate of utility maximization and the law of supply from the postulates of the production function and profit maximization. This view contrasts sharply with the inductive approach favored by Littleton. Littleton saw the derivation of accounting principles from the observation of good accounting practices; good business practices were accompanied by good accounting practices. Although the formal structure of postulates, principles, and rules did not appear explicitly in this process, the Littleton-Chambers debate suggests that a set of normative postulates underlie Littleton’s reasoning; to him, accounting was what accountants should do. Paton, on the other hand, summarized the postulates on which his theory was based.

(1) The separate existence of the business entity from its owners or managers

(2) The going concern assumption of continuity as the normal case

(3) The balance sheet equation, Assets=Equities

(4) The exhaustive nature of financial condition, in which every significant fact is expressed in dollars

(5) The stability of the measuring unit (dollars)

(6) The equivalence of cost and value on original entry

(7) The transitivity of cost, which “passes over and attaches’

(8) The accrual of costs, their expiry over time and attachability to production

A more formal approach is the taken by Mattessich, who starts with a definition:

Accounting is [ a discipline concerned with ] the quantitative description and projection of [the] income [circulation] and [of] wealth [aggregates] by [means of] a method based on the following set of assumptions...

There are eighteen assumptions, specifically :

(1) Monetary valuation

(2) Time

(3) Structure (accounting as a closed system)

(4) Duality (double-entry)

(5) Aggregation (algebraic operation)

(6) Economic objects (scarce resources)

(7) Inequity of monetary claims (stability of the measuring unit)

(8) Economic agents (human actors)

(9) Entities (social institutions)

(10) Economic transactions (movements of values)

(11) Valuation (operational rules for measuring movements of values)

(12) Realization (operational rules for measuring income)

(13) Classification (operational rules for analyzing movements of values)

(14) Data input (operating rules for bookkeeping)

(15) Duration (operating rules for relating entities to time)

(16) Extension (operating rules for consolidating entity accounts)

(17) Materiality (operating rules for identifying data)

(18) Allocation (operating rules for imputing values to parts of entities)

In spite of the elements of overlap, this most precise statement of assumptions which has been presented as such by an accounting theorist and from which explanations of accounting practices have been derived. Nevertheless, it could be viewed as incomplete, because it does not contain any reference to user needs (behavioral assumptions concerning the actor) and because it omits other postulates which appear to have general acceptance, particularly relevance, consistency, continuity, and objectivity.

**PERVASIVE PRINCIPLES AND**

**MODIFYING CONVENTIONS**

Since generally accepted accounting principles are found by inquiry and not deduced from postulates, we would not expect them to lie snugly within the framework established in the developmental part of the Statement. However, they are said themselves to form a hierarchy, pervasive principles being “few in number and fundamental in nature.” The Statement emphasized that “No attempt is made. . . to indicate specific relationships between principles nor indeed between postulates, objectives, basic features and

elements, as these terms are used in the Statement. The pervasive principles “establish the basis for implementing accrual accounting” and determine

1) the types of events to be recognized,

2) the bases on which to measure the events,

3) the time periods with which to identify the events, and

4) the common denomination of measurement.

The pervasive principles are six in number :

**P-1.** Initial recording of assets and liabilities “generally. . . on the basis of events in which the enterprise acquires resources . . . or incurs obligations. . . the assets and liabilities are measured by the exchange prices at which the transfers take place.” (emphasis supplied) The events do not include own construction of assets.

**P-2** Revenue recognition requires 1) that the earning process be complete and 2) that an exchange has taken place. [Note : this is a new realization assumption and does not correspond with current generally accepted accounting principles.]

**P-3** Some costs are recognized as expenses on the basis of a presumed direct association with specific revenue. (The matching principles)

**P-4** In the absence of a direct cause and effect measurement some costs are allocated to periods using a systematic and rational relationship to benefits.

**P-5** Some costs are expenses because no future benefits are likely, or allocation between periods seems pointless.

**P-6** The U.S. dollar is the unit of measure in the United States. Changes in its generalpurchasing power are not recorded in the basic financial statements. [This is an example of a principle which is clearly incompatible with the economic theories referred to in the developmental section, and the Statement refers to the use of LIFO and asselerated depreciation in the USA as attempts to minimize the effects of not recording changes in purchasing power.]

The modifying conventions have evolved to mitigate the unwanted effects of rigidly applying these pervasive measurement principles. They are : conservatism (understatement of net assets and net income preferred to overstatement); emphasis on income (the income statement take precedence over the balance sheet); judgment of the accounting profession may modify the principles, by approving measurements which are in direct conflict with the fundamental, pervasive, accounting principles of measurement.

**LOOKING TO THE FUTURE**

The Statement concluded by pointing to ways in which generally accepted accounting principles might change, even the pervasive and broad operating principles, in response to changes in economic and social conditions, technology and user demands. Orderly change depended upon the consistency of proposed principles with the general tenor of the Statement.

Suggestions for change included

1) eliminating differences in accounting practices not justified by differences in circumstances,

2) making accounting principles more consistent internally,

3) improving their effectiveness, and

4) reflecting more adequately the economic activities represented.

Specific proposals related to including commitments,

contracts, and leases in financial statements as assets and liabilities; developing unique methods for charging costs, including depreciation, against revenue recording revenue under the accretion method; substituting output values for input values; recognizing price-level changes; and including budgets as part of the basic financial statements. Other proposals concerned new financial statements; use of ratios in place of money amounts; more effective visual communication by graphs and charts. The Statement also pointed toward the development of international accounting standards, the world equivalent of generally accepted accounting principles.

**CHAPTER 4**

**Accounting Postulates, Concepts and Principles**

Introduction

Knowledge of accounting requires enquiry not only into accounting methods and principles but also the structure or framework of accounting theory from which the accounting methods and principles are derived. Many accounting theorists and writers have contributed in the development of structure of accounting theory, using either a deductive approach or an inductive approach. Littleton has suggested a framework of accounting theory whereby rules of action can be converted into accounting principles.The basic objective in developing structure of accounting theory has been to codify the accounting postulates and principles and to formulate a coherent accounting theory to improve the quality of financial reporting.

**POSTULATES, CONCEPTS, PRINCIPLES**

Terms such as postulates, concepts, principles are widely used, but with no general agreement as to their precise meaning. In order to avoid confusion, an attempt has been made to define these terms.

Accounting postulates are self-evident statements which arc generally accepted because of their conformity to the objective of financial statements. Accounting principles are general decision rules, derived from both the objectives and the theoretical concepts of accounting, which govern the development of accounting techniques. Accounting techniques are specific rules derived from the accounting principles to account for specific transactions and events faced by the accounting entity.

American Institute of Certified Public Accountants (U.S.A.) observes: “Postulates are few in numbers and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear their understanding and interpretation of that they are, to provide a meaningful foundation for the formulation of principals and the development of rules for the application of principles in specific situations.

According to Hendriksen, “Postulates are basic assumptions or fundamental propositions concerning the economic, political, and sociological environment in which accounting must operate. The basic criteria are that (i) they must be relevant to the development of accounting logic, that is, they must serve as a foundation for the logical derivation of further propositions, and (2) they must be accepted as valid by the participants in the discussion as either being true or providing a useful starting point as an assumption in the development of accounting logic. It is not necessary that the postulates be true or even realistic. For example, the assumption in economics of a perfectly competitive society has never been true, but has provided useful insights into the working of the economic system. On the other hand, an assumption of a monopolistic society leads to different conclusions that may also be useful in an evaluation of the economy. The assumptions that provide the greatest degree of prediction may be more useful than those that are most realistic.”

Financial Accounting Standards Board (USA) have been given below:

**ACCOUNTING POSTULATES**

1. Entity Postulate

2. Going Concern Postulate9 0 Accounting Theory

3. Unit of Measure Postulate

4. Accounting Period Postulate

**ACCOUNTING PRINCIPLES**

1. Cost Principle

2. Revenue Principle

3. Matching Principle

4. Objectivity Principle

5. Consistency Principle

6. Full Disclosure Principle

7. Conservatism Principle

8. Materiality Principle

9. Uniformity and Comparability Principle Source: Ahmed Belkaoui, Accounting Theory, Harcourt Brace Jovanovich, Sandiego, 1985. Chapter 6.

**ACCOUNTING CONCEPTS**

1. Money Measurement

2. Entity 8. Realisation

3. Going Concern 9. Matching

4. Cost 10. Consistency

5. Dual-Aspect 11. Materiality

6. Accounting Period

7. Conservatism

Source: Roben N. Anthony and lames S. Reece, Accounting Principles. Richard D.

Irwin, 1991, p.22.

POSTULATES

1. Going Concern

2. Time Period

3. Accounting Entity

4. Monetary Unit

**PRINCIPLES**

Input-Oriented Principles

I. General Underlying Rules of Operation

1. Recognition

2. Matching

II. Constraining Principles

1. ConservatismAccounting Postulates, Concepts and Principles 9 1

2. Disclosure

3. Materiality

4. Objectivity (also called Verifiability)

**Output-Oriented Principles**

I. Applicable to Users

1. Comparability

II. Applicability to Preparers

1. Consistency

2. Uniformity

Source: Harry I. Wolk, lere R. Francis and Michael G. Teamey, Accounting Theory, A Conceptual and institutional Approach, Ohio: South-Western Publishing Co., 1992, p.121.

FUNDAMENTAL CONCEPTS OF ACCOUNTING

A. Assumptions or Accounting B . Principles or Accounting

1. Separate-entity assumption. 1. Cost Principle.

2. Continuity assumption. 2. Revenue Principle.

3. Unit-of-measure assumption. 3. Matching Principle.

4. Time-period assumption. 4. Full-disclosure Principle.

Source: Financial Accounting Standards Board, USA, Statement of Financial

Accounting Concepts No. 6, Elements of Financial Statements. December 1985.

Note: Financial Accounting Standards Board (FASB) USA refers to assumptions and principles of accounting as ‘concepts of accounting.’Thus, it can be observed that finding a precise terminology has always been one of the most difficult task in accounting. Further, the lack of agreement about their precise meaning has affected, to some extent, the attempts made towards developing a theory for financial accounting. The purpose of this chapter is not to engage the readers on a debate of suitable terminology but to explain something which are widely accepted as of greatest importance and widest applicability, whether as postulates, concepts or principles. But before this, an attempt has been made to define the terms postulates, concepts and principles.

**Postulates**

Accounting postulates are basic assumptions concerning the business environment They are generally accepted as self-evident truths in accounting. Postulates are established or general truths which do not require any evidence, to prove them. They are the propositions taken for granted. As basic assumptions postulates cannot be overflew. They serve as a basis for inference and a foundation for a theoretical structure that consists of propositions derived from them. Postulates in accounting are few in numbers9 2 Accounting Theory and stem from the economic and political environments as well as from the customs and underlying viewpoints of the business community.

**Balkaouil defines accounting postulates**

“as self-evident statements or axioms, generally accepted by virtue of their conformity to the objectives of financial statements, that portray the economic, political, sociological and legal environment in which accounting must operate.”

American Institute of Certified Public Accountants (USA) observes:

“Postulates are few in numbers and are the basic assumptions on which principles rest. They necessarily are derived from the economic and political environment and from the modes of thought and customs of all segments of the business community. The profession, however, should make clear their understanding and interpretation of what they are, to provide a meaningful foundation for the formulation of principles and the

development of rules or other guides for the application of principles in specific situations.

According to Hendriksen

“Postulates are basic assumptions or fundamental propositions concerning the economic, political, and sociological environment in which accounting must operate. The basic criteria are that (1) they must be relevant to the development of accounting logic, that is, they must serve as a foundation for the logical derivation of further propositions, and (2) they must be accepted as valid by the participants in the discussion as either being true or providing a useful starting point as an assumption in the development of accounting logic. It is not necessary that the postulates be true or even realistic. For example, the assumption in economics of a perfectly competitive society has never been true, but has provided useful insights into the working of the economic system. On the other hand, an assumption of a monopolistic society leads to different conclusions that may also be useful in an evaluation of the economy. The assumptions that provide the greatest degree of prediction may be more useful than those that are most realistic.”

Concepts

Accounting concepts are also self-evident statements or truths. Accounting concepts are so basic that people accept them as valid without any questioning. Accounting concepts provide the conceptual guidelines for application in the financial accounting process, i.e., for recording, measurement, analysis and communication of information about an organisation. These concepts provide help in resolving future accounting issues on a permanent or a longer basis, rather than trying to deal with each issue on an ad-hoc basis. The concepts are important because they

(a) help explain the “why” of the accounting

(b) provide guidance when new accounting situations are encountered and

(c) significantly reduce the need to memorise accounting procedures when learning about accounting.

**Principle**

Accounting principles are general decision rules derived from the accounting concepts. According to AlCPA (USA), principle means “a general law or rule adopted or professed as a guide to action; a settled ground or basis of conduct or practice:’ Principles are general approaches used in the recognition and measurement of accounting events. Accounting principles are characterised as ‘how to apply’ concepts. Anthony and Reece

Comment:

“Accounting principles are man-made. Unlike the principles of physics, chemistry and other natural sciences, accounting principles were not deducted from basic axioms, nor can they be verified by observation and experiment. Instead, they have evolved. This evolutionary process is going on constantly; accounting principles are not eternal truths. A principle is an explanation concisely framed in words to compress an important relationship among accounting ideas into a few words. Principles are concise explanations. Accounting principles do not suggest exactly as to how each transaction will be recorded. This is the reason that accounting practices differ from one enterprise to another.

The differences in accounting practices is also due to the fact that GAAP

(generally accepted accounting principles) provides flexibility about the recording and reporting of business transactions. According to Wolk et al., accounting principles can be divided into two main types:

i. Input-oriented principles are broad rules that guide the accounting function. Input- oriented principles can be divided into two general classifications: general underlying rules of operation and constraining principles. As their names imply, the former are general in nature while the latter are geared to certain specific types of situations.

ii. Output-oriented principles involve certain qualities or characteristics that financial statements should possess if the input-oriented principles are appropriately executed. Accounting principles influence the development of accounting techniques which are specific rules to record specific transactions and events in an organisation.

To explain the relationship among postulates, concepts and principles and accounting techniques, the example of cost principle is taken. Cost concept or principle emphasizes historical cost which is based on going concern postulate and the going concern postulate says that there is no point in revaluing assets to reflect current values since the business is not going to sell its assets.

**ACCOUNTING POSTULATES**

**1. Entity Postulates**. The entity postulate assumes that the financial statements and other accounting information are for the specific business enterprise which is distinct from its owners. Attention in financial accounting is focused on the economic activities of individual business enterprises. Consequently, the analysis of business transactions involving costs and revenue is expressed in terms of the changes in the firm’s financial conditions. Similarly, the assets and liabilities devoted to business activities are entity assets and liabilities. This postulate defines the accountant’s area of interest and limits the number of objects, events, and their attributes that are to be included in financial statements. The transactions of the enterprise are

to be reported rather than the transaction of the enterprise’s owners. The postulate, therefore, enables the accountant to distinguish between personal and business transactions. The postulate applies to sole proprietorship, partnerships, companies, and small and large enterprises. It may also apply to a segment of a firm, such as division, or several firms, such as when interrelated firms are consolidated.

One approach to the definition of the accounting entity is to determine the economic unit that has control over resources, accepts responsibilities for making and carrying out commitments, and conducts economic activity. This is the basic view of AICPA’s Accounting Research Study No.l when it states that “economic activity is carried on through specific units or entities.” Another approach to define an accounting entity is in terms of the economic interests of various users rather than the economic activities and administrative control of the unit. This approach is user-oriented rather than firm-oriented. The interests of the users rather than the economic activities of the firm define the boundaries of the accounting entity and the information to be included in the financial statements. This view is held by the American Accounting Association’s Concepts and Standards Research Committee on the Business Entity Concept (1964) which states, “the boundaries of such an economic entity are identlifiable (1) by determining the interested individual or group, and (2) by determining the nature of that individual’s or that group’s interests.”

**2. Going Concern Postulate**. An accounting entity is viewed as continuing in operation in the absence of evidence to the contrary. Because of the relative permanence of enterprises, financial accounting is formulated assuming that the business will continue to operate for an indefinitely long period in the future. PastAccounting experience indicates that continuation of operations is highly probable for most enterprises although continuation can not be known with certainty. An enterprise is not viewed as a going concern, if liquidation appears imminent.

The going concern postulate justifies the valuation of assets on a non­liquidation basis and forms the basis for depreciation accounting. First, because neither current values nor liquidation values are appropriate for asset valuation, the going concern postulate calls for the use of historical cost for many valuations. Second, the fixed assets and intangibles are amortised over their useful life rather than over a shorter period in expectation of early liquidation.

**3. Money Measurement Postulate.** A unit of exchange and measurement is necessary to account for the transactions of business enterprises in a uniform manner. The common denominator chosen in accounting is the monetary unit. Money is the common denominator in terms of which the exchangeability of goods and services, including labour, natural resources, and capital, are measured. Money measurement postulate holds that accounting is a measurement and communication process of the activities of the firm that are measurable in monetary terms. Obviously, financial statements should indicate the money used.

**4. Accounting Period Postulate**. The financial accounting provides information about will economic activities of an enterprise for specified time periods that are shorter than the life of the enterprise. Normally the time periods are of equal length to facilitate comparisons. The time period is identified in the financial statements. The time periods are usually twelve months in length. Some’ companies also issue quarterly or half yearly statements to shareholders. The are considered to be interim, and essentially different from annual statements. For management use, statements covering shorter periods such as a month or week may be prepared.

**Accounting Principles**

**Accounting principles are listed as follows:**

**1. Cost Principle**

The cost principle implies the acquisition cost, or historical cost, which is recognised as the appropriate valuation basis for recognition of the acquisition of all goods and services, expenses, costs, and equities. In other words, an item is valued at the exchange price at the date of acquisition and shown in the financial statements at that value or an amortised portion of it. For accounting purposes, business transactions are normally measured in terms of the actual prices or costs at the time the transaction occurs. That is, financial accounting measurements are primarily based on exchange prices at which economic resources and obligations are exchanged. Thus, the amounts at which assets are listed in the accounts of a firm do not indicate what the assets could be sold for. However, some accountants argue that accounting would be more useful if estimates of current and future values were substituted for historical costs under certain conditions. The extent to which cost and value should be reflected in the accounts is central to much of the current accounting controversy.

The historical cost concept implies that since the business is not going to sell its assets as such there is little point in revaluing assets to reflect current values. In addition, for practical reasons, the accountant prefers the reporting of actual costs to market values which are difficult to verify. By using historical costs, the accountant’s already difficult task is not further complicated by the need to keep additional records of changing market value. Thus, the cost concept provides greater objectivity and greater feasibility to the financial statements.

**2. Dual-Aspect Principle**.

This concept lies at the heart of the whole accounting process. The Accountant records events affecting the wealth of a particular entity. The question is-which aspect of this wealth are important? Since an accounting entity is an artificial creation, it is essential to know to whom its resources belong or what purpose they serve. It is also important to know what kind of resources it controls e.g. cash, buildings or land

Moreover, any transaction or event affecting the wealth of entity must have two aspects recorded in order to maintain the equality of both sides of the accounting equation. If business has acquired an asset, it must have resulted in one of the following:

a. Some other asset has been given up.

b. The obligation to pay for it has arisen.

c. There has been a profit, leading to an increase in the amount that the business owes to the proprietor, or

d. The proprietor has contributed money for the acquisition of asset.

This does not mean that a transaction will affect both the source and form of wealth. There are four categories of events affecting the accounting equation such that:

a. Both sources and forms of wealth increase by the same amount.

b. Both sources and forms of wealth decrease by the same amount.

c. Some forms of wealth increase while others decrease without any change in the source of wealth.

d. Some sources of wealth increase while others decrease without any change in the form in which wealth is held.

**3. Accrual Principle**.

This is known as realisation concept also. According to Financial Accounting Standards Board, “accrual accounting attempts to record the financial effects on an enterprise of transactions and other events .and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise. Accrual accounting is concerned with the process by which cash expended on resources and activities is returned as more (or perhaps less) cash to the enterprise, not just with the beginning and end that process. It recognises that the buying, producing, selling Accounting and other operations of an enterprise during a period, as well as other events that affect enterprise performance, often do not coincide with the cash receipts and payments of the period.”

A business enterprises economic activity in a short period seldom follows the simple form of a cycle from money to productive resources to product to money. Instead, continuous production, extensive use of credit and long-lived resources, and over-lapping cycle of activity complicate the evaluation of periodic activities.

As a result, non-cash resources and obligations change in time periods other than those in which money is received or paid. Recording these changes is necessary to determine periodic income and to measure financial position. This is the essence of accrual accounting.

Thus, accrual accounting is based not only on cash transactions but also on credit transactions, barter exchanges, changes in prices, changes in the form of assets or liabilities, and other transactions, events, and circumstances that have cash consequences for an enterprise but involve no concurrent cash movement. Although it does not ignore cash transactions, accrual accounting is primarily accounting for non-cash assets liabilities, revenues, expenses, gains and losses.

**4. Conservatism.**

This concept is often described as “anticipate no profit and provide for all possible losses.” This characterisation might be viewed as the reactive version of the minimax managerial philosophy, i.e. minimise the chance of maximum losses. The concept of accounting conservatism suggests that when and where uncertainty and risk exposure so warrant, accounting takes a wary and watchful stance until the appearance of evidence to the contrary. Accounting conservatism does not mean to intentionally understate income and assets; it applies only to situations in which there are reasonable doubts. For example, inventories are valued at the lower of cost or current replacement value Backer explains the accounting doctrine of conservatism as follows:

“In its application to the earnings statement, conservatism encourages the recognition of all losses that have occurred or are likely to occur but does not acknowledge gains until actually realised. The procedure of reducing inventory values when market has declined below cost but the failure to countenance “write­ups” under: reverse conditions can be attributed to conservatism. The early amortisation of intangible assets and the restrictions against recording appreciation of assets have also, at least to some extent, been motivated by conservatism. Failure to recognise revenue until a sale has transferred is still another manifestation of conservatism.

**5. Matching Principle**.

The matching concept in financial accounting is the process of matching (relating) accomplishments or revenues (as measured by the selling prices of goods and services delivered) with efforts or expenses (as measured by the cost of goods and services used) to a particular period for which the income is being determined. This concept emphasises which items of cost are expenses in a given accounting period. That is, costs are reported as expenses in the accounting period in which the revenue associated with those costs is reported. For example, when the sales value of some goods is reported as revenue in a year, the cost of that goods would be reported as an expense in the same year

Matching concept needs to be fulfilled only after realisation (accrual) concept has been completed by the accountant; first revenues are measured in accordance with the realisation concept and then costs are associated with these revenues. Costs are matched with revenues, not the other way around. The matching process, therefore, requires cost allocation which is significant in historical cost accounting. Past (historical) costs are examined and, despite their historic nature, are subjected to a procedure whereby elements of cost regarded as having expired service potential are allocated or matched against relevant revenues. The remaining elements of costs which are regarded as continuing to have future service potential are carried forward in the historical balance sheet and are termed as assets. Thus the balance sheet is nothing more than a report of un allocated past costs waiting expiry of their estimated future service potential before being matched with suitable revenues.

**6. Objectivity Principle**

This principle holds that accounting must be carried out on an objective and factual basis. Entries in the books of accounts and the data reported in the financial statements must be based upon objectively determined evidence. Strict adherence to the objectivity concept is necessary to maintain the confidence of the users of the financial statements. This is also necessary to minimise the possibility of error and intentional fraud or bias.

**7. Consistency Principle.**

The principle of consistency aims at making the financial statements more comparable and useful. The convention holds that in accounting processes, all concepts, principles and measurement approaches should be applied in a similar or consistent way from one period to another period in order to ensure that the data reported in financial statements are reasonably comparable over time. For example the principle of valuing stock at cost or market price which ever is less” should be followed year after year to obtain comparable results. Similarly if it is once decided to charge depreciation on fixed or straight line method, it should be done year after year. The objective of consistency is to eliminate the personal bias of the accountant in reporting information. The rational behind this convention is that frequent changes in accounting treatment would make the financial statements unreliable to their users, such as management, banks and investors.

This convention permits changes in accounting techniques if it is likely to improve the measurement of financial results and financial position, e.g. switching over from the FIFO (first in first out) method to LlFO ( last in first out) method of inventory valuation, or changing over to diminishing balance method from straight line method of charging depreciation. However if a change is made, then its effect on profit and financial position as compared to the previous year should be clearly stated in the financial statements

**8. Full Disclosure Principle**. This convention-specifies that there should be complete and understandable reporting in the financial statements of all significant information relating to the economic affairs of the entity. All information which is of material interest to the owner, managers, investors etc. should be disclosed in accounting statements. There is a consensus in accounting that the disclosure should be full, fair and adequate.‘Full’ refers to a complete and comprehensive presentation of information ;’ fair’ implies an ethical constraint dictating an equitable treatment of users; and’ adequate’ connotes a minimum set of information to be disclosed.

‘Full refers to a complete and comprehensive presentation of information ;’ fair implies an ethical constraint dictating an equitable treatment of users; and’ adequate’ connotes a minimum set of information to be disclosed.

The convention of full disclosure is becoming popular because most of the big units in these days are organised in the form of joint stock companies where the ownership is divorced from management. The companies Act 1956 makes ample provisions for the disclosure of essential information so that there is no chance of any material information being left out

**9. Materiality Principles.**

The concept of materiality provides that only material information should be disclosed in the financial statement. Materiality is essentially a matter of professional judgement. The American Institute of Certified Public Accountant states that a statement, fact or item is material, if giving full consideration to the surrounding circumstances, as they exist at the time, it is of such a nature, that its disclosure, to the method of treating it, would be likely to influence or to make, a difference in the conduct and judgement of a reasonable person. Materiality depends upon the amount involved in the transaction. For example a small expenditure of Rs.10 for the purchase of a waste paper box may be treated as an expense rather than asset. Similarly the amounts due to creditors and receivable from debtors are not disclosed in the balance sheet against their individual names, instead, these accounts are clubbed into sundry creditors and debtor’s accounts.

**Generally Accepted Accounting Principles**

Financial accounting follows a set of ground rules or accounting principles (discussed earlier) in presenting financial information which are generally known as Generally Accepted Accounting Principles (GAAP). In fact, to be useful, financial accounting information should be collected, classified, summarised and reported objectively. The users who use such information and rely on such data have a right to be assured that the data are reliable, free from bias and inconsistencies, whether deliberate or not. For this reason, financial accounting depends on certain guides or standards that have proved useful over the years in accounting and reporting information. In this task, GAAP plays a vital role and financial accounting information can be meaningful only whea prepared according to some agreed-on standards and procedures, i.e., Generally Accepted Accounting Principles.

Accounting Principles Board of USA states: “Generally accepted accounting principles incorporate the consensus at a particular time as to which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes are to be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and which financial statements should be prepared.”

GAAP guide the accounting profession in the choice of accounting techniques and in the preparation of financial statements in a way considered to be good accounting practice. GAAP are simply guides to action and may change overtime. They are not immutable laws like those in the physical sciences. Sometimes specific principles must be altered or new principles must be formulated to fit changed economic circumstances or changes in business practices. In response to changing environments, values and information needs, GAAP are subject to constant examination and critical analysis. Changes in the principles occur mainly as a result of the various attempts to provide solutions to emerging accounting problems and to formulate a theoretical framework for the accounting discipline. Accounting principles originate from problem situations such as changes in the law, tax regulations; new business organisational arrangements, or new financing or ownership techniques. In response to the effect such problems have on financial reports, certain accounting techniques or procedures are tried. Through comparative use and analysis, one or more of these techniques are judged most suitable, obtain substantial authoritative support and are then considered a generally accepted accounting principle. Walgenbach et al comments:

“Because no basic natural accounting law exists, accounting principles have developed on the basis of their usefulness. Consequently the growth of accounting is more closely related to experience and practice than to the foundation provided by ultimate law. As such, accounting principles tend to evolve rather than be discovered, to be flexible rather than precise and to be subject to relative evaluation rather than be ultimate or final.”

**Similarly APB Statement No.4 observes:**

“Present generally accepted accounting principles are the result of an evolutionary process that be expected to continue in the future...Generally accepted accounting principles change in response to changes in the economic and social conditions, to new knowledge and technology, and to demand of users for more serviceable financial information. The dynamic nature of financial accounting—its ability to change in response to changed conditions—enables it to maintain and increase the usefulness of the information it provides.”

In India, Organisations like Accounting Standards Board (ASB), Institute of Chartered Accountants of India, Department of Company Affairs (Government of India), Securities and Exchange Board of India (SEBI), Institute of Costs and Works Accountants of India, Institute of Company Secretaries, Stock Exchange and the literature each publishes—are instrumental in the development of most accounting principles. In USA, Financial Accounting Standards Board (FASB), American Institute of Certified Public Accountants (AICPA), Securities and Exchanged Commission (SEC), Internal Revenue Service and the American Accounting Association are instrumental in the formulation of accounting principles.

The authority of accounting principles rests on their general acceptance by the accounting profession. The general acceptability of accounting principles is not decided by a formal vote or survey of practising accountants and auditors. An accounting principle must have substantial authoritative support to qualify as generally accepted. Reference to a particular accounting principle in authoritative accounting literature constitute substantive evidence of its general acceptance. The judgements given in an English case Associated Portland Cement Manufacturers Ltd. Vs. Price Commission (1974) illustrates the meaning of generally accepted. In this case the defendant Price Commission argued that, the term ‘generally accepted’ meant generally adopted or used in practice. The plaintiff company Associated Portland Cement Manufacturers Ltd. argued that the term ‘generally accepted’ meant generally recognised by the accounting\ profession as acceptable, irrespective of the degree of their use. The court supported the company argument. Justice Lord Denning observed; “it seems to me that the phrase (generally accepted) means generally approved accounting principles. It means principles which are generally regarded as permissible or legitimate by the accounting profession. That is sufficient even, though only one company applies in practice.”

**Selection of Accounting Principles**

Generally Accepted Accounting Principles are primarily relevant to financial accounting. In management accounting, the main objective of using GAAP is to help management in making decision, and in operating effectively and therefore, in the area of management accounting it is frequently useful to depart from accounting principles used in financial accounting. On many occasions, financial accounting data are reassembled or altered to be most useful in solving internal business problems and in making decision. Similarly, different accounting principles may need to be used for financial reporting purposes and income tax reporting purposes. That is, accounting principles useful for determining taxable income under the income tax regulations may differ from the accounting principles used for determining income acceptable for financial reporting, business reporting purposes. The considerations which guide the selection of accounting principles for financial reporting purposes are as follows:

**1. Accurate Presentation.**

One of the criteria tor assessing the usefulness of accounting information is accuracy in presentation of the underlying events and transactions. This criterion may be used by the firm as a basis for selecting accounting principles and methods. For example, assets have been defined as resources having future service potential and expenses defined as a measurement of the cost of services consumed during the period. In applying the accuracy criterion, the firm would select the inventory cost flow assumption and depreciation method that most accurately measure the amount of services consumed during the period and the amount of services still available at the end of period. As a basis for selecting an accounting principle, this approach has at least one serious limitation. It is difficult to know accurately the services consumed and the service potential remaining. Without this information the accountant cannot ascertain which accounting principles lead to the most accurate presentation of the underlying events. This criterion can serve only as a normative criterion toward which the development and selection of accounting principles should be directed.

**2. Conservatism**.

In choosing among alternative generally acceptable principles, the firm may select the set that provides the most conservative measure of net income. Considering the uncertainties involved in measuring benefits received as revenues and services consumed as expenses, some have suggested that a conservative measure of earnings should be provided. Conservatism implies that methods should be chosen that minimize cumulative reported earnings. That is, expenses should be recognised as quickly as possible and the recognition of revenues should be postponed as long as possible. This reporting objective, for example, would lead to selecting an accelerated depreciation method, selecting the LIFO cost flow assumption if periods of rising prices are anticipated, expensing research development cost in the year incurred.

**3. Profit Maximization**.

A reporting objective having an effect opposite to conservatism may be employed in selecting among alternative generally accepted accounting principles. Somewhat loosely termed reported profit maximization, this criterion suggests the selection of accounting principles that maximize cumulative reported earnings. That is revenue should be recognized as quickly as possible, and the recognition of expense should be postponed as long as possible. For example, the straight-line method of depreciation would be used, and when periods of rising prices were anticipated, the FIFO cost flow assumption would be selected. The use of profit maximization as a reporting objective is an extension of the notion that the firm is in business to generate profits, and it should present as favourable a report on performance as possible within currently acceptable accounting methods. Some firm’s managers whose compensation depends in part on reported earnings, prefer larger reported earnings to smaller. Profit maximization

is subject to a similar criticism as the use of conservatism as a reporting objective. Reporting income earlier under the profit maximization criterion must mea**n that** smaller income will be reported in some later period.

**4. Income Smoothing.**

A final reporting objective that may be used in selecting accounting principles is income smoothing. This criterion suggests selecting accounting methods that result in the smoothest earnings trend over time. Advocates of income smoothing suggest that if a company can minimize fluctuations in earnings, the perceived risk of investing in shares of its stock will be reduced and, all else being equal, its stock price will be higher. It is significant to note that this

reporting criterion suggests that net income, not revenues and expenses individually, is to be smoothed. As a result, the firm must consider the total pattern of its operations before selecting the appropriate accounting principles and methods.For example, the straight­line method of depreciation may provide the smoothest amount of depreciation expense on a machine over its life. If, however, the productivity of the machine declaims with age so that revenues decrease in later years, net income using the straight-line method may not provide the smoothest income stream.

**CHAPTER 5**

**Income Concept**

The measurement of income occupies a central position in accounting. Income The measurement of income occupies a central position in accounting. Income measurement is probably the most important objective and function of accounting,accounting concepts, principles and procedures used by a business enterprise. Generally speaking, income represent wealth increase and business success; the higher the income,the greater will be the success of a business enterprise. The following are some of the major areas where income information is practically useful:

**(i) Income as a guide to dividend and retention policy:**

Income information determines as to how much of a business enterprise's periodic income can be distributed to its owners and how much shall be retained to maintain or expand its activities. The income is the maximum amount, which can be distributed as dividends and retained for expansion. However, because of the difference in accrual accounting and cash accounting income, a firm may not distribute the total recognised income as dividends. Liquidity and investment prospects are necessary variables for the determination of dividend policy.

**(ii) Income as a measure of managerial efficiency**:

Income is regarded as an indicator of management's effectiveness in utilizing the resources belonging to the external users. Income tends to provide the basic standard by which success is measured. Thus, income is a measure is a measure to evaluate the quality of management's policy making, decision making, and controlling activities. The True blood Committee Report comments: "An objective of financial statements is to supply information useful in judging management's ability to utilize enterprise recourses effectively in achieving the primary enterprise goal."

**(iii) Income as guide to future predictions:** Income helps in predicting the future income and future economic events of business enterprise as current income acts to influence future expectations. It helps in evaluating the worth of future investments while making investment decisions.

**(iv) Income as a means of determining tax:** Income figure determines the tax liability of a business enterprise. How tax is determined is important to management and investors both. The taxation authorities generally accept accounting income as a basis of assessing the tax.

**(v) Income as a guide to creditworthiness and other economic decisions:**

Credit grantors- individuals and institutional both-require evidence of sound financial status before advancing loans to business enterprises. Income-current and future both-is a relevant data to determine a concern's ability to repay loans and other liabilities at maturity. Besides, income figure is useful in other decision areas also1 0 8 Accounting Theory such as pricing, collective bargaining, governmental, social and economic regulation and policies.

**Income Statement Vs. Balance Sheet**

The relationship between income statement, which reports net income of a business enterprise and balance sheet, which reports financial position, has been a matter of debate and research in accounting. The controversy between the two has had some amount of influence as how income should be measured. The Financial accounting Standard Board (U.S.A) in its 1976 D.M. entitled Conceptual Framework for Financial Accounting and Reporting: Elements of Financial statements and Their Measurement (para31) comments on this controversy when it says: "Difference in emphasis over the years has led to two schools of thought about measuring

earnings. One view is usually called the balance sheet, asset and liability or capital maintenance view; the other is usually called the income or earnings statement, revenue and expense or matching view. Many of the difference between them in articulated financial statements are matters of emphasis, but some result in significant differences in measures of earnings and statements of financial position."

Articulated financial statements, by definition, are statements in which net income for the period, less distributions to owners, is entered into the balance sheet as the change in owners' equity. It is this that makes the balance sheet balance. Articulated Statements further assume that there are no capital transactions between the enterprise and its owners. The debate between income statement and balance sheet is mainly about the primacy of the income statement or the balance sheet. An example of tank of water has often been used to explain this difference. If water is flowing into and out of a tank at different rates, the net inflow into the tank during a specified period can be measured by comparing the level in the tank at the beginning and at the end of the period, or by measuring the inflow and the outflow and subtracting one from the other. Assuming there are no leaks or evaporation, the two answers should be the same. Measuring net inflow by comparing the water levels at two points in time corresponds to measuring net income by comparing the owners' wealth at two points in time. The other approach corresponds to measuring net income by matching revenues with expenses.

Many accounting writers and researchers view net income as a quantity to be determined by comparing inputs and outputs, not by looking at the change in wealth during a period. Proponents of the input-output or expense-revenue view of income are not concerned if, as a result, the balance sheet has to accommodate deferred credits that are neither liabilities nor a part of owners' equity, or deferred expenditures that are not economic resources and therefore, not assets. In this view, the balance sheet is simply a list of what is left over after expenses have been matched with revenues. David Solomon's in his recent book Making Accounting Policy (1986) supports this view and says:

"… Determining income more or less independently of balance sheet changes has the great advantage of giving management more control over the number that emerges as earnings. If facilitates income smoothing and makes it easier to control the volatility of earning.

**Different Concepts of Income Measurement**

Measurement of income, as stated earlier, is probably the most important objective and function of accounting, accounting concepts, principles and procedures used by a business enterprise. Measuring periodic income of a business has, therefore, been debatable issue among the theorists, researchers, accounting bodies, accounting educators and practitioners. Accordingly, many concepts and approaches have emerged which aim to determine net income: of a business for an accounting period. The different concepts of income measurement have led to different types of income, which can be measured for a business enterprise. The different concepts of income measurement or different types of income are as follows:

(1) Accounting Income (or Business Income or Accounting concept of Income).

(2) Economic Income (or Economic Concept of Income).

(3) Capital Maintenance Income (or Capital Maintenance Concept of Income).

**Accounting Income**

Accounting income, often referred to as business income or conventional income is measured in accordance with generally accepted accounting principles. The profit and loss account or income statement determines the net income or operating performance of a business nterprise for some particular period of time. Income is determined by following income statement approach, i.e., by comparing sales revenue and costs related to the sales revenue. Net income is determined as follows:

**Revenue - Expenses =Net Income**

The net income defined as the difference between revenue and expenses determine the business income of an enterprise. Under the income statements approach, expenses are matched with the revenues and the income statement is the most significant financial statement to measure income of a business enterprise. Thus, business income of an entity represents the difference between the realized revenues arising from the transactions of the period and the corresponding historical costs. Accounting income is the increase in the resources of a business (or other) entity, which results from the operations of the enterprise. In other words, accounting income is the net increase in owner's equity resulting from the operations of a company. It should be distinguished from the capital contributed to the entity. Income is a net concept; it consists of the revenue generated by the business, less losses expires costs that contribute to the production of revenue.

Accounting income is measured in terms of transactions, which the business enterprise enters into with third parties in its operational activities. The transactions relate mainly to revenues received from the sale of goods and/or services, and the various costs incurred in achieving these sales. All these transactions will, in some way, involve the eventual receipt of payment of cash, and, if the eventual cash exchanges with third parties are not complete at the moment of measuring income, this incompleteness is allowed and adjustments are made for amounts due by debtors for sales on credit, amounts due to creditors for purchase on credit. Once these adjustments are made, the revenue and costs which have been recognised as having arisen during the defined period are then linked or matched in order to drive accounting income. Accounting income, thus, is computed in terms of matching or related operational revenue and cost. These revenues and costs are derived mainly from recorded business transactions, although they are also subject to the specific application of accounting principles such as those involved in depreciation and inventory accounting. In traditional accounting concept of income, a typical balance sheet describes and depicts unallocated or unmatched past costs as assets of the business.

Procedure of Computing Accounting Income

The procedure for computing accounting income may be summarized as follows:

(i) Defining the particular accounting period: Accounting income refers to the financial performance of the firm for a definite period. The commonly accepted accounting period is either the calendar or natural business year. It should be recognised, however, that income can be determined precisely only at the termination of the entity's life. The preparation of annual financial statements represents somewhat of a compromise between the greater accuracy achieved by lengthening theaccounting period and the greater need for frequent operating reports.

(ii) Identifying revenues of the accounting period selected: Accounting income requires the definition, measurement, and recognition of revenues. In general, realization principle is used for recognition of revenues and consequently for the recognition of income. Revenue is the aggregate of value received in exchange for the goods and services of and enterprise. Sales of goods are the commonest from of revenue. In accordance with realization principle, the accountant does not consider changes in value until they have crystallized following a transaction. The realization principle is not applicable in case of unrealized losses, which are recognised, measured, accounted for and subsequently reported prior to realization. There are some other instances where realization principle is ignored and unrealized income is recognised. Some such examples are valuation of properties, long-term contractbusiness.

(iii) Identifying costs corresponding to revenues earned: Accounting concept of income is based on the historical concept. Income for an accounting period considers only those costs, which have become expenses, i.e., those costs which have been applied against revenue. Those costs, which have not, yet expired or been utilized in connection with the realization of revenue are not the costs to be used in computing accounting income. Such costs are assets and appear on the balance sheet. Prepaid expenses, inventories, and plant thus represent examples of deferred unallocated costs.

(iv) Matching Principle: Traditional accounting income is expressed as a matching of revenue and expenditure transaction, and results in a series of residues for balances sheet purposes. Matching principle requires that revenues which are recognized through the application of the realization principle are then related to (or matched with) relevant and appropriate historical costs. The cost elements regarded as having expired service potential are allocated or matched against relevant revenues. The remaining elements of costs which are regarded as continuing to future service potential are carried forward in the traditional balance sheet and are termed asassets. Such asset measurements, together with corresponding measurements of the entity's monetary resources, and after deduction of its various liabilities, give rise to its residual equity or accounting

**Arguments in Favour of Accounting Concept of Income**

(1) Accounting income is very useful in judging the past performance and decisions of management. Also it is useful for control purposes and for making management accountable to shareholders for the use of resources entrusted to it.

(2) Another argument in favour of historical cost-based income is that it is based on actual and factual transactions which may be verified. Advocates of accounting income contend that the function of accounting is to report fact rather than value. Therefore, accounting income is measured and reported objectively and it is consequently verifiable.

(3) Accounting concept of income has the benefit of a sound, factual and objective transaction base. Accounting income has stood the test of time and therefore is used by the universal accounting community.

(4) In times of inflation, which is now a usual feature, alternative income measurement approaches as compared to accounting income could give lower operating income, lower rates of return which could lower share prices of a business firm.

(5) Income based on historical cost is the least costly because it minimizes potential doubts about information reliability, and effort in preparing the information.

**Limitations of Accounting Income**

There are certain limitations of the accounting income as given under:-

Firstly, the traditional accounting income is based upon historical cost principle and conventions which may be severally criticized, e.g., lack of useful contemporary valuations in times of price level changes, inconsistencies in the measurement of periodic income of different firms and even between different years for the same firm due to generally accepted accounting principles. Thus, accounting income could be misleading, misunderstood and irrelevant to users for making investment decisions.

Secondly, validity of business income depends on measurement process and the measurement process depends on the soundness of the judgments involved in revenue recognition and cost allocation and related matching between the two. There is a great deal of flexibility and subjectivity involved in assigning cost and revenue items to specific time periods and using matching concept. According to Spouse," In most cases matching costs and revenues is a practical impossibility." Spouse describes the process as one similar to judging a beauty contest where the judges cast their votes according to their personal preferences to decide the winner, because no established concepts exist to ascertain beauty, just as there are none to determine proper matching.

**Components of Accounting Income**

A profit and loss account or income statement, as stated earlier, determine the net income or business income of a business enterprise and displays revenues and expenses of the enterprises for a specified period. Therefore, business income has the following two major components or elements:

(1) Revenue

(2) Expenses

Besides the revenues and expenses, gains and losses are also considered while determining business income or net profit of an enterprise.

**Economic Income**

The economic concept of income is based on Hick's concept (1946) of income defined as follows:

"… the maximum value which he can consume during a week, and still expect to be as well-off at the end of the week as he was at the beginning."

Hicks presented his concept of "well offness" as the basis for a rough approximation of

personal income. According to Hicks, income is the maximum which can be consumed by a person in a defined period without impairing his "well offness" as it existed at the beginning of the period. "Well offness" is equivalent to wealth or capital. Hick's concept of personal income was subsequently adopted by Alexander and subsequently revised by Solomons to an equivalent concept of corporate profit. Alexander defined income of an enterprise as the maximum amount which a firm can distribute to shareholdersIncome Concepts during a period and still be as well off at the end of the period as at the beginning." Economics income may be defined as the operating earnings plus the change in asset values during a time period. Economic income is measured in real terms and results from changes in the value of assets rather than from the matching of revenue and expenses. Like accounting income, it is not based on money values. The "Well offness" is measured by comparing the value of company at two points in terms of the present value f expected future net receipts at each of these two points. In other words, economic income is the consumption plus saving expected to take place during a certain period, the saving being equal to the change in economic capital.

Economic income may be expressed as follows:

EI = C + (K1 - K2)

where EI = Economic Income

C = Consumption

K1 = Capital as at period 1

K2 = Capital as at period 2

Economic income and Hicksian approach follow balance sheet approach of income measurement. The balance sheet approach determines the income as the difference between the value of capital at the opening and closing balance sheets adjusted for the dividend or the additional capital contributed during the year. Under the balance sheet approach, income is determined as follows:

Income = Capital at the end minus capital at the beginning of the year plus Dividend or saving during the year minus capital contributed during the year.

It is significant to observe that under economic income and balance sheet approach, different items of assets and liabilities possessed by firm at the beginning as well as at the end of the year are to be valued to determine income for the year. Therefore, income measurement in this approach depend upon the valuation of assets and liabilities.

Therefore, economic income of the business is the amount by which its net worth has increased during the period, adjustments are made for any new capital contributed by its owners or for any distributions made by the business to its owners. This from of words would also serve to define accounting income, in so far as net accounting income is the figure which links the net worth of the business as shown by its balance sheet at the beginning of the accounting period with its net worth as shown by its balance sheet at the end of the period. The correspondence between the two ideas of increased worth is, however, a purely verbal one; for Hicksian income demands that in evaluating net assets on the bases of their unexpired costs. The relationship between these two different concepts of increase in net worth, economic income and accounting income may be summed up in the following manner, by starting with accounting income and arriving at economic income:

Accounting Income

+ Unrealised tangible asset changes during the period

- Realised tangible asset changes that occurred in prior periods

+ Changes in the value of intangible assets

= Economic Income.

The changes in the value of intangible assets do not refer to the conventional intangible

assets found in the balance sheet but to a concept called subjective goodwill arising

from the use of expectations in the computation of economic income. The following

example illustrates economic income and accounting income.

**Limitations of Economic Income**

The greatest problem lies in measuring the net assets at the beginning and end of the period, which are required to ascertain income. Several methods of valuation of assets may be suggested:

(i) capitalization of the expected future net cash flows or services to be received over the life of the firm,

(ii) aggregation of selling prices of the several assets of the firm less the total of the liabilities,

1. valuation of the firm on the basis of current share market prices applied to the total equity outstanding, and
2. (iv) valuation of the firm by using either historical or current cost for non-monetary assets and adding the present cash value of monetary assets and subtracting liabilities. In certainty, the cash flows and benefits could be determined with accuracy. But certainty is a rare factor, and the expected future cash flows upon which income exante (income at the beginning) and expost (income at the end) depend, are subject to a great deal of uncertainty. In practice, the economic income would be subject to extreme subjective ness and inaccuracies of the predictions:

Secondly, accurate predictions about the timing of the receipt of future cash flows are difficult to make. Different times of cash flows produce different measures of capital, and thus different income figures. Inaccuracies in forecasting of realization times will therefore produce corresponding inaccuracies in the income measure.

Thirdly, there is a problem regarding the choice of the discount factor used in computing the present values of the future cash flows. Ideally, the discount factor should reflect accurately the time values of the opening and closing capital will be distorted simply because the correct discount rate has not been used. The variations in the discount factors would lead inevitably to an increase in the subjectiveness of the resulting income figure; different discount factors produce entirely different measures of income.

Fourthly, the economic concept assumes a static situation, i.e., an individual or a business enterprise will attempt to maintain his "well offness" at a constant level. In fact, it seems reasonable to assume that individual will, on the whole, attempt to maximize their "welloffness" by investing capital in activities which will yield increasing benefits over time. Therefore, in forecasting benefits and cash flows for discounting purposes, a significant problem would be to incorporate degree of growth in the cash flows. The choice of such a growth factor increases the subjectiveness of the economic income.Edwards and Bell call economic income 'subjective income' and observe that it cannot be satisfactorily applied in practice by business enterprises. The notion of "well-offness" is indeed a matter of individuals' personal preferences. Because of the aforesaid limitations, the concept of economic income has little application to the area of financial accounting and reporting

**Differences Between Accounting Income and Economic Income**

The following are the differences between accounting income and economic income:

(1) Accounting income and economic income basically differ in terms of the measurement used. As Building observes: "accountants measure capital in terms of actualities, as the primary by-product of the accounting income measurement process; and that economist in terms of potentialities, in order to measure economic income." The accountant used market prices (either past or current) in measuring income based upon recorded transactions which may be verified. Current values, if used in accounting income, utilize the historic cost transactions base before updating the data concerned into contemporary value terms. The economist, on the other hand, uses predictions of future flows stemming from the resources which have the subject of past transactions. The accountant basically adopts a totally backward-looking or exposit approach, and consequently ignores potential capital value changes. The economist, on the other hand, is forward-looking in his model and bases his capital value on future events. Under accounting income, the accountant aims to achieve objectivity maximisation while measuring income for reporting purposes. The economist is free of such a constraint and is quite content in his model which may have large-scale subjectivity. As a result, the two income concepts appear to be poles apart in concept and measurement- certainly the accountant would find the economic model almost impossible to put into practice in financial reporting, despite its great theoretical qualities. On the other hand, the economist would not find the accounting model relevant as a guide to prudent personal conduct.

(2) The accounting income recognises income only when they have been realised. On the other hand, the economic, because it is based on valuations of all anticipated future benefits, recognises these flows well before they are realised. This means that, at the point of original investment, economic capital will exceed capital by an amount equivalent to the difference between the present value of all the anticipated benefit flows and the value of those resources transacted and accounted for at that time. The difference represents an unrealised gain which will, over time, be recognised gain which will, over time, be recognised and accounted for in computing income as the previously anticipated benefit flows are realised.

(3) Accounting income is an income resulting from business transactions arising from the cash-to-cash cycle of business operations. It is derived from a periodic matching of revenue (sales) with associated costs. Accounting income is an expost measure - that is, measured 'after the event.' In contrast to accounting income, economic income is a concept of income useful to analyse the economic behaviour of the individual. It focuses on maximizing present consumption without impairing future consumption by decreasing economic capital. Economic income is used as a theoretical model to rationalize economic behaviour. In this respect, it is similar to accounting income which measures, in aggregate terms, the results of human behaviour and activity, and which, through use, modifies and influences human behaviour. In other words, economic income aims to rationalize human behavior while accounting income measures the results of it.

(4) Conventional accounting income possess a limited utility for decision making purposes because of the historical cost and realization principle which govern the measurement of accounting income. Changes in value are not reported as they occur. Economic concept of income places emphasis on value and value changes rather than historical costs. Economic income stresses the limitations of accounting income for financial reporting and decision-making purposes.

**Similarities Between Accounting Income and Economic Income**

In spite of the above differences in concept and measurement between accounting income and economic income, there are some similarities between the two:

(1) Both use the transactions for income measurement.

(2) Both involve measurement and valuation procedures.

(3) Capital is an essential ingredient in income determination.

(4) In a world of certainty and with perfect knowledge, accounting and economic income as measures of better-offness would be readily determinable and would be identical. With such knowledge, earnings for a period would be the change in the present value for the future cash flows, discounted at an appropriate rate for the cost of money.

(5) Under current cost accounting, the reported income equals economic income in a perfectly competitive market systems. During periods of temporary disequilibrium and imperfect market conditions, current cost income may or may not approximate economic income. When asset market prices move in directions opposite to expected cash flows there tends to be a difference between current cost income and economic income i.e., the assets are overvalued. On the other hand, when asset values move together with expected cash flows, current cost income tends to approximate economic income quite well.

The Trueblood Committee Report comments on accounting income as follows:

"Accounting income or earnings should measure operations and represent the period- by-period progress of an enterprise towards its overall goals. Accounting measurements of earning should recognise the notion of economic better-offness, but should be directed specifically to the enterprise's success is using cash to generate maximum cash."

According to Trueblood Committee Report, accounting income, although having some

limitations, is preferable:

"…the real world does not afford decision-makers the luxury of certainty. Earnings, therefore, are based on conventions and rules that should be logical and internally consistent, even though they may not mesh with economists; notions of income. Enterprises have attempted to provide users with measures of periodic earnings. Since these measures are made without benefit of certainty, they are of necessity imprecise, because they are based on allocations and similar estimates."

**Capital Maintenance Income**

In Traditional accounting, the concept of accounting income has been recognised widely. Adequate attention has not been given to the capital maintenance concept associated with income measurement. In fact, 'income measurement' and 'capital maintenance' are interrelated concepts. Capital maintenance concept of income requires that capital of a business enterprise needs to be maintained intact before income can be distributed.

Return on capital (income) is distinguished from return of capital (cost recovery). Capital at the end of a year should be measured in order to determine the amount that can be distributed without impairing the capital that the firm had at the beginning of the year. Capital Maintenance may refer to maintaining capital impact in financial or in physical terms. According to Forker, the capital maintenance concept is viewed merely as a neutral benchmark to be used in determining the surplus which accrues to shareholders as income and implies nothing which ought to be interpreted as suggesting normative behaviour for the management of the enterprise. Choice of maintenance concepts may however be dictated by the preferences of managers and/or owners. The following are the concepts of capital maintenance:

(1) Financial Capital Maintenance

(2) General Purchasing Power Financial Capital Maintenance

(3) Physical or Operating Capital maintenance.

**(1) Financial Capital Maintenance**

Financial or money capital maintenance pertains to the original cash invested by the shareholders in the business enterprise. According to this concept periodic income should be measured after recovering or maintaining the shareholders' equity intact. Income under this concept is the difference between opening and closing shareholders' equity intact. Income under this concept is the difference between opening and closing shareholder's equity. It is this amount which may be distributed as income without encroaching upon the financial capital of the firm. For instance, the capital of a firm is Rs.15,000 at the beginning of the year and Rs.20,000 at the end of the year in monetary units. Assuming no capital transactions during the year, Rs.5,000 will be the income which can be distributed and still the firm will be well off at the end of the year as at the beginning. The financial capital maintenance concept is reflected in conventional or historical cost accounting. Financial capital maintenance concept assumes a constant (stable) unit of measurement to determine the income by comparing the end-or-the- year capital with the beginning capital. Changes in the price levels during the period is not recognised. Because of this and other underlying principles, income measurement under this concept may not prove to be reliable and useful for decision-making purposes.

**(2) General Purchasing Power Financial Capital Maintenance**

The concept aims at maintenance the purchasing power of the financial capital by continuously updating this historical cost of assets for changes in the value of money. This concept attempts to show to shareholders that their company has kept pace with general inflationary pressures during the accounting period, by easuring income in such a way as to take account changes in the price-levels. It intends to maintain the shareholders' capital in terms of monetary units of constant purchasing power. It reflects the proprietorship view of the enterprise which demands that the objective of profit measurement should focus on the wealth of equity shareholders. Taking the earlier example, if it assumed that the rate of inflation n was 10 percent during the year, the initial Rs.15,000 capital is adjusted in terms of inflation. That is, in the terms of inflation, the capital that needs to be maintained in fact is Rs.16,500, and income will be Rs.3,500 which can be distributed without encroaching the capital of the firm. This approach suggests that the accountant should be aware of the measurement-unit problem that arises in a period of unstable general price-level conditions. Instead of comparing the capital in units of money, it is preferable to compare beginning and ending capital, measured in units of the same purchasing power.

The main drawback of financial capital maintenance concept is that the resulting bottom-line income figure includes holding gains as a component of periodic income. Reflecting holding gains in the income statement may indicate (i) the success of the firm in buying inventories and equipment at prices which have subsequently increased, and (ii) a surrogate of an increase in the exit value or the present value from selling or using the assets in question. On the other hand, inclusion of such holding gains may raise two serious problems. First, the reported income figure, if distributed as dividends, could impair the firm's ability to maintain its current level of operations. Such holding gains can only be available for distribution if the company is liquidated. In the absence of evidence to the contrary, the firm is assumed to be going concern and, as such, any holding gains should not be considered income that can be distributed as dividends. The second criticism of the bottom-line income measure is that it may not be useful to investors interested in normal operating results as a basis for predicting future normal operating income. An enterprise that maintains its net assets (capital) at a fixed amount of money in periods of inflation or deflation does not remain equally well-off in terms of purchasing power.

**(3) Physical or Operating Capital Maintenance**

Physical or operating capital concept is expressed in terms of maintaining operating capability that is, maintaining the capacity of an enterprise to provide a given physical level of operations. The level of operations may be indicated by the quantity of gods and services of specified quality produced in a fixed period of time. Financial capital maintenance concept - money capital and purchasing power concept both - views the capital of the enterprise from the standpoint of the shareholders as owners. In other words, it recognises the proprietorship concept of the enterprise while measuring income and capital, and applies valuation system which are in conformity with this concept. On the other hand, the physical or operating capacity maintenance concept views capital as a physical phenomenon in terms of the capacity to produce goods or services and considers the problem of capital maintenance from the perspective of the enterprise itself and thus it reflects the entity concept of the enterprises.

Operating capacity concept provides that the income should be measured after productive (physical) capacity of the enterprise has been maintained intact, i.e., after provision has been made for replacing the physical resources exhausted in the course of business operations. Such income can be distributed without impairing the firm's ability to maintain its operating level. This income is also known as "sustainable" income implying that the firm can sustain such income as long as the firm insures the maintenance of its present physical operating capacity. This view is based on the following rationale. Firms produce certain goods or services. To ensure a firm's ability to produce such goods and services, at least at its present operating levels, it is necessary for the firm to maintain its prevailing physical operating capacity. This implies that income should represent the maximum dividend that could be paid without impairing the productive capacity of the firm.

The operating capability concept implies that in times of rising prices increased fund will be required to maintain assets. These funds might not be available if profit is determined without recognition of the rising costs of assets consumed in operations. For example, profit would not be earned on the sale for Rs.1,000 of 100 units of stock costing Rs.800 if their replacement cost was Rs.1,000. In this situation, an outlay of Rs.1,000 would be required in order to maintain the operating capability of the business in terms of 100 units of stock. In other words, the increase in the cost of the stock necessitates the investment of additional funds in the business in order to maintain it as an operating unit.

The operating capability concept does not imply that the firm should necessarily replace assets with identical items. Business enterprises, being dynamic, may extend, contract, or change their activities in whichever way desired. The concept simply means that the operating capability should be maintained at the same level at the end of as it was at the beginning.

The operating capability concept considers the problem of capital maintenance from the perspective of the enterprise itself. This concept emphasizes current cost accounting. However, there is a difference of opinion regarding the meaning of maintain physical productive capacity or operating capability. At least three different interpretation are

suggested:

(a) Maintaining identical or similar physical assets that the firm presently owns.

(b) Maintaining the capacity to produce the same volume of goods and services.

(c) Maintaining the capacity to produce the same value of goods and services.

The second interpretation implies technological improvements and in this respect is superior to the first interpretation, which essentially assumes the firm will maintain and replace its identical assets, an untenable assumption in light of technological improvements. The third interpretation not only reflects technological changes but also the impact of changes on the selling prices of outputs. Although this might be a highly refined approach, it may well be difficult to implement

On the balance sheet, the physical capacity maintenance concept requires the valuation of the physical assets of the firm at their current cost or lower recovery value (i.e., the higher of present value or net realisable value). To compute income that preserves the physical capital intact, the holding gains and losses resulting from increases or decreases in the current costs of the productive capacity of the firm are treated as "capital maintenance adjustments." Once the necessary capital maintenance adjustment are made, the difference between beginning and ending capital would represent (assuming the ending capital is greater, and in the absence of any capital transactions by the owners) the amount that could be distributed while maintaining the physical capital of the firm intact. In the income statement, the income of the period, under the physical capital maintenance approach, is measured by matching the realised revenues with the current cost of the assets sold or consumed. Such a direct comparison, however, is only possible under a stable monetary situation. When changes in the general level of prices occur, the respective monetary measures of the physical capital amounts must be restated in units of the same purchasing power.

The basic difference between the financial and physical capital maintenance concept using current (replacement) cost is in the treatment of "holding gains and losses." Under the financial capital maintenance concept, holding gains are reflected as income of the given period, whereas the concept of physical capital maintenance holding gains are shown in the shareholders' equity section of the balance sheet as "capital maintenance

adjustments." The physical capital maintenance concept is useful as a basis for providing information that would assist users in prediction the amounts, timing, and risks associated with future cash flows that could be expected from the firm. Information that enables users to assess whether an enterprise has maintained, increased or decreased its operating capability may be helpful for understanding enterprise performance and predicting future cash flows; in particular, it may help users to understand past changes and to predict future changes in the volume of activity. Also, the physical capacity maintenance concept is consistent with the going concern assumption - by maintaining the firm's ability to continue its normal operations - and the enterprise theory of the firm.

**Monetary Items**

In the discussion, so far, attention has been given to physical assets such as property,plant and equipment and stock. These items gain in money value in periods of inflation. Monetary items (e.g., bank balance and liabilities generally), are stated in fixed units of money which are not affected by a change in prices. However, the purchasing power of such items will change with fluctuations in the value of money. When prices are rising the purchasing powers of a bank deposit or an amount due from debtors will be falling and it may be argued that this represents a loss to the business. Conversely the purchasing power represented by the claims of creditors will fall during a period of inflation. It may be argued that such a reduction in the purchasing power of monetary liabilities represents a gain to the business. In order to represent this situation currentpurchasing power financial statements contain one type of item not represented in historical cost statement - purchasing power gains or losses on monetary items. This item is necessary to maintain financial capital of a company. The treatment of monetary items under the concept to maintaining the operating capability of a company is more complex, because supporters of the maintenance of operating capability are not united on a definition of capital. It is possible to identify seven different basic notions of what is meant by operating capability:

(a) Physical assets

(b) Physical assets and monetary assets (excluding fixed or long-term monetary assets).

(c) Physical assets and all monetary assets.

(d) Physical assets and all monetary assets minus current liabilities.

(e) Physical assets and monetary assets (excluding cash) minus creditors.

(f) Physical assets and net monetary assets

(g) Physical assets and all monetary assets minus all liabilities,

UK's SSAP 16 favours concept (e) of maintaining the operating capital of a business

firm.

Edwards and Bell's Concept of Business Income

Edwards and Bell developed the concept of business income. Business income concept

(labeled as Money Income by some writers) is based on replacement cost valuation

and recognises only the gains accruing during the period. More specifically, business

income comprises, (i) the current operating profit (X) which is the difference between

the realised revenues and the corresponding replacement cost, current operating profits

is defined as excess over a period of the current value of output sold over the current

cost of the related inputs. (ii) the realised and accrued holding gains of the period (Y)

and (iii) the unrealised holding gains and losses accruing in the period (W). A holding

gain arises whenever the current market value of an asset exceeds its historical cost.

Thus, business income (Bi) may be expressed as:

B1 = X + Y + W

where Bi = Business Income

X = Current operating profit

Y = Realised and accrued holding gains of the period

W = Unrealised holding gain and losses accruing in the period.

Accounting Principles for Business Income

If business income is to be determined, certain accounting principles are to be followed.

As stated earlier, business income is defined to include current operating profit and

realisable cost savings. Its measurement requires data on the price changes of individual

(or small group of) assets and entails the application of the following principles:

(i) When price changes increases the value of an assets, realisable cost savings should be recorded. These form the capital gains element of business profit.

Similarly, when price changes decrease the value of an asset, realisable capital losses should be recorded.

(ii) When an asset or asset service is used in production, its current cost should be

deducted from the current value of output to determine operating profit.

When these principles are applied in the accounts, the fundamental accounting equation

is modified from historic cost basis to a current cost basis, resulting into business income.

Barring dividends and new contributions of capital by shareholders, the following

relationship holds:

– Current value of output

Current value of input

\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

+ Current operating profit

Realisable capital gains Profit and Loss Account

Change in current – Change in current = Business Income or

value of assets value of liabilities change in proprietorship

Comparative Balance Sheet

A third principle can be enunciated:

(iii) The difference between current cost and historic cost of assets or asset services

used in production also marks the conversion of what was a realisable gain to a

realised gain. This amount should be transferred from the unrealised cost savings

account to a realised cost savings account.

Principal (iii) applied in the accounts in conjunction with Principal (i) yields data for

realised profit.

Relationship between accounting income and business income

It will be beneficial to understand the relationship between accounting income and

business income. Accounting income is defined as the difference between the realised

revenues arising from the transactions of the period and the corresponding historical

costs. Realised holding gains and losses are included in the accounting income. Realised

holding gains and losses may be divided into two elements, first, the holding gains and

losses realised and accrued during the period, second, the holding gains and losses

realised during the period but accrued during previous periods. More specifically,

accounting income (Ai) may be expressed as:

Ai = X + Y + Z

Where Ai = Accounting income

X = Accounting Operating profit

Y = Realised and accrued holding gains of the period

Z = Realised holding gains of the period accruing in previous periods.

More clearly, the accounting income has the following accounting relationships:

Sales (Current values) - Expenses (historic costs)

= Accounting operating profit + Realised capital gains

Change in assets – Change in liabilities = Accounting income (profit).

at historic costs at historic costs

Comparing accounting income with business income, it can be inferred that the business

income is equal to the accounting income less the realised holding gains of the period

accruing in previous periods and plus the unrealised holding gains and losses. The

relationship (reconciliation) between business income

**Operating Income**

The current operating concept of income focuses on effective utilization of a business

enterprise's resources in operating the business and earning a profit thereon. In this

way, operating income measures the efficiency of a business enterprise. In this concept

of income, the two terms 'current' and 'operating' are significant. Firstly, the events and

transactions relating to the current period are only considered. However, in some cases,

the transactions and resources are acquired in prior periods but may used in the current

period. For example, plant and equipment and even the services of workers are acquired

in prior periods. The decisions of the current period involve the proper use and

combination of those resources. A plant that is judged as obsolete in the current period

may have become obsolete in prior periods. If a decision is taken in the current period

to sell it, it is not operating event of the current period. Similarly, detection of an error in

the computation of net income for the prior periods is not used in the determination of

current period's net income.

Furthermore, the current operating income recognises changes relating to normal

operations; non-operating activities are not considered. It can be contended that income

in terms of normal operating activities better reflects the efficiency of management and

facilitates inter-period and inter-firm comparison of business performance. This inclusion

of non-operating activities makes the net income number unreliable and improper device to measure the performance of a business. If non-recurring items arise from normal

activities or operations, the current operating income will include it to provide a good

measure of the enterprise's earning power and show correct income trends.

To conclude, current operating income is more useful in judging the profitability of a

business enterprise, in making predictions and inter-period and inter-firm comparisons.

Although it is difficult to classify operating and non-operating items, it is preferable to

show them separately. The external users, however, are accustomed to use a single

income figure for making economic decisions. In such a case, it can be rightly said that

current operating income is a better measure of current operating performance of a

business enterprise.

**Operating and Non-operating Activities**

Operating activities are the central means by which the enterprise is expected to obtain

income and cash in the future. Results of central, continuing operations, therefore, have

a different significance from results associated with other non-recurring activities and

events. No definition of the term operations is likely to produce a clear identification of

the activities concerned in all types of business. However, operations normally comprise

the provision of goods and services that make up the main business of the enterprise

and other activities that have to be undertaken jointly with the provision of goods and

services. Such goods and services are produced and distributed at prices that are

sufficient to enable a firm to pay for the goods and services it uses and to provide a

satisfactory return to its owners. Operations would include for example, exploration for

and development of natural resources, manufacture and distribution of goods and the

results of trading and investment activities that are part of the main business of the

enterprise. Gains and losses on marketable securities maybe excluded from the results

of central operations of a manufacturing concern but may be included in central operations

for a dealer in securities.

Operating items are generally of recurring nature and non-operating items are generally

considered non-recurring and un-predictable. However, that is not always true. Many

items may be operating in nature, but not necessarily recurring. Over time payments

during a rush period and acquisition of aw material under extremely favourable conditions

both are operating events, but are possible non-recurring. Similarly, some non-operating

items maybe recurring in nature. Under both the income concepts (current operating

performance concept, and all inclusive concept), income from normal activities of the

enterprise generally is identified separately from unusual items. The fact that an item,

otherwise typical of the normal activities of the enterprise is abnormal in amount or

infrequent in occurrence does not qualify the item as unusual (known as extraordinary

or special items also). It remains a part of income from the ordinary (normal) activities

although separate disclosure of its nature and amount may be appropriate. An example

of such an item would be the write-off of a very large receivable from a regular trade

customer.

Although information about comprehensive income and its all components are useful

for assessments of enterprise performance, net income figure based on recurring

(operating) items is generally more useful to economic decision markers in predicting

future income and cash flows. Recurring non-operating items are just as important as

those recurring operating items that are the result of normal business operations. The distinction between operating and non-operating, however, is more useful for measuring

managerial efficiency. The advantage of classifying income items as recurring (operating)

or non-recurring is based upon the improved usefulness of the resulting net income

figure in the making of predictions by investors. External users and other persons may

find it difficult to distinguish between recurring and non-recurring transactions than that

of operating and non-operating items

**Comprehensive Income**

**Concept**

Comprehensive income, also known as all-inclusive concept of income, is the change in

equity (net assets) of an entity during a period from transactions and other events and

circumstances from non-owner sources. It includes all changes in equity during a period

except those resulting from investments by owners and distribution to owners. It is

equal to revenues plus gains minus expenses and minus losses. Overall enterprise

performance is indicated by the amount of comprehensive income, that is, by increase

in the amount of net assets resulting from transactions and other events and

circumstances in the period (excluding the effects of net assets resulting from transactions

and other events and circumstances in the period (excluding the effects of investments

by and distribution to owners). The International Accounting Standards Committee in

its IAS 8 (1978) entitled 'Unusual and Prior Period and Items and Changes in Accounting

Policies' says:

"Under the all-inclusive concept, transactions causing a net increase or decrease in

shareholders interests during the period, other than dividends and other transactions

between the enterprise and its shareholders, are included in the net income for the

period. Non-recurring items, including unusual items arising in the current period, prior

period items, or adjustments related to changes in accounting policies, are included in

net income but there may be separate disclosure of the individual amounts."

Solomons observes:

"A truly comprehensive concept of income for a period must include all changes in

owners' equity from non over sources that are associated with the period and that can

be measured reliably, regardless of the restrictions on recognition imposed by our present

GAAP. Arguments in Favour of Comprehensive Income

Many arguments have been advanced in support of measuring comprehensive income

of a business firm:

(i) An income statement that includes all income charges and credits recognised

during the year is said to be easier to prepare and more easily understood by the

readers. This is based on the assumption that accounting statements should be as

verifiable as possible; several accountants working independently on the same

figures should be able to arrive at identical income figures.

(ii) The annual reported net incomes, when added together for the life of the enterprise,

should be equal to the total net income of the enterprise.

(iii) The distinction between operating and non-operating transactions influencing the

income is not clear-cut. Transactions classified as operating by one firm may be

classified as non-operating by another firm. Furthermore, items classified as non-

operating in one year may be classified as operating by the same firm in a

subsequent year. This, in itself, leads to inconsistencies in making comparison

among different firms or over several periods for the same firm.

(iv) The omission of certain charges and gains from the computation of net income

lends itself to possible manipulation or smoothing of the annual earning figures.

(v) With adequate disclosure of items influencing the comprehensive income, the

financial statements users is assumed to be more capable of making appropriate

classification to arrive at an appropriate.

Advocates of the all-inclusive concept claim that reporting in the income statement of

all items affecting the shareholder's interests during the period, other than dividends

and other transactions between the enterprise and its shareholders, provides more useful

information for the users of financial statements to enable them to evaluate the importance

of the items and their effects on operating results. Although the all inclusive concept is

generally supported, there are circumstances in which it may be considered desirable

to report certain items outside the income statement for the current period. However,

unusual items are generally included in net income.

Components of Comprehensive Income

Comprehensive Income is a useful measure of overall performance. However,

Information about the components that make up overall performance is also needed.

A single focus on the amount of comprehensive Income is likely to result in a limited

understanding of enterprise performance; information about the components of

Comprehensive Income often may be more important than the total amount of

Comprehensive Income. Investors generally attach more importance to component parts of an enterprise's income for a period than knowing the aggregate figure shown on the "bottom line" for it is knowledge about the composition of the aggregate that makes judgment about the "quality earnings' possible. "Quality of earnings" generally refers to the durability and stability of earnings. For instance, one company may have Rs.1,00,000 income, all derived from continuing and recurrent operations, another may have the same aggregate income derived from a one time gain on redemption of debt. Most investors would give more value to the first income figure than to the second income figure.

Although some generalizations can be made about components of income, the separate components will differ for different kinds of enterprises. The components of

comprehensive Income usually consist of the following items:

(1) Items that are unusual or that occur infrequently, but that do not qualify as

"Extraordinary items."

(2) Results of transactions in investments in other enterprises.

(3) Items that can be estimated with only little reliability.

(4) Unrealised changes in the value of assets and liabilities, when these are recognised

by the accounting model in use.

(5) Exchange transactions and other transfers between enterprise and other entities

Those are not its owners.

(6) Items relating to the payment or recovery of taxes.

(7) Items relating to an entity's ongoing major or central operations.

The above list is not exhaustive. Among the above items, the "ongoing major or central operations" are generally the primary source of comprehensive income. It should be understood clearly that what are major or central operations for one kind of enterprise are peripheral or pr incidental for another, and for some it may be difficult to know where to draw the line. For most businesses, gains and losses on the sale of company automobiles are incidental; for a car rental company they are central. Transactions in marketable securities are incidental for a manufacturing business and central for an investment banker. Thus, what are revenues to one business enterprise are gains to another business enterprise. The various components of comprehensive Income may differ significantly from another in terms of stability, risk and predictability, indicating a need for information about these components of income. Duff and Phelps observe: "In the practical world of business and investment, however, net income determined on all-inclusive basis contains too much "noise", i.e.' earnings (positive or negative) derived from development outside the normal operations of the business, such as capital gains or accounting changes. These are generally non-recurring over a period of time, so that the analyst places his primary emphasis on earning power as something that can be counted on from year to year. Thus, earning power is a second concept of earnings and the one most meaningful to the investor.

**Prior Period Items**

Prior period items are generally infrequent in nature. They should not be confused with accounting estimates which are, by their nature, approximations that may need correction as additional information becomes known in subsequent periods. The charge or credit arising on the outcome of a contingency, which at the time of occurrence could not be estimated accurately, does not constitute the correction of an error but a change in estimate. Such an item is not treated as a prior period item.

**Extraordinary Items**

Extraordinary items are sometimes termed "unusual items." Some examples of such items could be the sale of a significant part of the business, the sale of an investment not acquired with the intention of resale or a liability arising on account of legislative changes or judicial pronouncement etc. The nature and amount of each extraordinary item are separately disclosed so that users of financial statements can evaluate the relative significance of such items and their effect on the operating results.

**Transactions Approach to Income Measurement**

The transactions approach in income measurement records changes in asset and liability valuations only as these are the result of transactions. The term transaction is used in a wider sense and it includes both external transactions and internal transactions. As it can be inferred, external transactions relate to dealings with outside parties and internal transactions arise due to use or conversion of assets within the firm. Changes in values are not recognized if such changes are based on market valuations or expectations and changes therein. Income is recognized when new market valuations are more than the input (cost) valuations and when the external transactions take place. Internal transactions may have valuation changes, but only those that result from the use or conversion of assets are usually recognized and recorded. When conversion takes place, the value of the old asset is usually transferred to the new asset. Therefore, the transactions approach fulfills the concept of realization at the time of sale or exchange and cost concept recognized in accounting.

**Activities Approach to Income Measurement**

The activities approach focuses on description of activities of a business enterprise

rather than on transactions (as in transactions approach). In activities approach, income is recognised when certain activities or events occur; income recognition is not confined to the mere result of specific transactions. A business firm does many activities such as planning, purchasing, producing, selling. Activity income is recognised at each of these activities. Practically speaking, activities approach are expansion of the transactions approach. The main difference between transactions approach and activities approach is that the former is based on the reporting process that measures an external eventthe transaction - and the latter is based on the real-world concept of activity or event in a wider sense. Both approaches, however, fail to achieve realistic income measurement.since both depend on same structural relationships and underlying concepts and bothhave no real-world counterpart.Recipients of Net Income The term 'net income' generally means net earning or net profits accruing to current shareholders or owners of the business. However, there may be valid reasons for the presentation of a net income figure that represents net earnings to a narrower or broadergroup of recipients. There are listed as follows:

**(1) Value-added concept of Income:**

Value-added concept of Income: Broadly speaking, it is possible to view the

enterprise as having a large group of claimants or interested parties, including not

only owners and other investors but also employees and landlords of rented

property. This is the value-added approach. Value added is the market price of

the output of an enterprise less the price of the goods and services acquired by

transfer from other firms. Thus, all employees, owners, creditors and governments

(through taxation) are recipients of the enterprise income. This is the total price

that can be divided among the various contributors of factor inputs to the enterprise

in the production of goods and services. The value-added income would include

wages, rent, interest, taxes, dividends paid to shareholders, and undistributed

earnings of the companies.

**(2) Enterprise Net Income:**

This concept of net income has an advantage from the

point of view of separating the financial aspects of an enterprise from its operating.

The net income to the enterprise is an operating concept of net income. The

operating concept of income has earlier been discussed in this chapter. Net income

resulting under 'operating capability concept' is known as enterprise net income.

**(3) Net Income to investors:**

: In accordance with the entity concept of the business

enterprise, both shareholders and creditors of long-term debt are considered equally

as investors of permanent capital. With the separation of ownership and control in

the business enterprises, the differences between shareholders and debt holders

are no longer as important as they once were. The main differences arise in the

priorities of claims against income and against assets in liquidation

**(4) Net Income to shareholders:**

Net Income to shareholders: The most traditional and accepted viewpoint of net

income is that it represent the return to the owners of the business. Although this

concept has its firm foundation in the proprietary approach, many authors apply it

to the entity approach and consider the accounting profit of the entity to be a

liability to the owners. FASB Statement of Financial Accounting Concepts No. 1,

emphasized the predictive nature of reported earnings. It states, for example, that

in addition to being used to evaluate management's performance, reported earnings

may be used to predict future earnings, to predict the long-term earning ability of

the enterprise, or to evaluate the risks of investing in or lending to the enterprise.

**(5) Net Income to residual equity holders:**

Net Income to residual equity holders: In financial statements presented primarily

for shareholders and investors, the net income available for distribution to common

shareholders is usually thought to be the most important single figure in the

Statements. Net income per share of common share and dividends per share are

the most commonly quoted figures in financial news, along with the market price

per share. Therefore, there is pragmatic support for presenting statements from

which the net income to residual equity holders can readily be obtained.

The holders of common stock and the prospective buyers of common shares are interested primarily in the future flow of dividends. Normally, only a part of the residual net income is distributed as dividends, but the knowledge of the net income available and the financial policy of the companies may provide useful information to common shareholders in their evaluation of the firm and in their prediction of the total amount of annual dividend distributions in the future. However, in order to predict the amount of dividends he may receive in the future, an investor must also predict the number of share that will be outstanding in each period.