

Accounting Principles and Theory

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Introduction

Almost all financial accounting is based on the double-entry bookkeeping, which was established centuries ago to provide owners mainly with a method of extracting information regarding the economic activity in their companies.

Business today is more complex and therefore there is an increased need for providing information to others such as: shareholders, banks, investors, suppliers, management, employees, and authorities.

The purpose of accounting may thus be seen to be serving all stakeholders in a company with accurate financial information.

The accounting needs differ between companies depending on the laws of the countries where the business is conducted, the size of the business, the type of the business, etc.

There is a need to align the accounting in different countries to simplify international investment as well as the accounting within multi-national companies with subsidiaries in foreign countries.

To ensure the quality of the accounting, a set of principles and standards have been established to govern the accounting practices being applied for each specific business.

Accounting theory is based on the study of these principles and practices, with the aim of providing a logical framework for accounting from which new principles and practices may be derived when needed.

Accounting Principles

Accounting Entity

It is assumed that the economic activity which is accounted for relates to a specific legal entity (or a well-defined part thereof) which is clearly separated from its owner.

Going Concern

It is assumed that the operation of an accounting entity will go on indefinitely.

Monetary Unit

It is assumed that the value of economic events of an accounting entity can be quantified using monetary units. The currency used is assumed to be stable, and thus inflation is not considered.

Time Period

It is assumed that the continuous activity of an accounting entity may be accounted for using arbitrary time periods such as months, quarters and years.

Objectivity

Accounting should be free from subjective valuation, and the financial information should be based on verifiable data.

Consistency

The same accounting principles should be used from one period to the next. A change of principles must be disclosed in the financial statements.

Substance over Form

Accounting should reflect that the substance of a transaction or event is more important than its legal form, which for example may require a company and its subsidiaries to provide consolidated financial statements.

Materiality

All information concerning economic activity, important enough to influence the decisions of a stakeholder, is said to be material and must be accounted for and disclosed in the financial statements.

Additional information should only be disclosed if benefits of providing it exceed the costs (or is required by law).

Full Disclosure

In addition to materiality, there may be specific conditions (such as lawsuits) that may have significant effects on the status of an accounting entity. Such information must also be disclosed.

Historical Cost

Economic items are accounted for at their cost at the time of the acquisition.

Fair Value

Economic items are accounted for based on the current market price for similar items.

Revenue Recognition

Revenues are recognized when they are earned, that is when a product is delivered or a service is completed, irrespective of when the corresponding payment is received.

Revenue may be recognized before delivery under some conditions such as for long-term construction contracts, where the percentage-of-completion method applies.

Expense Recognition

Expenses should be recognized as they are incurred in the process of earning revenues.

Matching

Economic events are recognized by matching expenses to revenues when transactions occur (and not when payment is made).

Conservatism

Gains and revenue should not be recognized until realized, that is when payment is received upon product delivery or service completion.

Losses and costs should be recognized when becoming apparent, and should then be reasonably estimated.

Accounting Standards

Each country defines what accounting standards, also referred to as General Accepted Accounting Principles (GAAP), that are applicable for what business in that country.

Swedish GAAP

Swedish GAAP is based on the legislation in the Annual Accounts Act and the Bookkeeping Act.

Bokföringsnämnden (Swedish Accounting Standards Board) and Redovisningsrådet (Swedish Financial Accounting Standards Council) both issue recommendations on how to apply Swedish GAAP. Public companies may choose what set of recommendations to apply.

US GAAP

US GAAP is not legislation but a set of recommendations issued by the Financial Accounting Standards Board (FASB).

The Security and Exchange Commission (SEC) have decided that all public companies must apply US GAAP.

US GAAP is much more detailed than Swedish GAAP.

IFRS

The International Financial Reporting Standard (IFRS) consists of a set of accounting standards that are becoming the global standard for financial statements of public companies.

IFRS is governed by the London-based International Accounting Standards Board (IASB), an independent body funded by private- and public organizations around the world.

EU has made IFRS mandatory for public companies.

IASB and SEC are working to align IFRS and US GAAP with the aim of allowing and later requiring US public companies to apply IFRS.

Accounting Theory

Accounting theory research was established in the 1960s and 1970s, and aims at providing a comprehensive theory that would be a logical framework from which to derive accounting principles and practices.

Descriptive (or positive) theory was based on generalisations made by observing how accounting was done in practice.

Decision-usefulness theory was based on the study of the information needs of stakeholders. Empirical theory was created based on analysis of how stakeholders actually use financial information. Normative theory was developed from models on how decision making ought to be made.

Decision-usefulness theory focused on the need for financial information for private use. However, as financial decisions may affect others than the one making the decision, welfare theory has been developed to incorporate the social effect on the organization at large.

Both IASB and FASB are striving towards developing principle-based accounting standards, and make use of these theories in that work.

References

The following literature has been used as sources when writing this report, and may serve as additional material also for the readers:

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