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Understanding theories of financial accounting

Al Wahfi Suhada [1], Amalia Utami [2], Dara Maisarah Ibthia [3], Iskandar Muda [4]
[1-4] Graduate Program in Accounting, Faculty of Economics and Business, Universitas Sumatera Utara, Indonesia

Corresponding Author: **Al Wahfi Suhada**

Abstract
Accounting has been one of the most important aspect in running a business in today's economic and social system. It is used to support decision making in various aspect of life. To be able to apply accounting properly, it is important to understand the basic of accounting and its theories. The position of accounting fundamentals is very important in education and business, where learning or training activities will work well if it is started from a good fundamental understanding as well. This paper is written to help giving general understanding on the fundamentals of accounting. By using theoretical review approach, explanations are given thoroughly for reader's understanding. From the discussion, it can be concluded that theories helps accountant to have consistent standards and determination of attitudes, functions and limitations of financial accounting and financial reporting. Though there are different kind of perspective in each theory, it is important to note that by applying the theories, accounting can be done reliably.

Keywords: Accounting, theories, Understanding, financial

Introduction

The research in economic field has resulted on the term accounting. Accounting become the most upfront and has important role in running our economy and social system. Fundamentally, decisions made by individuals, government, institutions and companies, and many others are determined by its use of the resources owned by the county which is accounted to make sure its conformity (Ikhsan & Suprasto, 2008) [6].

To be able to apply accounting properly, it is important to understand the basic of accounting and its theories. That way, a person can have fundamental understanding on accounting field. The position of accounting fundamentals is very important in education and business, where learning or training activities will work well if it is started from a good fundamental understanding as well. This paper is written to help giving general understanding on the fundamentals of accounting. By using theoretical review approach, explanations are given thoroughly for reader's understanding. The structure of this paper includes the basis of accounting, international accounting standard, theory of accounting, the formulation of accounting theory, theory of accounting and policy making, also normative vs positive accounting theories.

The Basis of Accounting

To understand better about the accounting itself, it is important to know about the foundation of it. Terminologically, accounting is defined by The Committee on Terminology of the American Institute of Certified Public Accountants (AICPA) as "the art of recording, classifying and summarizing transactions and events of a financial nature in an efficient manner and in the form of units of money, and interpreting the results of the process". Furthermore, there are plenty of researchers in the accounting field who tries to define the term accounting itself. (Siegel & Ramanauskas-Marconi, 1989) [9] defines accounting as "a service discipline that is able to give relevant and on time information about company's finance problem and to help internal and external users in economical decision-making process". This relates to Mariott *et al*. (2002) [8] who defines accounting as "a system for recording and reporting business transactions, in financial terms, to interested parties who use this information as the basis for performance assessment, decision-making and control". In an extensive manner, American Accounting Association defined accounting as "the process of identifying, measuring, and communicating economic information to enable informed judgments and decisions by information users". Thus said, we can define accounting as a systematic process of measuring the economic activity of a business by involving record, interpretation, and report to provide useful information to those who make economic decisions.

Accounting itself was formed as the companies starts to realize the importance of recording each transaction correctly so company can track its activities and progress. According to Ikhsan & Suprasto (2008) [6], every transaction event that occurs in the company must be recorded in accordance with the nominal value issued. Certain corporate transactions may give rise to events or circumstances that result in other transactions. For example, the purchase of merchandise on credit will be followed by other transactions, namely payments to creditors. Every time merchandise is sold, another transaction arises. Hence, the process of the process of identifying, measuring, recording, classifying, parsing, combining, summarizing and presenting basic financial data that occurs as a result of operating activities of an organizational unit, in certain ways, to produce accounting information is considered important.

International Accounting Standard

As our world has now runs globally where almost all aspects are integrated between nations, researchers find it is necessary to build a global standard of accounting. The standard was started to be formed with the support given by International Accounting Standards Board (IASB) around 1970s. The standard was formed with the goal to create a globally harmonized world accounting standard (Hery, 2017) [5]. As per today, there are two accounting standards accepted and used internationally. One is American Generally Accepted Accounting Principles (GAAP) and the International Financial Reporting Standards (IFRS).

GAAP provide tolerance for companies to choose the accounting method that will be used in accordance with the conditions of the company, making it easier for managers to carry out earnings management (Fischer, *et al*. 1995). Meanwhile, IFRS provide convenience in understanding financial statements by using SAK (Financial Accounting Standards) which are known internationally, as well as increasing global investment flows and lowering the cost of capital through global capital markets (Fathonah, 2014).

One of the important features that distinguishes IAS/IFRS from U.S. GAAP is the application of the concept of fair value (fair value). Fair value is the amount used to exchange an asset between willing and knowledgeable parties in an arm's length transaction. In many cases, IFRS is more flexible than U.S. GAAP. IFRS generally have fewer clear guidelines than the U.S. GAAP, moreover, more judgment is required in applying IFRS. IFRS is said to be a principles-based accounting system (broad principles with limited detailed rules) and the U.S. GAAP as a rule-based system. However, in some cases, IFRS is more detailed than U.S. GAAP (Doupnik & Perera, 2007).

Theory of Accounting

In developing the field of accounting, it is necessary to understand what is the theory of accounting is. The formulation of accounting theory arises because of the need to provide logical reasoning about what accountants do. In other words, changes in accounting principles occur mainly because of various efforts made to solve various accounting problems and formulate a theoretical framework for accounting practice (Ikhsan & Suprasto, 2008) [6]. The theory of accounting itself is defined by Kam (1990) as a comprehensive system which includes the postulates and theories related to them. He divided the elements of theory into several elements: basic postulates or assumptions, definitions, accounting objectives, principles or standards, and producers or methods. In Hery (2017) [5], it is noted that accounting theory can also explain current practices and gain a better understanding of these practices.

Understanding the theory plays an important role in the formulation of accounting theory. Accounting theory can be formulated as an arrangement of concepts, definitions, and propositions that present a systematic description of accounting phenomena, as well as explain the relationship between variables in the accounting structure, with the aim of being able to predict emerging phenomena (Hery, 2017) [5]. The main objective of accounting theory is to provide a logically interrelated set of principles that form a general framework as a reference for assessing and developing good accounting practice (Ikhsan & Suprasto, 2008) [6].

Kam (1990) also put forward the function of the existence of accounting theory as follows

1. As a guide for accounting standard setting institutions in preparing their standards.
2. To provide a frame of reference for resolving accounting issues in the absence of an official standard.
3. To determine the limit in terms of making judgments in the preparation of financial statements.
4. To increase the understanding and confidence of the report readers towards the information presented in the financial statements.
5. To improve the quality of comparable reports.

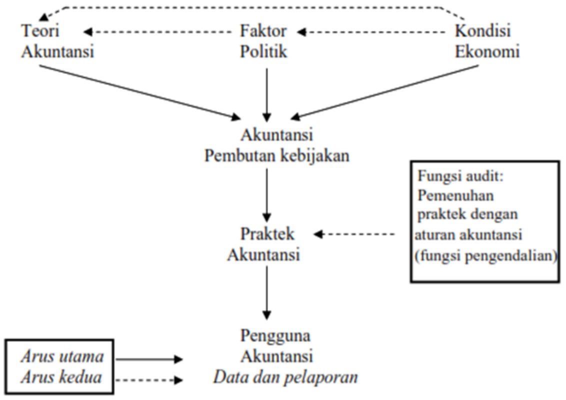
Hery (2017) [5] explained that a theory must be debatable, refutable, arguable, justifiable, against new criticisms and arguments expressed by society. This process is called the verification theory process. For a theory that lacks that trait, the formulation of the principle it gives rise to would be fragile. Therefore, accounting theory must be born from the process of theory construction as well as theory verification. If a theory cannot survive the verification process, then the theory must be replaced with a better theory whose size ultimately returns to the response that society gives to the accounting output.

Theory of accounting and policy making

The relationship between accounting theory and the standard-setting process should be understood in a broad context, as shown in Figure 1. Economic conditions have an impact on political factors and accounting theory. Political factors, in turn, also have an influence on accounting theory. Bodies such as the FASB and the SEC that have been charged with making financial accounting rules, form the function of a policy. The policy function is also called standard setting or rule making which specifically refers to the process from the arrival of announcements issued by the FASB or SEC. Input to the policy-making function comes from three main sources.

The term political factors refer to the influence on policy making of all subjects on the outcome of rules or regulations. Included in this category will be the auditor, who is responsible for assessing whether the rules have been followed; preparing financial reports, representing organizations such as financial executives, institutions, investors, representing organizations such as Chartered Financial Analysis, and the public itself, which may be represented by government groups such as congress or government agencies departments. In addition, company management and industry trade associations are important political components of the policy-making process.

Accounting theory was developed and rediscovered by the accounting research process. Generally accounting professors take it in the direction of research, but some individuals from policy-making organizations, public accountants and private industry also play an important role in the research process. Standards and other announcements from policy-making organizations are interpreted and put into practice at the organizational level. On the other hand, the output to the policy level is the implementation of the practice level accounting.



Source: Ikhsan & Suprasto, 2008

Fig 1: The Environment of Finance Accounting

Users consist of several groups and include potential and actual shareholders and creditors as well as the wider public. It is important to remember that users not only work on financial statements and reporting in decision making but are also influenced by the policy-making function and its application at the level of accounting practice.

Importance of Theory

The FASB recognizes that general theory will lead to consistent standards and determination of attitudes, functions and limitations of financial accounting and financial reporting. The FASB says that it is generally agreed that comprehensive theory can certainly produce advantages for the profession. As theory can:

1. Guidance of the body responsible for setting accounting standards.
2. Provide a framework of reference for solving accounting questions in the absence of specific standards.
3. Determine the limits for consideration in providing financial statements.
4. Improving the understanding of users of financial statements on trust in financial statements.
5. Comparable levels (Ikhsan & Suprasto, 2008) [6].

As we conclude from this explanation, the reason theory is important is to find answers to questions, the kinds of questions we can trust. In every discipline or profession, there are desirable questions. Since accounting prescriptions were developed to solve specific problems, the underlying theory was also developed based on specific models.

Formulation method of accounting theories

Formulating accounting theory or in other words conducting accounting research must have a method. Theory is what is reduced from reality or practice. According to Godfrey (2010), in linking theory (abstract world) and reality (world of experience) there are 3 relationships in the theoretical structure:

1. Syntactic

a. Here the theory is formulated in the form of a logical relationship. The relationship is formulated in the form of rules such as language rules (Grammar), mathematical rules and so on. Often, the formulation of theories using syllogisms that provide logical relationships syllogisms are not intended to state truth, but only explain logical relationships, such as:

Premise 1: All assets have a debit balance

Premise 2: The rental fee has a debit balance

Conclusion: rent is an asset

The series of premises and conclusions above is a language theory in the game of logic (syllogism). Not all of the syllogistic structures can guarantee truth. Syntactics only describe the world of reality in the form of scientific language or language theory.

2. Semantics

Here the theory connects the basic concepts of a theory to real objects. This relationship is stated in the form of appropriate rules or operational definitions. Semantics concerns the relationship of words, signs or symbols from reality so that the theory is easier to understand, realistic and meaningful. For example, the accounting equation Assets = Debt + Equity.

3. Pragmatic

Not all aspects of theory are pragmatic. Here the pragmatic relationship is related to the influence of words, symbols on humans. Accounting is considered to have the ability to influence people's behavior. Accounting theory is considered to be useful for decision makers so that accounting information must also be in accordance with the needs of these decision makers.

Theory must be able to formulate truth, so this theory must be constantly tested and verified. There are 3 criteria or parties or sources who have the authority to determine the truth.

a. Dogmatic

A statement or theory can be called true if the party who conveys it has the authority to and convey the truth and this does not need to be tested again. Belief in this truth is only based on one's belief, belief or faith. Sources of domain, for example, come from religious beliefs, someone's charisma, position, indoctrination, and so on. In accounting there are several institutions that are known for their authority in giving birth to accounting theory, for example AAA, FASB, IAI.

b. Self-evident

Here truth is proved by general knowledge, observation, experience. For example, it is stated that accounting uses the value of money or monetary measures. This statement doesn't need to be verified anymore because it has been proven by ourselves based on our knowledge, experience, and observations

c. Scientific

Here the truth is proved by a scientific method. Theories are formulated, tested, and repeated over and over again. This scientific method is very diverse and will be discussed in the following.

Several authors disagree with this description of the scientific process. Thomas Khun, for example, said that science operates by applying what he calls a paradigm, which can be defined as a basic framework for generating research questions. Scientists are less concerned with confirming or disproving theories; they are more concerned with whether they find theories more or less useful in provoking deep questions about the nature of our world. Theories are discarded when they are not useful and generate questions.

Normative vs Positive Accounting Theories

Accounting theory is sometimes confused with normative and positive terms Budiarto & Murtanto (1999) explained normative theory as “a theory that seeks to explain what information should be communicated to users of accounting information, and how that information will be presented”. So normative theory tries to explain what accountants should do (what ought to be) in the process of presenting financial information (what is) or why this happens.

On the other hand, the positive theory approach aims to describe and explain what and how financial information is presented and communicated to users of accounting information (Budiarto & Murtanto, 1999). In other words, the positive theory approach is not to provide advice on how accounting practice should be, but to explain why accounting practice has reached its current state. In addition, the positive theory approach emphasizes the importance of empirical research to test whether the accounting theory that has been put forward in many accounting theory literatures can explain the prevailing accounting practice.

Normative theory began to be questioned again for its relevance, especially in the mid-1960s with the emergence of the efficient market hypothesis which had a major influence on various accounting research, ideas began to appear that were contrary to the concept of normative theory, which stated that the capital market was not systematically misled by accounting methods or techniques. certain. Recognizing this gap, Watts & Zimmerman (1990) developed an approach rooted in positivism. It aims to explain the importance of empirical research to justify various accounting methods or practices that are currently applicable with a descriptive approach.

This positive approach is also expected to provide the basis for in-depth empirical research in the field of accounting theory. In its development, accounting research in the capital market closely follows the views of the positive theory approach. Empirical research that tests the truth of a theory is emphasized. According to the positive theory view, the theory that will survive is the theory that has been tested empirically and which can explain the reality that exists in the capital market.

Conclusion

This paper studies about the fundamentals of accounting and its theory. According to what found, it is the developing of economic activity which pushes the emergence of accounting. Accounting itself helps institutions, companies, even government to keep a good track of what goes in and what goes out. The activity of accounting at times requires further elaboration to help people understand what are done in the accounting process. Therefore, theories of accounting are created from thorough formulation process. Theories helps accountant to have consistent standards and determination of attitudes, functions and limitations of financial accounting and financial reporting. Though there are different kind of perspective in each theory, it is important to note that by applying the theories, accounting can be done reliably.

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