

**FINANCIAL ACCOUNTING THEORY**  
Craig Deegan

**CHAPTER 1**  
**Introduction to financial accounting theory**

Slides written by Craig Deegan

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**Introduction to CMA301/PRBA005**

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**CMA301/PRBA005 Assessment**

1. Article presentation	20%
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## We are studying financial accounting theory but... what is a theory?

- *A coherent set of hypothetical, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry* (Hendriksen 1970, p.1)
- *A scheme or system of ideas or statements held as an explanation or account of a group of facts or phenomena* (*The Oxford English Dictionary*)
- Based on logical (coherent) reasoning, and not *ad hoc* in nature
- Different to a 'hunch'

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## What is a theory? (cont.)

- A theory could be based on numerous observations (**inductive reasoning**) or developed on the basis of logic (**deductive reasoning**)
- Could be 'positive' or 'normative'
- Theories can help us make sense of the world in which we live and can provide a structure to understand our (social) experiences
- What makes a theory a 'good' theory?

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## What is a theory? (cont.)

Llewelyn (2003, p. 665) states that:

*Theories impose cohesion and stability. So that whenever 'life' is ambiguous (which is most of the time!) people will work at confronting this ambiguity through 'theorizing'. Also, because 'life' and situations commonly have multiple meanings and give rise to different assessments of significance, everyone has a need for 'theory' to go about their everyday affairs. 'Theories' do not just reside in libraries, waiting for academics to 'dust them down'; they are used whenever people address ambiguity, contradiction or paradox so that they can decide what to do (and think) next. Theories generate expectations about the world.*


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## Accounting theories

- Accounting is a human activity (if no humans then no 'accounting')
- It would seem illogical to study financial accounting (for example, the accounting standards) without also studying accounting theory
- Theories of accounting consider:
  - why particular accounting rules are mandated by regulators
  - people's behaviour with respect to accounting information
  - people's needs for accounting information
  - why people within organisations elect to supply particular information

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## Examples of uses of accounting theories

- Theories might:
  - prescribe how assets *should* be valued
  - *predict why* managers will choose particular accounting methods
  - *explain how* an individual's cultural background affects accounting information provided
  - *prescribe* what accounting information should be provided to particular classes of stakeholders
  - *predict* that the relative power of a stakeholder group will affect the accounting information it receives
  - *explain or predict* how accounting disclosures might be used as part of a strategy to legitimise the operations of an organisation

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## Why study accounting theories?

- Learning the rules of financial accounting without considering the implications of accounting information is not recommended
- Accounting plays a very important and pervasive role within society....and our theories help to explain why:
  - accountants are very powerful members of society!
- Studying theories of accounting enhances your ability to be a critical thinker and differentiates you from 'the average accountant'

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### Why study accounting theories? (cont.)

- Studying theories of accounting exposes students to various issues, including:
  - how elements of accounting *should* be measured
  - the motivations driving organisations to provide certain types of accounting information
  - the motivations driving individuals to support or lobby regulators for some accounting methods in preference to others
  - the implications for organisations and their stakeholders if one accounting method is chosen or mandated in preference to others
  - how and why the capital markets react to particular information
  - whether there is a 'true measure' of income

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### How can accounting theories help the accounting profession?

- Without a theoretically informed understanding it is difficult to:
  - evaluate the suitability of current accounting practices
  - develop improved accounting practices where current practices are unsuitable for changed business circumstances
  - defend the reputation of accounting when accounting practices are blamed for causing companies to fail (as has been the case with the global financial crisis)

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### Overview of theories of accounting

- Many theories of financial accounting exist
- No universally accepted theory of accounting
  - different perspectives about the central objective, role and scope of financial accounting
- No universally accepted perspective about the role of accounting theory
  - different researchers have different perspectives of the role of accounting theory (for example, to explain and predict practice versus prescribing particular practice)
  - a researcher's own values will influence which theory he or she elects to embrace

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## Early development of accounting theory

- Relied upon the process of induction
  - An inductive approach refers to the development of ideas or theories through observation of 'real world' phenomena
- 1920s to 1960s theories developed from observing what accountants did in practice
  - Common practices were codified as doctrines or conventions of accounting



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## Criticisms of inductive method

- *'... concentrates on the status quo, is reactionary in attitude and cannot provide a basis upon which current practice may be evaluated or from which future improvements may be deduced'* (Gray, Owen & Maunders 1987, p.66)
- Assumes what is done by the majority is the most appropriate practice
- Perspective of accounting Darwinism



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## Example of inductive approach to theory development

- Grady (1965) undertook research commissioned by the American Institute of Certified Public Accountants (AICPA)
- Formed the basis of APB Statement No. 4 'Basic Concepts and Accounting Principles Underlying the Financial Statements of Business Enterprises'
  - reflected generally accepted accounting principles at the time



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## Theory development— 1960s and 1970s

- There was a shift in research focus
- This period became known as the '*normative period*' of accounting research
- The normative research sought to *prescribe* particular accounting practices
  - known as normative theories (normative theories provide prescription)
- The research was not driven by existing practices, and hence not typically inductive in nature (that is, not based on observation)
- Rather, were *deductive in nature* and, based on logical argument, sought to develop new methods of accounting
- Theories were critical of historical cost accounting
- Sought to provide improved approaches to asset valuation in a time of widespread inflation

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## Example of prescriptive theory

- 1961 and 1962 studies by Moonitz, and Sprouse and Moonitz commissioned by the Accounting Research Division of the AICPA
- Authors proposed that accounting measurement systems be changed from historical cost to a system based on current values
- Such research should not be evaluated by reviewing current practice (indeed, there is a general rule that prescriptions about *what should be* should not be evaluated by reviewing observations of *what is*)
- Not supported by AICPA as too radically different from current practice

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## Normative theories

- Based on what the researcher believes *should occur* in particular circumstances
  - that is, they provide prescription and tell us what we *should do*
  - not developed simply on the basis of observing what people (accountants) currently do
- Example of normative theory
  - Continuously Contemporary Accounting (CoCoA) by Raymond Chambers
  - *Conceptual Framework of Accounting*
- Should not be evaluated on whether they reflect actual accounting practice – indeed the prescriptions might reflect radical departure from existing practices

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## Theory development—mid to late 1970s

- Another shift in research focus
- Research began to aim at **explaining and predicting** accounting practice rather than prescribing particular practices, and started to become popular
- Known as positive theories
- Contrast with normative theories

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## Positive theories

- Seek to predict and explain particular phenomena
- Begin with assumption(s), and through logical deduction enable prediction(s) to be made:
  - an assumption might be that all individuals are self-interested and are motivated by wealth maximisation
- If predictions are sufficiently accurate when tested against observations of reality, they are regarded as having provided an explanation of why things are as they are

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## Developing positive theories

- Researchers might firstly identify a number of key assumptions
  - for example, that individuals are driven by self-interest, that capital markets are efficient, and so forth
- Through logical argument, make predictions and/or provide explanations of actual phenomena based upon assumptions (deduction)
- Test the predictions/explanations through actual 'real world' observations
- Modify the theory, if necessary, based upon the real world observations

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## An example of a positive theory

- Positive Accounting Theory
  - is explored more fully in Chapter 7
  - was developed by Watts and Zimmerman
  - is a specific example of a positive theory of accounting
  - seeks to predict and explain why accountants elect to adopt particular accounting methods in preference to others
  - is based on 'rational economic person' assumption
    - individuals motivated by self-interest tied to wealth maximisation
    - challenges the view that accountants will be 'objective'



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## Evaluating theories of accounting

- As we should now understand, there are a multitude of accounting theories available
- Why or how would we select one theory in preference to another?
- Students should consider the merit of the argument and the research methods employed
- Some researchers may adopt strategies (such as overt condemnation of alternative theories) to support their own research and theoretical perspective
- Researchers that adopt a given 'paradigm' often challenge the views of people researching from a different paradigm
- A 'paradigm' can be described as an approach to knowledge advancement that adopts particular theoretical assumptions, research goals and research methods (Kuhn 1962).



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## Revolutionary scientific progress (Kuhn)

- Knowledge advances when one theory is replaced by another as particular researchers attack the credibility of an existing paradigm and advance an alternative
- Different researchers often embrace different (and conflicting) paradigms
- Possible explanation of why researchers try to denigrate the credibility of alternative theories
  - but no accounting theory has to date overthrown all other alternatives



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### Criticism of positive theories— an example

- Positive theories of accounting have been criticised for not providing prescription
- The decision not to provide prescription could alienate academic accountants from their counterparts within the profession

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### Criticism of normative theories— an example

- Normative theories have been criticised for lack of empirical observation
  - they are based on personal opinion about what *should happen*
  - positive theorists argue that they would prefer to provide information about expected implications of actions and let others decide themselves what they should do
  - positive theorists also make value judgements

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### Is the theory parsimonious?

- Another consideration when evaluating a theory is whether it is 'parsimonious'
- A parsimonious theory is one that provides the most 'logically economic' explanation for a particular phenomenon or event
- For example, if we were evaluating two alternative positive theories with relatively similar explanatory ability and the first theory utilised 4 independent variables and the second theory utilised 20 independent variables then we would tend to favour the first theory

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## Can we prove a theory?

- Can we expect that a theory of financial accounting (and hence, about people) can provide perfect predictions in all cases?
- A theory might not have perfect predictive capabilities, but still be useful
- Saying that we have proved a theory on the basis of observations ignores the fact that subsequent observations might not be in accordance with the theory

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## Can we prove a theory? (cont.)

- There is a group of theorists known as 'falsificationists'.
  - falsificationists believe that theory develops through trial and error and 'good' theory should generate hypotheses or predictions that have the potential to be rejected
  - rejection leads to refinement of theory
  - falsificationists would argue that a theory can never be proved, though it might be the 'best' available at a particular point in time
  - safer to say that our evidence supports a particular theory (rather than 'proves' a theory)



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## Evaluation of theories—the position taken in this book

- Theories of accounting are only abstractions of reality
- The choice of one theory in preference to another is based on value judgements
- Theories of accounting cannot be expected to provide perfect explanations or predictions of human behaviour or assess what types of information users actually need



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## Evaluating theories—logic and evidence

- When evaluating theories, you need to consider:
  - whether the argument supporting the theory is logical
  - whether you agree with the central assumptions of the theory
  - whether you accept any supporting evidence provided

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## Logical deduction

- Acceptance of an argument must be based on the accuracy of the premises
  - an argument is logical to the extent that if the premises on which it is based are true, then the conclusion will be true
- We do not need to refer to 'real world' observations to determine the logic of an argument
- However, although the argument might be logical, if it can be shown that a given premise is untrue then the conclusion or prediction may be rejected
- As an example, refer to the syllogism on p.19

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## The role of assumptions

- Even though an argument is logical we might only accept the argument if we accept any critical assumptions being made.
  - If we reject any central assumptions we may reject the prediction no matter how logical the theory might be
  - For example, Positive Accounting Theory (Watts and Zimmerman) is based on the central economics-based assumption that all individual action is motivated by self-interest tied to wealth maximisation. If we do not accept this central assumption then we would dismiss the explanations and predictions provided by the theory

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## The role of assumptions (cont.)

- As another example, in September 2010 the components of the revised *Conceptual Framework for Financial Reporting* were released in which it is stated that:  
*...the objective of general purpose financial reporting is to provide information about a reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers*
- If we were not to reject this central assumption then we would reject the new conceptual framework despite how logically developed it might be
- So, we must consider *both* the logic of the argument and the central assumptions made



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## Dishonest tricks in argument

- In evaluating theories we sometimes need to be aware of the 'dishonest tricks' some researchers use to support their research, or to denigrate the theories utilised by others
- Thouless (1974) identifies 38 dishonest tricks some writers use to support their argument including:
  - emotionally toned words
  - statements where 'all' is implied but 'some' is true
  - diversion to another question or to a side issue
  - use of speculative argument
  - prestige by false credentials
  - appeal to mere authority

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## Dishonest tricks in argument (cont.)

- We must be careful that our acceptance of a theory has not been 'coerced' through the use of colourful or emotive language



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## Overview of key factors that influence research

- From the material discussed in this chapter we can provide the following summarising points:
  - Different theories will generate different research questions, and require different research methods
    - For example, a positive theory of accounting will ask questions about when accountants will be likely to use particular accounting methods, and will empirically investigate actual practice to answer the questions
  - Theories will often be based on key assumptions that in turn are influenced by the 'values' of the researcher and how the researcher 'sees' the real world
    - Assumptions about individual behaviour and whether there is an 'objective reality' out there are referred to as ontological assumptions – which are assumptions about how we see the world

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## Overview of key factors that influence research (cont.)

- Therefore, we can summarise by saying that the ontological assumptions held by the researcher, their values and beliefs, the theory being used, the research questions to be addressed, and the research methods to be used are all highly inter-related.
  - For example, a researcher that does not believe in an 'objective reality' in which all people act in the same predictable manner will not do large scale empirical research utilising statistical testing with the objective of developing generalisable hypotheses
- These inter-relationships are reflected in Figure 1.1 on the following slide:

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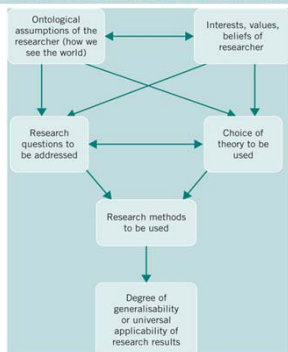
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Figure 1.1 The interdependence of various factors within the research process




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### Some concluding points

- You should now make sure you:
- understand some of the roles of accounting theory
  - can describe some of the different functions performed by different accounting theories
  - can explain why it is important to critically evaluate theories before accepting them
  - are able to explain why it is important that future accounting professionals have an understanding of accounting theory



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