

CHAPTER 1

INTRODUCTION TO FINANCIAL ACCOUNTING THEORY

LEARNING OBJECTIVES

On completing this chapter readers should:

- understand that there are many theories of financial accounting;
- understand how knowledge of different accounting theories increases our ability to understand and evaluate various alternative financial accounting practices;
- understand that the different theories of financial accounting are often developed to perform different functions, such as to *describe* accounting practice, or to *prescribe* particular accounting practices;
- understand that theories, including theories of accounting, are developed as a result of applying various value judgements and that acceptance of one theory in preference to others will in part be tied to one's own value judgements;
- be aware that we should critically evaluate theories (in terms of such things as the underlying logic, assumptions made and evidence produced) before accepting them;
- understand why students of accounting should study accounting theories as part of their broader accounting education.

OPENING ISSUES

At the beginning of each chapter a number of issues or problems are raised that relate to the material covered. On completion of the chapter you should be able to supply answers to the problems. In this introductory chapter, some of the issues that are considered are as follows:

1. Why do students of financial accounting need to bother with the study of 'theories'? Why not just study some more of the numerous accounting standards (and there are certainly plenty of them!) or other pronouncements of the accounting profession?
2. Why would (or perhaps 'should') accounting practitioners and accounting regulators consider various theories of accounting?
3. Do all 'theories of accounting' seek to fulfil the same role, and, if there are alternative theories to explain or guide particular practice, how does somebody select one theory in preference to another?

No specific answers are provided for each chapter's opening issues. Rather, as a result of reading the respective chapters, readers should be able to provide their own answers to the particular issues. You might like to consider providing an answer to the opening issues before reading the material provided in the chapters, and then, on completing the chapter, revisit the opening issues and see whether your opinions have changed as a result of being exposed to particular points of view.

WHAT IS A THEORY?

In this book we consider various theories of financial accounting. Perhaps, therefore, we should start by considering what we mean by a ‘theory’. There are various perspectives of what constitutes a theory. The *Oxford English Dictionary* provides various definitions, including:

A scheme or system of ideas or statements held as an explanation or account of a group of facts or phenomena.

The *Macquarie Dictionary* provides the following definition of a theory:

A coherent group of general propositions used as principles of explanation for a class of phenomena.

The accounting researcher Hendriksen (1970, p. 1) defines a theory as:

A coherent set of hypothetical, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry.

The definition provided by Hendriksen is very similar to the US Financial Accounting Standards Board’s definition of its Conceptual Framework Project (which in itself is deemed to be a *normative* theory of accounting), which is defined as ‘a coherent system of interrelated objectives and fundamentals that can lead to consistent standards’ (FASB, 1976). The use of the word ‘coherent’ in three of the above four definitions of theory is interesting and reflects a view that the components of a theory (perhaps including assumptions about human behaviour) should logically combine together to provide an explanation or guidance in respect of certain phenomena. The definitions are consistent with a perspective that theories are not *ad hoc* in nature and should be based on logical (systematic and coherent) reasoning. Therefore, when we talk about a ‘theory’ we are talking about much more than simply an idea or a ‘hunch’, which we acknowledge is different from how the term ‘theory’ is used in some contexts (for instance, we often hear people say they have a ‘theory’ about why something might have occurred when they really mean they have a ‘hunch’). As will be seen in this book, some accounting theories are developed on the basis of past observations (empirically based) of which some are further developed to make predictions about likely occurrences (and sometimes also to provide explanations of why the events occur). That is, particular theories may be generated and subsequently supported by undertaking numerous observations of the actual phenomena in question. Such empirically based theories are said to be based on inductive reasoning and are often labelled ‘scientific’, as, like many theories in the ‘sciences’, they are based on observation. Alternatively, other accounting theories that we also consider do not seek to provide explanations or predictions of particular phenomena but, rather, *prescribe* what *should* be done (as opposed to describing or predicting what is done) in particular circumstances. Llewelyn (2003) points out that the term ‘theory’ in accounting not only applies to ‘grand theories’ that seek to tell us about broad generalisable issues (like the theory of gravity in physics) but also applies to any framework that helps us make sense of aspects of the (social) world in which we live, and that helps provide a structure to understand our (social) experiences. We stress that different theories of accounting often have different

objectives. Llewelyn provides some interesting views about what constitutes theory. She states (2003, p. 665) that:

Theories impose cohesion and stability (Czarniawska, 1997, p. 71). 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.

Because accounting is a human activity (you cannot have 'accounting' without accountants), theories of financial accounting (and there are many) will consider such things as people's behaviour and/or people's needs as regards financial accounting information, or the reasons why people within organisations might elect to supply particular information to particular stakeholder groups. For example, this book considers, among others, theories that:

- *prescribe* how, based on a particular perspective of the role of accounting, assets should be valued for external reporting purposes (such prescriptive or normative theories are considered in Chapters 5 and 6);
- *predict* that managers paid bonuses on the basis of measures such as profits will seek to adopt those accounting methods that lead to an increase in reported profits (such descriptive or positive theories are considered in Chapter 7);
- seek to *explain* how an individual's cultural background will impact on the types of accounting information that the individual seeks to provide to people outside the organisation (such a theory is considered in Chapter 4);
- *prescribe* the accounting information that should be provided to particular classes of stakeholders on the basis of their perceived information needs (such theories are often referred to as decision usefulness theories, and are discussed in Chapter 5);
- *predict* that the relative power of a particular stakeholder group (with 'power' often being defined in terms of the group's control over scarce resources) will determine whether that group receives the accounting information it desires (which derives from a branch of Stakeholder Theory, which is discussed in Chapter 8);
- predict that organisations seek to be perceived by the community as legitimate and that accounting information can be used by the organisation as a means of gaining, maintaining or regaining legitimacy (which derives from Legitimacy Theory, considered in Chapter 8).

WHY IT IS IMPORTANT FOR ACCOUNTING STUDENTS TO STUDY ACCOUNTING THEORY

As a student of financial accounting you will be required to learn how to construct and read financial statements prepared in conformity with various accounting standards and other professional and statutory requirements. In your working life (whether or not you choose to

specialise in accounting) you could be involved in such activities as analysing financial statements for the purposes of making particular decisions, compiling financial statements for others to read, or generating accounting guidance or rules for others to follow. The better you understand the accounting practices underlying these various activities, the more effective you are likely to be in performing these activities—and therefore the better equipped you are likely to be to succeed in your chosen career.

Given that accounting theories aim to provide a coherent and systematic framework for investigating, understanding and/or developing various accounting practices, the evaluation of individual accounting practices is likely to be much more effective if the person evaluating these practices has a thorough grasp of accounting theory. Although all students of accounting (like students in any subject) should be interested in critically evaluating the phenomena they are studying, we recognise that, in the past, many students have been content with simply learning how to apply various accounting practices without questioning the basis of these practices.

However, in the wake of a growing number of high-profile accounting failures (such as Enron and WorldCom in the United States, and ABC Learning, Fincorp, HIH Insurance, One.Tel and Harris Scarf within Australia), it has arguably never been more important for accountants to understand thoroughly and be able to critique the accounting practices that they use. Without such a theoretically informed understanding, it is difficult to evaluate the suitability of current accounting practices, to develop improved accounting practices where current practices are unsuitable for changed business situations, and to defend the reputation of accounting where accounting practices are wrongly blamed for causing companies to fail. This is a key reason why it is important for you to study and understand accounting theories.

As a result of studying various theories of financial accounting in this book, you will be exposed to various issues, including:

- how the various elements of accounting should be measured;
- what motivates managers to provide certain types of accounting information;
- what motivates managers to select particular accounting methods in preference to others;
- what motivates individuals to support and perhaps lobby regulators for some accounting methods in preference to others;
- what the implications for particular types of organisations and their stakeholders are if one method of accounting is chosen or mandated in preference to other methods;
- how and why the capital markets react to particular accounting information;
- whether there is a ‘true measure’ of income.

Accounting plays a very important and pervasive role within society. Simply to learn the various rules of financial accounting (as embodied within accounting standards, conceptual frameworks and the like) without considering the implications that accounting information can have would seem illogical and, following the high-profile accounting failures at Enron and other organisations, potentially dangerous. Many significant decisions are made on the basis of information that accountants provide (or in some circumstances, elect not to provide), so accountants are often regarded as being very powerful and influential people. The information generated by accountants enables others to make important decisions. For example: Should they support the organisation? Is the organisation earning sufficient ‘profits’? Is it earning excessive ‘profits’? Is the organisation fulfilling its social responsibilities by investing in community support programs and environmentally responsible production technologies and, if so, how much?

In considering profits, is profitability a valid measure of organisational success? Further, if the accountant/accounting profession emphasises particular attributes of organisational performance (for example, profitability) does this in turn impact on what society perceives as being the legitimate goals of business?¹ As a result of considering various theories of financial accounting, this book provides some answers to these important issues.

At a broader level, an understanding of accounting theories can be crucial to the reputation and future of the accounting profession. Unerman and O'Dwyer (2004) have argued that the recent rise in high-profile accounting failures has raised the level of awareness among non-accountants of some of the significant impacts that accounting has on their lives. These events have also led to a substantial reduction in the level of trust that many non-accountants place in financial accounts and in accountants. If this trust is to be rebuilt, along with the reputation of accountants, it is now more crucial than ever that we develop the capacity to critically evaluate accounting practices and to refine these practices as the business environment rapidly changes. The insights from a varied range of accounting theories are essential to this process of continual improvement in financial accounting practices.

A BRIEF OVERVIEW OF THEORIES OF ACCOUNTING

There are many theories of financial accounting. That is, there is no universally accepted theory of financial accounting or, indeed, any universally agreed perspective of how accounting theories should be developed. In part this is because different researchers have different perspectives of the role of accounting theory and/or what the central objective, role and scope of financial accounting should be. For example, some researchers believe that the principal role of accounting theory should be to *explain* and *predict* particular accounting-related phenomena (for example, to explain why some accountants adopt one particular accounting method while others elect to adopt an alternative approach), whereas other researchers believe that the role of accounting theory is to *prescribe* (as opposed to *describe*) particular approaches to accounting (for example, based on a perspective of the role of accounting, there is a theory that prescribes that assets *should* be valued on the basis of market values rather than historical costs).

Early development of accounting theory relied on the process of induction, that is, the development of ideas or theories through observation. According to Chalmers (1982, p. 4), there are three general conditions that would ideally exist before theory could be developed through observation:

1. The number of observations forming the basis of a generalisation must be large.
2. The observations must be repeated under a wide variety of conditions.
3. No accepted observation should conflict with the derived universal law.

¹ Chapters 2 and 3 consider some research (for example, Hines, 1988) that suggests that accountants and accounting do not necessarily provide an unbiased account of reality, but rather create reality. If the accounting profession emphasises a measure (such as profitability) as being a measure of success and legitimacy, then, in turn, profitable companies will be considered successful and legitimate. If something other than profitability had been supported as a valid measure, then this may not have been the case.

From approximately the 1920s to the 1960s, theories of accounting were predominantly developed on the basis of observation of what accountants actually did in practice. That is, they were developed by the process referred to as ‘induction’. This can be contrasted with a process wherein theories are developed by deductive reasoning, which is based more on the use of logic rather than observation.²

Returning to the use of observation to develop generalisable theories (inductive reasoning), after observing what accountants did in practice, common practices were then codified in the form of doctrines or conventions of accounting (for example, the doctrine of conservatism). Notable theorists at this time included Paton (1922), Hatfield (1927), Paton and Littleton (1940) and Canning (1929). Henderson, Peirson and Harris (2004, p. 54) describe the approaches adopted by these theorists as follows:

Careful observation of accounting practice revealed patterns of consistent behaviour. For example, it could be observed that accountants tended to be very prudent in measuring both revenues and expenses. Where judgement was necessary it was observed that accountants usually underestimated revenues and overstated expenses. The result was a conservative measure of profit. Similarly, it could be observed that accountants behaved as if the value of money, which was the unit of account, remained constant. These observations of accounting practice led to the formulation of a number of hypotheses such as ‘that where judgement is needed, a conservative procedure is adopted’ and ‘that it is assumed that the value of money remains constant’. These hypotheses were confirmed by many observations of the behaviour of accountants.

While there was a general shift towards prescriptive research in the 1960s, some research of an inductive nature still occurs. Research based on the inductive approach (that is, research based on observing particular phenomena) has been subject to many criticisms. For example, Gray, Owen and Maunders (1987, p. 66) state:

Studying extant practice is a study of ‘what is’ and, by definition, does not study ‘what is not’ or ‘what should be’. It therefore 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.

In generating theories of accounting based on what accountants actually do, it is assumed (often implicitly) that what is done by the majority of accountants is the most appropriate practice. In adopting such a perspective there is, in a sense, a perspective of *accounting Darwinism*—a view that accounting practice has evolved, and the fittest, or perhaps ‘best’, practices have survived. Prescriptions or advice are provided to others on the basis of what most accountants do, the ‘logic’ being that the majority of accountants must be doing the most appropriate thing. What do you think of the logic of such an argument?

² Chapter 5 considers various theories of accounting that were developed to deal with problems that arise in times of rising prices—for example, when there is inflation. Such theories include one developed by a famous accounting researcher named Raymond Chambers. His theory of accounting, known as Continuously Contemporary Accounting, was developed based on the basis of a number of logical assumptions about what types of information the readers of financial accounting reports needed. His theory was not based on observing what accountants do (which would be inductive reasoning); rather, his theory was based on what he thought they *should* do; and using various key assumptions about people’s information needs, he derived his theory through deductive (logical) reasoning. His proposals for accounting represented radical departures from what accountants were actually doing in practice.

As a specific example of this inductive approach to theory development we can consider the work of Grady (1965). His research was commissioned by the American Institute of Certified Public Accountants (AICPA) and was undertaken at a time when there was a great deal of prescriptive (as opposed to descriptive) research being undertaken. Interestingly, in 1961 and 1962 the Accounting Research Division of the AICPA had already commissioned prescriptive studies by Moonitz (1961) and Sprouse and Moonitz (1962) which proposed that accounting measurement systems be changed from historical cost to a system based on current values. However, before the release of these research works, the AICPA released a statement saying that 'while these studies are a valuable contribution to accounting principles, they are too radically different from generally accepted principles for acceptance at this time' (Statement by the Accounting Principles Board, AICPA, April 1962).

History shows that rarely have regulatory bodies accepted suggestions (or, as some people call them, *prescriptions*) for significant changes to accounting practice. This is an interesting issue which is considered more fully in Chapter 6 when conceptual framework projects are discussed. However, it is useful to consider at this point a statement made in the United States by Miller and Reading (1986, p. 64):

The mere discovery of a problem is not sufficient to assure that the FASB will undertake its solution ... There must be a suitably high likelihood that the Board can resolve the issues in a manner that will be acceptable to the constituency—without some prior sense of the likelihood that the Board members will be able to reach a consensus, it is generally not advisable to undertake a formal project.

Grady's (1965) work formed the basis of APB Statement No. 4, 'Basic Concepts and Accounting Principles Underlying the Financial Statements of Business Enterprises'. In effect, APB Statement No. 4 simply reflected the generally accepted accounting principles of the time. That is, the research was inductive in nature (as it was based on observation) and did not seek to evaluate the logic or merit of the accounting practices being used. It was therefore not controversial and had a high probability of being acceptable to the AICPA's constituency (Miller & Reading, 1986).

While some accounting researchers continued to adopt an inductive approach, a different approach became popular in the 1960s and 1970s. This approach sought to *prescribe* particular accounting procedures, and as such was not driven by existing practices. The period of the 1960s and 1970s is commonly referred to as the 'normative period' of accounting research. That is, in this period the financial accounting theories were not developed by observing what accountants were doing; many of the theories being developed at this time were based on the development of arguments about what the researchers considered accountants *should* do. Rather than being developed on the basis of inductive reasoning, these theories were being developed on the basis of deductive reasoning. At this time there tended to be widespread inflation throughout various countries of the world and much of the research and the related theories sought to explain the limitations of historical cost accounting and to provide improved approaches (based on particular value judgements held by the researchers) for asset measurement in times of rapidly rising prices. However, while a number of highly respected researchers were arguing that measuring assets on the basis of historical cost was inappropriate and tended to provide misleading information, particularly in times of rising prices, there was a lack of agreement between the various researchers about what particular asset measurement basis should be used.

For example, some argued that assets should be valued at replacement costs, some argued that assets should be valued at net realisable value, and others argued for measurements based on present values. Throughout this debate there was no clear choice in terms of which approach was best, and, perhaps because it was difficult to resolve the differences in opinions provided by the various normative researchers, the historical cost approach to accounting continued to be used.

In the mid to late 1970s there were further changes in the focus of accounting research and theory development. At this time a great deal of accounting research had the major aim of *explaining* and *predicting* accounting practice, rather than *prescribing* particular approaches. This was another movement by many accounting researchers away from descriptive research—this time towards predictive research. Nevertheless, there are many researchers who still undertake descriptive research. What is being emphasised is that a variety of accounting theories have been developed across time; for example, some are descriptive in nature, some attempt to explain and predict particular aspects of financial accounting practice, and others generate guidance about what accountants should do. Different theories serve different purposes.

In reading accounting research you will see that much research is labelled either *positive research* or *normative research*. Research that seeks to predict and explain particular phenomena (as opposed to prescribing particular activity) is classified as positive research and the associated theories are referred to as *positive theories*. Henderson, Peirson and Harris (2004, p. 414) provide a useful description of positive theories. They state:

A positive theory begins with some assumption(s) and, through logical deduction, enables some prediction(s) to be made about the way things will be. If the prediction is sufficiently accurate when tested against observations of reality, then the story is regarded as having provided an explanation of why things are as they are. For example, in climatology, a positive theory of rainfall may yield a prediction that, if certain conditions are met, then heavy rainfall will be observed. In economics, a positive theory of prices may yield a prediction that, if certain conditions are met, then rapidly rising prices will be observed. Similarly, a positive theory of accounting may yield a prediction that, if certain conditions are met, then particular accounting practices will be observed.

As noted above, positive theories can initially be developed through some form of deductive (logical) reasoning. Their success in explaining or predicting particular phenomena will then typically be assessed based on observation—that is, observing how the theory's predictions corresponded with the observed facts.³ Empirically (observation) based theories can continue to be tested and perhaps refined through further observation, perhaps in different institutional or geographical settings, and a great deal of published research is undertaken to see if particular results can be replicated in different settings, thereby increasing the generalisability of the theory in question. Apart from providing the basis for predicting future actions or effects, positive accounting research often goes to the next step of attempting to provide explanations for the phenomena in question.

³ Again, it is stressed that not all theories will be assessed in terms of how the theory's predictions match actual behaviour. Normative theories, for example, might provide prescriptions about how accounting should be undertaken, and such prescriptions might represent significant departures from current practice. These theories, which may be developed through logical deduction, should not be evaluated by observing the theories' correspondence with current behaviours of accountants.



Chapter 7 considers a positive theory of accounting principally developed by Watts and Zimmerman (relying on the works of other researchers, such as Jensen and Meckling (1976) and Gordon (1964)). Their positive theory of accounting, which they called *Positive Accounting Theory*, seeks to predict and explain why managers (and/or accountants) elect to adopt particular accounting methods in preference to others.⁴

Chapter 7 demonstrates that the development of Positive Accounting Theory relied in great part on work undertaken in the field of economics, and central to the development of the theory was the acceptance of the economics-based ‘rational economic person assumption’. That is, an assumption was made that accountants (and, in fact, all individuals) are primarily motivated by self-interest (tied to wealth maximisation), and that the particular accounting method selected (where alternatives are available) will be dependent on certain considerations, such as:

- whether the person supporting the use of a particular accounting method, for example a manager or an accountant, is rewarded in terms of accounting-based bonus systems (for example, whether they receive a bonus tied to reported profits);
- whether the organisation they work for is close to breaching negotiated accounting-based debt covenants (such as a debt-to-asset constraint);
- whether the organisation that employs them is subject to political scrutiny from various external groups, such as government, employee groups or environmental groups (with that scrutiny being focused on the organisation’s reported profits).

The assumption of self-interest, as embraced by researchers that use Positive Accounting Theory, challenges the view that accountants will predominantly be objective when determining which accounting methods should be used to record particular transactions and events (objectivity is a qualitative characteristic promoted within various conceptual frameworks of accounting, as will be seen in Chapter 6).⁵

Positive theories of accounting do not seek to tell us that what is being done in practice is the most efficient or equitable process. For example, while we have a (positive) theory of accounting, developed to predict which accounting methods most accountants will use in particular circumstances (Positive Accounting Theory), this theory will not tell us what we should do (it is not a ‘prescriptive’ theory), nor will it tell us anything about the efficiency of what is being done. As Watts and Zimmerman (1986, p. 7) state:

It [Positive Accounting Theory] is concerned with explaining [accounting] practice. It is designed to explain and predict which firms will and which firms will not use a particular [accounting method] ... but it says nothing as to which method a firm should use.

⁴ It should be noted at this point that Positive Accounting Theory is one of several positive theories of accounting (other positive theories that relate to accounting include Legitimacy Theory, Institutional Theory and certain branches of Stakeholder Theory). This book uses lower case when referring to the general class of theories that attempt to explain and predict accounting practice (that is, ‘positive theories of accounting’) and refers to Watts and Zimmerman’s positive theory of accounting as ‘Positive Accounting Theory’ (that is, it uses upper case).

⁵ As emphasised throughout this book, researchers make a choice between the theories they will apply in particular circumstances. In part, the choice of theory will be influenced by the researcher’s own beliefs and values. For example, many accounting researchers will not use Positive Accounting Theory to explain particular phenomena because they reject the central assumption made within the theory that all individual action is best described on the basis that individuals are driven by self-interest. For example, Gray, Owen and Adams (1996, p. 75) reject Positive Accounting Theory because it portrays ‘a morally bankrupt view of the world’. We will return to Gray, Owen and Adams’ dismissal of this theory later in the chapter.



As will be seen shortly, the practice of electing not to advise others as to what should be done in particular circumstances has been the subject of criticism of positive accounting research.

While positive theories tend to be based on empirical observation, there are other theories that are based not on observation but on what the researcher believes *should* occur in particular circumstances. For example, Chapter 5 discusses a theory of accounting developed by Raymond Chambers. His theory of accounting, called *Continuously Contemporary Accounting*, describes how financial accounting *should* be undertaken. That is, his theory is prescriptive. Central to his theory is a view that the most useful information about an organisation's assets for the purposes of economic decision making is information about their 'current cash equivalents'—a measure tied to their current net market values. As such, it prescribes that assets should be valued on the basis of their net market values. Theories that prescribe (as opposed to describe) particular actions are called 'normative theories', as they are based on the norms (or values or beliefs) held by the researchers proposing the theories (they are also often referred to as 'prescriptive theories'). The dichotomy of positive and normative theories is one often used to categorise accounting theories and this dichotomy is adopted throughout this book.

As noted above, normative theories of accounting are not necessarily based on observation and therefore cannot (or should not) be evaluated on the basis of whether the theories reflect actual accounting practice. In fact they may suggest radical changes to current practice. For example, for a number of decades Chambers had been advocating the valuation of assets on a basis related to their net market values—a prescription that challenged the widespread use of historical cost accounting (it is interesting to note, however, that in recent years the use of market values for asset valuation has gained popularity with the International Accounting Standards Board). Other researchers concerned about the social and environmental implications of business (see, for example, Gray and Bebbington, 2001; Gray, Owen and Adams, 1996; Mathews, 1993) have developed theories that prescribe significant changes to traditional financial accounting practice (Chapters 9 and 10 of this book consider such theories). The conceptual framework of accounting that is discussed in Chapter 6 is an example of a normative theory of accounting. Relying on various assumptions about the types or attributes of information useful for decision making, the conceptual framework of accounting (within Australia, this is referred to as the *Framework for the Preparation and Presentation of Financial Statements*, which is based on the conceptual framework developed by the International Accounting Standards Board) provides guidance on how assets, liabilities, expenses, income and equity should be defined, when they should be recognised, and ultimately how they should be measured. As will be seen in later chapters, normative theories can be further subdivided. For example, some normative theories can be classified as 'true income theories' and other theories as 'decision usefulness theories'. The true income theories make certain assumptions about the role of accounting and then seek to provide a single 'best measure' of profits (for example, see Lee, 1974).⁶

Decision usefulness theories ascribe a particular type of information for particular classes of users on the basis of assumed decision-making needs. According to Bebbington, Gray and Laughlin (2001, p. 418), the decision usefulness approach can be considered to have two branches, the *decision-makers emphasis* and the *decision-models emphasis*. The decision-makers

6 Much of the work undertaken in developing 'true income theories' relies on the work of Hicks (1946). Hicks defined 'income' as the maximum amount that can be consumed by a person or an organisation in a particular period without depleting the wealth that existed for that person or organisation at the start of the period.

emphasis relies on undertaking research that seeks to ask the users of the information what information they want.⁷ Once that is determined, this knowledge is used to prescribe what information should be supplied to the users of financial statements. Much of this research is questionnaire-based. This branch of research tends to be fairly disjointed, as different studies typically address different types of information, with limited linkages between them.

Another variant of the decision-makers emphasis, which is explored in Chapter 11, is security price research. Briefly, security price research works on the assumption that if the capital market responds to information (as evidenced through share price changes that occur around the time of the release of particular information) the information must be useful.⁸ This forms the basis for subsequent prescriptions about the types of information that should be provided to users of financial statements. It also has been used to determine whether particular mandatory reporting requirements (such as the introduction of new accounting standards) were necessary or effective, the rationale being that, if a new accounting standard does not evoke a market reaction, it is questionable whether the new requirement is useful or necessary in providing information to the stock market or investors. Research that evaluates information on the basis of whether it evokes a market reaction, or whether stakeholders indicate that it is useful to them, ignores the possibility that there could be information that is 'better' than that provided or sought. There is also the broader philosophical issue of whether the information they 'want' is actually what they 'need'. These broader issues are explored throughout this book.

On the other hand, proponents of the decision-models emphasis develop models based on the researchers' perceptions of what is necessary for efficient decision making. Information prescriptions follow (for example that information should be provided about the market value of the reporting entity's assets). This branch of research typically assumes that classes of stakeholders have identical information needs. Unlike the decision-makers emphasis, the decision-models emphasis does not ask the decision makers what information they want; instead, it concentrates on the types of information considered useful for decision making. As Wolk and Tearney (1997, p. 39) indicate, a premise underlying this research is that decision makers may need to be taught how to use this information if they are unfamiliar with it.

EVALUATING THEORIES OF ACCOUNTING

In the process of studying accounting, students will typically be exposed to numerous theories of accounting, and the accompanying research and argument that attempts to either support or reject the particular theories in question. In undertaking this study, students should consider the merit of the argument and the research methods employed by respective researchers. What students often find interesting is that many researchers seem to adopt one theory of accounting and thereafter adopt various strategies (including overt condemnation of alternative theories) in

⁷ For example, in recent years a number of research studies have asked a number of different stakeholder groups what types of social and environmental performance information the stakeholders considered to be useful for their various decision-making processes.

⁸ Based on the Efficient Markets Hypothesis, which predicts that the stock market instantaneously reacts, through price adjustments (changes), to all relevant publicly available information.

an endeavour to support their own research and theoretical perspective. In some respects, the attitudes of some researchers are akin to those of the disciples of particular religions. (In fact, Chambers (1993) refers to advocates of Positive Accounting Theory as belonging to the 'PA Cult'.) Deegan (1997) provides a series of quotes from the works of various high-profile researchers who are opposed to Watts and Zimmerman's Positive Accounting Theory. In providing arguments against the contribution or validity of Positive Accounting Theory, the opponents used such terms and descriptions as:

- It is a dead philosophical movement (Christenson, 1983, p. 7).
- It has provided no accomplishments (Sterling, 1990, p. 97).
- It is marred by oversights, inconsistencies and paradoxes (Chambers, 1993, p. 1).
- It is imperiously dictatorial (Sterling, 1990, p. 121).
- It is empty and commonplace (Sterling, 1990, p. 130).
- It is akin to a cottage industry (Sterling, 1990, p. 132).
- It is responsible for turning back the clock of research 1000 years (Chambers, 1993, p. 22).
- It suffers from logical incoherence (Williams, 1989, p. 459).
- It is a wasted effort (Sterling, 1990, p. 132).

These criticisms indicate the degree of emotion that a particular theory has stimulated among its critics, particularly those accounting researchers who see the role of accounting theory as providing prescription rather than description. Students of financial accounting theory will find it interesting to ponder why some people are so angered by such a theory—after all, it is just a theory (isn't it?). Many proponents of Positive Accounting Theory have also tended to be very critical of normative theorists.

The Positive Accounting theorists and the normative theorists would be considered to be working from different 'paradigms'—paradigms that provided greatly different perspectives about the role of accounting research. According to Hussey and Hussey (1997, p. 47):

The term **paradigm** refers to the progress of scientific practice based on people's philosophies and assumptions about the world and the nature of knowledge; in this context, about how research should be conducted. Paradigms are universally recognised scientific achievements that for a time provide model problems and solutions to a community of practitioners. They offer a framework comprising an accepted set of theories, methods and ways of defining data ... Your basic beliefs about the world will be reflected in the way you design your research, how you collect and analyse your data, and even the way in which you write your thesis.

Hussey and Hussey's discussion about 'paradigms' is consistent with Kuhn (1962), who states that a paradigm can be defined as an approach to knowledge advancement that adopts particular theoretical assumptions, research goals and research methods.⁹

In explaining or describing why a certain 'camp' of researchers might try to denigrate the credibility of alternative research paradigms, it is relevant to consider one of the various views about how knowledge advances. Kuhn (1962) explained how knowledge, or science,

⁹ A similar definition of a paradigm is provided by Wolk and Tearney (1997, p. 47). They define a paradigm as a shared problem-solving view among members of a science or discipline.

develops: scientific progress is not evolutionary but revolutionary. His view is that knowledge advances when one theory is replaced by another as particular researchers attack the credibility of an existing paradigm and advance an alternative, promoted as being superior, thereby potentially bringing the existing paradigm into 'crisis'. As knowledge develops, the new paradigm may be replaced by a further research perspective, or a prior paradigm may be resurrected. In discussing the process of how researchers switch from one research perspective (or paradigm) to another, Kuhn likens it to one of 'religious conversion'.¹⁰ While the perspective provided by Kuhn does appear to have some relevance to explaining developments in the advancement of accounting theory, so far no accounting theory has ever been successful in overthrowing all other alternatives. There have been, and no doubt will continue to be, advocates of various alternative theories of accounting, many of which are discussed in this book.

Returning to our brief review of financial accounting theories, we have stated previously that positive theories of accounting do not seek to prescribe particular accounting practices (that is, they do not tell us which accounting practices we should adopt). Some critics of this positive theoretical perspective have argued that the decision not to prescribe could alienate academic accountants from their counterparts within the profession. As Howieson (1996, p. 31) states:

... an unwillingness to tackle policy issues is arguably an abrogation of academics' duty to serve the community which supports them. Among other activities, practitioners are concerned on a day-to-day basis with the question of which accounting policies they should choose. Traditionally, academics have acted as commentators and reformers on such normative issues. By concentrating on positive questions, they risk neglecting one of their important roles in the community.

Counter to this view, many proponents of Positive Accounting Theory have, at different times, tried to undermine normative research because it was not based on observation but on personal opinion about what *should* happen. (Observation-based research was deemed by them to be 'scientific', and 'scientific research' was considered to be akin to 'good research'.) Positive Accounting theorists often argue that in undertaking research they do not want to impose their own views on others as this is 'unscientific'; rather, they prefer to provide information about the expected implications of particular actions (for example the selection of a particular accounting method) and thereafter let people decide for themselves what they should do (for example, they may provide evidence to support a prediction that organisations that are close to breaching accounting-based debt covenants will adopt accounting methods that increase the firm's reported profits and assets thereby 'loosening' the effects of the accounting-based debt covenants).

However, as a number of accounting academics have quite rightly pointed out, and as should be remembered when reading this book, selecting a theory to adopt for research (such as Public Interest Theory, Capture Theory, Legitimacy Theory, Stakeholder Theory or Positive Accounting Theory) is based on a value judgement; what to research is based on a value judgement; believing that all individual action is driven by self-interest (as the Positive Accounting Theorists do) is a

¹⁰ Kuhn's 'revolutionary' perspective about the development of knowledge is in itself a theory and, as with financial accounting theories, there are alternative views of how knowledge develops and advances. Although a review of the various perspectives of the development of science is beyond the scope of this book, interested readers are referred to Popper (1959), Lakatos and Musgrove (1974), Feyerabend (1975) and Chalmers (1982).

value judgement; and so on. Hence, no research, whether using Positive Accounting Theory or otherwise, is value free and it would arguably be quite wrong to assert that it is value free. As Gray, Owen and Maunders (1987, p. 66) state:

In common with all forms of empirical investigation we must recognise that all perception is theory-laden. That is, our preconceptions about the world significantly colour what we observe and which aspects of particular events we focus upon. Thus accountants are more likely to view the world through accounting frameworks and conventions.

Watts and Zimmerman (1990, p. 146) did modify their original stance in relation to the objectivity of their research and conceded that value judgements do play a part in positive research just as they do in normative research. They stated:

Positive theories are value laden. Tinker et al. (1982, p. 167) argue that all research is value laden and not socially neutral. Specifically, 'Realism operating in the clothes of positive theory claims theoretical supremacy because it is born of fact, not values' (p. 172). We concede the importance of values in determining research: both the researcher's and user's preferences affect the process.

Competition among theories to meet users' demand constrains the extent to which researcher values influence research design. Positive theories are 'If ... then' propositions that are both predictive and explanatory. Researchers choose the topics to investigate, the methods to use, and the assumptions to make. Researchers' preferences and expected pay-offs (publications and citations) affect the choice of topics, methods and assumptions. In this sense, all research, including positive research, is 'value laden'.

The position taken in this book is that theories of accounting, of necessity, are abstractions of reality, and the choice of one theory in preference to another is based on particular value judgements. Some of us may prefer particular theories in preference to others because they more closely reflect how we believe people do, or should, act. We cannot really expect to provide perfect explanations or predictions of human behaviour, nor can we expect to assess perfectly what types of information the users of financial statements actually need—my perceptions of information needs will probably be different from your views about information needs. There is a role for prescription if it is based on logical argument, and there is a role for research that provides predictions if the research methods employed to provide the predictions are assessed as valid.

CAN WE PROVE A THEORY?

This book does not intend to provide an in-depth insight into the development of scientific thought, but one interesting issue that often arises with students is whether a theory can actually be 'proved'. In this book various theories are considered, a number of which provide alternative explanations for the same events. The next section of this chapter considers how to evaluate a theory in terms of logic and evidence, but before this we should perhaps look at the issue of whether we can prove a theory.

One's view about whether we can prove a theory as correct depends on how one views the development of scientific thought. When it comes to accounting theories—which might, for example, consider how people react to particular accounting numbers, or might consider why accountants would choose particular accounting methods in preference to others—we need again to appreciate that financial accounting is a human activity (we cannot have accounting without accountants) and that common sense would dictate that not all people will react in a similar way to accounting numbers. Hence, logic might indicate that a theory of financial accounting (and therefore a theory that describes human behaviour in relation to accounting numbers) would not provide perfect predictions of behaviour in all cases (and in this explanation we are talking about positive theories—theories that seek to explain and predict particular phenomena).

If the theories of financial accounting were developed to explain and predict people's actions and reactions to financial accounting information (that is, they are positive theories), we might consider that if a theory provides sound predictions the majority of the time then the theory is still of use, albeit that its predictions are not 'perfect'. That is, we would evaluate it on the basis of the correspondence between the prediction of behaviours provided by the theory and the subsequent behaviour, and we might accept that a theory is useful even though it does not provide accurate predictions in all cases. That is, an 'acceptable' theory might admit exceptions.¹¹ It should also be appreciated that, while we might use observations to 'support' a theory, it would generally be inadvisable to state that we have proved a theory on the basis of observations. There is always the possibility that one further observation might be made that is inconsistent with our theory's predictions.

In relation to the issue of whether we can 'prove' a theory (or not), it is useful to refer to insights provided by a group of theorists known as 'falsificationists', the major leader of which is considered to be Karl Popper.¹²

Popper and the falsificationists consider that knowledge develops through trial and error. For example, a researcher might develop hypotheses from a theory.¹³ To develop scientific knowledge, the falsificationists believe that these hypotheses must be of a form that allows them to be rejected if the evidence is not supportive of the hypotheses. For example, a hypothesis of the following form would be deemed to be falsifiable:

Hypothesis 1: Managers who receive bonuses based on accounting profits will adopt income-increasing accounting methods.

According to Popper and other falsificationists, knowledge develops as a result of continual refinement of a theory. When particular hypotheses are deemed to be false through lack of empirical support, the pre-existing theories will be refined (or abandoned). The refined

¹¹ The degree to which we might consider a theory to be acceptable will perhaps depend on the costs or implications associated with the theory 'getting it wrong' in a particular circumstance. For example, if the theory related to medicine and the theory was wrong only 10 per cent of the time—thereby causing deaths in 10 per cent of the patients—such a theory might not be acceptable. In accounting we might tolerate higher levels of inconsistency between theory predictions and related outcomes.

¹² One of the first detailed descriptions of falsificationism appeared in Karl Popper, *The Logic of Scientific Discovery*, Hutchinson, London, 1968.

¹³ Simply stated, a hypothesis can be defined as a proposition typically derived from theory which can be tested for causality or association using empirical data. For example, a hypothesis might be: the greater the negative media attention given to a particular social issue the greater the amount of annual report disclosures addressing the issue.

theories will be accepted until a related hypothesis is deemed to be false (falsified), at which time the theory will be further refined. Chalmers (1982, p. 38) provides a useful overview of falsificationism. He states:

The falsificationist freely admits that observation is guided by and presupposes theory. He is also happy to abandon any claims implying that theories can be established as true or probably true in the light of observational evidence. Theories are construed as speculative and tentative conjectures or guesses freely created by the human intellect in an attempt to overcome problems encountered by previous theories and to give an adequate account of the behaviour of some aspects of the world or universe. Once proposed, speculative theories are to be rigorously and ruthlessly tested by observation and experiment. Theories that fail to stand up to observational and experimental tests must be eliminated and replaced by further speculative conjectures. Science progresses by trial and error, by conjectures and refutations. Only the fittest theories survive. While it can never be legitimately said of a theory that it is true, it can hopefully be said that it is the best available, that it is better than anything that has come before.

Popper's view regarding how theories are developed can be contrasted with the views adopted by the inductivists considered earlier in the chapter. The inductivists construct theories based on typically long periods of careful observation. This discussion will not be pursued any further in terms of how theories develop, but consistent with some of the above discussion we would caution readers about making any claims to 'proving' a theory. It is always safer to say that our evidence 'supports' a theory but that it is also possible that we might embrace an alternative theoretical perspective at a future time should better explanations for a particular phenomenon become available.

EVALUATING THEORIES—CONSIDERATIONS OF LOGIC AND EVIDENCE

Throughout this book various theories of financial accounting are discussed. Where appropriate, an evaluation of the theories is also undertaken. The book considers such issues as whether the argument supporting the theories is (or at least appears to be) logical and/or plausible in terms of the central assumptions (if any) that are being made. If possible, the argument or theory should be broken down into its main premises to see if the argument, in simplified form, appears logical. What is emphasised is that we/you must question the theories that we/you are exposed to—not simply accept them. Acceptance of a theory and its associated hypotheses must be tied to whether we accept the logic of the argument, the underlying assumptions and any supporting evidence provided. (As indicated previously, hypotheses can be described as predictions typically expressed in the form of a relationship between one or more variables.)

As an example of logical deduction, consider the following simplistic non-accounting-related argument (reflecting the bias of the author—it refers to surfing). It shows that, although the argument may be logical (if we accept the premises), if it can be shown that one of the premises is untrue or in doubt, then the conclusions or predictions may be rejected. Where there are a number of premises and a conclusion, it is often referred to as a 'syllogism'.

- All surfers over the age of 35 ride longboards.
- Jack is a surfer over the age of 35.
- Jack therefore rides a longboard.

If we accept the above premises, we might accept the conclusion. It is logical. To determine the logic of the argument, we do not need to understand what a ‘surfer’ is or what a ‘longboard’ is. That is, we do not need to refer to ‘real world’ observations. We could have deconstructed the argument to the form:

- All As ride a B.
- C is an A.
- Therefore C rides a B.

An argument is logical to the extent that *if* the premises on which it is based are true *then* the conclusion will be true. That is, the argument (even if logical) will only provide a true account of the real world if the premises on which it is based are true. Referring to the above syllogism, evidence gathered through observation will show that the first premise does not always hold. There are surfers over 35 who do not ride longboards. Hence we reject the conclusion on the basis of observation, not on the basis of logic. Therefore, we had two considerations. If the argument seeks to provide an account of real-world phenomena, we must consider the logic of the premises and the correspondence between the premises and actual observation. This simplistic example can be extended to a review of theories. We might try to break the theory down into a series of premises. When the central premises are considered, do they lead to a logical conclusion? Further, if the premises are based on ‘real world’ observation, do they seem to be true? However, it should be remembered that not all theories or arguments seek to correspond with real-world phenomena—for example, some normative theories of accounting promote radical changes to existing practices. For many normative theories we might consider only the logic of the argument and whether we are prepared to accept the premises on which the argument is based.

Returning to the subject of the syllogism provided above, we could have argued alternatively that:

- A lot of surfers over 35 ride longboards.
- Jack is a surfer over 35.
- Therefore Jack rides a longboard.

The above is not a logical argument. The first premise has admitted alternatives and hence the conclusion, which does not admit alternatives, does not follow. We can dismiss the argument on the basis of a logical flaw without actually seeking any evidence to support the premises.

Chapter 7 reviews in greater depth Positive Accounting Theory as developed by such researchers as Jensen and Meckling (1976) and Watts and Zimmerman (1978). As noted earlier, their positive theory of accounting has a number of central assumptions, including an assumption that all people are *opportunistic* and will adopt particular strategies to the extent that such strategies lead to an increase in the personal wealth of those parties making the decisions. That is, self-interest is a core belief about what motivates individual action. Wealth accumulation is assumed to be at the centre of all decisions. The theory does not incorporate considerations of morality, loyalty, social responsibility and the like.

If we were to accept the economics-based assumption or premise of researchers such as Watts and Zimmerman that:

- self-interest tied to wealth maximisation motivates *all* decisions by individuals, and *if* we accept the following premises (which we might confirm through direct observation or through research undertaken by others) that:
- manager X is paid on the basis of reported profits (for example, he/she is given a bonus of 5 per cent of accounting profits), and
- accounting method Y is an available method of accounting that will increase reported profits relative to other methods, *then* we might accept a prediction that, all other things being equal,
- manager X will adopt accounting method Y.

This argument appears logical. Whether manager X is paid on the basis of reported profits and whether accounting method Y will increase reported profits are matters that can be confirmed through observation. But if the premises are both logical and true, then the conclusion will be true.

The argument may be logical but we might accept it only if we accept the critical assumption that the actions of individuals are motivated by the desire to maximise personal wealth. If we do not accept the central assumption, then we may reject the prediction. What is being emphasised here is that you need to consider whether you are prepared to accept the logic *and* the assumptions on which the arguments are based. If not, then we may reject the theory and the associated predictions. For example, in Gray, Owen and Adams (1996) the authors explicitly state that they reject the central assumptions of Positive Accounting Theory (although by their own admission it has 'some useful insights') and that they will not use it as a means of explaining or describing the practice of corporate social responsibility reporting. (The topic of corporate social reporting is covered in Chapter 9 of this book.) As Gray, Owen and Adams state (p. 75):

There is little doubt that these theories have provided some useful insights into the way in which they model the world. There is equally little doubt that some company management and many gambling investors may act in line with these theories. It is also the case that some authors have found the form of analysis employed in these theories useful for explaining corporate social reporting; but apart from the limitations which must arise from a pristine liberal economic perspective on the world and the profound philosophical limitations of the approach, the approach cannot offer any justification why we might accept the description of the world as a desirable one. It is a morally bankrupt view of the world in general and accounting in particular. Its (usual) exclusion of corporate social reporting is therefore actually attractive as an argument for corporate social reporting.

Chapter 6 discusses the Conceptual Framework Project, which is considered to be a normative theory of accounting (applying a decision usefulness perspective). This framework provides a view about the objective of general purpose financial reporting (to provide information that is useful for economics-based decisions) and the qualitative characteristics that financial information should possess. It also provides definitions of the elements of accounting (assets, liabilities, income, expenses, equity) and prescribes recognition criteria for each of the elements. As discussed in Chapter 6, in recent years the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been undertaking an initiative

to develop, on a joint basis, an improved conceptual framework for financial reporting. In May 2008 the IASB and the FASB jointly released an exposure draft entitled *Exposure Draft of an Improved Conceptual Framework for Financial Reporting*, which provided a definition of the revised conceptual framework as:

a coherent system of concepts that flow from an objective. The objective of financial reporting is the foundation of the framework. The other concepts provide guidance on identifying the boundaries of financial reporting; selecting the transactions, other events and circumstances to be represented; how they should be recognised and measured (or disclosed); and how they should be summarised and communicated in financial reports.

Hence, if we were to decide whether we agreed with the guidance provided within the revised conceptual framework, which is an example of a normative theory (as already indicated, a normative theory prescribes how we should undertake a particular activity—in this case, how we should do financial accounting), then we clearly would need to evaluate the assumed objective identified in the framework. As everything else is constructed around this objective (as the quote shows, it is deemed to be the ‘foundation of the framework’), then, logically, if we disagree with the stated objective, we would have to disagree with the balance of the prescriptions provided in the revised conceptual framework. The *Exposure Draft* states:

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers.

Therefore, if we believed that the central objective of financial accounting was to provide information to a broad cross-section of stakeholders, inclusive of employees, local communities and other groups that are not directly involved as capital providers, then we would reject the conceptual framework being developed by the IASB and FASB, despite the fact that it might be considered to be logically structured.

While the in-depth study of logic and a critique of argument are beyond the scope of this book, interested readers should consider studying books or articles that concentrate on the development of logical argument.¹⁴ Thouless (1974) describes various approaches to identifying logical flaws in arguments and he also identifies thirty-eight ‘dishonest tricks in argument’ that some writers use to support their arguments. Some of the ‘tricks’ he refers to, and which are often used to distract readers from limitations in the logic of an argument or theory, are:

- the use of emotionally toned words;
- making a statement in which ‘all’ is implied but ‘some’ is true;
- evasion of a sound refutation of an argument by use of a sophisticated formula;
- diversion to another question, to a side issue, or by irrelevant objection;
- the use of an argument of logically unsound form;
- change in the meaning of a term during the course of an argument;
- suggestion by repeated affirmation;

¹⁴ A good book in this regard is *Straight and Crooked Thinking* by Robert H. Thouless (1974). Sterling (1970) is also useful.

- prestige by false credentials;
- the appeal to mere authority;
- argument by mere analogy.

When reading documents written to support particular ideas or theories, we must also be vigilant to ensure that our acceptance of a theory has not, in a sense, been coerced through the use of colourful or emotive language, or an incorrect appeal to authority. Earlier, reference was made to terms and descriptions used by critics of Positive Accounting Theory, some of which were very emotive. Quite often (but not always) emotive or colourful language is introduced to support an otherwise weak argument. Where emotive or colourful language has been used, we should perhaps consider whether we would take the same position in terms of accepting the author's arguments if the author had used relatively neutral language. Thouless (1974, p. 24) provides some advice in this regard:

The practical exercise which I recommend is one that I have already performed on some passages in which truth seemed to be obscured by emotional thinking. I suggest that readers should copy out controversial passages from newspapers, books, or speeches which contain emotionally coloured words. They should then underline all the emotional words, afterwards rewriting the passages with the emotional words replaced by neutral ones. Examine the passage then in its new form in which it merely states facts without indicating the writer's emotional attitude towards them, and see whether it is still good evidence for the proposition it is trying to prove. If it is, the passage is a piece of straight thinking in which emotionally coloured words have been introduced merely as an ornament. If not, it is crooked thinking, because the conclusion depends not on the factual meaning of the passage but on the emotions roused by the words.

While we must always consider the logic of an argument and the various assumptions that have been made, what we also must remember is that theories, particularly those in the social sciences, are by nature abstractions of reality. We cannot really expect particular theories about human behaviour to apply all the time. People (thankfully) are different and to expect theories or models of human behaviour (and remember, accounting theories relate to the action of accountants and the users of accounting information) to have perfect predictive ability would be naive. If a number of theories are available to describe a particular phenomenon, then considering more than one theory may provide a more rounded perspective. Difficulties will arise if the theories provide diametrically opposite predictions or explanations, and in such cases a choice of theory must generally be made.

For those theories that attempt to predict and explain accounting practice (positive theories of accounting) it is common practice to test the theories empirically in various settings and across various types of decisions. But what if the particular theories do not seem to hold in all settings? Should the theories be abandoned? Returning to an issue considered previously in this chapter, can we accept a theory that admits exceptions? Certainly, readings of various accounting research journals will show that many studies that adopt Positive Accounting Theory as the theoretical basis of the argument fail to generate findings consistent with the theory (however, many do). According to Christenson (1983, p. 18), an outspoken critic of Positive Accounting Theory:

We are told, for example, that 'we can only expect a positive theory to hold on average' [Watts and Zimmerman, 1978, p. 127, n. 37]. We are also advised 'to remember that as

in all empirical theories we are concerned with general trends' [Watts and Zimmerman, 1978, pp. 288–289], where 'general' is used in the weak sense of 'true or applicable in most instances but not all' rather than in the strong sense of 'relating to, concerned with, or applicable to every member of a class' [American Heritage Dictionary, 1969, p. 548] ... A law that admits exceptions has no significance, and knowledge of it is not of the slightest use. By arguing that their theories admit exceptions, Watts and Zimmerman condemn them as insignificant and useless.

Christenson uses the fact that Positive Accounting Theory is not always supported in practice to reject it.¹⁵ However, as stressed previously, as a study of people (accountants, not 'accounting'), it is very hard to see how any model or theory could ever fully explain human action. In fact, ability to do so would constitute a very dehumanising view of people. Hence, the failure of a particular study to support a theory might not in itself provide a basis for rejecting a theory as 'useless and insignificant'. From another perspective, the failure to support the theory may have been due to the data being inappropriately collected or the data not providing a sound correspondence with the theoretical variables involved. However, if the theory in question continuously fails to be supported, then its acceptance will obviously be threatened. At this point we could speculate whether in fact there are any theories pertaining to human activities that always hold.

In developing and testing accounting theories, many accounting researchers use methods borrowed from the pure sciences (such as physics and chemistry) which assume that the phenomena being studied will behave in the same way in all similar situations. As we will see when reading accounting (and other) research, these researchers believe that it is possible to develop generalisable accounting theories and therefore that the results they derive from particular samples of observations can be generalised to the broader population of the phenomenon in question. Other researchers hold the opposite view—that it is not possible to make any valid generalisations in the social sciences as we are dealing with human activity, and human behaviour varies from person to person. These researchers will develop theories of a fundamentally different nature from those developed by researchers who believe that it is possible to generalise in accounting theory, and these theories will tend to deal with specific localised situations. Between these two extremes, there are other researchers (such as Laughlin, 1995, 2004) who believe that it is possible to make some very broad generalisations in developing social science theories, but the way these broad generalisations apply to specific situations will vary according to the specific individual factors applicable to each situation. Researchers holding this view regarding the way the world works may use some very broad theories to help understand some aspects of the phenomena they are studying, but are ready to amend and adapt these broad generalisations in light of specific evidence from each individual study.

While a comprehensive review of research methods is beyond the scope of this book, if researchers are attempting to generalise the findings of their studies (based on particular samples)

¹⁵ Where a proposition is not supported in a particular instance, many of us have probably heard the phrase 'the exception proves the rule' being applied. Such a statement implies that we cannot accept a rule or proposition unless we find some evidence that appears to refute it. This clearly is an illogical argument. As emphasised above, we must always guard against accepting arguments that are not logically sound.

to a larger population, we need to consider the data on which the generalisation is based.¹⁶ For example, if we are going to generalise our findings from a sample (we typically cannot test the whole population), then we must consider how the original sample was chosen. For instance, if we have a prediction that all companies will adopt a particular accounting method in times of inflation and we test this prediction against the ten largest companies listed on the stock exchange in a period of inflation, then common sense should dictate that the findings really should not be considered generalisable. Can we really be confident about what small companies will do given that our sample included only large listed companies? Hence, throughout your readings of various research studies you should consider not only how the argument is developed, but also how it is tested. If there are flaws in how the testing has been done, we may question or reject the significance of the findings. We must evaluate whether the data collected really represent valid measures of the theoretical variables in question.

As noted previously, for normative theories it is usually not appropriate to test them empirically. If researchers are arguing that accountants should provide particular types of accounting information, or if other researchers are providing a view that organisations have a social responsibility to consider the needs of all stakeholders, then this does not mean that what they are prescribing actually exists in practice. For example, if Chambers' model of accounting prescribes that all assets should be valued at their net market value, and we go out and find that accountants predominantly value their assets on the basis of historical cost, we should not reject Chambers' theory, as he was *prescribing*, not *predicting* or *describing*. We should always keep in mind what the researchers are attempting to achieve. Our acceptance of Chambers' theory is dependent on whether we accept the logic of the argument as well as the assumptions made by Chambers, including the assumption that the central role of accounting should be to provide information about an entity's ability to adapt to changing circumstances (which he argues is best reflected by measures of assets that are tied to their net market values), and the assumption that firms should exist primarily to increase the wealth of the owners.

OUTLINE OF THIS BOOK

A book of this size cannot be expected to cover all the theories of financial accounting. Nevertheless, it covers those theories that have gained widespread acceptance by various sectors of the accounting community.

Chapter 2 provides an overview of various financial reporting decisions that entities typically face, emphasising that some reporting pertaining to particular transactions and events is regulated, and some is unregulated. The chapter emphasises that financial accountants typically make many professional judgements throughout the accounting process, and discusses the qualitative attribute of objectivity, but it emphasises that considerations (other than the

¹⁶ Entire books are dedicated to research methods. Interested readers may refer to: C. Humphrey & B. Lee (eds) (2004), *The Real Life Guide to Accounting Research: A Behind-the-Scenes View of Using Qualitative Research Methods*, Kidlington, Oxford: Elsevier; J. Collis & R. Hussey (2003), *Business Research*, London: Palgrave Macmillan; A. Bryman (2004), *Social Research Methods*, 2nd edn, Oxford: Oxford University Press; P. Ghauri & K. Gronhaug (2002), *Research Methods in Business Studies: A Practical Guide*, Harlow: FT Prentice Hall.

pursuit of objectivity) may sometimes influence accounting method selection and disclosure practices.

Chapter 3 provides an overview of various arguments for and against the regulation of financial reporting, with an overview of various perspectives on the costs and benefits of regulating financial reporting. The chapter explores why some accounting approaches and/or methods are adopted by regulators and/or the profession while others are not. The political process involved in the setting of accounting standards is highlighted.

Chapter 4 explores the international harmonisation of accounting requirements. Recently, moves have been made to standardise accounting practices internationally. Australia and the European Union were at the forefront of such moves. This chapter considers some potential costs and benefits of this process. Particular consideration is given to issues of *culture* and how *cultural differences* have typically been proposed as a reason to explain international differences in accounting requirements. International standardisation ignores this research and assumes that all countries (with different cultures) can and should simply adopt the same accounting practices.

Chapter 5 gives an overview of various normative (or prescriptive) theories of accounting that have been advanced to deal with various accounting issues associated with periods of rising prices (inflation). The chapter considers such issues as whether there is a 'true' measure of income. Conceptual frameworks as normative theories of accounting are considered in Chapter 6. Applying material covered in Chapter 3, Chapters 5 and 6 also consider why various normative theories of accounting did not gain favour with the accounting profession or the accounting standard-setters.

Chapters 7 and 8 show that, while much financial reporting is regulated, organisations still have some scope for voluntarily selecting between alternative accounting methods for particular types of transactions. The treatment of many transactions and the disclosure of many/most issues associated with various social and environmental events relating to an organisation are unregulated. Chapters 7 and 8 consider some theoretical perspectives (including Positive Accounting Theory, Legitimacy Theory, Stakeholder Theory, Political Economy Theory and Institutional Theory) that explain what drives the various unregulated/voluntary reporting decisions.

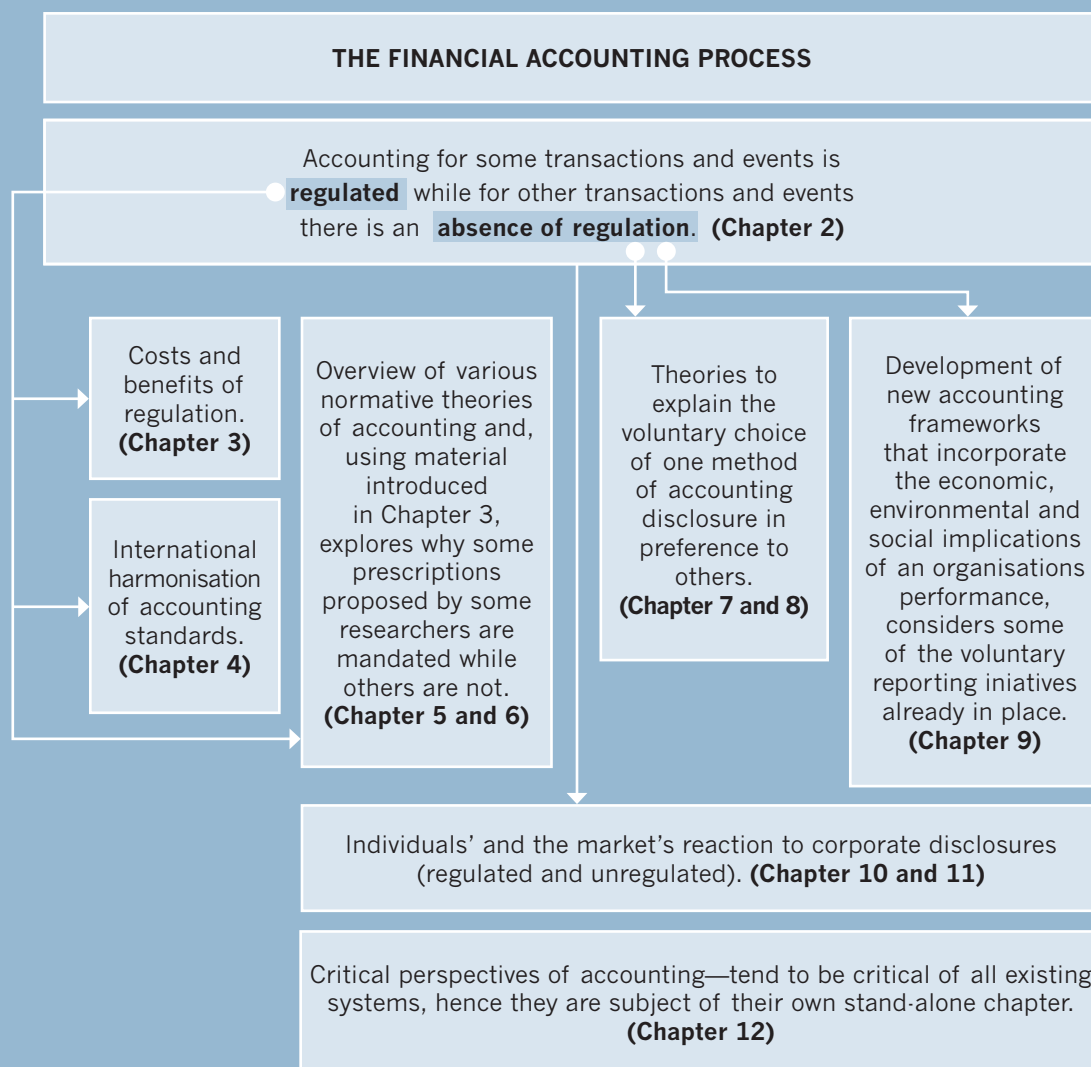
Chapter 9 considers the development and use of new systems of accounting that incorporate the economic, social and environmental performance of an organisation. The relationship between accounting and sustainable development is explored. This chapter includes a consideration of the limitations of traditional financial accounting, with particular focus on its inability to incorporate social and environmental issues.

Chapters 10 and 11 consider how individuals and capital markets react to various corporate disclosures. The chapters consider the various theories that have been used to test whether the market is actually using particular types of disclosures, as well as theories that indicate how individuals use accounting information. The chapters also consider who should be deemed to be the users of various types of disclosures. Issues associated with stakeholder *rights to know* are also explored.

The concluding chapter, Chapter 12, provides an overview of various critical perspectives of accounting—perspectives that tend to criticise the entire system of accounting as it stands (accounting practice is anthropocentric, masculine and so on)—arguing that accounting tends to support current social systems, which favour those with economic power but marginalise the interests of parties that lack control of necessary resources.

In summary, the balance of this book can be presented diagrammatically, as in Figure 1.1.

Figure 1.1 Diagrammatic overview of *Financial Accounting Theory*



QUESTIONS

- 1.1 What is the difference between a positive theory of accounting and a normative theory of accounting?
- 1.2 If you developed a theory to explain how a person's cultural background influences how they prepare financial statements, would you have developed a positive theory or a normative theory?
- 1.3 What is a conceptual framework, and would it be considered to be a positive or a normative theory of accounting?

- 1.4** In an article that appeared in the *Age* ('Way cleared for Turnbull to challenge', by Michelle Grattan, 12 September 2008), Peter Costello, former federal treasurer, is quoted as saying, 'I have a theory that every government wins one more term than it should.' Do you believe he really has a 'theory' in terms of the way a 'theory' is defined in this chapter?
- 1.5** Why would it not be appropriate to reject a normative theory of accounting because its prescriptions could not be confirmed through empirical observation?
- 1.6** The IASB and the FASB are currently developing a revised conceptual framework of financial reporting. If you have been asked to review the framework—which is an example of a normative theory of accounting—why would it be important for you to pay particular attention to how the objective of financial reporting is defined within the framework?
- 1.7** If a normative theory of financial accounting has been developed to prescribe how we should do financial accounting, is it possible that we can decide to reject the theory because we do not agree with a central assumption of the theory (such as an assumption about the objective of financial reporting), but at the same time decide that the theory is nevertheless logical? Explain your answer.
- 1.8** What is the difference between developing a theory by induction and developing a theory by deduction?
- 1.9** Is the study of financial accounting theory a waste of time for accounting students? Explain your answer.
- 1.10** In the 1960s a number of accounting researchers concentrated on developing theories of accounting based on observing and documenting the behaviour of practising accountants. Do you think that such research is useful in improving the practice of financial accounting? Explain your answer.
- 1.11** Gray, Owen and Maunders (1987, p. 66) make the following statement in relation to research based on the inductive approach (that is, research based on observing particular phenomena):
- Studying extant practice is a study of 'what is' and by definition does not study 'what is not' or 'what should be'. It therefore 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.
- With this comment in mind, do you consider that research based on induction is useful for improving the practice of financial accounting? Explain your answer.
- 1.12** Explain the meaning of the following paragraph and evaluate the logic of the perspective described:
- In generating theories of accounting that are based upon what accountants actually do, it is assumed (often implicitly) that what is done by the majority of accountants is the most appropriate practice. In adopting such a perspective there is, in a sense, a perspective of accounting Darwinism—a view that accounting practice has evolved, and the fittest, or perhaps 'best', practices have survived. Prescriptions or advice are provided to others on the basis of what most accountants do, the logic being that the majority of accountants must be doing the most appropriate thing.

- 1.13** In 1961 and 1962 the Accounting Research Division of the American Institute of Certified Public Accountants (AICPA) commissioned studies by Moonitz and by Sprouse and Moonitz. These studies proposed that accounting measurement systems be changed from historical cost to a system based on current values. However, before the release of these studies, the AICPA released a statement saying that ‘while these studies are a valuable contribution to accounting principles, they are too radically different from generally accepted principles for acceptance at this time’ (Statement by the Accounting Principles Board, AICPA, April 1962). Explain why if something is ‘radically different’ (though it might be logically sound) this difference in itself might be enough to stop regulators embracing a particular approach to accounting.
- 1.14** Read the following quotation from Miller and Reading (1986, p. 64). If constituency support is necessary before particular accounting approaches become embodied in accounting standards, does this have implications for the ‘neutrality’ and ‘representational faithfulness’ (qualitative characteristics that exist in various conceptual framework projects around the world) of reports generated in accordance with accounting standards?
- The mere discovery of a problem is not sufficient to assure that the Financial Accounting Standards Board will undertake its solution ... There must be a suitably high likelihood that the Board can resolve the issues in a manner that will be acceptable to the constituency—without some prior sense of the likelihood that the Board members will be able to reach a consensus, it is generally not advisable to undertake a formal project.
- 1.15** As Watts and Zimmerman (1986, p. 7) state, Positive Accounting Theory ‘is concerned with explaining [accounting] practice. It is designed to explain and predict which firms will and which firms will not use a particular accounting method ... but it says nothing as to which method a firm should use’. Do you think that this represents an ‘abrogation’ of the academics’ duty to serve the community that supports them?
- 1.16** Briefly identify the two branches of ‘decision usefulness’ theories described in this chapter and explain what they are.
- 1.17** Briefly explain the revolutionary perspective of knowledge advancement proposed by Kuhn (1962).
- 1.18** What is a ‘paradigm’ and would you expect accounting researchers to embrace more than one paradigm when undertaking research? Explain your answer.
- 1.19** In your opinion, can accounting research be ‘value free’? Explain your answer.
- 1.20** What role do value judgements have in determining what particular accounting theory a researcher might elect to adopt to explain or predict particular accounting phenomena?
- 1.21** If an accounting researcher adopts a particular accounting theory to predict which firms will make particular accounting disclosures, how much supporting evidence must the researcher gather before he or she can claim that the theory is ‘proved’? Explain your answer.
- 1.22** Assume that you have been asked to evaluate a particular theory of accounting. What factors would you consider before making a judgement that the theory appears ‘sound’?

- 1.23** If you were trying to convince another party to support your theory about a particular facet of financial accounting, would you be inclined to use emotive or colourful language? Why, or why not?
- 1.24** What do we mean when we say that ‘theories are abstractions of reality’? Do you agree that theories of accounting are necessarily abstractions of reality?
- 1.25** What is a ‘hypothesis’ and do you consider that accounting research should necessarily involve the development of empirically testable hypotheses?
- 1.26** Would you reject as ‘insignificant and useless’ a positive theory of accounting on the basis that in a particular research study the results derived failed to support the hypotheses and the related theory? Explain your answer.
- 1.27** If a researcher tested a theory on a particular sample of companies, what considerations would you examine before you would agree with the researcher that the results can be generalised to the larger population of companies?

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