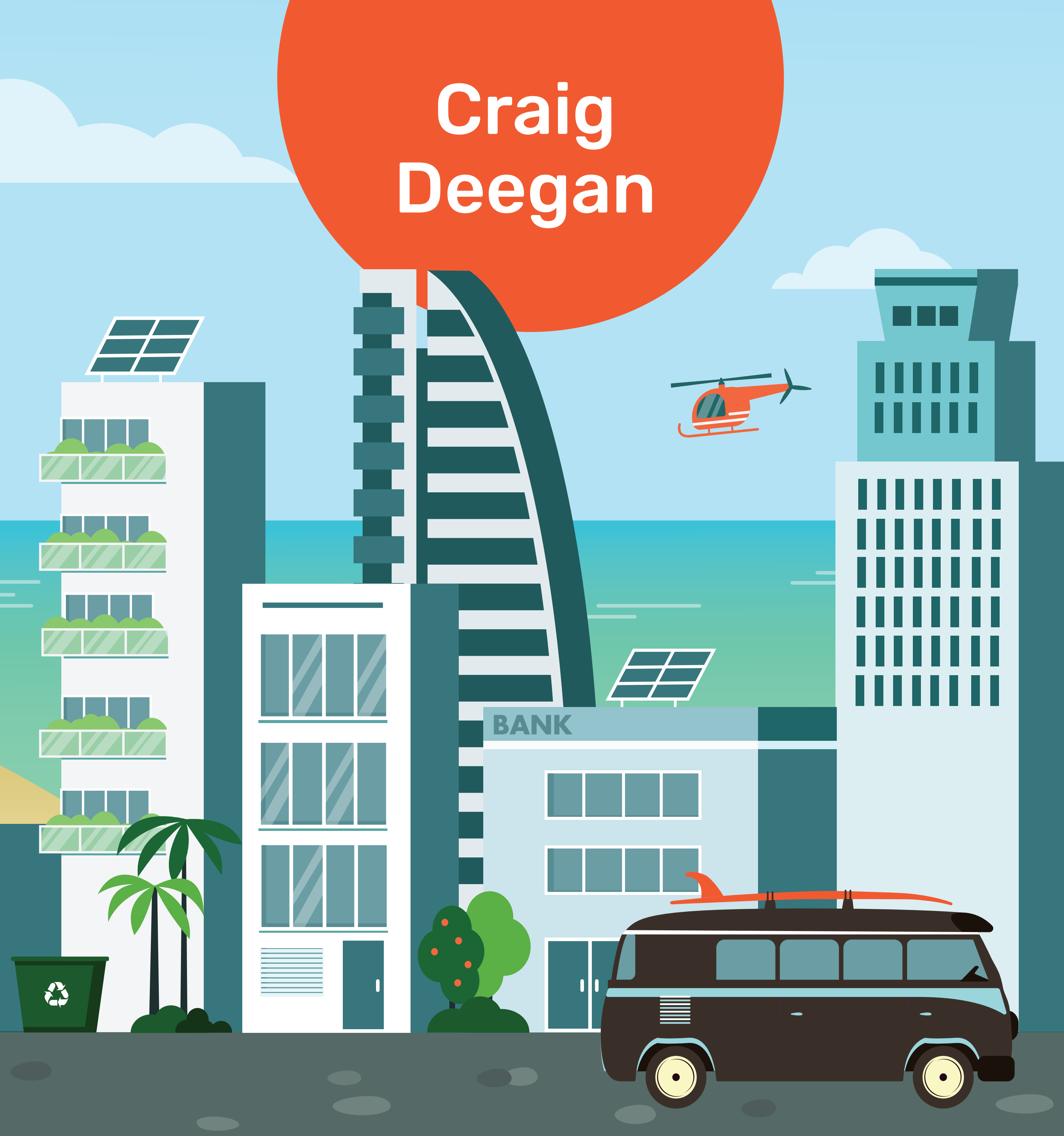
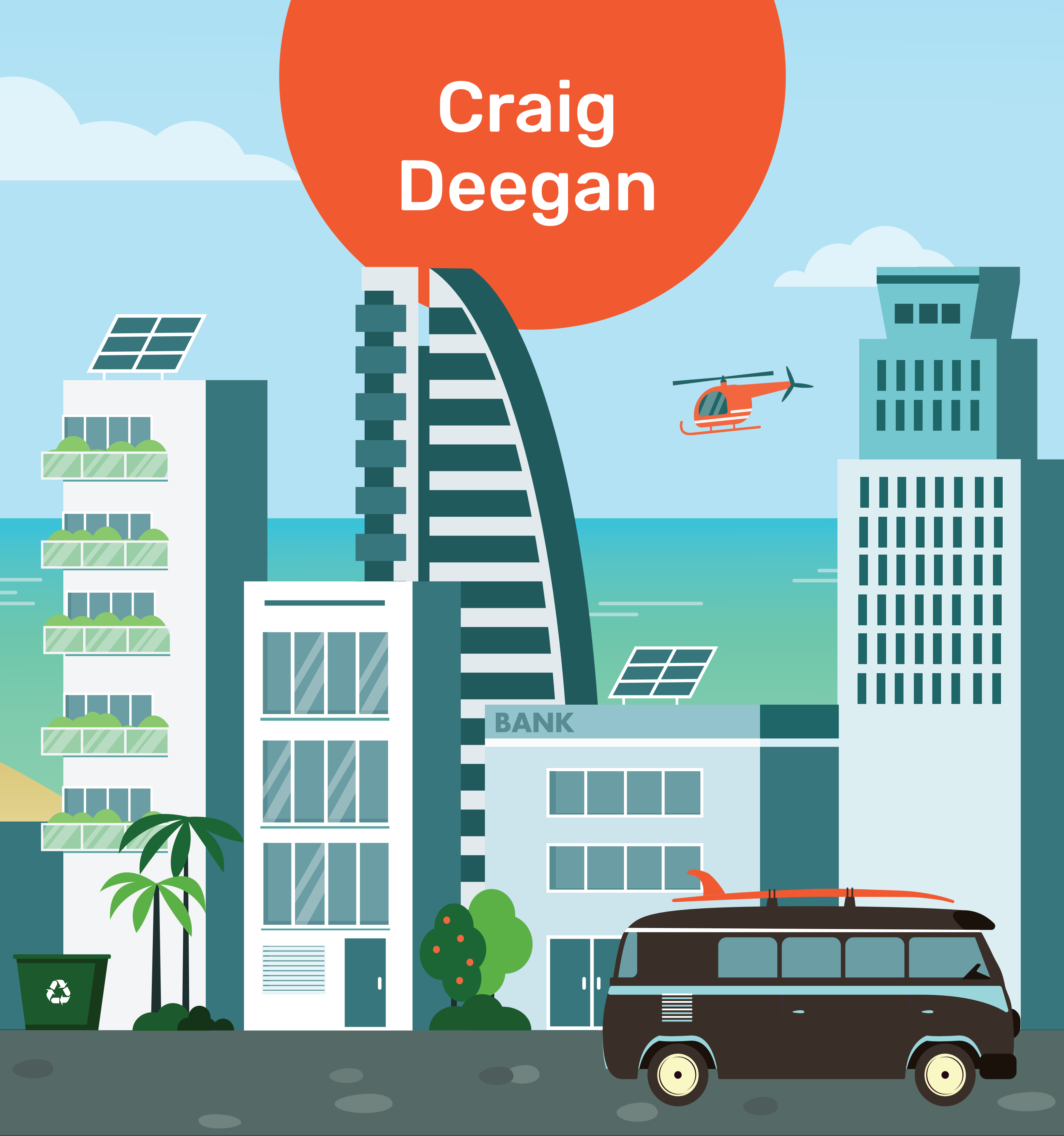
Craig Deegan



Financial Accounting Theory

5e

Craig Deegan



Financial Accounting Theory

5e

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Brief contents

Contents

Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of financial accounting theory and help you understand how the theory is applied in the real world.

CHAPTER-OPENING FEATURES

Identify the key concepts you will engage with through the **Learning objectives** at the start of each chapter.

LEARNING OBJECTIVES

On completing this chapter, readers should:

- LO1.1 understand that there are many theories of accounting
- LO1.2 understand how knowledge of different accounting theories increases our ability to understand and evaluate various alternative accounting practices
- LO1.3 understand that the different theories of accounting are often developed to perform different functions, such as to *describe* accounting practice, or to *prescribe* particular accounting practices
- LO1.4 understand that theories, including theories of accounting, are developed as a result of applying various value judgements and also appreciate that acceptance of one theory in preference to others will in part be tied to one's own value judgements
- LO1.5 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
- LO1.6 understand some alternative perspectives about how knowledge develops across time
- LO1.7 understand why students of accounting should study accounting theories as part of their broader accounting education.

Check your understanding of accounting concepts with the **Opening questions**. Answers to these opening questions can be found at the end of the chapter so you can check how your understanding has changed.

OPENING QUESTIONS

NEW

Before reading this chapter, please consider how you would answer the following three questions. We will return to these questions at the end of the chapter, where we suggest some answers.

1. Why do students of accounting need to bother with the study of 'theories'? For example, 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 have knowledge of 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?

FEATURES WITHIN CHAPTERS

Reflection questions encourage you to pause and reflect on concepts that have you learned in the chapter.

REFLECTION QUESTION 4.2

The public interest perspective

Question

If government has said that an accounting regulation was introduced for the 'public interest', would you believe them?

Solution

Our answer to such a question will be influenced by our own assumptions about what motivates government regulators – is it public interest, self-interest or perhaps a mixture of both? We can consider the evidence of research that has investigated people in governments' motivation for particular decisions. Broadly speaking, the evidence is mixed – some points to self-interest and some points to public interest.

Another point to be noted is that we will all potentially have different views about what is in the 'public interest'. Some people might believe in the 'trickle-down effect' such that any regulation which directly supports or protects the interests of investors will likely be in the broader public interest, because confidence in the capital markets benefits everybody. Conversely, other people, on the basis of their own research or evidence, might dispute such flow-on effects and argue that the government is simply supporting already rich investors because such investors have the financial means to help re-elect the government.

As we have also discussed, different political parties have different ideologies and will have different views about the responsibilities and accountabilities of organisations, and what is in the 'public interest'. Therefore, it is very possible that different political parties will have diametrically opposing views on the needs for particular regulation, including the regulation of corporate reporting, but all will be arguing that their views are in the 'public interest'.

Therefore, the solution to this question is clearly not an easy 'Yes' or 'No' answer. We need to consider existing research, the philosophical views of the researchers involved and our own notions about what represents the 'public interest'.

Why do I need to know ...? boxes provide context to complex subject matter to show how the topic relates to the real world.

Why do I need to know about theories of regulation?

NEW

The practice of financial reporting is heavily regulated. As students of accounting, it is important that we understand some of the potential reasons why regulation might have been introduced, or why regulation might have been introduced and subsequently amended or removed. As we have learned, while regulation is often assumed to be in place for the 'public interest', this is not always the case. To be able to critically evaluate the practice of accounting and to exercise our need to be critical thinkers, we need to be aware of these insights.

Important **Key terms** are marked in bold in the text and **defined in the margin** when they are used for the first time.

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 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.

Decision usefulness theories
Theories that ascribe a particular type of information for particular classes of users on the basis of assumed decision-making needs.

END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

Review your understanding of the key chapter topics with the **Chapter summary**.

CHAPTER SUMMARY

This chapter has addressed a number of issues that are fundamental to the understanding and practice of accounting. We have provided definitions of 'accounting' and 'accountability', and we have explored the relationship between organisations' responsibilities, accountability, and accounting practices. We have emphasised that different managers will interpret their responsibilities (to whom, and for what) differently, and this will have implications for the accounting practices that they will have in place. We have also emphasised that perceptions of organisational responsibility will change over time, and this has implications for the evolution of accounting practice.

We introduced a four-step accountability model that emphasises how various judgements made as part of an 'accountability relationship' between organisations, and their stakeholders, have sequential implications for subsequent judgements. For example, the reasons why managers are reporting information has implications for who is intended to receive the information, which in turn has implications for what is reported, and how it is reported.

Refer to the **Answers to the opening questions** to assess how your understanding has developed, as a result of reading the material provided within the chapter.

ANSWERS TO THE OPENING QUESTIONS

At the beginning of the chapter, we asked the following five questions. As a result of reading this chapter, you should be able to provide informed answers to these questions – ours are shown below.

1 What does 'accountability' mean?

In this chapter we have provided a number of definitions of accountability. One useful definition is that provided by Gray, Adams and Owen (2014, p. 50) which is 'the duty to provide an account or reckoning of those actions for which one is held responsible'. The 'accountability' of an organisation is very much linked to judgements made about an organisation's responsibilities.

2 How do perceptions of organisational responsibility influence perceptions of organisational accountability?

In this chapter we provided a simple, but useful, diagram – see Figure 2.1. As we discuss, perceptions of organisational responsibilities directly influence perceptions about to whom an

Test your knowledge and consolidate your learning through the end-of-chapter **Questions**.

QUESTIONS

2.1 Define 'accountability'. LO2.1
2.2 Would different managers necessarily have similar views about organisational accountability? Why? LO2.2
2.3 Why might different managers have different perceptions of their organisation's responsibilities? LO2.4
2.4 Does it make sense to study accounting without considering, in some depth, the issue of 'organisational accountability'? Why? LO2.2
2.5 What is a 'stakeholder' of an organisation? LO2.3
2.6 Does a stakeholder have to be a person or group of people? LO2.3
2.7 What is stakeholder engagement, and what is its purpose? LO2.3 LO2.4
2.8 What is the connection between stakeholder engagement and organisational accountability? LO2.2 LO2.3

Extend your understanding with the list of **References** relevant to each chapter.

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Preface

About this book

The underlying motivation for writing this book is a belief that all students of accounting, whether at the undergraduate or postgraduate level, and indeed all practitioners of accounting, should have a rich understanding of the implications that flow from the practice of accounting. Accounting practice can be linked to various economic, social, and environmental impacts that reverberate throughout society, and students and practitioners of accounting need to understand this. In understanding this, they need knowledge of different theories. This book has therefore been written to provide readers with a balanced discussion of different theories of accounting. Chapter 1 provides a discussion of the role and importance of theory and discusses the different types of accounting theories 'out there' and the different ways in which theories are developed. Chapter 1 also provides tools for evaluating theories. Chapter 2 then explores the link between organisational responsibilities, accountabilities, and accounting and in doing so, introduces a four-step accountability model. It also discusses corporate governance and the linkage between corporate governance and accounting practice. Chapter 2 emphasises that relevant and reliable accounting information provides power to users of that information that enables them to make informed choices. Chapters 3 and 4 explore the objectives, use and regulation of general purpose financial reports and critically discuss various theories for and against the regulation of financial reporting.

Chapter 5 explores the topic of 'international accounting' and critically evaluates efforts towards, and the obstacles to, the standardisation of international financial reporting practices – something that has been aggressively pursued by the International Accounting Standards Board (IASB). The book also describes and evaluates the development of various normative theories of accounting, including various approaches developed to account for changing prices (Chapter 6), as well as various issues associated with the development of conceptual frameworks for financial reporting, in particular the Conceptual Framework for Financial Reporting developed by the IASB (Chapter 7).

Apart from exploring various normative prescriptions for how the practice of financial reporting *should* be undertaken, we also explore various positive theories that have been used to *explain* and/or *predict* the practice of accounting. Chapter 8 explores Agency Theory and Positive Accounting Theory while Chapter 9 explores Political Economy Theory, Legitimacy Theory, Stakeholder Theory, and Institutional Theory. Reflecting the growing relevance globally of the sustainability agenda – including efforts to address climate change and modern slavery – social and environmental accountability/sustainability and reporting issues are discussed in depth in Chapter 10. Chapter 10 provides one of the most comprehensive coverages of sustainability/social and environmental accounting and accountability available within any published accounting-related text.

Chapters 11 and 12 then focus on how people use and react to accounting information, with Chapter 11 focusing on capital markets research and Chapter 12 focusing on behavioural research. The book then concludes with Chapter 13, which provides a fascinating exploration of the insights provided by critical accounting theorists – insights that tend to challenge many preconceived ideas about the role of accounting, accountants, professions and the state within society.

From the outset, the aim has been to present a balanced perspective about alternative and sometimes conflicting theories of accounting. As such, this book also provides an excellent basis for readers contemplating further research in different areas of accounting. This book has proved to be an invaluable and highly cited resource for accounting researchers and accounting research students, including those pursuing a PhD in the area of accounting.

In writing this book, a style has been adopted that enables readers at both the undergraduate and the postgraduate level to gain a sound understanding of accounting theory. As each chapter incorporates research from around the world, the book is of relevance to accounting students and researchers internationally. To assist in the learning process, each chapter provides learning objectives and opening questions which readers are encouraged to answer before reading the chapter. Solutions to each opening question are then provided at the end of the chapter and readers are encouraged to consider how their answers changed as a result of reading the chapter material. 'Why do I need to know ….?' boxes also appear throughout every chapter with the aim of enhancing the 'real world relevance' of the material by pointing out the respective materials' likely relevance to readers' lives within, and beyond, university. Reflection questions have also been incorporated throughout each chapter to encourage readers to apply the material to various real-world issues. There are also chapter summaries and end-of-chapter discussion questions. This fifth edition is also supported by videos for each chapter which are both entertaining and informative.

Throughout the book readers are encouraged to critically evaluate and challenge the various views presented. To give the different theoretical perspectives a 'real world' feel, some chapters use extracts from newspapers, directly related to the issues under consideration. The chapters also draw upon various published research papers to support particular views. As a review of the references list at the end of each chapter will show, the writing of the chapters has drawn upon a great deal of high-quality internationally published research. A glossary of key terms is provided towards the back of the book which brings together in one place all the key terms that were used throughout the book.

In the 23 years since the first edition of this book was published, it has proved very popular with students and academics across the world. This new edition retains and builds on the features of the previous four editions that readers have found so appealing and distinctive, such as the use of straightforward explanations, the assessable nature of the language, frequent practical examples, and illustrations using newspaper articles. We have taken the opportunity of updating the text to reflect significant developments in accounting theory over the 23 years.

How is this book different to other books?

Unlike many other accounting theory texts, this text is written in language that should be accessible to most readers. It also draws on research that is international in orientation and is used in a way that reinforces the real-world relevance of the material that is addressed. That is, we show how the documented research has relevance to our daily lives.

The text accepts that there are different, often competing, views about the role of theory and the roles of accounting and the accounting profession and we try to provide a balanced representation of these different beliefs. This is often not the case with other theory texts. What is clearly emphasised is that accounting is both a technical and social practice and that the impacts of accounting reverberate throughout society.

The videos that support each chapter are also different to the material that generally accompanies books of this type. The videos are informal but informative and contribute greatly to the readers' learning experience.

The intention in writing this book has been to show that the practice of accounting is far from mundane. Rather, we show that accounting is actually a very interesting and arguably exciting practice that impacts all of our lives.

How to use this book?

Divided into 13 chapters sequenced in a logical order, this book provides the basis for subjects/units that investigate financial accounting theory. Alternatively, the book can be used as a key text across multiple subjects/units that include coverage of different aspects of accounting practice.

The entire book could realistically be used in an eleven- to thirteen-week university term, with chapters being studied in the sequence in which they are presented. Alternatively, some universities have elected to only use between eight and ten chapters from the book and this works, as there is not generally a need that certain chapters must be read in order to be able to understand other chapters. If only some of the chapters are to be used, then it is recommended that Chapter 1 be initially read as it sets the scene for all the chapters that follow. If a unit's focus allows, then it would also be recommended that consideration be given to concluding the unit/subject with Chapter 13, as the 'critical content' of Chapter 13 provides a very useful and thought-provoking way to wrap up a discussion of accounting theory.

We hope readers continue to find this book interesting, informative and enjoyable to read. As usual, we welcome constructive feedback.

About the author

Craig Deegan, BCom (University of NSW), MCom (Hons) (University of NSW), PhD (University of Queensland), FCA, is Professor of Accounting in the School of Accounting at the University of Tasmania. Craig has taught at both undergraduate and postgraduate level for many years and has supervised over 30 PhDs to completion as well as many Honours and Masters by Research students. Prior to working in the university sector, Craig worked as a chartered accountant. His research focuses on various social and environmental accountability and financial accounting issues, and he has been published in a number of leading international accounting journals, including: *Accounting, Organizations and Society; Accounting and Business Research*; *Accounting, Accountability and Auditing Journal*; *Accounting and Finance; British Accounting Review*; *Critical Perspectives on Accounting*; *Journal of Business Ethics*; *Australian Accounting Review*; *Australian Journal of Management*; *Meditari Accountancy Research*; *Accounting Forum*; *The International Journal of Accounting*; *Managerial Auditing Journal*; and *Environmental and Planning Law Journal*. According to Google Scholar, Craig's work has attracted approximately 30 000 citations making him one of the most highly cited researchers internationally within the accounting and/or finance literature. On 28 September 2018, and reflective of the extent to which Craig's research has been relied upon by many researchers and practitioners, the leading Australian national newspaper, *The Australian* (within its annual feature on research), identified Craig as being Australia's Research Field Leader in the Field of Accounting and Taxation.

Craig has regularly provided consulting services to corporations, government and industry bodies on issues pertaining to financial accounting, stakeholder engagement and corporate social and environmental accountability. He was former Chairperson of the *Triple Bottom Line Issues Group* of the Institute of Chartered Accountants in Australia (now Chartered Accountants Australia and New Zealand) and for many years was involved in developing the *CPA Program* of CPA Australia, as well as being a judge on the *Australasian Sustainability Reporting Awards*. He is on the editorial board of a number of academic accounting journals and has been the recipient of various teaching and research awards, including teaching prizes sponsored by KPMG and the Institute of Chartered Accountants in Australia. He was the inaugural recipient of the *Peter Brownell Manuscript Award*, an annual research award presented by the Accounting and Finance Association of Australia and New Zealand. He was also awarded the *University of Southern Queensland Individual Award for Research Excellence*. Craig is currently a member of the United Nations sponsored organisation, Education for Sustainability (EfS), is a member of the University of Tasmania Sustainability Committee, and is a member of the Australian Accounting Standards Board (AASB) Academic Advisory Panel.

Craig is also the author of the leading corporate accounting textbook, *Financial Accounting*, now in its ninth edition (McGraw Hill), as well as being the author of the leading introductory accounting textbook, *An Introduction to Accounting: Accountability in Organisations and Society*, a second edition of which was published by Cengage in 2023. All Craig's books are widely used throughout Australia as well as in many other countries. Above all, Craig has a passion for emphasising that accounting is both a technical and social practice that creates various affects that reverberate throughout society. This passion is very well reflected and encapsulated within the contents of this thought-provoking book.

Acknowledgments

The writing of this fifth edition, as well as the preceding editions, has been influenced by many people with whom I have been blessed to work with throughout my academic career. When the first edition was published back in 1999, various people generously provided invaluable help and insight, including Reg Mathews, Rob Gray, Dave Owen and Michaela Rankin. Reg and Rob have since passed away and are greatly missed, but their intellectual contribution to the accounting literature is still strongly evident today. I was also very fortunate to have some great mentors along my academic journey, including Malcolm Miller, the late Bill Birkett, Don Stokes, Richard Morris, and the late Ian Zimmer.

I have supervised many Honours, Masters, and PhD students throughout my academic career, many of whom I have published with and several of whom have become lifelong friends. These people have exposed me to various important and rich insights and have helped maintain my motivation to gain new knowledge – knowledge that often challenged my pre-existing beliefs. Supervising research students is such a rewarding experience and a vital part of being within a university. Relatedly, I have co-authored over 40 papers in leading international accounting journals at the A or A* level [applying the Australian Business Deans Council (ABDC) Journal Quality List rankings] with my former research students. I deeply thank all the past research students that I was lucky enough to supervise. In writing this text I have drawn on much of the knowledge that has come from this supervisory-related work.

I would also like to than Jeffrey Unerman who reviewed the third edition of this book and added some content to pre-existing chapters in order to 'Europeanise' it for the purpose of two 'European editions' of this book, which were published in 2006 (1st edition) and 2011 (2nd edition). Jeffrey is also sadly missed, but his work also continues to contribute widely to academic debate.

The writing of the first four editions of this book was undertaken while I was employed at the University of Southern Queensland and RMIT University. I thank these two institutions for supporting my work. I am now at the University of Tasmania, and I would like to thank UTAS for supporting my efforts in writing this 5th edition – an exercise that does take considerable time. I would also like to thank the staff at Cengage for all the work they have done to publish this book. I would particularly like to extend my appreciation to Geoff Howard for his early support in making this 5th edition come to life, to Paul Petrulis VP Cengage Australia for supporting this book, as well as thanking Rachael Pictor, Nathan Katz and Anne Mulvaney for all their work.

Lastly, I would like to thank my 'most excellent' daughter Cassandra Joy Deegan who was born around the time that the first edition of this book was published (no causality inferred). She provides my life with necessary love and purpose.

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CHAPTER

1

INTRODUCTION TO FINANCIAL ACCOUNTING THEORY

LEARNING OBJECTIVES

On completing this chapter, readers should:

- **LO1.1** understand that there are many theories of accounting
- **LO1.2** understand how knowledge of different accounting theories increases our ability to understand and evaluate various alternative accounting practices
- **LO1.3** understand that the different theories of accounting are often developed to perform different functions, such as to *describe* accounting practice, or to *prescribe* particular accounting practices
- **LO1.4** understand that theories, including theories of accounting, are developed as a result of applying various value judgements and also appreciate that acceptance of one theory in preference to others will in part be tied to one's own value judgements
- **LO1.5** 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
- **LO1.6** understand some alternative perspectives about how knowledge develops across time
- **LO1.7** understand why students of accounting should study accounting theories as part of their broader accounting education.

OPENING QUESTIONS

Before reading this chapter, please consider how you would answer the following three questions. We will return to these questions at the end of the chapter, where we suggest some answers.

1. Why do students of accounting need to bother with the study of 'theories'? For example, 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 have knowledge of 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?

LO1.1 LO1.2 What is a theory?

تئوری چیست؟

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

In this book, we consider various theories of 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.

سیستم ایده های گزاره ها برای تبیین پدیده

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.

مجموعه ای گزاره های کلی مورد استفاده، برای تبیین پدیده

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

مجموعه فرضیات، اصول مفهومی، عملی تشکیل دهنده چارچوب کلی مرجع

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

تعریف هندریکسن

The definition provided by Hendriksen is very similar to the US Financial Accounting Standards Board's definition of its Conceptual Framework for Financial Reporting (which, in itself, is deemed to be a *normative* theory of accounting), which is defined as:

objective → concept

> a coherent system of concepts that flow from an objective. (FASB, 2016)

coherent انسجام

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.

انسجام منطقی برای تشریح

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').

Theories can have various applications, including being used to answer particular research questions. A research question is a question that a particular research project seeks to answer. A well-constructed research question would be clear and specific. The determination of the research question is typically one of the first steps undertaken within a research project. The

Theory $\xrightarrow[\text{answer}]{}$ Problem

Past observation → empirically based → Theory

نظریه مبتنی بر تجربه

nature of the research question will be influenced by the theory to be used within the research, and the nature of the research question will influence the research methods to be applied to answer the research question.

As will be seen in this book, some accounting theories are developed on the basis of past observations (they are **empirically based**), some of which 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. However, **empirical research** is restricted by the data that is currently available, which in turn means that empirically based studies cannot be undertaken of phenomena that cannot be observed by the researcher – and this has broader philosophical implications. 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.

استدلال استقرائی

تمرین استقرایی
استدلال استقرائی

Empirically based theories
A theory developed on the basis of past observations, and developed to make predictions about likely occurrences of particular events.

Inductive reasoning
A way to explain a set of particular facts, weighing up observational evidence for a general proposition about a set of facts.

Empirical research
Research that relies upon observing actual phenomena or data.

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.
>
> …Theorizing expresses the meaning and significance of social phenomena, it negotiates peoples' everyday experiences, and it generates expectations about the social world.

نظریه — معنا و اهمیت پدیده اجتماعی

Llewelyn (2003) suggests that five levels of theorising can be, and have been, utilised within the accounting literature, ranging from 'level 1 theories' which rely on 'metaphors' and which form foundations for simple insights that can be further developed, through to 'level five theories' that are considered as 'grand theories' and which are proposed as having universal application across all settings. 'Grand theories' are deemed to be those that tend to generate concepts that are highly abstract and which cannot easily be operationalised into, for example, variables which might be used within hypotheses developed to explain particular organisational activities. According to Llewelyn, at the extreme, level five theorisation may aim for universal explanations that are beyond history and society and where 'meaning' attributed to local conditions and issues by organisational actors are not seen as particularly significant. Llewelyn argues that 'level four theorising', which explains, for example, specific social, organisational or individual phenomena in their respective settings (rather than across all settings as would be the case for grand theories), is the form of theorising most often applied within accounting research. Level four theories explain relationships between various social phenomena in the particular social or environmental context in which they are being researched (but perhaps, not beyond such settings). Some of the theories we explore within this book (Legitimacy Theory, Institutional Theory, Stakeholder Theory) are identified by Llewelyn as being level four theories.

۵ سطح نظریه پردازی
۱- استعاره
METAPHORS
۲-
۳- چارچوب - مفاهیم
۴- پدیده خاص
پدیده اجتماعی در رابطه علی
۵- نظریه های کلان
GRAND

تقسیم بندی تئوری ها براساس
تعمیم پذیری
۱ ۲ ۳ ۴ ۵
دور از شرایط

While we do not need to fully understand all the different levels of theorising proposed by Llewelyn, it is nevertheless useful to know that theories can be classified in terms of their sophistication or their perceived level of generalisability to different settings. Other researchers have also applied similar schema to categorise theories. For example, Merton (1968) used the term 'middle range theories', which referred to theories that fall somewhere in between theories that are based upon 'minor hypotheses' and those that are 'grand theories'. Middle range theorists tend to focus on measurable aspects of social reality; for example, they focus on issues that are studied within particular settings, rather than seeking to explain the entire social world. This is similar to what Llewelyn refers to as 'level four theorists'.

اثر محیط فرهنگی بر پذیرش
تئوری

Llewelyn (2003) also suggests that accepted theories form part of, and are influenced by, the cultural environments in which they are applied. Further, Llewelyn notes that the application of particular theories brings particular objects or phenomena into view that otherwise might go unnoticed, as well as noting that the same objects or phenomena might be seen differently as the result of the application of a different 'theoretical lens'.

Because accounting is a human activity (we cannot have 'accounting' without accountants), theories of accounting (and there are many) will consider such things as people's behaviour and/or people's needs as regards to 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:

- تجویزی *prescribe* how, based on a particular perspective of the role of accounting, assets should be measured for external reporting purposes (such prescriptive or normative theories are considered in Chapters 6 and 7)
- اثباتی *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 8)
- تبیین 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 theories are considered in Chapters 5 and 9)
- *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 6)
- *predict* that the relative power of a particular stakeholder group (with 'power' often being defined in terms of the group's control over scarce and necessary 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 9)
- *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 organisational legitimacy (which derives from Legitimacy Theory and Institutional Theory, both considered in Chapter 9)
- *explain* how certain commonly used accounting practices are not neutral in orientation (as conceptual frameworks for financial reporting suggest), but rather act to maintain a social order that privileges those people with financial capital at the expense of workers (some theories with this orientation come from a class of accounting theories known as 'critical theories', which are examined in Chapter 13).

LO1.2 LO1.7 Why is it important for accounting students to study accounting theory?

As a student of, for example, 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 financial 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 knowledge of accounting theories. 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 corporate failures (such as Lehman Brothers, Enron and WorldCom in the United States, HMV Group in the United Kingdom, Parmalat, Lernout and Hauspie Speech in Europe, Wirecard in Germany, and HIH Insurance, One.Tel, Harris Scarfe and Allans Music in Australia), which have subsequently been linked to questionable accounting practices, 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, and with the increasingly relevant role of 'accounting' to addressing social and environmental problems such as climate change, 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 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 accounting in this book, you will be exposed to various issues, including:

- how the various elements of financial accounting should be measured
- what motivates managers to provide certain types of accounting information (whether it be financial, social, environmental or sustainability-related 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 different cultural attributes influence accounting practices
- how and why the capital markets react to particular accounting information
- whether there is a 'true measure' of profit
- how accounting can contribute to, or be used to solve, social and environmental problems such as climate change, or the incidence of 'modern slavery' within supply chains.

Accounting plays a very important and pervasive role within society. Simply to learn, for example, the various rules of financial accounting (as embodied within accounting standards, conceptual frameworks for financial reporting and the like), or particular sustainability-related reporting frameworks (such as that of the Global Reporting Initiative or the International Sustainability Standards Board), without considering the implications that accounting information can have, would seem illogical, and potentially dangerous.

Many significant decisions, which in turn might lead to various financial, social and environmental impacts, 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 practice of 'accounting', which often relies upon various technical rules, principles or standards, leads to decisions that can create various social consequences. This is why accounting can be considered as both a technical and social practice. The information generated by accountants enables others to make important decisions. Indeed, relevant and reliable information provides the users of accounting information with 'power' to make informed decisions. For example: should they support the organisation? What social and environmental impacts is the organisation creating? 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 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 rise in high-profile accounting failures has raised the level of awareness among non-accountants about some of the significant social 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. Massive corporate failures, such as those at Enron and WorldCom, fuelled various criticisms of accounting, including that financial accounting practices failed to reveal a deterioration of the financial position and financial performance of such entities to shareholders and other interested groups on a timely basis. Moreover, prior to such corporate collapses, there was evidence that financial accounting was being used to create benefits for managers (for example, by using methods that inflated profits, thereby leading to larger and potentially unjustifiable bonuses) at a time when the company was actually in financial distress. Research could look at devising ways to guard against such practices. 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 existing (and potential) 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 accounting practices.

Why do I need to know about accounting theory?

In your career, you might hold various roles. For example, you might be a manager/accountant considering making particular accounting disclosures; you will likely be a reader of various accounting disclosures; or perhaps you might be in a role that involves introducing regulations or standards relating to accounting practice. Some knowledge of accounting theory will allow you to consider the context, implications of or motivations for particular accounting practices that might otherwise not be considered. Arguably, your accounting education would be incomplete, and your ability to be a critical thinker with respect to accounting practice would be undermined, if you did not have sufficient exposure to different accounting theories.

[1] Chapters 3 and 4 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.

LO1.1 LO1.2 LO1.3 A brief overview of theories of accounting

There are many theories of accounting. That is, there is no universally accepted theory of 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 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 financial 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 measured on the basis of market values rather than historical costs).

پیش بینی پدیده حسابداری

تجویز یک رویکرد

Also, the practice of accounting is continuously evolving. For example, financial accounting is not represented by a static set of rules, and many of the accounting rules we learn at university – perhaps as embodied within accounting standards – will be superseded in due course. It is generally accepted that business transactions have, in recent decades, become more varied and complicated, with direct implications for how we account for such transactions. There is also a growing recognition of the role of accounting in addressing issues associated with sustainable development. Societal expectations and priorities change across time, with implications for accounting. Technical capabilities of information (accounting) systems increase across time, as do the size and influence of many corporations. These ongoing changes create new research questions, which then might require the refinement of existing theories, or the development of new theories, to perhaps explain or guide practice. For example:

- In recent times, it has been accepted that climate change is a significant issue for societies globally. Accounting has a role in addressing this issue. Relevant research questions would include: how can accounting be used to reduce organisations' contribution to climate change; what disclosures stakeholders demand in relation to climate change; and what motivates managers to provide particular climate change-related disclosure, or to use particular accounting methods to account for the assets and liabilities associated with emission trading schemes.
- The global financial crisis (GFC) (2007–09) and the more recent COVID-19 pandemic (2019–22) created pressures for governments, organisations and societies that had not been encountered in recent history. Interesting research questions would include: the role of poor financial accounting practices in contributing to the GFC; the efficiency of regulatory reactions; the merit of the accounting profession's response to the GFC in terms of the development of new accounting practices and related governance practices; and whether financial accounting practices appropriately responded to COVID-19 in respect of adjustments to asset valuations and going concern assumptions.
- Since 2005, many countries throughout the world elected to adopt the accounting standards issued by the International Accounting Standards Board (IASB), these being known as International Financial Reporting Standards (IFRS). This raises a number of questions, including: how well the IASB standards 'fit' local requirements; whether the related financial statements are now more useful to various financial statement users relative to former locally developed reporting standards; or how the switch to IFRS has impacted the way financial accounting numbers are used within debt contracts or management bonus systems.

Again, to address the above issues, we can potentially use theory that currently exists, or there may be a need to develop new theory. In the discussion that follows, we consider some general classifications of theories.

observation → Theory

Inductive accounting theories

Induction
The development of ideas or theories through observation.

Early development of financial 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.

From approximately the 1920s to the 1960s, theories of financial 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]

Deductive reasoning
A way to explain a set of particular facts which is based more on the use of logic rather than observation.

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:

Prescriptive research
Research that is generally based on deductive reasoning and provides prescriptions, or suggestions, about what people should do.

> 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.

Inductive approach
An inductive approach to research is based upon developing theory through observation of particular phenomena.

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

[2] Chapter 6 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 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. 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.

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?

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 conducted. 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 one based on current values. However, before the release of these research works, the AICPA issued 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' (Accounting Principles Board, 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 7 when the IASB *Conceptual Framework for Financial Reporting* is 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 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.

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 and 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 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 among the various researchers about what particular asset measurement basis should be used. For example, some argued that assets should be measured at replacement costs, some argued that assets should be measured at net realisable