FINANCIAL ACCOUNTING THEORY IN PERSPECTIVE

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Abstract

Accounting theory is a body of methods and procedures concerned with (i) the appropriate ways of determining costs for the valuation of assets and (ii) the matching of expired costs against realized revenues. Primarily, the "revolution" involves a willingness, whenever necessary, to modify the orthodox historical cost and realization "principles" of accounting. As a result of the rapid changes in economic and social environments, accountants have to face new problems, to which traditional explanations of accounting do not seem to apply. Accountants are now liable to clients and third parties. It is now more difficult to convince the specialist of other disciplines merely by saying "this has been the practice." In order to provide frame of reference on which the development of accounting techniques is base, accounting theory which composed principles and practices was introduced of vital importance to the accounting discipline is the accounting profession and other interest groups accept these principles and practices. In this paper each of these approaches is examined in terms of its contribution to the development of an accounting theory and in terms of its relative advantages, the difference between theory formulation or construction. This paper conclude that the provision of financial reports which meet the need of external users should determine the objectives of financial accounting theory. It was therefore recommended that inductive reasoning that provides a better understanding of financial accounting data should be provided for as well as ethics which provides for a general philosophy as a basis for establishing logical accounting principles.

Introduction

Accounting is a common term which people use freely although they know only a little of its meaning. There are many definitions of accounting. To some people, it simply means how to count money, keep records of income and expenditure, while to others it means how to check fraud or how to know if an organization is making profit or not. However, the one that captures the thrust of this research, is the definition given by the American Accounting Association, (1966), which defines accounting as "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information." Thus, accounting refers to an act of recording, analyzing and interpreting financial records of an organization.

The origin of accountancy profession is rooted deep in history. The 14th century Italians developed the double entry book keeping system, which over time had evolved into modern accounting as we know it today (www.acaus.orglacc-his.Ltml). Today, we no longer record transactions the way they were recorded in Renaissance Europe. Similarly, our understanding of ethics is much sharper than it was several years ago. However, we should note the existence of a concept which has not experienced major modifications over time: fraud. Fraud existed when the double-entry system was only being developed in the 14th century, it existed in the beginning of the 21st century when the corporate giants such as Enron and Arthur Andersen collapsed, and unfortunately, it may still exist centuries from now. Fraud is a legal and not an accounting concept. Accountants are professionally trained persons that are involved in the recording of business transactions, analyzing and interpreting the information generated for management, which are used in decision-making.

On the other hand, Auditors are practitioners who are members of the Institute of Chartered Accountants of Nigeria (ICAN) and Association of National Accountant of Nigeria (ANAN) as provided in Companies and Allied Matters Act (CAMA) 1990 that perform statutory audit and attesting to the credibility of financial statements, to protect the interest of stakeholders. Forensic Accounting is the application of financial skills, and an investigative mentality to unresolved issues, conducted within the context of rule of evidence. As a discipline it encompasses financial expertise, fraud knowledge and a sound knowledge and understanding of business reality and the working of the legal system.

Development in Financial Accounting Theory

Glautier and Underdown (1976) observed that traditionally, financially accounting reports have been based on the stewardship concept of accounting, which is concerned with safeguarding assets and ensuring that they have been honestly managed. The misunderstanding of accounting is partly due to the lack of relevance of the accounting profession to everyday life, as is the case with professions like medicine, law, engineering and religion that can render services on sympathy ground whereas no such causal service by an accountant except is engaged.

As a demonstration of the relevance of those other professions to everybody life, the following examples are given:

- A doctor may be called up late in the night by a neighbor whose child develops cold.
- A lawyer may be convinced to prepare documents for bail in respect of a relation who has been unjustifiably arrested by the police during the weekend or even during the public holidays.

The major legislation governing the financial reporting of enterprises in Nigeria is contained in the Companies and Allied Matters Act Cap 59 Laws of the Federation (CAMA 1990). Other rules and guidelines consist of the Statements of Accounting Standards (SAS) of the Nigerian Accounting Standard Board (NASB). International Accounting Standards (IAS), and pronouncements of other regulatory bodies.

Section 334 CAMA requires that the Directors of every company shall in respect of each year of the company prepare financial statements for the year which as stated in subsection (2) shall include:

a. The statement of accounting policies;
b. The balance sheet as at the last day of the year;
c. A profit and loss account or in the case of a company not trading for profit, an income and expenditure account for the year;
d. Notes on the account;
e. The auditors report;
f. The director's report;
g. Statement of source and Application of Funds now replaced since 1997 with the statement of cash flows;
h. A value added statements for the year
i. A five-year financial summary; and
j. The group financial statement in the case of holding company.

Section 334(3) exempts private companies from the statements in a,g,h and i.

The task of accounting is to reduce a tremendous mass of detailed information to manageable and understandable proportions in our present day accounting system. Auditing does none of these things. However, it may consider business events and conditions, too, but it does not have the task of measuring and communicating them because of the financial accountant is to prepare the account. In brief auditing is analytical, it is critical, investigative, concerned with the basis of accounting measurements and assertions. It also emphasizes proof and support for financial statements and data. In the same vein, Mauzt and Sharaf (1961) cited in Alalade (1987) states that "auditing has principal roots, not in accounting which it reviews, but on Logic on which it leans heavily for ideas and methods." In view of this, Mauzt and Sharaf (1961) believe that, "the relationship of auditing to accounting is close, yet their natures are very different, they are business associates, not parent and child."

However, Accounting itself, stretches beyond the mere mechanics of recording transactions to the analysis and interpretation of such records. It may also be concerned with the future as well as the past in order to form the basis of business decisions.

As a discipline, accounting has further evolved along two very distinct lines:

i. Management accounting, concerned with external decision-making
ii. Financial accounting, concerned with external decision-making

This distinction has been brought about by:

i. A separation of ownership from control which now characterizes modern corporate enterprise, i.e. while the shareholders own the assets it is management who are entrusted with them.
ii. An increasing awareness by other groups in society who are interested or concerned with a firm's performance.

Irrespective of all the time horizon involved, external decision-making is concerned with the allocation of funds between competing claims. Whilst not wishing to underestimate the element of social responsibility involved, this requires that, in the private sector at least, companies are recognized primarily as economic entities, that is to say that they exist to convert resource inputs of money and physical capital into outputs of goods and services which satisfy consumer demand and generate money profits and value.

Since most economic resources are finite, management's role in all this can be perceived as the allocation of scarce resources for the benefit of their providers and, because money capital is typically the controlling factor, the problem ultimately is one of how management chooses to allocate limited funds between alternative uses.

In order to understand why financial reporting is at variance with user needs it is worthwhile, therefore, to return to first principles and examine critically the basic concepts and conventions upon which it is based.

Accounting Concepts and Conventions

The concepts and conventions of financial accounting are particularly significant for two reasons. First, they are part of the empirical process which nationalizes the complexity of business. They represent the ground rules which provide the framework or axioms with in which accountants many operate. Second, they reflect the influence of institutional forces which shape the philosophy of accounting in a given economic and social environment. Premised largely upon one assumption, which shall be discussed later, the concepts and conventions of financial accounting are as follows:

The Concepts

1. **Money Measurement:** Accounting is only concerned with those facts which can be quantified in monetary terms.
2. **The business entity:** The facts recorded in firm's books are transactions that affect the firm and do not extend to the personal resources of the proprietors.
3. **The concept of continuity or going concern:** Unless information is available to the contrary, it is assumed that a business will operate indefinitely. This has arisen in part because break-up valuations bear no relation to going concern valuations. In addition, accounting divides the life of the firm into arbitrary accounting periods in order to facilitate periodic income measurement.
4. **The cost concept:** Relating to continuity, this means that assets are ordinarily recorded at their invoice cost, which also forms the basis of valuation. This in turn is based upon objectivity- exchange prices are facts – and conservatism.
5. **The duality or doubt entry concept:** This highlights the twofold effect that any transaction has on the firm. It is the basis of bookkeeping.
6. **The realization concept:** In accounting, profits are made at the moment the goods are exchange and not when cash is transacted. This is why a firm can make a profit yet have an overdraft. Unrealized profits, i.e. the potential for exchange or sales are what gives the firm 'value'.
7. **The accrual concept:** this is concerned with the timing of matching costs against revenue when calculating profits or losses. Just as profits relate to what has been earned, irrespective of whether cash been transacted, as too costs do not necessarily relate to assets, goods or services paid for during the accounting period but simply represent those that are consumed, irrespective of payment. The accrual system of accounting may be distinguished from cashflow accounting.

The Conventions

Over time, the basic concepts of accounting have been modified by certain conventions. The main conventions are:

1. **Determinism:** Accountancy does not lend itself to subjective quantification. It is, therefore, held desirable to be objective. To the practicing accountant, objective implies 'freedom from bias' by quantifying economic events in monetary terms using factual exchange transactions.
2. **Materiality:** Accounting is only useful if the recording of a transaction is worthwhile. Thus, an asset may be written off as an expense, even if its use extends over one accounting period and its initial cost was small.
3. **Conservatism:** The conventions of conservatism, which is inextricably tied to the previous conventions, means that accountants take figures which neither under nor overstate profit and when faced with a choice they will choose a figure which will show the capital of a firm at a lower, rather than higher amount. Tied to realization, this convention can be said to ensure that losses are recorded but profits are not anticipated.
4. **Consistency:** This is designed to ensure that when a firm has decided upon a particular method of accounting treatment, it will subsequently enter all similar terms into the books in exactly the same way. If changes in treatment occur and profit are affected by a material amount then the effect of this change should be stated in the accounts.

Pragmatism

The concepts and conventions listed above are broad in scope and have evolved over a long period of time. It is important to realize, however, that they do not constitute a theoretical basis for accounting in the true sense of the term. Indeed, it is probably true to say that accounting is the only profession where practice developed before anyone thought about theory; put succinctly, it is an applied discipline. One reason for this that the evolution of the concepts and conventions has been determined by their usefulness i.e. along pragmatic lines following this philosophy, a lack of usefulness signals rejection. Usefulness itself is judged by general acceptance of a particular procedure or methodology.

The advantage of such a pragmatic approach is that accounting serves a function only if it useful. Thus, if it is assumed that accountants know what is most useful, then the most commonly used practices can be assumed to be the best. Since pragmatism makes known new methods that may prove useful it also leads to greater uniformity and consistency by their widespread adoption.

Yet, while it may be helpful to know that methods are in common use, the dissemination of generally accepted procedures essentially the approach adopted by the Accounting Standard Committee (ASC) in the publication of Statement of Standard Accounting Practice (SSAPs) on the assumption that these are the best methods, may actually be theoretically regressive. Accountants may rely on these procedures rather than explore other avenue of thought. Indeed, the main criticism of SSAPs is that they have failed to provide a general overall framework of accounting? To whom should accounting data be useful and for what purpose? A clear statement of the objectives of accounting should have preceded detailed analyses of the how specific procedures can help accounting fulfill its functions.

Of course, accountants defend their position by emphasizing the ethical nature of their discipline since the concepts also reflect justice, truth and fairness which have long been basic objectives in the presentation of financial reports.

The first conclusion to which one is drawn, therefore, is that accounting may well profit from the development of a body of theory. It is, therefore, worthwhile to define that we understand by theory before going on to evaluate the needs of users.

Accounting Theory and the Needs of Users

A theory may be regarded as a “coherent set of hypothetical conceptual and pragmatic principles forming the general frame of reference for a field of enquiry” (Hendrickson, 1977). It requires logical reasoning in the form of a set of principles that:

1. Provide a general frame of reference for evaluation
2. Guide the development of new practices
3. Explain existing practices and therefore give better understanding

Thus, the goal of accounting theory must be to provide logical principles which, in turn, provide a frame of reference for the evaluation of sound practice.

Theory does not explain all practice, however, because all theory is based on logic while practice is not always logically conceived. Therefore, if an attempt is made to explain techniques there is a certain need to modify theory.

With regard to the facts explained by theory, financial accounting theory is not the explanation of financial facts but rather, the economic relationships which may appear differently to various observers. Thus, several theories may be developed from the same set of facts which may appear logical within the framework of different users’ perceptions.

The choice of an appropriate accounting theory, therefore, depends on how well it supports the development of techniques and fulfils the needs of users. To develop any theory it is therefore necessary to state users' objectives. The problem, however, is that shareholders' needs may not be synonymous with, say, employee welfare which may not be on a par with other users. This is not to say that different objectives will not lead to common accounting principles; rather that there is no *a priori* reason for believing so. Furthermore, objectives may change over time as different user groups assume dominance.

As a consequence, there is a need to monitor the relative importance of such groups and the information which they require in order to determine whether current accounting repot are not at variance with objectives. Failure to do this may result in theories of accounting being constructed on incorrect information, with the result that the remedy will be worse than the original disease.

Because of the iterative and intuitive nature of business it may be argued that the utility of financial data still relates move to the evaluation of past events, rather than future decisions. In as much as the ultimate responsibility for the future also rests with the management of a company, it is their analysis of the past, rather than any other, which should lead to better decisions and modifications to business policy. Hence, for external reporting purpose, records of stewardship should suffice.

Historically, professional accounting and legal opinion has upheld this view, namely that a balance sheet is a past record and not an estimate of current or future worth. Likewise, the income statement was held to be similarly so (JCAEW 1954, ASC 1975). The Cohen Committee on Company Law Amendment actually disallowed the provision of current financial data and supplementary information in financial statements (1945). Case law too, proclaim that no ordinary shareholder would succeed in an action based on negligent information provided in company accounts, the reason being that reports are not prepared for investment purposes unless issued as part of a prospectus (Rex v Kylsant and Morland 1932). As a result, the legislative intention of successive Companies Acts in the U.K. has been that annually reported information should primarily reflect the stewardship function exercised by company directors (HMSO, 1948; 1967; 1980; 1981).

Approaches to Theory Construction

Even a cursory glance at the empirical evidence reveals that, in U.K. and elsewhere users have long required more than accounting records of stewardship which merely state periodic income expost and attribute it solely to the actions of management. What they require is an indication of whether this is good or bad in relation to what management intended and what they anticipate in the future. Academics have, therefore, responded by developing numerous theories.

Positive Theory

Positive or descriptive theories are essentially concerned with explaining accounting practice so as to determine general principles concerning how a particular matter should be treated. In effect, the mechanical tasks which accountants perform are observed in order to derive a general theory of financial accounting.

In developing explanations, the process relies upon inductive reasoning, so common in the physical sciences. As applied to theory formulation:

1. Measurements are observed
2. Conclusions or principles are drawn and generalizations are established
3. Generalizations are subjected to later confirmation

The advantage of this inductive approach is that we are not to constrained by any preconceived idea and that allow us make a free choice of data. Because principles may be falsified, generalizations are also confirmed by logic.

On the other hand, it may be difficult to derive general principles, particularly if the raw accounting data and its relationship differ from firm to firm. As a consequence, only hose generalized practices as do exist may be subject to scrutiny. Alternatively, if there is a subconscious idea of what is relevant, the theorist may be influenced by choosing data which focuses upon only certain aspects of what is measurable in the accounting environment. In the extreme case of a reporting system dealing with only historical financial transactions, the resultant theory may be partial and regressive, confirming no more than existing practice. Indeed, many early proponents of a positive approach actually subscribed to the view that the objective of financial statements be associated with the stewardship concept and the provision to shareholders of information relating to the past management of their investments (Littlelton, 1954).

Normative Theory

During the 1950s there emerged a widespread disillusion with positive theories, particularly their research emphasis upon the relevance of existing accounting practices to economic and social reality. A number of academic accountants therefore began to draw upon micro-economics as a natural source of ideas concerning the nature of income and value and adopted a normative approach in their search for a generalized theory of financial reporting. Less concerned with observing and describing what actually happens, this new development attached greater importance to prescription, independent of existing practice.

Chambers (1955), commenting upon the nature and purpose of accounting theory at the time state that:

> "It is necessary to distinguish between systems of rules relating to the practice of accounting and a theory of accounting. A system of rules is necessary for the consistent practice of any art, and it is useful to attempt to sort out the rules which appear to be followed. Only if the rules are adequately described is it possible to discover inconsistencies in the system. But the adequate description does not assist in determining which of two inconsistent rules should be adopted and which should be abandoned. The question should be referred to a more fundamental set of propositions, to the theory of the subject."

Accordingly, normative theories are concerned with specifying objectives, for example profit maximization of shareholders' wealth. These, in turn, determine a theoretical accounting framework that can provide point of reference by which the information content of actual accounting systems maybe assessed and improved.

Normative theories utilized the process of deductive reasoning whereby:

1. Objectives or postulates are established
2. Logical Principles are developed into a theoretical framework
3. The framework may provide practice applications

Thus, applications are derived from logic which does more than support current conventions.

The formulation of objectives is the most important aspect of normative theorizing, if only because different objectives might produce different accounting principles. Thus, a major criticism is that if the objectives are inappropriate the resultant framework may be inapplicable also.

Behavioural Theory

During the 1960s, disaffection with generalized normative theories led to increase behavioural research into financial reporting. Instead of concentrating upon how the data contained in conventional financial statements might better reflect economic reality, the emphasis was on the reaction of individuals and firms to accounting data. For example, why a sound economic concept applied in practice might lead to undesirable behavior and vice versa.

Although the question of what is undersirable relies heavily upon subjective judgment and affords a direct comparison with pragmatism, the advantage of the behavioural approach lies in its concern with how accounting information determines user decisions, rather than logic. To quote the American Accounting Association (AAA, 1971):

> *The principle purpose of accounting repot is to influence actions, that is behavior. Additionally, it can be hypothesized that the very process of accumulating information, as well as the behavior of those who do accounting will affect behavior. In short, by its very nature accounting is a behavioural process.*

Note surprisingly, the expansion of behavioural research quickly embraced communications theories which perceive financial reporting as an integrated information system. Such theories are useful, in as much as they seek to determine the type of information required by users, how it should be processed and the best method of communicative quality of different information. These developments, in turn, promoted the formulation of decision-making theories of accounting, which can today be classified as empirical and normative-specific.

The failure of generalized normative theories, with their emphasis upon improving the data contained in conventional accounting statements based on the accrual concept, led to a substantial increase in empirical research during 1970s. this new work was more rigorous and sought to highlight not only possible improvements in the information already disclosed in financial reports, but also, suggest radical alternatives relevant to decision-making by external user. Normative-specific theories too, concentrated upon specific decision models for external users. However, unlike empirical research, which examines how users of accounting information apply it in practice, the normative approach specifies the manner in which decisions ought to be made as a precondition of information requirement. Thus, it provides an insight into the decision-making needs of particular users such as employees and investors as a basis for developing new theoretical model of accounting. Tom Lee's (1972; 1981; 1982) case for financial statements based on actual and forecast cash flows, rather than accrual reports is a particularly fine example.

Corporate Reporting

The notion of corporate reporting, or social responsibility, reflects a welfare approach to financial accounting theory. It too emerged in the 1960s when changing social values and expectation led to widespread debate about the role of business in society, particularly by academics searching for alternatives to the neo-classical economic model of profit maximization upon which most normative accounting theories are based. This gave rise to the view that social responsibility could be discharged through a variety of multi-dimensional accounting statements (AICPA, 1977). These embraced purely descriptive records of stewardship, specific user reports and cost-benefit analyses. Corporate reporting therefore complements the decision-making approach by still focusing upon the effects of accounting information, but in a broader social context, rather than on user decisions. It has its objective the maximization of social welfare.

Recommendation

Based on this paper, the following recommendations have been made:

1. Inductive reasoning, which provides a better understanding of financial accounting data should be provided for.
2. Pragmatism which sets limitations on abstract theory and assists in the formulation of objectives should be encouraged
3. There should be professional ethics that provide for a general philosophy as a basis for establishing logical accounting principles
4. New concepts and new accounting procedures which satisfy the stated objectives should be established by law.

Conclusion

The provision of financial reports which meet the need of external users should determine the objectives of financial accounting theory. The criterion by which the effectiveness of the current system of financial reporting should also be judged is the usefulness of its information content to external users. The preceding discussion suggests that financial accounting should provide, not simply records of past performance, but also information concerning the future, so that users can evaluate the investment opportunities offered by different opportunities offered by different firms. Only then can they allocate and ration their scarce resources so as to maximize their potential benefit to society. Suffice it to say that only by default can conventional reports achieve this aim. A description of claims to resources, and how they have been allocated to earn past profits, is an important function of published financial statements but in modern corporate society it should not be the one. A case can therefore be made for preparing a number of single purpose statements to meet the needs of various users, although no open-ended system is ever likely to achieve this, if only because the costs and preparation time would eventually exceed the benefits.

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