
Unit 1 □ Accounting Theory-Its Nature, Foundation & Classification

Structure

- 1.0 Introduction**
- 1.1 Meaning and Nature of Accounting Theory**
- 1.2 Foundation of Accounting Theory**
 - 1.2.1 Measurement Aspect**
 - 1.2.2 Decision-making Aspect**
- 1.3 Classification of Accounting Theory**
 - 1.3.1 Structural or Syntactical Theories**
 - 1.3.2 Interpretational or Semantical Theories**
 - 1.3.3 Behavioural or Pragmatic Theories**
- 1.4 Accounting Environment**
 - 1.4.1 Economic Environment**
 - 1.4.2 Social Environment**
 - 1.4.3 Legal or Statutory Environment**
- 1.5 Exercise**
- 1.6 References**

1.0 Introduction

Until very recently, accounting was regarded as what the accountants did. That is, accounting was just an art and artist was at liberty to do whatever he liked. As a result, myriads of alternative approaches were developed for the measurement or reporting of the same phenomenon. It was said “you ask ten accountants and they all will give you different sets of accounting figures”. For this, accounting information produced earlier was neither comparable nor reliable. This had been going on upto the beginning of the twentieth century, and in the year 1929 when the New York Stock Exchange crashed or in the year 1930 when the world experienced an unprecedented depression, the accounting profession was brought to a challenge by both accounting and non-accounting people. Then possibly, we started to think for the first time that no discipline can develop in a scientific manner unless it has a sound theoretical base. Accounting has a procedural orientation no doubt, but until and unless we put a conceptual emphasis on it, accountants themselves will find it

difficult to justify their actions if faced by any challenge from inside or outside the profession. Actually, this answer to 'why' was not available earlier and the accountants were busy to give answer to the questions starting with 'what' or 'how'. Thus, accounting was just a rule-based discipline which can be memorised, not conceptualised. In the search for a defence by accountants who are now liable to a number of clients and in the face of a strong criticism by even the laymen, accountants started during 1920s and 1930s to develop a body of knowledge that can be recognised as accounting theory. This body of knowledge also started to gain ground very rapidly, as the accountants were relieved to a large extent having got a defence to satisfy the people of conflicting interests. No more could the owners pressures the accountants to show less-profit to deprive the workers or governments of their legitimate shares. No more could the directors stress for inflated profit that would help them in having higher remuneration. All accountants started to show more or less the same amount of accounting profit. Comparability and reliability of accounting information were mostly ensured with this development of accounting theory during 1920s and 1930s. The historical cost was then the basis for accounting as this could be documented easily with vouchers etc. to ensure reliability of accounting information. But during the 1960s, the theory so far developed was brought again to challenge in face of soaring prices, as the accounting information then started to lose much of its relevance, though reliability .of it was beyond any question, Hence, we found in the 1960s the development of a newer type of accounting theory which is popularly known as 'valuation theory'. With these two sets of theories we constantly try to draw a balance between the reliability and relevance criteria of accounting information. We are yet to reach the optimum balance and perhaps no discipline has been able to do so. At least we can now explain or justify the accounting actions. Specialists of other disciplines have also been convinced now that accounting is based on logic and sound reasoning. We have a long way to go in this respect. But what we have got in the mean time is not negligible.

1.1 Meaning and Nature of Accounting Theory

Accounting theory as G. D. Roy defines it, is a body of knowledge that explains and justifies the accounting functions. What is deduced from the definition is that accounting theory will give answer to why- we have measured, recognised and reported one accounting event in a particular way and whether that adopted way is justified or not from the viewpoint of the objective of accounting. According to E. S. Hendriksen, accounting theory is a set of broad principles that provides a general

frame of reference by which accounting practices can be evaluated, and guides the development of new practices. That is, accounting theory has actually twin objectives- evaluation of old practices and promotion of new practices. While evaluating the old ones, the theory may either revise or replace them and at the same time it may add fresh ones to them. The theory, thus, attempts to build up a” developed as well as largely acceptable set of conceptual and ideological interpretations of accounting functions, together with guidelines appropriate for their executions. It was difficult earlier to convince people, both inside and outside the profession, merely by saying that “this has been the practice”. Now theory has attempted to provide us with a solid and reasonable argument by which we can logically convince people as to what is what or why this is so.

But the fact is that, unlike in most other disciplines, in accounting there is no generally accepted theory. There are rather a number of accounting theories to explain the same phenomenon. For this, we see that, instead of convincing the users of accounting information as to why one event or phenomenon has been accounted for in a particular way, it is rather confusing them. This is because we have got different approaches to the formulation of accounting theory. The approaches that we see usually in this respect are as follows :

- (i) Authoritarian approach
- (ii) Ethical approach
- (iii) Sociological approach
- (iv) Economic approach
- (v) Behavioural approach etc.

We know that the authoritarian approach imposes theory from the fourteenth floor which may not have any practical consequences. The ethical approach focuses on the concept of ‘fairness’, whereas the sociological approach on the concept of ‘social welfare’. The economic approach focuses on the concept of ‘general economic welfare, whereas behavioural approach emphasizes the relevance to decision-making by the users. So, if we look from different angles, our interpretations cannot but be different. Because of these differences the Committee on Concepts and Standards formed by the American Accounting Association (AAA) arrived at the following conclusion :

1. No single governing theory of financial reporting is rich enough to encompass the full range of user-environment specifications effectively, and hence.

2. There exists in the financial accounting literature not a theory of financial accounting, but a collection of theories which can be arranged over the differences in user-environment specifications.

Not only the approaches, but also the methodology or process of formulating accounting theory is not what it should be. Greater emphasis has so far been given on deriving a theory from the practice of accountants. That means the inductive approach has been mostly followed hitherto that has just codified the existing practices instead of evaluating and revising them. At present, deductive approach is also used in some cases to the formulation of accounting theory. A number of regulatory bodies have been set up at present both at national and international levels. The Institute of Chartered Accountants of India (ICAI), and the International Accounting Standards Board (IASB) are worth mentioning in this regard. These bodies are pronouncing accounting principles and procedures every now and then based on deductive principle and the practitioners and individual enterprises are being 'influenced by those pronouncements. But till today, most of those pronouncements are voluntary in nature and hence, the compliance with them by individual enterprises is not yet so significant. However, the position is changing rapidly. There has been a world-wide trend at present to follow the pronouncements of some regulatory bodies in pursuit of harmonization of accounting practices. But all in the accounting profession must recognise that accounting theory is not, probably never will be, a stable phenomenon. Hence, diversity and at the same time an attempt towards harmonization will always be there.

1.2 Foundation of Accounting Theory

We have seen from the discussion in earlier section that accounting theory can never be said to be stable. It has been rather changing continuously in keeping pace with the changes in socio-economic conditions. Thus, gradually or over time the structure of accounting theory has undergone a number of changes, and obviously each of those structures has been built on some new and different foundations. So, the accounting theory that has been developed up-to-date does not have only one foundation. At least three key-factors can be named here which can be termed as the foundations of accounting theory. Earlier, the basic objective of accounting was to measure the income for owners. The question of measurement was then the key-factor or foundation of accounting theory. Gradually, the emphasis has been shifted to communication of information and then to the-decision-usefulness of information. These three phenomena can be called as the foundations of accounting theory till today.

1.2.1 Measurement Aspect

Accounting is generally defined as the measurement of financial information and presentation of this information in a meaningful and understandable form. But so long the businesses were only the sole proprietors' firms, the communication part of accounting was not as challenging as it is today. The sole proprietor being the only owner, he could have access to accounting information during the process of measurement itself and as a result, no further process was needed to present the information in suitable formats. Thus, for a long time the accountants have focussed their attention on measurement of profits. Accounting theory that developed during those days, for obvious reason, was based only on this aspect of measurement.

Measurement is the assignment of numerical values to represent specific attributes of selected subjects or events. Attributes means the traits or aspects of an element to be quantified or measured, such as historical cost or proceeds, current cost or proceeds etc. Thus, the theory that deals with the measurement of attributes attempts to explain the problem of assessing and evaluating data, the significance of which can be correctly stated and accurately represented. While doing so the theory writers had to face mainly three problems associated with the measurement. They are:

1. What events or objects should be measured
2. What standard Of scale should be used
3. What should be dimensions of the 'unit of measurement

The objects selected must reflect the objectives of business decisions clearly without ambiguity. An ideal measurement scale should be one that is stable over time. And the unit of measurement should encompass only those objectives that are measurable in true sense. These being the normative theories of measurement, the measurement scale in current practice has been the normal units of money. This scale is simpler than any other units of measure. This measuring rod is reliable as well. Hence, the accounting theory authenticates this practice. At low rates of change in general purchasing power, the scale of nominal units of money creates no problem. But during soaring prices or deflation, the scale may require adjustment. A number of accounting theories have been developed to that end. But the accounting people are not yet prepared to measure information in a way that may produce data useful or relevant for future decisions. The attitude of accountants should, however, be changed so that measurement possesses a high degree of predictive ability.

1.2.2 Information needs

Accounting gradually moves away from its traditional procedural base encompassing record-keeping and such related work as the preparation of budgets and final accounts, towards a role which emphasizes its social importance. It is interesting to contrast definitions which were accepted a little time ago with more recent statements. According to definitions made in 1950s. "The central purpose of accounting is to make possible the periodic matching of costs and revenues". This concept, i.e., the measurement aspect, is the nucleus of accounting theory no doubt but rapidly we have extended the boundaries of accounting and at the same time have redefined the scope of the subject. Accordingly, the purpose of accounting has been 'to provide information to different segments of society.' According to this latter viewpoint, the scope of accounting should not be restricted to the private use of information. Rather, the significance of such information may be seen in the context of various groups having vested interests in business organisations. Thus, the communication part of accounting has become of greater importance and for obvious reason, the theory starts to veer round that. Ultimately, we see that along with measurement aspect, the communication of information to interested parties has become a foundation to accounting theory.

Along with the needs of information by different parties, a number of problems crop up as to how to meet the diversified needs-of diverse and sometimes conflicting groups of interest. Needs are not identical but special purpose reporting to each group is not feasible from the viewpoint of cost and benefit. Moreover, if a number of reports are issued, the users may be confused as to the credibility of the information. Hence, one multipurpose report, instead of a number of special purpose reports, is stressed upon. But this is not also an easy task. Groups are diverse and the sophistication levels in the same group are also different.

The next problem that needs solution in this respect is the existence of multiplicity in accounting practices. It is said that accounting profit is what the accountants measure it to be. If different accountants are employed to compute profits from the same set of transactions and events, there is little likelihood that they will arrive at the same figure. Thus, the comparability of information supplied becomes the problem. This problem has not been solved completely as yet. But the diversity in accounting practices has narrowed down to a large extent as this subject has become the core of accounting literature and research.

1.2.3 Decision-making Aspect

Users need information not for information's sake. They need information because they feel that information will help them in making effective decisions.

Decisions are always addressed to future. But traditional accounting, that depends largely on historical cost data, usually gives information relating to the past. It is argued that historical cost basis is an objective basis of accounting, and as the historical cost can easily be documented with vouchers, receipts etc., the information produced as such is reliable. For a long time the accountants were more concerned with this reliability criterion of information, as the users were also interested then mainly in stewardship accounting, i.e., in knowing whether the managers are doing effectively as stewards of their resources or not. Thus, the users, mainly the owners, were interested mostly in analysing past events instead of predicting the future. But in the past four decades, the changing social attitude, developments in technology, quantitative methods and the behavioural sciences all combined to shift attention from historical emphasis to decision theory. The essential purpose of accounting now is providing information for decision-making. Thus, in addition to reliability has the relevance of accounting information for decision-making become another corner stone towards the development of accounting theory. This need for decision-making actually paved the way for the great valuation debate of the 1960s.

It is during this period of the 1960s that several major theoretical works in accounting emerged. Much research interest during this period was devoted to an examination of valuation approaches as alternatives to historical cost-based valuation. Although some researchers were still attempting a theoretical justification of historical cost, there were others who demonstrated active interest in developing alternatives so that users get necessary information relevant and useful for their decision purposes. CPP accounting, current entry or exit price accounting, present value accounting and many of the line were developed with the same object in view. None of them is free from limitations. The major single criticism lodged against them is that they are subjective in nature and hence not reliable. This reliability-relevance tangle has some truth no doubt, but still these developments are described as the works of a golden age in the history of accounting, and the thing that acts as the foundation to the development of these valuation theories is undoubtedly the decision-making aspect of accounting.

1.3 Classification of Accounting Theories

There are several ways of classifying accounting theories Taking foundation of accounting theories as the basis, we may classify accounting theories in the line of discussion of the earlier section, i.e., as measurement theory, information theory and decision theory. Having taken 'the time' as a basis some have classified accounting theories as pre-industrialisation theories, post-industrialisation theories and the modern

theories of accounting. According to the function of accounting, the accounting theories have again been classified as stewardship accounting theory, decision usefulness theories and social responsibility accounting theories. Accounting centres have also been the focal point at the time of classifying accounting theories. In that case accounting theories have been grouped as business accounting theory, government accounting theory and national income accounting theories. But the most useful frame of reference, according to E. S. Hendriksen, is to classify theories as :

1. Structural or syntactical theories
2. Interpretational or semantical theories
3. Behavioral or pragmatic theories.

1.3.1 Structural or Syntactical Theories

These theories attempt to explain how accountants would react to certain situations or how they would report specific events. Actually, until very recently, accounting meant what accountants did. Thus, different accountants used to react to same situation differently. They used to report the same event in different manners. Hence, a general framework for accounting was badly needed. The structural or syntactical theories have been developed to meet that end. These theories try to evaluate first the current practices of accountants. Then they codify some of the practices as generally acceptable and simultaneously they prescribe some new procedures or principles that the accountants in general would follow while measuring or reporting any accounting event. Thus, structural theories are made up of both descriptive and normative theories whereby the accountants can have a guideline as to how one journal or ledger book is to be opened, what should be the format of the balance sheet or the -profit and loss account, what of historical and current cost should be treated as the basis for accounting measurement or what of cost and market price should be used for valuing stocks. Structural theories in this way outline the scope and boundary of accounting and simultaneously they specify the limit beyond which the accountants must not go. This does not mean that structural theories provide no flexibility to the accountants. They rather explain the situations that will help the accountants to choose the proper alternative.

1.3.2 Interpretational or Semantical Theories

Structural theories of accounting provide for a large number of symbols, terms, formats or technical languages to help a systematic and scientific measurement and presentation of accounting information. But an accounting structure, although logically

formulated, does not convey meaningful interpretations unless the symbols and words representing descriptions or measurement are related empirically to real world phenomena. It is often said that existing financial reports are documents which are prepared by accountants for accountants. That means the people outside accounting profession cannot understand what accountants mean to say through accounting reports. Hence, accounting writers or researchers delve upon this interpretational aspect and ultimately we get a number of theories, known as interpretational theories, that help the users understand the structural theories of accounting. Recent attempt by the US FASB (Financial Accounting Standards Board) to provide a meaningful interpretation to different terms that are used in financial statements is an example of the aforesaid interpretational theories. Earlier attempts in this direction were made by Canning, Edwards and Bell, Sprouse and Moonitz and many other accounting personalities or accounting bodies. They all endeavoured to find ways to improve the ability of accounting information to be interpreted in terms of human observation and experience. Empirical studies, however, reveal that these interpretational theories are not so successful as yet, because different terms and concepts of accounting get different meanings even today depending upon the perception of different users or different environment. So, the development of theories is not enough. But they should be verified or tested by researches to determine whether users of accounting information understand and correctly interpret the information producers' intended meaning.

1.3.3 Behavioural or Pragmatic Theories

The Behavioural Theories attempt to measure and evaluate the economic, psychological and sociological effects of alternative accounting procedures and reporting media. This kind of accounting theories is still in its infancy no doubt, but there is a great scope and need for development of theories that may help in creating a behavioural change on the part of users. Not only the interpretation but also the efficient use of accounting information has been now the objective of accounting theories. For this, attempts are needed to seek answers to some basic questions like who are the users of financial statements, what is the type of specific information wanted by them, whether the statements meet those needs or not? Since the middle of twentieth century it is being realized that accounting is useful not merely to assess the results of past performance but also that it can be more useful in decision-making by the management, present and potential investors, creditors, government and others. The most important facet of decision-making is the ability for proper prediction. So, if accounting has to be decision-oriented, it must help

prediction by users, and for this the accounting information should be so designed as to reflect a trend of occurrence of some events having analysed which the users may take decisions for future. Researches are being conducted in such behavioural areas of accounting. The progress is not so significant, but very soon perhaps we shall break through the barrier.

1.4 Accounting Environment

Accounting is substantially a product of its own environment. We have noted that as the environment changes, accounting structure, systems, processes also change. This is the major testimony of the fact that accounting is solely dependent on the environment in which it is to operate. Socio-economic environment in particular has a great influence on accounting structures and processes. This environment is made of, inter alia, interrelated micro and macro socio-economic activities. Since accounting covers the entire administration or management of information for all socio-economic activities in both micro and macro economic sectors, a clean analysis and assessment of this accounting environment is of prime importance. The environment in developing and underdeveloped economics is different from that prevailing in developed economics. Naturally we find sophisticated accounting systems in developed countries compared to simple and obsolete systems in use in underdeveloped economics. So, the efficiency or otherwise of accounting theory cannot be evaluated in an isolated way. The economic, social as well as the legal environment of the concerned accounting theory must be analysed to understand the latter properly.

1.4.1 Economic Environment

With the economic development of a country, the accounting systems assume higher significance. For centuries after the system of double entry book keeping appeared, accounting was devoid of methodology or any form of theory. It was only after the industrial revolution of the nineteenth century that we saw a move from book-keeping to accounting-a move away from the relatively simple recording and analysis of transactions towards a comprehensive accounting information systems. Consistent with mass production techniques and high capital investment, there have been refinements in cost and management accounting in the twentieth century. More recently, the cross-border flow of capital has increased tremendously. As a result, the need for international harmonization of accounting has got now a new impetus. Along with the introduction of value-added tax (VAT) in Indian tax structure, the value added accounting has got a new dimension. From all these, it may be said that economic environment has a notable influence on the development of accounting theories and practice.

1.4.2 Social Environment

Along with economic events, a number of social phenomena like poverty, social security, ecology etc. have also a significant bearing on accounting measurement and reporting. This area is referred to as social accounting. Even corporate bodies today have to take social aspects into consideration. Environmental pollution, product or service contributions to consumers and society, human resources as well as community development have come within the domain of corporate social accounting and reporting. It is now well recognised that corporate activities have economic as well as social impacts on society. Hence, instead of limited study of revenues and expenses alone, we have reached a stage where the analysis of social cost and social benefit is considered more significant. This is undoubtedly the result of social impact on accounting theory.

1.4.3 Legal or Statutory Environment

Economic, social and legal-all jointly contribute to the making of the environment as a whole. But so far as the components are separately concerned, possibly the legal environment plays the superior role. The positions of debtors and creditors, of which *Dr.* and *Cr.* are the abbreviations, have invariably a legal implication that evidently dominates accounting. Laws of contracts and properties invariably govern such positions. Moreover, enactments on partnership, companies etc. and judicial pronouncements on the nature of profit, goodwill and the like have added considerably to this supremacy enjoyed by law in shaping accounting forms. Law is held so overriding among all environmental factors, that continuation of a market fostered by a particular social philosophy is warranted only on the continuation of a particular legal system. In the USA, however, the private sector is dominant. The statements of concepts and standards issued from time to time by the FASB and guidelines issued by the AICPA, NAA and others have self-regulating mechanisms. The role of the US Securities and Exchange Commission (SEC) is partly supportive and partly regulatory. But in developing countries, such private bodies are not so effective and hence, there is need for an active regulatory role to be played by governments. However, too much control by the government may hamper the functioning of capital market and economic development. So, a balance between the two extremes has to be struck depending upon the stage of economic and social development in a country.

It will, thus, be seen that since accountancy operates in a socio-economic framework as a 'service' function, the socio-economic activities and policies have a major bearing on accounting structures and processes. Socio-economic influences, the professional and institutional structures and the legal and statutory requirements are important factors in any assessment of a country's accounting system.

1.5 Exercise

A. Short-answer type questions :

1. What are the approaches to the formation of accounting theory?
2. How will you define 'accounting theory'?
3. Define deductive and inductive approaches in the context of accounting theory.
4. Give a brief note on structural theory for accounting.
5. How does legal environment influence the development of accounting theory?
6. Distinguish between accounting theory and accounting practice.

B. Long-answer type questions :

1. Explain meaning of accounting theory. Discuss the factors that have led to the development of accounting theory?
2. Discuss the foundation of accounting theory. What kind of accounting theory have we got upto now having based on that foundation?
3. Give a classification of accounting theory. How do those different kinds of accounting theories help in achieving the objectives of accounting?
4. "Accounting environment has a vital role to play in the development of accounting theory." Discuss.
5. Explain the nature of accounting theory currently in use. What are the limitations of this kind of accounting theory?
6. "The multitude of approaches to accounting theory represents confusion about the scope and limitations of accounting." Do you agree with the statement? Explain.

1.6 References

1. L. S. Porwal—Accounting Theory
2. E. S. Hendriksen—Accounting Theory
3. Glautier and Underdown—Accounting Theory
4. A. K. Basu—Rediscovering the Balance Sheet.