# *Chapter 1: Introduction to financial accounting theory*

## Solutions

1.1 Broadly speaking, a positive theory seeks to *explain* and/or *predict* particular phenomena whereas a normative theory seeks to prescribe what *should* be done in particular circumstances based on particular assumptions made by the researcher. In relation to accounting, these assumptions might relate to such things as what motivates people or what is the central objective of accounting. Positive theories are typically evaluated by considering how well the explanations or predictions relate to actual observations. Normative theories are not evaluated on the basis of their correspondence with observations of real world phenomena. For example, a researcher may develop a theory that prescribes a particular approach to asset valuation. The theory should not be considered as invalid if people currently do not adopt the prescribed approach to asset valuation.

1.2 If we developed a theory to explain how a financial statement preparer's cultural background influences how they prepare financial statements then, as we are attempting to 'explain' particular practice, we have developed a positive theory. Such a theory would then be evaluated in terms of how well its predictions (perhaps based on particular cultural attributes of a given population) correlate with the predicted accounting practices (for example, we might have predicted that people from a 'conservative' society are more likely to adopt historical cost accounting rather than utilising valuations based on fair values). In developing such a theory we are not attempting to prescribe what accounting methods should be used – which contrasts our research with normative research.

1.3 A conceptual framework, such as the International Accounting Standards Board (IASB) *Conceptual Framework for Financial Reporting*, provides some fundamental assumptions about the role of general purpose financial reporting and the attributes that financial information should possess for it to be useful in assisting the resource allocation decisions of financial statement readers. As indicated in this chapter, the United States' Financial Accounting Standards

Board (FASB) defined a conceptual framework as 'a coherent system of interrelated objectives and fundamentals that can lead to consistent standards'.

Since conceptual frameworks provide perspectives about such issues as: the qualitative characteristics that financial information *should* posses; the identification of the types of entities that *should* produce general purpose financial reports; the way in which the elements of financial accounting *should* be defined and recognised, and so forth (note the emphasis on 'should'), the conceptual frameworks—in providing prescription—are considered to be normative in nature. Positive research, on the other hand, might simply attempt to describe or predict the behaviour of those people in charge of producing general purpose financial reports, or the behaviour of financial report readers

1.4 Arguably, Peter Costello has a hunch, rather than a theory. *The Oxford English Dictionary* defines a theory as 'a scheme or system of ideas or statements held as an explanation or account of a group of facts or phenomena'. Theories would not generally be considered to be *ad hoc* in nature, and should be based on systematic and coherent reasoning. It is not obvious that Peter Costello's ideas match with our views of what constitutes a theory.

1.5 Prescriptions are clearly not the same thing as predictions. If, for example, a researcher is prescribing a particular approach to accounting (that is, he or she is being 'normative' in nature) that does not mean when we look at actual accounting practice we will find that the prescribed method is being used. In fact, the reason why the researcher developed a particular normative theory (a theory that prescribes what should be done) could well be driven by the researcher's observation of the inadequate practices currently being employed. For instance, Raymond Chambers developed a theory of accounting (labelled *Continuously Contemporary Accounting*) which prescribes that assets should be valued on the basis of exit (market) values. He did this on the basis of the perceived limitations of historical cost accounting. The fact that almost all reporting entities used historical cost at the time does not of itself invalidate Chambers' theory.

1.6 If the revised conceptual framework (which is an example of a normative theory) is based upon, or built upon, a particular assumption then, before we are likely to accept the prescriptions provided by the revised framework we would need to satisfy ourselves that we accept the central assumption. If we reject the central assumption, then no matter how logically developed the theory might be we will reject its prescriptions.

Within the component of the *revised IASB Conceptual Framework for Financial Reporting* that was released in 2010 it was stated:

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

Therefore, if we rejected the above belief about the objective of general purpose financial reporting then we would probably reject the contents of most of the revised conceptual framework; given that is has been developed from the perspective of this underlying objective. For example, if we believed that general purpose financial reporting should provide information about the financial impacts an organisation has on a broad group of stakeholders beyond those that hold, or intend to hold, a financial interest (that is, we take a broader accountability-based perspective rather than one that focuses on providing information to parties involved in resource allocation decisions) then we would question the prescriptions provided by the framework.

1.7 Yes, we can reject a theory even though we believe that it is very logical. For example, if we were to adopt an assumption that capital markets are efficient and that individuals are motivated by self-interest tied to wealth maximisation (two very important assumptions made in a great deal of economics literature) that might lead us to make particular prescriptions about what information organisations should produce. However, if we reject these assumptions (perhaps we consider that markets are not efficient and that human behaviour is not based upon self-interest) then we might consider that the prescriptions provided by the theory are unsound – and potentially even damaging to particular groups within

society – even though we might nevertheless believe that the theory is logically developed.

1.8 As explained in this chapter, theory that is developed through induction is developed as a result of undertaking a series of observations of particular events, and on the basis of these observations, a theory is developed. Early theories of accounting (for example, in the 1960s) were often developed by observing what accountants were actually doing in practice. This led to the formulation of certain conventions and doctrines of accounting which were considered to be theories. As we discussed however, developing theory on the basis of observation typically does not allow us to address the issue of what would be the most appropriate behaviour in particular circumstances (and determining 'appropriate behaviour' will in turn be influenced by particular assumptions or value judgments made by the researcher). That is, it does not encourage us to evaluate what the accountants are doing.

By contrast, developing theory on the basis of deduction does not rely upon observation. Rather, it relies upon the use of logic to develop arguments and related theory. Some theories developed through deduction—such as positive accounting theories which are developed and then used to predict particular behaviour—can be tested (but not initially developed) through subsequent observation. Other theories developed through deduction—such as Chambers' theory of accounting (Continuously Contemporary Accounting)—should not be evaluated through subsequent observation as he was prescribing a particular approach to accounting that was in stark contrast to what accountants were doing at the time.

1.9 Some interesting answers should be given here. Some students might argue it is a total waste of time. The perspective adopted by the author of your textbook, and many other accounting academics, however, is that the outputs of the accounting system are used in many decisions throughout society and hence it is important to consider how particular accounting methods, or changes thereto, will impact various groups. If we only considered how to calculate accounting numbers, without considering their impacts, then we would be only getting a

fraction of the total 'story'. People involved in accounting logically need to have some perspective about how people will react to different accounting numbers or forms of disclosure; accounting theories can provide us with such insight. Apart from considering how accounting numbers might impact different groups, people involved in accounting should arguably understand the different factors which might have influenced accounting standard-setters when they developed particular requirements. They should also be aware of research that suggests improvements to current practices (with such information perhaps being derived from different normative theories of accounting).

As you will see throughout the textbook, there are various perspectives about why organisations might adopt particular accounting methods. If we are ultimately involved in reading financial statements, then understanding the possible motivations of those in charge of preparing the financial statements will be useful. For example, some theories suggest that managers will want to use those accounting methods that provide the greatest benefits to themselves personally (from Positive Accounting Theory). Other theoretical perspectives suggest that a reporting entity will be motivated to provide information primarily to powerful stakeholders (from Stakeholder Theory), or that the managers of reporting entities provide information to legitimise the entity's ongoing existence (from Legitimacy Theory). Chapter 12 of the book provides a perspective (a critical perspective) that suggests that financial accounting is a mechanism to further the interests of those people who currently have wealth, and to undermine the interests of those without wealth. As this brief discussion shows, there are numerous views about the implications of accounting, and the factors which cause managers to select one accounting method in preference to another. Such insights might be useful when interpreting particular accounting disclosures. If we do not read about accounting theory then these valuable insights might not be available to us.

1.10 It can be argued that before we can seek to improve the practice of financial accounting we need to know which methods of accounting are currently being used. Research which describes what is currently being done as well as

describing the generally accepted conventions is therefore useful to the overall process of improving financial accounting.

What might not be constructive, however, is where theories are developed through observing current practice and these observations/theories are then used to prescribe what all other people should do. Just because the majority of people are doing something does not necessarily mean that it is the *best* or most efficient thing to do. As the chapter emphasises, studying *what is* does not mean the same thing as studying what *should be*. As Gray, Owen and Maunders (1987, p. 66) indicate, an approach to developing theories on the basis of observing *what is* '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'.

As the chapter explains, research that provides prescription on the basis of what is already being done does not tend to be very controversial (for example, the work of Grady, 1965) and will not tend to generate opposition from the accounting profession. But again, assuming that what is being done is the best approach (perhaps on the basis that only the 'fittest' survive) is not really logical.

1.11 Undertaking research based on observing actual practice provides an understanding of what is being done, although a key point here is: what we actually observe to be happening, and what we record, might be influenced by our own values and biases that we have prior to undertaking the research. This means that researchers with different 'views of the world' (perhaps they work from quite different research paradigms) might actually see things differently; ask different questions and record different events than would other researchers. Inductive researchers need to be careful that their own biases do not overly influence the data they are collecting if they are attempting to develop a theory based on actual practice.

With the above in mind we might nevertheless argue that it is important to understand current practice and therefore inductive research provides an

important basis for subsequently providing suggestions for improvement to practice. However, if we restrict our research to describing what currently occurs, this in itself does not allow us to evaluate the practice or to prescribe improvements. For example, just because most accountants do things in a certain way – which would be identified by inductive research – this does not in itself mean that it is the best way to do things.

1.12 This answer is very much related to the answers given for questions 1.10 and 1.11. Just because the majority of accountants do something, this does not necessarily mean there is not a better, unknown approach (unless we start adopting all sorts of assumptions about the high level of efficiency of accountants in determining what methods best reflect the underlying performance and position of particular entities).

The other point that must be appreciated is that the longer the time that particular accounting methods have been used then arguably the greater will be the resistance of accountants to change. Accounting practices can effectively become 'institutionalised' across time, despite the possibility that the practices are not longer the most efficient way to do something.

A change in accounting methods means that accountants and users of financial statements need to retrain and, realistically, there may be some opposition to this. Also, there could be many contractual arrangements in place that use accounting numbers (for example, borrowing agreements with banks or accounting-based bonus schemes negotiated with employees) and hence there could be all sorts of social and economic consequences if the accounting rules, and hence, the ultimate accounting numbers, change.

There is also an argument by some researchers, identified as critical theorists (covered in Chapter 12 of the textbook), that financial accounting practices tend to provide results that favour people with control over capital at the expense of those without capital. These 'powerful' people will tend to argue against reform if it appears that new rules will favour those who have traditionally had limited wealth.

1.13 History indicates that in situations where researchers have prescribed significant departures from existing accounting practices, such prescriptions have often been met with a great deal of opposition from the accounting profession and other representatives of the business community. There are many possible reasons for this. Perhaps it is not made clear that the newly prescribed methods are any better than what is currently being used (and we can reflect about whose perspective should be taken when considering the costs and benefits of new methods of accounting). Since there would be many contractual agreements between different parties that rely on accounting numbers (for example, between an organisation and its lenders, employees or government), changing accounting measurement systems might lead to real costs being imposed on particular parties. For many years accounting regulators have considered the *economic consequences* of particular proposals prior to efforts to put such accounting proposals in place. If it is considered that a change in accounting rules might lead to significant economic (and social) consequences then the proposal might be abandoned even though it might arguably provide the best reflection of the financial performance or position of a reporting entity. However, an issue that should be taken into account when considering the economic consequences of proposed accounting methods is whether existing accounting rules are appropriate and/or whether the existing rules unfairly advantage some parties at the expense of others.

Another issue that might explain why some accounting proposals are promoted by an accounting standard setter, while others are not, is the level of constituency support for the proposals. Throughout the world, the ongoing existence of many accounting standard-setting bodies has historically relied on support from the public. History shows that when the standard-setting bodies' constituency are critical of the standard-setting body then in certain situations the particular body has been disbanded and replaced by another group (obviously this does not always happen). Hence, whether a particular accounting proposal is promoted by a standard-setting body might be dependent upon whether the proposals are acceptable to the standard-setter's constituency.

A further issue that is raised in Chapter 12 of the book relates to the views of 'critical theorists'. They argue that the rules which exist in financial accounting act to maintain the vested interests of people with wealth and to undermine the interests of other people (the work of some critical accounting theorists is informed by the works of philosophers such as Karl Marx). For example, financial accounting emphasises the positive attributes of increased income and profits (which ultimately go to the owners of capital) but highlights the negative implications of rising costs—including payments made to employees. Critical theorists would argue that standard-setters would be more likely to support particular accounting proposals to the extent that the proposals support existing social structures (which in turn support the social positions of professionals, such as accountants).

1.14 For financial reports to be 'neutral' and 'representationally' faithful then arguably, they would be constructed from the application of a set of accounting standards which have themselves been developed by way of a process that is neutral and which has involved the assessment of each proposed rule on the basis of whether it improves the output of the accounting process (perhaps in terms of qualitative characteristics, such as those identified in the *IASB Conceptual Framework for Financial Reporting*).

In many countries accounting standards are developed through a political process. This might involve the development of a draft standard which is then circulated (perhaps more than once) to interested parties who in turn, make submissions to the accounting standard-setting body. Quite often these submissions come from large corporations that have the necessary funding to have people who specialise in activities such as making submissions to standard-setting authorities. The standard-setting body will then consider the merit of the various arguments before developing the final accounting standards. Because it is often the case that the views of people in different countries will be different (which in turn might be related to issues such as cultural differences, as Chapter 6 of this book explains) accounting standards developed within a particular nation will typically be different to the accounting standards developed in other countries to cover the same issue. As Chapter 4 discusses, the current efforts

underway in many countries to standardise local accounting standards with International Accounting Standards tend to ignore how cultural differences influence the types of accounting information demanded by different cultures.

Once we accept that accounting standard-setting is a political process (with standard-setters themselves possibly being concerned that they have constituency support) then it is hard to accept that accounting standards themselves can be neutral and objective documents. If we accept this position, we might then find it difficult to accept that accounting reports developed in accordance with these accounting standards can themselves be neutral and representationally faithful.

1.15 This is clearly a matter of opinion. There are many people (such as Howieson, 1996, from whom this quote is taken) who consider that the role of an academic is to provide guidance as to what practitioners *should* be doing—because practitioners do not typically have the time to do the research that improves practice in the same way as academics (with academics typically having their salaries paid by way of community-based taxes). Positive accounting theorists (particularly those that apply Positive Accounting Theory) are typically reluctant to provide prescription (that is, to use the 'should' word) and this has, in turn, been the cause of much criticism of this theory (for example, by researchers such as Sterling and Chambers).

Positive theory is theory that *describes* and/or *predicts* particular phenomena and does not tend to *prescribe* particular activities. Researchers such as Watts and Zimmerman (central figures in the development of Positive Accounting Theory) considered that 'good, scientific' research was research which was free of the researchers own values and biases and that by restricting one's attention to describing and predicting one was not taking the value-based step of saying what people *should* do. As we would appreciate however, no research can be value free (for example, Positive Accounting theorists accept the theoretical economics-based assumption that all people are self-interested wealth maximisers—accepting such an assumption is obviously a value judgement).

While positive accounting theorists might not elect to provide prescription, their research, which provides information about the possible implications of particular accounting approaches and the potential motivations that drive managers to select particular accounting methods, could provide the resources and knowledge that others might use to develop prescription. Hence, positive theory can arguably provide benefits to 'the community', just as normative theory can.

1.16 The two branches of 'decision usefulness' theories are the *decision-makers emphasis* and the *decision-models emphasis*. The decision-makers approach relies upon finding out what types of information particular groups seek. The information might be found out by means such as the use of questionnaires or interviews. Once the information demands or needs are discovered, these form the basis for prescriptions about what information should be provided to the groups in question. As is explained in this chapter, developing prescriptions based upon what information individuals say they want or need ignores the fact that there might be other types or forms of information that are 'better'. As an illustration of the potential logical flaws in this approach we can consider the following, perhaps somewhat extreme, illustration. Assume that a group of people were asked to give an opinion about what is the most useful implement for digging a hole. Assuming they have been exposed to spoons but not to shovels, then they may indicate that spoons are the most useful implement to use to dig a hole. If a prescription follows that spoons should be provided to all people then we can see that this is perhaps not in the benefit of potential 'diggers'.

The decision model's emphasis relies upon the researcher's own perceptions about what information is necessary for efficient decision making and these perceptions are used to develop prescriptions about what information should be disclosed. This form of research does not rely upon finding out what information users actually want, and it typically assumes that all stakeholders have identical information needs. In situations where people are unfamiliar with the form of information being prescribed, it is assumed that they can be taught how to use it. An example of this branch of research might be Chambers' *Continuously*

*Contemporary Accounting*. In his theory Chambers prescribes that the most useful information for financial statement users is information about the net market values of a reporting entity's assets.

1.17 Kuhn (1962) proposes that knowledge develops through a process of *revolution* rather than *evolution*. New theories replace old theories as a result of researchers questioning the existing theories. The view is that once theories are in place they will continuously be scrutinised and cannot be expected to maintain a position of dominance indefinitely. When theories are under maintained attack they are considered as being brought into *crisis*. The view is that when a theory is brought into question (in crisis) another theory might be advanced as superior and this theory may then become the one that is more generally accepted. As a result of critical analysis this theory may in turn be brought into crisis, and so forth. Because of new arguments and insights it is also possible that 'old' theories will re-emerge.

Kuhn's perspective appears to imply that particular theories can 'overthrow' others (at least temporarily). However, within the accounting discipline it is not at all clear that a particular theory has ever been successful in overthrowing all others. Nevertheless, Positive Accounting Theory certainly did displace many normative theories in many accounting schools throughout the world in the 1980s (but they in turn seemed to be displaced as the dominant theory throughout the 1990s—but arguably by a number of other theories rather than just one theory).

In discussing how some theories displace others Kuhn parallels the experience as being similar to 'religious conversion'. Certainly when we think of how some researchers defend their theoretical perspectives against all others we can perhaps liken some of them to religious *zealots*.

1.18 This chapter provided a number of definitions of a paradigm. According to Hussey and Hussey (1997, p.47):

> *The term paradigm refers to the progress of scientific practice based on people's philosophies and assumptions about the world and the nature of knowledge; in this context, about how research should be conducted.*

> *Paradigms are universally recognised scientific achievements that for a time provide model problems and solutions to a community of practitioners. They offer a framework comprising an accepted set of theories, methods and ways of defining data … Your basic beliefs about the world will be reflected in the way you design your research, how you collect and analyse your data, and even the way in which you write your thesis.*

An important point to emphasise from the above definition is that one's own values will impact the research paradigm they elect to embrace. Kuhn (1962) also provided a definition of a paradigm. He stated that 'a paradigm can be defined as an approach to knowledge advancement that adopts particular theoretical assumptions, research goals and research methods'.

In terms of whether researchers would typically embrace more than one paradigm when doing research, the general answer would be no (although there are some limited exceptions to this). As we have already indicated, the paradigm a researcher embraces is impacted in large part by their own values and beliefs, hence often researchers would feel uncomfortable embracing more than one paradigm (perhaps it is like embracing more than one religion). For example, if I strongly disagreed with a perspective that all individual action is driven by self-interest then I would not feel comfortable embracing a paradigm—such as Positive Accounting Theory—that embraces as a core assumption the view from neo-classical economics that individuals are principally motivated by self-interest. Similarly, if I believed that it is inappropriate to treat all organisations as being homogeneous (that is, as being the same) then I would adopt a research paradigm that perhaps relied upon in-depth case study research, rather than large scale research undertaken by way of mail-out questionnaires, or research that utilised secondary data, such as details of share-price movements of many companies.

1.19 There is a difference between financial accounting theory and financial accounting research. Financial accounting theory provides a basis for undertaking a great deal of financial accounting research. For example, the theory provides us with insights on what factors to investigate, what evidence to collect, and how and where we should collect the data.

Different theories can lead to very different research being undertaken. For example, advocates of Positive Accounting Theory will often undertake large-scale research that seeks to provide results that can be generalised across various situational contexts. By contrast, advocates of various critical theories (discussed in Chapter 12) would not undertake such research and would not necessarily seek to provide generalisable predictions.

Financial accounting research can lead to the development of new theory, or the refinement or acceptance of existing theories. That is, research can precede the development of theory, and then subsequently, theory can guide research.

Not all research requires theory. For example we might want to initially find out what methods of accounting are being used by different organisations. This would be called descriptive research and would not necessarily be theory-based.

1.20 Arguably, accounting research cannot really be considered to be value-free. Many value judgements must be made in the research process. For example, selecting a theory to use from among competing alternatives can be based on a value judgement. We might dismiss a theory because in our view its assumptions about what motivates human behaviour do not tie in with our own views. Also, determining what is important or interesting enough to research in the first place can be a value judgement. What I think is worthwhile research might be dismissed by others as a waste of time.

1.21 Value judgements have a great deal to do with what theory a researcher might elect to use to explain or predict particular phenomena. To demonstrate this, we can consider the alternative theories accounting researchers might use to explain why companies elect to voluntarily produce information about their social and environmental performance. If I believed that corporate managers are motivated by self-interest then I would embrace an economics-based theory—such as Positive Accounting Theory—that has self-interest (tied to wealth maximisation) as one of the fundamental assumptions about what drives human behaviour. These people would have a predisposition towards believing that all human

activity—including the disclosure of social and environmental information—is undertaken to the extent that the activity can somehow be related back to positively impacting the managers' wealth.

By contrast, if I was a researcher who embraced a vision of sustainable development—which in itself typically requires people of current generations to sacrifice current consumption to the extent it is in the interests of future generations—then I would reject Positive Accounting Theory as self-interest and sustainable development are to a great extent, mutually exclusive. Such a researcher would embrace another theoretical perspective (perhaps such as legitimacy theory or stakeholder theory, which we discuss in Chapter 8). It is interesting to note that almost no researchers in the area of social and environmental accounting embrace Positive Accounting Theory.

1.22 Central to this question is the issue of whether a theory can ever be proved. There are different views on this. The falsificationists, initially led by Karl Popper, would typically argue that theories cannot be proved regardless of the amount of evidence collected to support a theory. Theories are deemed to be developed through trial and error and at a particular time a theory might appear to provide the best explanation for a particular event among the theories available at a point in time—but there is always the possibility that a new or refined theory might ultimately provide better explanations or predictions.

In accounting we are dealing with human behaviour, so from a logical perspective we would not expect to have a theory that provided perfect explanations or predictions in all cases—hence we would be cautious about saying our data 'proved' a theory. Indeed, when some researchers say that they have 'proved' particular theories, or have proved the existence of particular relationships, this often effectively signals a degree of naivety this is held by the researchers in that they appear to be ignorant of alternative plausible explanations for particular phenomena. There is always likely to be somebody who acts differently to the majority. We are safer in saying that our evidence 'supports' a theory.

1.23 The answer to this question follows on from the answer to Question 1.22. If we accept the views provided by falsificationists then we should be careful not to say we have 'proved' a theory. It is much safer to say that the findings that we have generated 'support' a particular theory. There is always the chance that a 'better' theory can be subsequently developed, or that a future observation might not be consistent with our theory.

1.24 Whether we think a particular theory is a 'good theory' or not will often be very much a subjective assessment (although a poorly developed theory should be rejected by all researchers). Some criteria that we might use to evaluate a theory as appropriate for our own use (and a number of these criteria overlap) include the following (and although the question has asked for five criteria we have provided more):

- Is the theory logical? That is, do the arguments logically flow given the central assumptions that have been made? The chapter suggests that one way to test this is to break the theory up into its key premises and then depict the theory by way of a 'syllogism'. The argument will be logical to the extent that if the premises upon which the theory or argument is based are true, then the conclusion will be true. When considering the logic of the argument we must be careful to consider whether our acceptance of an argument has been influenced by any emotive or colourful language that has been used (or by any of the other 'dishonest tricks in argument' identified on page 21 of your textbook).
- Are the underlying assumptions adopted within the theory realistic? This point ties in with the above point. If the assumptions appear to conflict with how we see the world, or are overly simplistic, then we might tend to reject a theory. While a theoretical argument might logically follow (in syllogism form, or otherwise), if the assumptions on which the argument is based are 'outlandish' then we might reject the theory.
- Is it consistent with our own values? This also ties in with the above point. Whilst a theory might be 'sound' and logical, we nevertheless need to determine whether we are happy with the various assumptions it makes, or whether it addresses, or generates, research questions that we think are interesting and worthwhile pursuing.

- Does the theory tie in well with our own perspectives of what 'theory' should achieve? For example, if we think that theory should be capable of generating generalisable predictions, then does the theory in question do this?
- Whether we accept a particular theory might also be dependent upon whether it appears to be superior to existing theories in terms of explaining particular phenomena (if we are applying *positive* theories).
- Was the theory developed by well respected researchers? This will provide some comfort, however we must remember that everybody will get it 'wrong' at some stage.
- Is the theory widely applied and supported by other people within the 'research community'? Again, whilst this is comforting, particularly if many research studies have generated results that support the theory, it needs to remembered that just because a lot of people are doing something does not necessarily mean it is the 'best' way to do something.
- Is the theory parsimonious? That is, compared to other theories that provide similar insights, is our theory more 'straightforward', or simpler to understand?
- Is the theory falsifiable? That is, according to some researchers (the 'falsificationists') a 'good theory' is one that can produce predictions that have the potential to be disproved.
- Also, at a pragmatic level, if we use one theory in preference to another, will this impact the possibility of getting the research published? (While it could be argued that such considerations of 'publishability' should not be relevant, and they certainly deviate from the issue of whether we evaluate a theory as being 'sound', in practice promotion within an academic career is typically based on issues such as number of publications, and hence such concerns can be very real. Further, it is generally accepted that it is easier to get research published if it follows existing theories, rather than relying upon a newly developed theory.

1.25 A good theory, according to the falsificationists, should generate predictions or hypotheses that are of a nature that they can be rejected should evidence be provided that is not supportive of the theory's predictions or hypotheses. Knowledge is deemed to advance as a result of continual refinement of theories. Lack of empirical support for theories, through rejection of predictions or hypotheses that emanate from the theory, encourage refinement of existing

theories. Therefore, failure to find support for a theory is not deemed to be a 'bad' outcome. Researchers are expected to continually look for evidence which challenges or disproves a theory.

1.26 This is an interesting issue. If we are trying to get others to accept our theory, or point of view, then of course we should try to gain their acceptance by showing them the logic of our argument. However, in the process of trying to convince others it is difficult not to use some form of emotive or colourful language—indeed, *converting* or convincing others might be assisted by such tactics. What we must be vigilant about is whether our own acceptance of particular perspectives is based on logic, or has been impacted by the use of language.

While some people might argue that academic research must be written in an objective, emotionless manner, such material can be particularly difficult to read. Without some obvious emotion on the part of the author we can find it difficult to maintain an interest. Hence, there is possibly some trade-off between being objective and being emotive. For many of us that read numerous research articles it is sometimes pleasing to see how excited somebody is about the research they are undertaking. Objective, non-emotive writing cannot signal such excitement.

1.27 The *IASB Conceptual Framework for Financial Reporting* and accounting standards are normative documents in the sense that they tell us how we *should* do general purpose financial reporting. The *Conceptual Framework* is considered to represent a normative theory of accounting which is based on various key assumptions about such things as the objective of general purpose financial reporting, the users of general purpose financial reports, the knowledge of accounting expected to be possessed by users of general purpose financial reports, the required qualitative requirements that financial accounting information should possess, and so forth.

Whilst these documents are normative in nature, they are backed by a deal of research that is positive in nature. For example, bodies such as the IASB review and even fund research that looks at how various stakeholders react to

accounting information. They also consider research that investigates what motivates organisations to provide particular information, or adopt particular accounting methods, in preference to others. Such research is positive in nature. Bodies such as the IASB will also draw on normative research which has been generated by researchers who prescribe the benefits of certain approaches to accounting (for example, relating to measurement issues) relative to other approaches.

Therefore, their work involves and utilises research that is of both a positive and normative nature. Their final outputs – conceptual framework requirements and accounting standards – are normative in nature.

1.28 It is generally accepted that theories cannot be 'proved'. They are often developed to explain a particular phenomenon (positive theory) and will rely upon a number of simplifying assumptions to make them 'workable' (some of the 'best' theories are often considered to be the simplest theories – such theories would be considered as parsimonious). When considering the development of theories to explain human behaviour (for example, the behaviour of accountants or the behaviour of users of financial statements) a number of assumptions must be made about how people act, how they are motivated, and so on. Arguably, people are all different and their behaviours cannot be predicted with total accuracy. Further, people will not always be consistent in how they act. If we attempted to develop a theory to predict behaviour with near-perfect accuracy then the development of the theory would take forever and really could probably never achieve its goal. Hence, theorists make simplifying assumptions and the ultimate theory will therefore be a simplifying abstraction of reality. Nevertheless they will provide us with a basis of understanding certain phenomena.

1.29 It would be good. As the book explains, a parsimonious explanation is one that applies the most logically economic explanation to explain a particular phenomenon of interest to the researcher.

Generally speaking a simple explanation of something is preferred to a complicated explanation, and the same applies to theories. Some of us would be familiar with people who undertake research that uses many independent variables to try to explain why a particular phenomenon occurs. For example, to explain why a company might voluntarily adopt a particular accounting method the researcher might consider a multitude of many different factors. If another researcher also provides an explanation of the particular accounting choice, but he or she only identifies a small number of important factors that seem to influence the choice, then this theory would be preferred to the extent it appears to provide similar predictive accuracy. Where possible, we should always try to 'keep it simple'. A simple explanation will be understood by more people and is more likely to be used by more people.

1.30 A hypothesis can be defined as a proposition, typically derived from theory, which can be tested for causality or association using empirical data.

Not all research will provide testable hypotheses. For example, normative research which prescribes what organisations *should do* would typically not involve the development of hypothesis about what organisations *actually do*. Hypotheses often act to provide predictions that can then be empirically tested. For much normative research there is not an intention to explain or predict current practice, hence the development of empirically testable hypotheses would not necessarily be appropriate. Nevertheless, normative research has the potential to provide valuable insights into improving the practice of accounting.

Whilst hypotheses are often developed within positive research that utilises large amounts of observations (for example, thousands of observations of movements in share prices), for researchers who seek to develop 'rich insights' from case study research (which might involve the detailed investigation of the practices adopted in only one or more organisations), it is generally accepted that the use of hypotheses is not appropriate. Further, if a researcher adopts a view (or research paradigm) that suggests that all organisations and individuals are fundamentally different, then such a researcher would not tend to develop hypotheses to test across a broad range of individuals or organisations. By

contrast, a researcher who adopts an assumption that all individuals are fundamentally the same (for example, they are all motivated by self interest tied to wealth maximisation) might be inclined to develop hypotheses for testing across different samples of the population.

What is being emphasised here is that the absence of empirically testable hypotheses does not necessarily negate the value of particular research.

1.31 We would probably not reject a theory as 'insignificant and useless' on the basis that a particular study failed to provide support for the theory. Since theories, by necessity, are 'abstractions of reality' they cannot be expected to generate predictions that will always hold. Theories about human behaviour (such as the behaviour of accountants) rely upon a number of assumptions about human behaviour. These assumptions will not necessarily always reflect actual behaviour. Hence, we would generally not be inclined to abandon a theory because a particular research project generated results that did not support the theory. Also, it is possible that the results failed to support the theory because there were problems with how the underlying data was gathered and analysed, or how the theoretical variables were defined.

Obviously, if a theory continued to be unsupported by many studies then we might ultimately question its relevance.

1.32 Of importance is how the sample was selected. Generally speaking, to generalise the results of a particular sample to a larger population the sample must be representative of that larger population. This will usually require that the sample was of a reasonable size and that the selection process was of a random nature, such that each item in a population has an equivalent chance of being selected. If a sample is not randomly selected then any efforts at generalising will commonly be criticised.

When selecting a sample it is also important that the items in the 'population' have similar attributes (which in itself is the essence of a 'population'). Some researchers from more of an 'interpretive' perspective question whether different

organisations are actually that similar. They consider that because of differences in personalities, social and organisational structures and cultures, institutional influences, and so on, then large scale research (which relies on sampling) is inappropriate because it is not valid to generalise across organisations, that in essence, are very different. Researchers working within an 'interpretive paradigm' generally do small-scale, in-depth research.

1.33 When referring to 'herding' they are referring to the fact that it is common that researchers in a particular discipline tend to adopt theories that are used by many other people within that discipline. That is, it is not uncommon for many researchers to adopt particular theories because the majority of people researching the particular topic also adopt or use the theory – what some people might call as 'running with the herd'. Whilst this is not necessary a bad or wrong thing to do, just because the majority of people might be applying the theory does not mean it is necessarily the best theory available to fulfil whatever aims or objectives the researcher is hoping to achieve. Adopting something because 'everybody else does it' can also potentially be considered as intellectually lazy. Embracing a theory should be based on an assessment that it is the best available theory (and in the chapter we have indentified a number of factors to consider when evaluating a theory).

In terms of some of the advantages associated with using a commonly used theory, one benefit would be that it will save time for the researcher. If a logical and coherent theory has already been developed then we do not have to replicate the work that others have already done to develop the theory. Also if a theory has become accepted within a paradigm and is used by leaders in the field (who would also conceivably act as journal paper reviewers and editors), the less resistant path to publication is deemed to be one that embraces the apparently accepted theory of the day. Generating publications is a key performance requirement of university researchers.

The disadvantage in using theories that many others are using is that our contribution to the literature would not be as significant as it would be if we were responsible for developing a theory. Whilst it is generally considered a risky exercise to develop new theory (for example, it might be relatively more

difficult to get the work published relative to research which applies accepted theories) if the work is published, despite the hurdles, it will tend to command high citation rates. Also, if we simply use theories that everybody else is using then we will never potentially be considered as a 'leader' within our field.

1.34 What the diagram is attempting to emphasise is that there are many interdependencies between various factors, or decisions, made in the process of undertaking research. For example, our own values and expectations will influence how we 'see the world'. How we see the world will influence the sort of research questions we think are interesting or worthwhile pursuing. How we see the world also influences the theories we elect to use. For example, if we do not want to accept the assumption that all individual action is driven by wealth-maximising self interest then we would reject many economic theories.

There is a relationship between the theory we use and the research questions we will seek to answer. For example, if we are embracing Positive Accounting Theory then we might try to answer questions about why a company elected to use one method of depreciation in preference to another. But Positive Accounting Theory would not generate questions about whether a particular depreciation method is influenced by cultural or ethical considerations. Different theories generate different questions.

While the choice of theory influences the type of research questions addressed, it will also influence the research methods to be employed. For example if our theory incorporates an assumption that all people act in the same manner (for example, they are all motivated by self-interest, as is the case in many economic theories) then large scale sampling and statistical testing might be appropriate. However, if we adopt a theory that assumes that individual behaviour is influenced by many different factors then we might not undertake large scale testing (such as mailing our questionnaires to thousands of individuals).

The assumptions we make about individuals, organisations and so forth not only influences the research methods we apply but also the degree of generalisability we believe is associated with out findings. For example if our theory suggests

that different cultural aspects influence how people use accounting information then it would be inappropriate to generalise the results derived from people within a given culture to people in a different culture.

As emphasised in the chapter, different research paradigms embrace different philosophies, values, assumptions, research goals and research methods.

1.35 Absolutely yes! In developing accounting standards there will be many questions, such as:

- What will be the effect of the related information on different stakeholder groups?
- Will the new rules incorporated within the proposed accounting standard provide more benefits to some groups relative to others?
- Will organisations be likely to oppose the requirements, and why?
- Does the proposed accounting standard provide the best approach for accounting for the particular transaction or event?
- What are the costs and benefits of the proposed accounting requirements?
- Is the accounting standard applicable across all countries?

To answer questions such as those provided above requires knowledge of various theories of accounting.

## *Chapter 2: The financial reporting environment*

## Solutions

2.1 Accounting standard-setters do not specifically address the expected accounting knowledge of financial statement readers but there is an expectation that the readers of general purpose financial reports have a 'reasonable knowledge' of business and economics. Specifically, the *IASB Conceptual Framework for Financial Reporting* states that 'financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently'. Hence, there appears to be an implied expectation that financial statements are not tailored to meet the needs of people