

Accounting theory essay sample

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Introduction

Many accountants are familiar with the accounting standards and practices. They are always keeping their eyes on new standards and regulations roll-out. On the back of the new accounting practices, there are many accounting theories supported. Accounting standards are developed based on many descriptive and prescriptive accounting theories which were derived from many researches and studies performed by scholars and professionals. The backgrounds of the researches and studies are supported by some theories as well. The motivations of scholars in performing their studies, the society needs of new regulations as well as the information disclosure behaviors of entities can also be explained by theories. Various theories for and against regulation of financial accounting are discussed by the public. Various theoretical perspectives, including those provided by Positive Accounting Theory, Political Economy Theory, Stakeholder Theory, Institutional Theory and Legitimacy Theory can explain different types of voluntary reporting decisions. Critical (Accounting) theory, Behavioral Decision Theory Open System Theories and Decision Usefulness Theory goaded scholars and researchers to perform studies.

Prescriptive Theory and Descriptive Theory

Prescriptive theory means how accounting should be undertaken while descriptive theory means how accounting was generally performed.

There are many studies and researches performed around decision-makers emphasis and the decision-models emphasis. The aims of the studies are that the accounting experts want to figure out what information the

financial statements users needs in order to develop the accounting frameworks. The users can rely on the information in making economic decisions. Some accounting professional develop prescriptive frameworks focused on the standards and presentations of financial reporting. Some accounting professionals concentrate on developing descriptive frameworks to express how accounting was generally performed. Prescriptive and descriptive accounting theories are inter-related. In general, prescriptive accounting frameworks are established based on the descriptive accounting frameworks.

Accounting conceptual frameworks are revised over time in order to reflect changes in markets, business practices and overall economic environment. Different countries have inconsistent frameworks because of different environment. However, with increasing use of IFRSs, it seems that global uniformity adopted by accounting regulators.

Why scholars and researchers in different countries are motivated to work on those studies? The objective is to ensure everyone in a community is treated fairly. Everyone can obtain the useful and meaningful information to make economic decisions. According to the results of the studies ad researches, accounting standard-setters and regulators therefore review and amend the organization financial disclosure requirements in order to ensure everyone is protected.

Economic Theory

Reiter (1995), Economic theories tend to value the characteristics associated with the masculine stereotypes such as abstraction, mind, efficiency,

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equilibrium, rationality, pursuit of self-interest, and autonomy. The opposite characteristics of concretism, body, randomness, humanity, mutuality and connectedness, which are associated with feminine stereotypes, are as missing from theory.

Economic theory influences the assumptions and basis of many accounting theories. Based on some masculine stereotypes, accounting professionals can develop solid accounting theories in order to resolve the reporting problems associated with characteristics of human beings. Feminine characteristics lead to problems complicated with unexpected outcomes. The feminine stereotypes are seldom associated with the accounting theories because those critical theories with feminine characteristics that the theorists cannot provide solutions to what they see as perceived problems. Accounting professionals and communities can develop the accounting practices and regulations in accordance with the masculine stereotypes.

Decision Usefulness Theory

Gray, Owen and Adams (1996), it can be considered to have two branches, these being the decision-makers emphasis and the decision-models emphasis. The decision-makers emphasis relies on undertaking research that seeks to ask decision makers what information they want. Proponents of the decision-models emphasis, on the other hand, develop models based on the researcher's perceptions about what is necessary for efficient decision making. Unlike the decision-makers emphasis, the decision-models emphasis does not ask the decision makers what information they want, but, instead, it

concentrates on what types of information are considered by the researcher to be useful for decision making.

According to the decision usefulness theory, decision-makers emphasis relies on undertaking research that seeks to ask the users of the information what information they want. Once that is determined, this knowledge is used to prescribe what information should be supplied to the users of financial statements. Because of the decision-makers emphasis, decision-models are therefore developed. Accounting professional establish the accounting frameworks to provide useful information to users. It also has been used to determine whether particular mandatory reporting requirement were necessary and efficient for users to make decision accordingly. Because the researchers continues to perform studies on what information the users need, the accounting professionals therefore change the accounting frameworks and practices in order to ensure the users have a clearer pictures to make decisions.

Critical Accounting Theory and Critical Theory

Critical (Accounting) Theory is used to refer to an approach to accounting research that goes beyond questioning whether particular methods of accounting should be employed, and instead focuses on the role of accounting in sustaining the privileged positions of those in control of particular resources while undermining or restraining the voice of those without capital.

Roslender (1995), Critical theory seeks to provide a form of knowledge that is questioning of the prevailing social arrangements, i. e. an alternative knowledge.

Critical accounting theory is to support the accounting theory developments. The objective of the accounting theories is to turn the overall accounting practices benefit to the society as a whole. According to Tony Tinker, all forms of social praxis that are evaluative, and aim to engender progressive change within the conceptual, institutional, practical, and political territories of accounting. Therefore, accounting professionals are encouraged to involve in researches because of the wealth distribution impacts of unregulated markets. More often, new accounting theories are developed to encourage new business behaviors in which measures of corporate performance reflect efforts to benefit a diverse group of stakeholders and the environments. On the other hand, the accounting theories influence the ethical, social, political and economic life of the society. Critical theorists argue that governments tend to put in place mechanisms and regulations to support existing social structure. Critical accounting theories explain that accounting professionals tend to highlight the key role of accounting in society via critical analysis. Accounting is construed as being objective and legitimizing particular social structures.

System-Oriented Theories

Gray, Owen and Adams (1996), A system-oriented view of the organization and society permits us to focus on the role of information and disclosure in the relationship between organizations, the State, individuals and groups.

Legitimacy theory, Stakeholder theory and Institutional theory are the examples.

System-oriented theories are some fundamental theories based on the human behaviors and norms. In recent decades, there were many researches which were adopted the system-oriented theories. Those theories can explain the phenomenon in selection of accounting practices and information disclosures of organization as well as predictions of particular managerial decisions. For example, legitimacy theory, stakeholder theory and institutional theory can be applied to help explain why an entity might elect to make particular voluntary disclosures.

Open System Theories

Gray, Owen and Adams (1996), System-oriented theories have also been referred to as open-system theories. Open-system theories have reconceptualised organizational boundaries as porous and problematic. Many dynamics in the organizational environment stem not from technological or material imperatives, but rather, from cultural norms, symbols, beliefs and rituals. Corporate disclosure policies are considered to represent one important means by which management can influence external perceptions about their organization.

According to open system theories, corporate disclosures rely on management's cultural, norms, symbols, beliefs and rituals. Therefore, the quality of financial statements is mainly influenced by the opinions of few top managers. Some managers tend to disclose more information but some managers likely disclose as less information as possible. It leads public users

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cannot easily compare the performances between companies even they are within a particular industry. In order to minimize unfairness of information accessibilities, accounting professionals are encouraged to refresh the required disclosures of financial reporting.

Behavioral Decision Theory

Libby (1975), the goal of much of this work is to describe actual decision behavior, evaluate its quality, and develop and test theories of the underlying psychological processes which produce the behavior. In addition, these descriptions reveal flaws in the behavior and often suggest remedies for these deficiencies. It has been used to investigate a variety of decision making processes, such as the valuation of market shares by individual analysts, the lending decisions of loan officers, the assessment of bankruptcy by bankers or auditors, and assessment of risk by auditors.

Behavioral decision theory is to understand individuals react to available information to make decisions. The results of behavioral researches are relevance to corporations and the accounting profession for anticipating individual reactions to accounting disclosures. Those results can form the basis for developing ways to use accounting-related data more efficiently. There are many new regulations introduced in relating to the disclosure of new items of information in financial statements. By performing behavioral researches, accounting regulators can understand what information will be considered as important and useful for them to take informed economic decisions when the accounting regulators propose to introduce new regulations.

There are a number of theoretical perspectives proposed to explain why an entity may select particular accounting and disclosure policies inclusive of legitimacy theory, political economy theory, institutional theory and stakeholder theory. Those theories are also adopted by many researchers when they perform studies.

Legitimacy Theory

Lindblom (1984), It asserts that organizations continually seek to ensure that they are perceived as operating within the bounds and norms of their respective societies – that is, they attempt to ensure that their activities are perceived by outside parties as being ‘legitimate’.

As corporations are part of an entire community, their behaviors and activities are viewed as desirable and appropriate within the community’s beliefs, norms and values. Different communities often have different ideas about what constitutes legitimate corporate behavior. In a dynamic society, the public expectations are changes over time. Therefore, managers of organizations have to understand the public expectations and take various actions to close legitimacy gaps so that the companies are operating and being perceived to be legitimate. If organizations cannot comply with social expectation may result in sanctions being imposed by society. Illegitimate companies cannot survival because of new regulations or decrease in demand for their products.

Companies can use of accounting reports in their legitimating strategies by social responsibility reporting. Companies provide information to interested parties about their attributes and draw people attention to their strengths

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while neglect or down-play information concerning negative implications of their activities. As such, there may be financial reporting practices developed in to govern the quality of legitimacy information disclosure in financial reporting.

The media are able to influence the society perceptions about issues. Companies must develop good relationships with the media to influence the community to support the particular organizations or industries by providing sponsorships to the media.

Legitimacy is achieved by tapping into this central proposition because accounts generated around this proposition are perceived as normal. Accounting standard-setters develop the accounting framework according to the legitimacy general accepted by the communities. Because of different legitimacy around the world, the accounting standards are various in different countries. Further, accounting standards may changes over time because of the beliefs, norms and values within the community.

Political Economy Theory

Gray, Owen and Adams (1996), It is defined as the social, political and economic framework within which human life takes place social, political and economic issues are considered as inseparable.

The political economy theory encourages accounting reports focus on not only companies' financial performances but also the presentation of social and political perspectives as being corporation citizens. Disclosures have the capacity to transmit social, political and economic meanings for a pluralistic

set of report recipients. As a result, accounting professionals are considered as watchdogs to ensure corporations operated with sufficient social and economic controls. The development of accounting practices and reporting disclosure requirements may therefore be influenced as well. The extent of social and political disclosure must be meaningful to report recipients. CLP is one of the examples in Hong Kong. Apart from annual reports provided to the public, CLP prepares sustainability reports to report the company strategy, performance and commitments related to climate change expand this scope to include all operating units in which CLP has an ownership interest. Because of the additional disclosures that the community expected, additional costs involved in preparing accounting reports are coming from the pockets of shareholders.

Institutional Theory

DiMaggio and Powell (1983), Carpenter and Feroz (2001), It considers the forms organizations take and provides explanations for why organizations within a particular “organizational field” tend to take on similar characteristics and form. It provides another lens through which to view economic resource dependency incentives for accounting rule choices.

Institutional theory views organizations as operating within a social framework or norms, values and taken-for-granted assumptions about what constitutes appropriate or acceptable economic behavior.

Organizations always adapt some particular reporting approaches to bring them into align with the expectations and demands of their powerful stakeholders while possible ignoring the expectations of less powerful

stakeholders. Therefore, the organizations within a particular field or industry are structured into similar characteristics and form that are generally accepted by the key stakeholders. Because of the implications of this theory, companies may use voluntary corporate reporting disclosures to address the social, economic, environmental and ethical values and concerns of the key stakeholders. Companies will adapt similar reporting practices in a particular industry. Further, new regulations are imposed to monitor the organizations within a particular industry if the key stakeholders have enough powers to influence the governments. Accounting professionals are expected to comply with accounting standards acts as a form of normative isomorphism for the organizations for whom accountants work to produce accounting reports that are shaped by accounting standards. The institutional theory causes the organizations to disclose the information more about “ in form” than about “ substance”. Companies obtain and disclosure huge amount of information that are not relevant for the stakeholders to make decisions accordingly.

Stakeholder Theory

Freeman, R. Edward (1984), It has both an ethical/normative branch and a positive (managerial) branch. The ethical branch explicitly considers various groups (of stakeholders) that exist in society, and how the expectations of particular stakeholder groups may have more impact on corporate strategies while the managerial branch attempts to explain when corporate management will be likely to attend to the expectations of particular (typically powerful) stakeholders.

It means that the managers of companies are likely to attend the expectations of particular stakeholders who have more impact and stronger power to the company, such as major shareholders and bankers. The benefits of other minor stakeholders might be ignored.

Managers adopted some accounting treatments to satisfy the needs and expectations of those particular stakeholders. Therefore, the financial statement might not provide a true and fair view of the company affairs. In worse situation, the benefits of the particular stakeholders derive from the costs of minor stakeholders. Adverse selection might arise. The management may provide more information to the particular stakeholders for their interests. The opportunity of insider dealing might increase.

Further, shareholders no longer are the most important stakeholders that the organizations to be served. For example, when an electricity company increase the electricity charged, the pressure groups and the government must step in to maintain the “ public interest”. In certain extent, managerial decisions benefit to general public but shareholders’ costs.

Agency Theory

Brushman and Smith (2001) stated that agency theory is a branch of game theory that studies the design of contracts to motivate a rational agent to act on behalf of a principal when the agent’s interests would otherwise conflict with those of the principal.

When decision-making authority is passed from the principals to the agents, it is possible that the agents may not work as hard as the principals because

the agents were assumed to act in their own interest and it often has trade-off between the interest of the agents and the principals. To minimize the conflict, the principal usually give an account or value base bonus to the agents for aligning the interests of the agents together with the interests of the owners. Therefore, the operating cost was increased. It would delay out of proportion to the value of the principals.

To obtain more reliable information of the organization, certain of additional monitoring cost was incurred. For examples, the principals needed to employ auditors to review the financial statement which was prepared by the agent.

Normative Theory

A conceptual framework of accounting usually is considered to be a normative theory of accounting. With a conceptual framework, accounting standards are established and expected to be more consistent. Users of financial statements would be considered as the beneficiaries of a conceptual framework as financial statement will be more consistent and comparable. Hence, it assists various resource allocation decisions. The costs associated with using accounting data are therefore decreasing because the accounting information does not necessary to be adjusted due to the different accounting approaches across different organizations. General public can be benefited because more information is available to make resource allocation decisions so as to reduce the likelihood of resources flowing to inefficient uses. Organization also benefit because they have explicit guidance for reporting. The standardized accounting practices can

provide meaningful information for potential investors and encourage them to put resources into the organizations.

Based on particular judgments about the types of information people need which could be different from what they want, the various normative theories provide prescriptions about how the process of financial accounting should be taken. Normative theory is a broad type of many theories of accounting, such as public interest theory, capture theory and the economic interest theory.

Public Interest Theory

According to Posner (1974, p. 335), public interest theory holds that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market practices. That is, regulation is initially put in place to benefit society as a whole, rather than particular vested interests, and the regulatory body is considered to be a neutral arbiter that represents the interests of the society in which it operates, rather than the private interests of the regulators.

Under public interest theory, all individuals were protected by the regulatory body. All stakeholders received same level of information of the organization. The opportunity for market failures such as insider trading might be decreased.

According to rules and regulations, many accounting standards are therefore established. Accountants can rely on those standards to prepare financial statements of the organization and minimize the conflicts arising from

different accounting concepts. The financial statements of different organization can also be compared as they are prepared on same basic of accounting.

However, due to increasing of rule and regulation, the workload of the accountants was increased. For example, the Sarbanes-Oxley Act provides more rules for organizations to follow. Both accountants and auditors need much time to fulfill their duties.

Capture Theory

Levine, M. E., & Forrence, J. L. (1990) stated that, although regulation might be introduced with the aim of protecting the “ public interest”, the laudable aim will not ultimately be achieved because, in the process of introducing regulation, the organizations that are subject to the regulation will ultimately come to control the regulator.

It means that the regulatory body was not only focus on the public interest. They also need votes, resources and money for their operations. Regulatory body was captured by some parties which provide income to them. The rules and regulations will tend to protect the interest of such parties. The interest of other parties might not be protected.

According to above reason, accountant might followed some bias rules and regulations to prepare the financial statement. Therefore, the financial statements was not objective

Economic Interest Theory/Private Interest Theory

Ponser (1974) assumes that groups will form to protect particular economic interests. Different groups, with incompatible or mutually exclusive interests and objectives, are viewed as often being in conflict with each other and they will lobby government or other regulators to put in place legislation that economically benefits them.

People usually group together in order to form a big power to influence and give pressures to the regulators or government to put legislations in preferences of that particular group of people. For example, public utility organizations (e. g. Hong Kong Electricity) prefer the new regulations and accounting standards which lead to reduced profits because they can increase the charges according to the accounting profits reported. On the other hand, managers usually encourage the accounting practices that higher profits can be reported if their compensations are based on the operating profits. Accounting firms welcome the regulations that reduce the risk involved in an audit in order to protect themselves from lawsuits. Economic interest theory illustrates that all people are worked on their own interest.

Positive Accounting Theory

Watts (1995) & Friedman (1953), positive theory is a theory that seeks to explain and predict particular phenomena. Positive theory is diverged from normative theories that we adopted in our existing practice. Positive accounting theory relies in large part on assumptions from the economic literature. It assumes that markets are efficient and that all individual action

is driven by self-interest. Positive accounting theory emphasized the role of accounting in reducing the agency costs of an organization.

By adoption of positive accounting, accountants might choose the most appropriate accounting treatment for their own business and therefore provide more relevant and reliable information to the stakeholders. On the other hand, accountants might choose some treatment to fulfill their own interest. For example, increase their bonus by increasing the net profit for the organization. Chambers' Theory is one of the positive accounting theories.

Chambers' Theory of Accounting

Under Chambers' theory, which he labeled CoCoA. All assets should be measured at net market value. According to Chambers, such information is more useful for informed decision making than information based on historical costs, which may be misleading. Chambers made a judgment about the role of accounting and as a result of this judgment he prescribed a particular accounting practice.

Chambers' theory of accounting encourages the financial reporting preparers to adopt a decision usefulness approach to provide information to the users. Entities would like to adopt this theory to prepare the reports if they have assets with higher current market values because all gains are treated as profit regardless of realized and unrealized gains. CoCoA cannot obtain general acceptance by the public because it changes the revenue recognition points and major adjustments to asset valuations. The value of entities cannot be determined by CoCoA because it ignores the "value in use" of assets. It is also inconsistent with the going concern principle. The <https://assignbuster.com/accounting-theory-essay-sample/>

goodwill of the asset is not taken into account as well. Further, asset valuation process may introduce a degree of subjectivity into the financial statements. Manipulation of information in financial statements will be escalated. As a result, no one can rely on the information disclosed in reports. Managers as well as accountants will make asset acquisition decisions on the foreseeable values of the individual assets instead of the abilities of profit generation.

Trickle Down theory

Aghion and Bolton (1997), trickle down theory is the term of political rhetoric that refer to the policy of providing tax cuts or other benefits to businesses in the belief that this will indirectly benefit the broad population.

Trickle down theory means if the actions of all individuals and corporations are motivated solely by a self-interested position to maximize personal wealth, this will benefit all in society because the wealth generated by the successful individuals will trickle down to the less successful. Under trickle-down theory, there are lesser regulations required to impose the corporations because successful corporations will actively move to strategies for their social and environmental responsibilities. However, there is lack of evidences to support this theory. In reality, the gap between rich and poor are growing. For example, many Hong Kong organizations have profit increases but their staff experience salary cut or salary freeze in this decade. That is the reason why the government is working on the regulations of minimum salaries. If Trickle-down theory is effective, the government does not require stepping in the topic of minimum salary rates.

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