

Basic Approaches to Formulation of Accounting Thoughts: Evidence from Financial Accounting Framework

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Abstract

For more than a century, accounting has been offered as a discipline course in most of our various Universities and higher institutions. For the first time in a century, American Institute of Accountant (AIA) has put forward an effort to assemble the General Acceptable Accounting Principle (GAAP) back in 1939, since then, it has been observed that there are more efforts in setting accounting standards alongside with expansion of accounting theory or thought. All of the efforts are signs of the facts that accounting is going through a change from a profession into a field of science. Thus, no author can claim accounting as a scientific field without any justifications, reasoning, postulates and assumptions. Nevertheless, this article tries to study basic approaches to formulation of accounting thought: evidence from financial accounting framework. There is an attempt to elucidate the various roles in developing the accounting thought, meaning of accounting theory or thought, classification, structure and element of accounting theory, explaining the relevancy of various approaches to formulation of accounting thought, as well as merits and demerits of each approach in accounting thought.

Keywords: Accounting thought, Basic Approaches, Inductive and Deductive reasoning, Financial Framework

INTRODUCTION

Any students or graduate of accounting who are in the accounting business do believe that all accounting problem has a solution. No, it is far away from the truth because there are many issues remain unresolved after having the knowledge of mere accounting, also book-keeping which forms the foundation or basis of accountancy did not solve all problems associated with accounting. Accounting thought plays an important role in preparation of credible financial statement and financial reporting in order to solve most of the problems associated with accounting. The purpose is to ensure that ultimate objectives of accounting are achieved. Studying and understanding accounting theory and its benefits, element and structures have therefore become inevitable in order to have unbiased and credible financial statement. To solve accounting problems in real sense of the business world, one should also concentrate on understanding the problems of accounting practice and profession. There is still a growing need for the accounting profession to bring theory and practice into alignment. Studying and understanding accounting thought or model and its elements have become unavoidable as a result of high incidence of fraud and embezzlement in the accounting statement such as payroll fraud, budget padding and what have you. Internationally, billions of Naira are lost on daily basis in government institutions, individual businesses, international companies as a result of jettisoning some basics principle and theory in the preparation and presentation of accounting statement. For this matter and reason, the accounting theory is recommended. The accounting theory provides the knowledge of Generally Accepted Accounting Principles (GAAPs), though; there is no universally acceptable theory of accounting. Theory evaluation is based on logic, assumption, and evidence criteria. Nevertheless, accounting theory may be perceived from two perspectives: the one which is far from reality, only exists on theory not in practical, and another one which is about theory is the “cause- effect relationship” that exists behind any event or practice. For instance, anything that goes up must come down “cause- effect relationship”. This maybe explained by applying scientific method that may arrive at. The theory of gravitation in a logical sense, a good theory should fulfill the following criterion:

- i. It should explain or predict phenomena, i. e., they should be empirical. Theories should be capable of being tested empirically. Theories which fail tests are not of universal applicability; therefore, it must be replaced by better or non refutable theories.
- ii. Theories should be consistent both internally and externally. Internal consistency is present when the analytical properties of theory ensure that the given theory predicts the same outcome in every identical

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- case. External consistency implies that the theory should be consistent with theories in other disciplines.
- iii. To provide a framework for the development of new ideas and procedures.
 - iv. To explain observed phenomenon.
 - v. To help in making choice among alternatives

A theory should be exhaustive so as to cover the full range of variations relating to the nature of the phenomena in question. However, Hendriksen, used the definition of the *Webster's Third International Dictionary* as the basis to define Accounting Theory. Thus, "Accounting Theory may be defined as logical reasoning in the form of a set of broad principles that: (i) provide a general frame of reference by which accounting practices can be evaluated, and (ii) guide the development of new practices and procedure. He further states that accounting theory may be used to explain existing practices to obtain a better understanding of them. Both the definitions of accounting theory given above underpin the use of theory as a guide to accounting practices. But the fact that, there has been a concurrent development in accounting, while accounting was developing as a practical art, it was also evolving a body of theoretical premises. The theoretical evolution of accounting can be traced back to (500) five hundred years ago. Both the theoretical and practical approaches have contributed to the existing organized body of knowledge presently known as accounting theory. It has been observed that most of researchers have not place much emphasis on the need to align accounting thought with accounting practice. Scanty paper or study discussed on the need to support accounting theory with accounting practice, but, importance is currently being given on just teaching accounting theory with less importance on exemplifying the theory and improving accounting practices. The current study is thus, an attempt to fill this gap. In this paper, we are going to succinctly explain as follows: basic approach to formulation of accounting thought, accounting theory, evidence from financial accounting framework, classification of accounting theory, elements of accounting theory, structures of accounting theory and the conceptual framework for financial accounting and reporting.

From the foregoing, the objective of this study is to understand the basic approach to formulation of accounting thought or accounting theory, its elements, and structures and conceptual framework including the divergent interpretations surrounding these concepts. The specific objectives of this conceptual are to;

- i. Explain the meaning of accounting theory with examples.
- ii. Disclose and explain the relevance of the various approach to formulation of accounting thought
- iii. Highlight issues relating to the accounting thought or theory.
- iv. Disclose and explain the elements and structures of accounting theory
- v. Discuss the conceptual framework for financial accounting framework

LITERATURE REVIEW

Conceptual Framework

Accounting theory can be defined as a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures (Hendrickson, 1992). Perara and Matthew (1996), opined that accounting theory as logical reasoning in the form of a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures. It is the cognizance of the rules of accounting which further explains the manner in which accountants collect, records, classifies report and interprets monetary amount of financial data is determined in the financial statements. The first step is to develop of accounting thought which has been achieved. The objectives of accounting theory is to ensure that adequate reporting is made in the preparation and reporting of financial accounting to the users of the accounts without any bias. However, the objectives are always met and being taken into consideration.

Element of Accounting Theory

Accounting Theory is 'naturally' expected to be helpful in providing guidelines for research into elements of Accounting Theory. It has five basic elements namely; usefulness, relevance, reliability, comparability and consistency. In more concise terms the elements are enumerated below.

Usefulness

A good financial statement should be effective by creating adequate and important information that an entity should be included in the financial statements i.e. any information that will enable the stakeholders to accurate business and investment decisions.

Relevance

Good accounting information must be relevant to the needs of the users, such as shareholders' creditors, debtors, and so on, which will influence the decision of the users.

Reliability

Good account information must be free from bias, and material mis-statement, and it should not be misleading. Consequently, the information should faithfully signify transactions and other events reflect the fundamental events that happen in the business, and carefully represent estimates and un-certainties through proper disclosure in the financial statement.

Comparability

Good account information must be comparable to with financial information of other similar business ventures and compare for other accounting periods, so that users can identify trends in the performance and financial position of the reporting entity.

Consistency

Good accounting information must be consistence with the concept and convention over a given similar accounting periods. Accounting theory may also be used to explain existing practices to obtain a better understanding of them. But the most important goal of accounting theory should be to provide a coherent set of principles that form the general frame of reference for the evaluation and development of sound accounting practices.

Limitations of Accounting Theory

As posited earlier, accounting theory can be defined as a set of broad principles that provide a general frame of reference by which accounting practice can be evaluated and guide the development of new practices and procedures. Thus, the limitations of accounting theory includes;

Accounting theory does not explain all its practices. Due to the utilitarian nature of accounting, many of the conventions and principles of accounting have been constructed on the basis of convenience rather than as rules of logic.

Littleton and Zimmerman (2018) argued that accounting is not as strongly oriented toward logical argument as towards utilitarian service. It is less concerned with deductive generalization than with practical accomplishments.

The concepts and postulates of accounting theory are not rigorously defined. Some of the fundamental assumptions of accounting theory are not realistic such as; the assumption about stable value of money.

Unlike the theories of pure science, accounting theory suffers from internal uniformity. For instances, according to the entity concept, which is a basic postulate of accounting statements should be prepared to represent the activities of the entity rather than the groups connected with it. But in many cases the tenet of the concept is violated e.g., the net income is defined as net income of the Shareholders instead of those to the entity.

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The practical nature of accounting does not lend itself to have a general theory of accounting such that a high level of generality makes it possible to be applied to all countries, industries and all firms. For example, generally accepted accounting principles in the USA and India are not the same due to different socio economic conditions.

Theoretical Discussion

Agency theory

The relationship between accounting theory and financial statement provide the justification procedures which prevents the agent (manager) from pursuing self-interest when his principal delegates resources with the agent. Agency theory provides a structure to understand the process in a firm and from principles-agent view.

Stewardship theory

A steward theory is motivated not by self-interest, but by what he is mandated by his principal to do and by what he is responsible for. This is made possible by compliance with laid down rules which also align accounting theory and practice.

Accountability Theory

Accountability theory expressed that evidence must be provided for the use of accounting resources as well as rules for use, also guide in preparation and presentation of accounting. Currently, there is no a single universally accepted accounting theory in accounting. Instead, different theories have been suggested and continue to be suggested in the accounting literature, which lead to classifications of Accounting Theory: which are; Accounting Structure Theory; Interpretational Theory; Decision Usefulness Theory; Accounting Structure Theory. This is recognized by different terms such as classical, descriptive, or traditional theory, which endeavors to explain current accounting practices and foresee how accountants would react to certain situations or report to specific events. The theory explains, accounting data collection process and preparation of financial statement. Hence, accounting structure theory is directly related with accounting practice. It concerned with the work which accountants perform based on assumption that the objective of financial statement is associated with the stewardship concept of the management role, and providing the shareholders with the information relating to the manner in which their assets (resources) have been managed.

As a result of this, managers, directors who occupied a position of responsibility and trust in regards to shareholders, and the discharge of their obligations require the publication of annual financial reports to shareholders. Ijiri narrated traditional accounting practice which places emphasis on the historical cost system. The theory elucidation traditional accounting practice are desirable to obtain greater insight into current accounting practices and give a more evaluation of traditional theory and assessing of existing practices that do not correspond to traditional theory, which can be tested for internal logical consistency, or tested or predicted to see what accountant do. However, this study is hang on "Accounting Structure Theory".

Interpretational Theory

This theory is part of classical accounting theory model which based on interpreting of financial statement for both internal and external users.

Decision useful theory

This emphasizes on the importance of the information on the financial statement which has to communicate for adequate decision making on a firm and individuals. It bases on the relevancy and importance of information being communicated to the management, and the behaviour of different individual or and group as a result of preparation and presentation of accounting information, either for internal like shareholders, management etc, or external users - such as creditors, Investors, customers, debentures, government authority and so on. However, decision useful theory can also show the effect of external reports on the decision of management and their feedback on the actions on the accountants and auditors. Meanwhile, accounting is considered to be behavioural process, and the theory applies

behavioural science to accounting and sometimes, decision-usefulness theory also known as behavioural theory. In a bigger angle, it always studies and analyses behavior of individual user of information. It attempts to assess, and determine the economic, sociological and physiological effects of alternative accounting procedures and modes of financial preparation.

METHODOLOGY

Methodology is an orderly procedure of carrying out a research work. It involves a broad method, rules, postulates employed in a field of accounting. Also, is a systematic way of study and technique used in under-taking a research. Once the objective of accounting theory is achieved, there is need to establish an approach for the formulation of accounting thought that must be chosen in order to develop logical conceived accounting principles. These objectives are basic accounting thought which can be grouped into non-theoretical and theoretical approach. The Non-theoretical approach are Practical and Authoritarian, while, Theoretical (formal) approach are Inductive, Deductive, Ethical, Sociological, Mathematical (axiomatic), Economic, Events, Behavioural, and Predictive approach.

RESULT AND DISCUSSION

Non-Theoretical (Informal) Approach

i. Practical Approach:

The practical approach is also referred to as the ‘pragmatic approach’, though it does not fully employ the formal rule of the pragmatic school of logicians. Yet, this approach constitutes an important part of theory in accounting because “it enables the theory to have operational utility, based on an understanding of relations between business phenomena, of constraints on the measurement system, and of the needs of users of accounting information”. The practical approach is essentially a problem solving approach. Its primary objective, as can be seen from the most of the “generally accepted accounting principles”, is to find a workable solution to a problem. As a result, any solution obtained through this approach should be viewed as a tentative solution to problems. In a nutshell, it involves the development of ideals that are in agreement with real world situation and which find usefulness in realistic conditions. It is practical approach and since accounting is practical, whatever its concepts must be practicable. The approach makes use of both inductive and deductive approach in order to make it applicable and practicable in formulating a theory.

ii. Authoritarian Approach

This approach is sometimes equated with the practical approach because of the common methodology its theoretical grounding based on operational utility under the stamp of approval of the regulatory bodies. “The role of authoritarianism is to discriminate between well-founded but conflicting theories (given on the state of knowledge at the time. Carrying out a research based on directives from accounting institutions or body.

Theoretical (Formal) Approach

i. Inductive Approach

This is the process of formulating accounting theory; through the process of observation of detailed measurement and drawing generalize conclusions or principles from these. The theory formulation begins with observing the phenomena or premise and moving towards generalized solutions. It also requires experimental testing of observation to support conclusions. It graduates from specific observation to broad generalization. For Example, the inductive approach in accounting” begins with observation of financial information of business enterprises and proceeds to draw generalization and principle of accounting” (Zalaghi & Khazaei, 2016). Finally, general propositions are formulated through an inductive process. It has some merits:

- (a) Free to make any observations. i.e no any constraints either by pre-conception or
- (b) The generalization need not be absolute so that two persons can come out with two different generalizations.

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- (c) It is an easy method to use.

Demerits of inductive approach are

- (a) Observation made may not be adequate enough to permit reasonable generalizations.
- (b) The observers may be slightly influenced by personal pre-conceptions or basis.

ii. Deductive Reasoning Approach

This is the formulating of accounting thought / theory through the process of commencing with the objectives and postulates, and from these, logical principles or conclusions that provides the basis for concrete or practical solution. Deductive approach moves from general (basic proposition about the accounting environment) to the particular accounting principles first and accounting techniques second. Thus, the practical applications and rules are derived from logical reasoning. The demerit of deductive process method is that for any postulation or premises that are false, the conclusion may also be faulty. It has some advantages which are:

- (a) It is basically based on objectives and goals and not observations
- (b) It leads to general guide to action rather than from experience
- (c) It is not absolute, so anybody can come out with a better guidance.

Disadvantages of inductive are:

- (a) It may not have much impact on accounting practice
- (b) If any of the bases for assumptions for defining the postulate is faulty, then the rules established will be faulty as well.
- (c) The technique is far removed from reality as such, it may not be workable or practicable

The structure of the deductive process should include the following:

1. The formulation of general or specific objectives of financial reporting:
2. A statement of the postulates of accounting relating to the economic, political, and sociological environment in which accounting must operate:
3. A set of constraints guiding the reasoning process
4. Structuring set of symbols or framework in ideas expressed and summarized:
5. The development of a set of definitions:
6. The formulation of principles or generalized statements of policy derived by the process of logic, and finally
7. The implementation of the principles to specific situations and establishment of procedural methods and rules. Henderiken (1965); Zalaghi & Khazaei (2016).

iii. Ethical Approach

This emphasizes the concepts of justice, truth, and equity. The basic concepts of accountings are:

1. Accounting procedures must provide equitable treatment to all interested parties
2. Financial reports should present a true and accurate statement without misrepresentation.
3. Accounting data should be fair, unbiased, and impartial without serving special interests.

iv. Sociological Approach (Social Welfare)

This encourages the business entity that functions in a free –market system to account for the impact of their private production activities in the social environment through measurement, internalization and disclosure in their financial statements. i.e. it calls for an assessment of the accounting techniques and policies *vis-a-vis* their impact on the society. Its suggested dimensions, among others, include internalizing the social cost and assessment of social benefits arising from the activities of the private firms, disclosure of socially oriented data to assess a firm's relative role and contribution to the society).

v. Mathematical (Axiomatic)

This is the formulation of accounting theory through the process of mathematical symbols that are given to certain ideas and concepts, and frame work is provided in the form of mathematical models utilizing matrix, algebra on symbolic logic which provides techniques for summarizing the basic proposition of accounting (postulates, concepts and other observable phenomena) in the abstract language to draw conclusions that provides the basis for concrete or practical solution.

vi. Economic Approach

While the ethical approach focuses on the concept of fairness and sociological approach on the concept of ‘social welfare’, the economic approach to the formulation of accounting theory emphasizes the macro and micro economic welfare of the affected parties arising from the proposed accounting technique. In fact, economic consequence is a pervasive consideration which was given due importance in the choice of accounting techniques.

vii. Communication Approach

Accounting can borrow profitably from other social science to establish a framework for development theory and evaluating the proper accounting objective, though little has done in applying communication theory of accounting. This theory tries to evaluate that accounting may be viewed as an integrated system of the communication process.

viii. Eclectic or Combination Approach

Eclectic approach does not profess commitment to any particular methodology; it is mainly the result of numerous attempts by individuals, professionals and other agencies [AICPA, AAA and the like] to remove the deficiencies of other approaches. Such an approach is particularly useful in the absence of a universally accepted accounting theory.

ix. The Events Approach

The events approach to the formulation of accounting theory was first proposed by George Sorter, as an alternative to the value approach to accounting which was endorsed by the majority of the members of the AAA committee that issued “A statement of Basic Accounting theory” in 1966. The principal argument used in favour of the events approach is that, due to wide ranging use and heterogeneous users of financial statements, accountants should not direct the published financial statements to specified ‘assumed’ group. Given this argument, the events approach suggests expansion of accounting data in the financial statements. The limitations of the events approach, however, are the following:

1. Events approach presupposes that the users are sophisticated enough to be able to classify and aggregate accounting data for their own use.
2. Events approach does not explicitly mention which data are to be selected for the financial statements.
3. There is definite limit to the amount of data a person can handle at a time. The expansion of data may cause information overload to the users.

x. The Behavioural Approach

The behavioural approach is concerned with direct evidence of user’s reaction to accounting reports as a basis for descriptive generalization about the behavioural aspects of particular accounting techniques and problems, such as:

- (1) The adequacy of disclosure.
- (2) The usefulness of financial statement data.
- (3) Attitudes about corporate reporting practices.
- (4) Materiality Judgments.

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While this approach, may be useful in research and evaluations, its similar to the pragmatic approach and is subjected to the same criticism that it relies on subjective judgments regarding what behaviour is good or appropriate and what is bad and inappropriate.

xi. Predictive Approach:

Under the traditional approach accounting measures are generally used for non-predictive purposes e.g., accountability and reporting on stewardship. The predictive approach is directly related to the 'predictive ability' of financial data and is purported to provide a purposive criterion to relate the function of collecting financial data to the task of decision-making.

Given the foregoing, the following positions are being put forward; Accounting approach facilitates the preparation of realistic financial statements; Elements of accounting thought set the rules for generating credible and realistic financial statements. Also, the structure of accounting thought consists of postulates, assumptions, objectives and principles which are oftentimes used interchangeably and the conceptual framework for financial accounting statement and reporting are derived from accounting thought's element and structure. Similarly, the study methodology covers basic approach to formulation of accounting thought evidence from financial accounting framework, the methodology examines basic theoretical and non theoretical approach to accounting thought and consequently, accounting thought lays the foundation for financial account preparation and reporting.

CONCLUSION AND RECOMMENDATIONS

In this study, whilst elucidation on basic approaches to formulation of accounting thought, the paper tries to detail on their role in accounting theory, developing standards, and accounting research. Accounting thought has been developed by the process of accounting research and has been modified regularly. Accounting thought is one of the main factors influencing the development of accounting standards. The standards and other pronouncement of policy making bodies have been interpreted and implemented. In the process of developing an accounting theory or thought, the reasoning method is highly significant. Developing the theory in the first place on non-theoretical approach which is practical as well as authoritarian approach was adopted and further reasoning and research theory deduce that accounting theory is a deductive process in social sciences. The researcher observing phenomenon or studying the literature, presents a theory over why a phenomenon has happened, and as it was happened, in the early years of developing accounting theory, inductive approach was used more and the goal was for practical applications to be the subject of later theories. Then, a general shift in approach towards research based on deductive reasoning happened. However, as a result of limitations in the above approaches after a few years, the focus of research and accounting theory was again shifted towards the other approaches in accounting theory.

Therefore, in spite of the element of overlapping among the accounting thought, the most precise statement of assumptions has been presented by most of accounting scholars and from which details of accounting practices have been derived. Yet, it always views as incomplete, because, it does not contain any reference to user needs. For instance, behavioural approach considered to neglect some postulates which have general acceptance, relevant, consistency continuity and objectivity. As it was explained in the paper, that accounting theories have been formed through combining deductive, inductive pragmatic, ethical, and sociological, welfare, behavioural, and communication approach. Accounting theorists generally begin with inductive reasoning and change their course towards a deductive approach, followed by pragmatic, ethical, behavioural communication and sociological approach in order to improve the theory through development of understanding of various thought in accounting. In accounting research, inductive reasoning is used more in qualitative research. While deductive reasoning is more applicable for quantitative research. However, inductive and deductive research methods are not mutually exclusive, and they are usually used to complement each other. Since, the researchers use their knowledge about the practical procedures for accounting solutions. The paper recommends that professional accountants, accounting instructors, financial regulators and other financial experts should increase their research orientation on accounting thought or theory. Also, the financial expert or lecturers in most of our higher institutions should embrace the teaching of more principles of accounting thought or theory, even at undergraduate level.

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