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COURSE GUIDE



COURSE TITLE: Accounting Theory

COURSE CODE: ACC 307

LECTURER: Akinwumi T. TALEATU



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COURSE OBJECTIVES



GENERAL INTRODUCTION AND COURSE OBJECTIVES

This course aims at exposing the students to foundations of accounting theory including the nature, history and development of accounting theory. It will also cover approaches to the development of accounting theory; the International Accounting Standard Board (IASB); Source of accounting standards in Nigeria; Statement of accounting standards (SAS) 5-22 and International Financial Reporting Standards (IFRS); Conceptual consideration in financial reporting, objectives of financial reporting, developing a financial reporting framework, purpose of financial reporting among others.



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LECTURE 1

INTRODUCTION ACCOUNTING THEORY

1.0 Introduction

Every discipline has theories upon which it is based. Accounting researchers relied on theories from other social science fields like Economics and Finance. However, some accounting researchers have developed some theories to explain and predict accounting practices. This lecture will serve as introduction to the discourse on the development of accounting theory.

Objectives

At the end of this lecture, students should be able to:

1. define theory and accounting theory
2. appreciate nature of accounting theory
3. understand theory construction and verification
4. explain the role of theory in accounting

Pre Test

1. What is accounting?
2. What is theory?
3. What is accounting theory?

CONTENT

1.1 Theories

Theories are generalizations which serve to organize otherwise meaningless masses of data and thereby establish significant relationships in respect of such data. Kerlinger (1964) defined a theory as a set of interrelated constructs, definitions and propositions that present a systematic view of phenomena by specifying relations among variables with the purpose of explaining and predicting the phenomena. According to Webster's Third New International Dictionary, theory represents the coherent set of hypothetical, conceptual and pragmatic principles forming the general frame of reference for a field of enquiry.

However, MacDonald (1972) argued that a theory must have three elements namely:

1. Encoding of phenomena to make a symbolic representation.
2. Manipulation or combination according to rules.
3. Translation back to real-world phenomena.

Each of these components of a theory is found in accounting. First, accounting employs symbolic representation or symbols like 'debit' and 'credit'. These terminologies are proper and unique to accounting. Second, accounting employs translation rules. It makes symbolic representations of economic transactions and events. Third, accounting employs rules of manipulation. Techniques for determination of profit may be considered as rules for the manipulation of accounting symbols.

1.2 Nature of Accounting Theory

Hendriksen (1992) adapted the definition of theory according to Webster's Third New International Dictionary to define 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 that guide the development of new accounting practices and procedures". This definition implies that accounting theory provides a coherent set of



logically-derived principles that serve as a frame of reference for evaluating and developing accounting practices. It also indicates that accounting theory may be used to explain existing practice to obtain a better understanding of the practice.

1.3 Construction and Verification of Accounting Theory

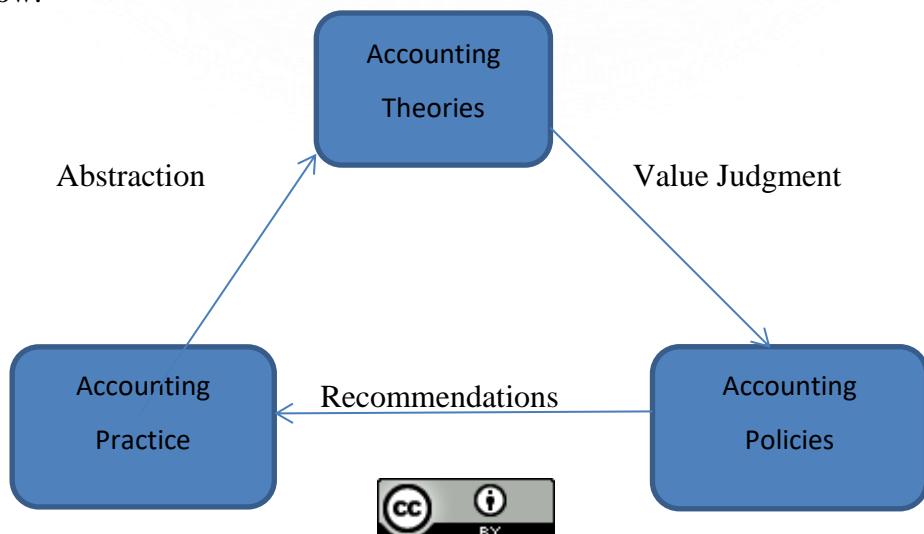
Accounting theory is constructed either to justify or to refute the existing practice. Accounting theory construction emanates from the needs to provide rationale for what accountants do or expected to be doing. The construction of theories requires a process of reasoning about the problems implicit in the data under observation in order to distinguish the basic relationships. Thus theory construction is a process of simplification which requires assumptions that permit the representation of reality by a generalization that is easily understood.

However, the process of accounting theory construction should be completed by theory verification or theory validation. Scientific method of theory construction consists of the following stages:

1. Availability of data or facts
2. Recognition of a problem
3. Collection and organization of data
4. Formulation of propositions and definitions
5. Development of hypotheses
6. Testing hypotheses
7. Theory verification, modification or rejection
8. Theory acceptance

1.4 The Role of Theory in Accounting

The role played by theory in accounting is different from that played in the natural sciences. Theories are developed from empirical observations in the natural sciences. The reverse is the case in accounting. Accounting practice may be changed to accommodate a theory. A tripartite relationship exists among accounting practice, accounting theory and accounting policy. Existing accounting techniques can be investigated to justify its continuous usage, modification or jettisoning. Through abstraction, accounting practice provides data for formulation of accounting theory. Through value judgment, policy makers incorporate research findings into accounting policies they formulate to enhance usefulness of accounting information. The recommendations included in accounting policies are implemented by accounting practitioners. This tripartite relationship can be represented diagrammatically as shown below:



Post Test

1. MacDonald (1972) argued that a theory must have three elements. Interestingly, each of these components of a theory is found in accounting. **Required:** (a) Define Theory?
(b) List the three elements of a theory according to MacDonald (1972). (c) Justify the existence of these components of a theory in accounting. **(10 marks)**
2. Accounting theory is constructed either to justify or to refute the existing practice. Accounting theory construction emanates from the needs to provide rationale for what accountants do or expected to be doing. **Required:** List and explain the stages of scientific method of theory construction. **(10 marks)**
3. A tripartite relationship exists among accounting practice, accounting theory and accounting policy. Discuss? **(10 marks)**

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Riahi-Belkaoui, A. (2000). *Accounting theory* (4ed.). United Kingdom, Thompson Learning.



LECTURE 2

STRUCTURE OF ACCOUNTING THEORY

2.0 Introduction

The development of the structure of accounting theory to justify the existing rules and techniques began with Paton (1922) who examined the basic foundations of accounting. The effort was continued by a number of theorists who attempted to codify accounting postulates and accounting principles in a bid to formulate a coherent accounting theory to enable accountants improve on the quality of financial reporting. The resulting theories provide a frame of reference or a structure of accounting theory.

Objectives

At the end of this lecture, students should be able to:

1. Identify and define the essential elements of accounting theory
2. Discuss theoretical accounting concepts

Pre Test

1. What is accounting theory
2. What are the components of a theory?

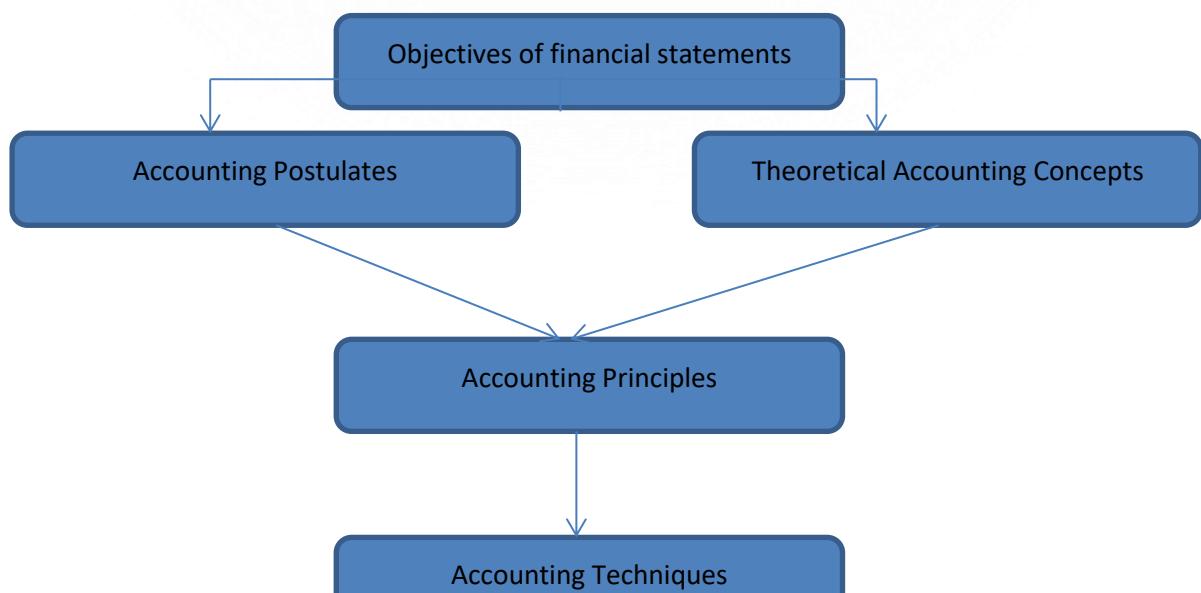
CONTENT

2.1 Consensus on Structure of Accounting Theory

A consensus exists in the literature and in practice on certain elements as essential foundations of accounting theory. These elements are:

1. A statement of the objectives of financial statements.
2. A statement of accounting postulates and theoretical accounting concepts concerned with the assumptions and the nature of an accounting entity.
3. A statement of basic accounting principles based on both accounting postulates and accounting concepts.
4. A body of accounting techniques derived from the accounting principles.

Figure 2.1 Structure of an accounting theory



2.2 Objective of general purpose financial statements

The objective of general purpose financial statements, is to provide information about the financial position, performance and cash flows of an entity that is useful to existing shareholders and potential inventors, lenders and other creditors in making economic decisions. These groups of users make decisions to provide resources to the entity through buying, selling or holding equity and debt instruments and providing or settling loans and other credits. For the purpose of making these decisions, the users need information to help in assessing the prospects for future cash inflows of the entity and thus will need information about the resources of the entity, the claims against such resources and the efficiency and effectiveness of the entity's management in using the entity's resources. The general purpose financial statements provide information about:

- i) The entity's financial position. That is information about economic resources and the claims against them.
- ii) Changes in the entity's financial position which could be as a result of:
 - financial performance; and /or
 - other events or transactions such as share issue
- iii) The entity's inflows and outflows of cash and cash equivalents.

2.3 Accounting Postulates

Accounting postulates are self-evident statements or axioms generally accepted by virtue of their conformity to the objectives of financial statements that portray the economic, political, sociological and legal environments in which accounting must operate. They include the entity postulate, going concern postulate, unit of measure postulate and accounting period postulate.

2.4 Theoretical Accounting Concepts

Theoretical accounting concepts are also self-evident statements or axioms and are generally accepted by virtue of their conformity to the objectives of financial statements that portray the nature of accounting entities operating in a free economy characterized by private ownership of property. They include proprietary theory, entity theory and fund theory

Proprietary Theory

According to proprietary theory, the entity is the agent, representative or arrangement through which the individual entrepreneurs or shareholders operate. The primary objective of proprietary theory is the determination and analysis of proprietor's equity. This is represented in accounting equation as shown below.

Proprietor's equity = Assets – Liabilities

The proprietor owns the assets and the liabilities. The theory is asset-centered and balance sheet-oriented. Assets are valued and the statement of financial position is prepared to measure the changes in proprietor's wealth. Revenue is considered as increase in proprietor's wealth while expenses are viewed as decrease in proprietor's wealth. So, profit can be classified as revenue while taxes can be classified as expenses.

Entity Theory

The entity theory considers a business entity as a separate and distinct body from those who provide capital to the entity. The firm is the center of accounting interest. The company owns



the resources of the enterprise and it is liable to both the claims of the owners and the claims of the creditors. Thus, accounting equation from the perspective of entity theory becomes:

Assets = Proprietor's equity + Liabilities

The preparation of consolidated financial statements or group accounts is consistent with the entity theory.

Fund Theory

Under the fund theory, the basis of accounting is neither the proprietor nor the entity but a group of assets and related obligations and restrictions called a fund governs the use of the assets. The theory posits that a business entity consist of economic resources called fund and related obligations and restrictions related to the use of these resources. The accounting equation in respect of fund theory is as follows:

Assets = Restrictions on assets

The accounting entity is defined in terms of the assets and the uses to which these assets are committed. Liabilities represent a series of legal and economic restrictions on the use of the assets. The theory is assets-centered. The primary objective of this theory is the preparation of the statement of cash flow statement which reflects the conduct of the firm's operations in terms of the sources and applications of funds.

2.5 Accounting Principles

Accounting principles are general rules derived from both the objectives of financial statements and the theoretical accounting concepts that govern the development of accounting techniques. They include the cost, revenue, matching, objectivity, consistency, full disclosure, conservative, materiality, and uniformity principles.

2.6 Accounting Techniques

Accounting techniques are specific rules derived from accounting principles for treatment of specific transactions and events by a business entity. Examples include stock valuation methods like FIFO, LIFO and weighted average.

Post Test

1. A consensus exists in the literature and in practice on certain elements as essential foundations of accounting theory. Discuss? **(10 marks)**
2. Write short notes on:
 - (a) Proprietary theory
 - (b) Entity theory
 - (c) Fund theory. **(10 marks)**

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Glautier, M. W. E. (2001). *Accounting theory and practice* (7ed.). Great Britain, Prentice Hall.

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LECTURE 3

APPROACHES TO THE DEVELOPMENT OF ACCOUNTING THEORY

3.0 *Introduction*

Glautzer and Underdown (2001) identified three approaches for developing accounting theory namely; Descriptive, Decision Usefulness (normative and empirical) and welfare approaches. These approaches will be discussed in the course of this lecture.

Objectives

At the end of this lecture, students should be able to:

Pre Test

1. What is accounting theory?
2. Name some accounting theorists you know?

CONTENT

3.1 *The Descriptive Approach*

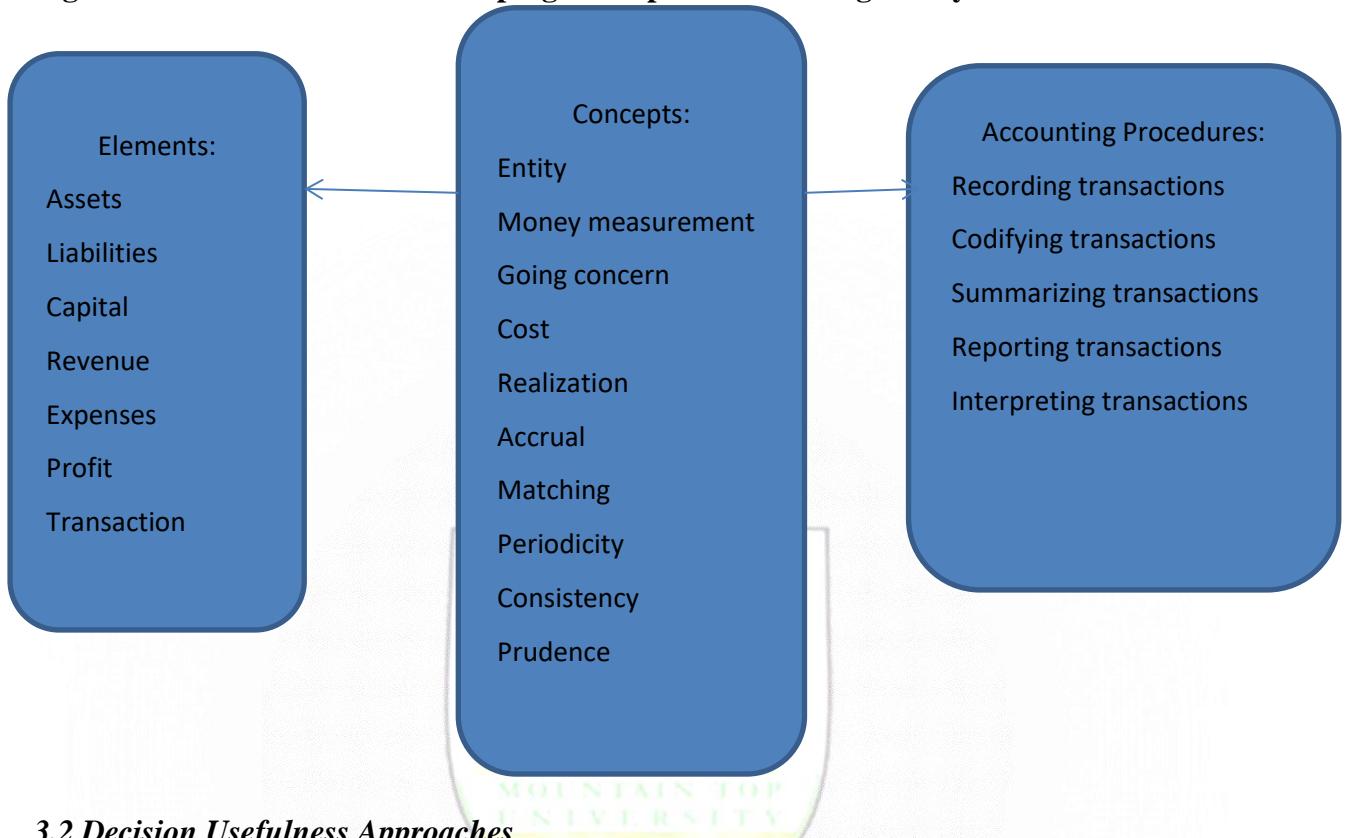
The descriptive approach is used to develop theories that are concerned with what accountants do. Accounting is generally believed to be an art that cannot be formalized and the methodology traditionally used to formulate an accounting theory is an attempt to justify “**WHAT IS**” by codifying accounting practices. Descriptive theories rely on a process of inductive reasoning, which consists of making observations and of drawing generalized conclusions from those observations. The objective is to look for similarity of instances and to identify a sufficient number of such instances to develop a theory about all the instances.

The descriptive approach emphasizes the practice of accounting as a basis from which theories are developed. It relates the practices of accountants to a generalized theory about accounting. This approach is of the view that accounting theory is to be discovered by observing the practices of accountants because accounting theory is primarily a concentrate distilled from experience (Littleton & Zimmerman, 1962). The descriptive approach results in *positive theories of accounting* which “*explains what accountants do*” and enable predictions to be made about behavior. For an instance, it is possible to predict that the receipt of cash will be entered in the debit side of the cash book.

The underlying belief in the descriptive approach is that the objectives of financial statements are associated with the stewardship concept which refers to the needs to provide the owners of the business with information on the manners in which their assets have been managed. The company’s directors are in fiduciary relationships with the shareholders. They are therefore required to publish the annual reports for the use of the shareholders. This disclosure of accounting information is aimed at protecting the shareholders from fraudulent management practices. The framework within which descriptive accounting theory has developed is shown below.



Figure 3.1: Framework for developing descriptive accounting theory



3.2 Decision Usefulness Approaches

The expansion of behavioural research into accounting resulted in an interest in decision usefulness theories of accounting. Two types of decision usefulness theories of accounting developed from this approach are: **NORMATIVE** approach and **EMPIRICAL** approach.

Normative approach theory construction is concerned with specifying the manners in which decisions “ought to be made”. It provides insight on the information needs of decision makers, as a basis for developing accounting theory.

Empirical approach on the other hand concentrates on how users apply this information in decision making. It was designed to make accounting research more rigorous and to improve the reliability of results. Sophisticated statistical techniques were increasingly explored for this purpose.

3.3 The Welfare Approach

The welfare approach is the extension of decision making approaches. It considers the effect of decision making on society welfare. The external social effects of decisions made on the basis of accounting information leads to social welfare dimension of accounting theory.

Post Test

Write short note on the following approaches to development of accounting theory:

- Descriptive approach
- Decision usefulness approach
- Welfare approach

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Glautzer, M. W. E. (2001). *Accounting theory and practice* (7ed.). Great Britain, Prentice Hall.

Riahi-Belkaoui, A. (2000). *Accounting theory* (4ed.). United Kingdom, Thompson Learning.



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LECTURE 4

CONCEPTUAL FRAMEWORK IN FINANCIAL REPORTING

4.0 Introduction

A conceptual framework is a set of concepts and principles which underpin the preparation of financial statements. It is a framework upon which International Financial Reporting Standards (IFRSs) are based. It determines the scope of information contained in financial statements. The International Accounting Standards Committee (IASC), the fore bearer of the International Accounting Standard Board (IASB) issued a document in 1989 called “Framework for the Preparation and Presentation of Financial Statement”. This “Framework” which is not an accounting standard in itself was adopted by the IASB when it came on board in 2001.

Objectives

At the end of this lecture, students should be able to:

1. Define conceptual framework
2. Identify the components of conceptual purpose
3. Outline the purpose of conceptual framework

Pre Test

1. What is financial reporting?
2. What is conceptual framework?

CONTENT

4.1 Components of Conceptual Framework

The framework comprised of the following sections:

- a) The objective of financial statements
- b) Underlying assumptions of financial statements
- c) The qualitative characteristics that determines the usefulness of information in financial statements
- d) The definition of the elements of financial statements
- e) The recognition of the elements of financial statements
- f) The measurements of the elements of financial statements
- g) Concepts of capital and capital maintenance

The IASB in collaboration with the Financial Accounting Standards Board (FASB), the national standard setters of the United States of America, is currently working to develop a conceptual framework common to each Generally Accepted Accounting Principles (GAAP). The new conceptual framework is being developed on a chapter by chapter basis.

For now, only two chapters have been finalized and released to replace the sections (a) and (c) in the 1989 “Framework” described above. To ensure effective replacement of the two sections and probably avoid possible confusion, the IASB issued a new document called “The Conceptual Framework for Financial Reporting” which is made up of the following chapters:

- i) Chapter 1 - The objective of general purpose financial reporting
- ii) Chapter 2 - The reporting entity (to be added – yet to be finalized)
- iii) Chapter 3 - Quantitative characteristics of useful financial information
- iv) Chapter 4 - The Framework (1989): That is the remaining sections of the 1989 document not yet replaced, comprising:
 - (a) Underlying assumption of financial statements



- (b) The elements of financial statements
- (c) Recognition of the elements of financial statements
- (d) Measurement of the elements of financial statements
- (e) Concepts of capital and capital maintenance

However, the changes between the “Framework” 1989 and the “Concept framework” are not fundamental in terms of their impact on IFRS.

4.2 Purpose of Conceptual Framework

The need for a formal conceptual framework is recognized by most preparers and users of financial statements as it will enhance uniformity in the treatment and presentation of financial issues and reports. The conceptual framework outlines the concepts which underlie the preparation and presentation of financial statements especially for external users. Thus, the purposes of conceptual framework include:

- i. it assist preparers of financial statements in applying IFRSs and in dealing with matters not yet covered by any IFRS.
- ii. It assists users when interpreting the information contained in IFRS compliant financial statements.
- iii. It assists auditors informing an opinion on whether or not the financial statements adequately complied with IFRSs.
- iv. It assists national standard setting bodies when developing their national or local standards.
- v. It assists the IASB when developing new IFRSs and in the review of existing ones.
- vi. It assists the IASB by providing a basis for the reduction of the number of alternative accounting treatments permitted by IFRSs and therefore promoting harmonization of regulations and procedure for presentation of financial statements.
- vii. It provides information about the approach to the formation of IFRSs to parties interested in the work of the IASB.

It should be noted that where there is a conflict between the conceptual framework and an IFRS, the requirements of the IFRS will prevail over those of the Conceptual Framework in all cases.

Post Test

1. What is conceptual framework? Outline the purpose of conceptual framework. **(10 marks)**
2. Identify and define the elements of financial statement in line with conceptual framework for financial reporting. **(10 marks)**
3. ***Bibliography***

ATSWA (2009). Principles and practice of financial accounting. Lagos, ATSWA Publishers.
IASB, www.iasb.org



LECTURE 5

FINANCIAL REPORTING REGULATIONS

5.0 Introduction

Users rely on the financial statements to take investment decisions hence their presentations need to be regulated to ensure credibility and fairness. The preparation and presentation of financial statement is based on large number of concepts, principle and detailed rules. Some of these are contained in law and others are in financial reporting standard. Many of the most fundamental concepts are not contained in any law or regulations or standards, but are simply accepted accounting principles and conventions

All the concepts principles conventions, laws, rules and regulations that are used to prepare and present financial statements are known as Generally Accepted Accounting Principles or GAAPs. Generally Accepted Accounting Principles vary from country to country because their legal and regulatory systems are not the same. However many countries all over the world have now accepted a uniform accounting standards which is known as International Financial Reporting Standards (IFRS or IAS). These standards and appropriate local GAAPs are applied when preparing and presenting financial statements.

Objectives

At the end of this lecture, students should be able to:

1. Understand the role of IASB in setting accounting standards
2. Appreciate the role of Financial Reporting Council of Nigeria in corporate financial reporting

Pre Test

1. What is financial reporting?
2. What do you understand by regulations?
3. Mention some bodies responsible for accounting regulation?

CONTENT

5.1 International Accounting Standards Board (IASB)

The IASB is the board charged with responsibility for developing international accounting standards. The board is made up of 14 members that are highly skilled in accounting and each member contribute to the issue and publications of the following documents issued by the board:

- an exposure draft of the standard
- a revised International Accounting Standards (IAS)
- an International Financial Reporting Standards(IFRS)
- a final Interpretation of the IFRS interpretation committee(IFRSIC)

The IASB has full responsibility for all technical matters and they have issued IASB – CONCEPTUAL FRAME WORK which set out the concepts that underlie the preparation and presentation of financial statements for users. The term IFRS is normally used to refer to the whole body of the standards (i.e IAS and IFRS). The IFRS is made up of accounting standards (IFRS and IAS) and its interpretations (SICs and IFRSICs).

5.2 Roles of Accounting Standard Setting Bodies

The responsibility for setting Accounting Standards at global level rests with the International Accounting Standards Board (IASB). There are also National Accounting Standards setting



bodies in different countries like the Financial Reporting Council of Nigeria (FRCN), which now ensure compliance of entities' financial statement with the International Financial Reporting Standards (IFRS).

5.3 International Accounting Standards Board (IASB)

The fore bearer of the IASB is the International Accounting Standards Committee (IASC) which was established in 1973 to develop international accounting standards with the aim of harmonizing accounting procedures worldwide. The first set of International Accounting Standards (IASs) were issued in 1975. The IASC was supported by another body called the Standing Interpretation Committee (SIC) which issued interpretations of rules in standards when practitioners have divergent opinion in treatment of items.

Following the change in the constitution of IASC in 2001, two new bodies were established to replace the IASC and its supporting body, the SIC. The bodies were International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRSIC). The IASB adopted all the standards (IASs) and Interpretations by SIC that were extant at the time, but pronounced that all new standards written from that time were to be called "International Financial Reporting Standards" (IFRS) and that all interpretations by IFRSIC are to be known as International Financial Reporting Interpretations Committee pronouncements or IFRICS.

Thus, when IFRS is mentioned, it means:

- (i) All Accounting Standards (IASs) and Interpretations by SIC published by the IASC up to 2001 (those not yet replaced) and;
- (ii) (ii) All Accounting Standards (IFRSs) and Interpretations (IFRICs) published by the IASB from 2001. Since 2001, the IASB has published the following standards using the new nomenclature IFRS:
 - IFRS 1 - First time adoption of IFRS
 - IFRS 2 - Share-based payment
 - IFRS 3 - Business combination
 - IFRS 4 - Insurance contracts
 - IFRS 5 - Non-current assets held for sale and discontinued operations
 - IFRS 6 - Exploration for and evaluation of mineral resources
 - IFRS 7 - Financial Instruments: Disclosure
 - IFRS 8 - Operating segments
 - IFRS 9 - Financial instruments
 - IFRS 10 - Consolidated Financial Statements
 - IFRS 11 - Joint arrangements
 - IFRS 12 - Disclosure of interests in other entities
 - IFRS 13 - Fair value measurement
 - IFRS 14 - Regulatory deferral accounts
 - IFRS 15 - Revenue from contracts with customers
 - IFRS 16 - Leases
 - IFRS for SMEs. So far, many IASs and SIC pronouncements have been repealed or amended by IASB since its establishment in 2001.

5.4 Financial Reporting Council of Nigeria

The Financial Reporting Council of Nigeria (FRCN) is the national accounting standards setting body in Nigeria. It replaced the Nigerian Accounting Standards Board (NASB) in June 2011. The FRCN was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011 which repealed the Nigerian Accounting Standard Boards Act No. 22 of 2003.



The FRCN is an agency of the federal government which is directly supervised by the Federal Ministry of Industry, Trade and Investment.

According to the Act, the main objectives of FRCN are:

- (a) To protect investors and other stakeholders interest;
- (b) To give guidance on issues relating to financial reporting and corporate governance to professional, institutional and regulatory bodies in Nigeria;
- (c) To ensure good corporate governance practices in the public and private sectors of the Nigerian economy;
- (d) To ensure accuracy and reliability of financial reports and corporate disclosures, pursuant to various laws and regulations currently in existence in Nigeria;
- (e) To harmonize activities of relevant professional and regulatory bodies as relating to corporate governance and financial reporting;
- (f) To promote the highest standards among auditors and other professionals engaged in the financial reporting process;
- (g) To enhance the credibility of financial reporting; and
- (h) To improve the quality of accountancy and audit services, actuarial, valuation and corporate governance standards.

For effective operations, the FRCN is structured into seven directorates which are:

- (i) Directorate of Accounting Standards – Private sectors
- (ii) Directorate of Accounting Standards – public sectors
- (iii) Directorate of Auditing Practice Standards
- (iv) Directorate of Actuarial standards
- (v) Directorate of Valuation Standards
- (vi) Directorate of Inspection & Monitoring
- (vii) Directorate of Corporate Governance

In order to achieve its purpose of developing and publishing accounting standards in Nigeria, the Directorate of Accounting Standards is assigned the following responsibilities:

- (a) To develop accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and small and medium scale enterprises;
- (b) To promote the general acceptance and adoption of such standards by preparers and users of financial statements;
- (c) To promote compliance with the accounting standards developed or reviewed by the Directorate;
- (d) To review from time to time the accounting standards developed in line with prevalent social, economic and political environment;
- (e) To promote compliance with accounting and financial reporting standards adopted by the Council;
- (f) To promote in the public interest, accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities; and
- (g) To perform such other duties which in the opinion of the Board are necessary or expedient to ensure the efficient performance of the function of the Council.

It should be noted that international accounting standards cannot be used or applied in any country without the involvement and approval of the national regulators in that country. Every country has its peculiar approval process or road map which must be followed before IFRS can be applied in such country. In Nigeria, the FRCN constructed a plan, called a road map, which was used in driving the convergence of Nigerian GAAP to IFRS from January 2012 to 2014. Effectively Nigeria adopted IFRS from January 1, 2012.

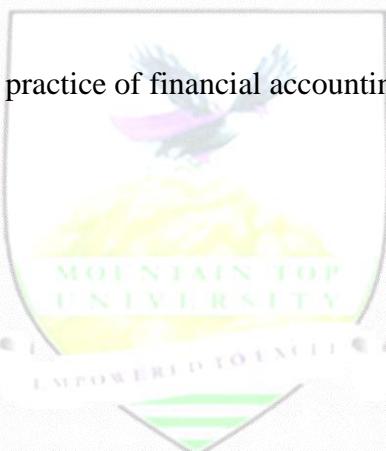


Post Test

1. Briefly explain the following acronyms:
 - (a) IASB
 - (b) IAS
 - (c) IFRS
 - (d) SICs
 - (e) IFRSICs **(10 marks)**
2. Differentiate between accounting standards and GAAPs? List 5 objectives of IASB. **(10 marks)**
3. The Financial Reporting Council of Nigeria (FRCN) is the national accounting standards setting body in Nigeria. It replaced the Nigerian Accounting Standards Board (NASB) in June 2011. The FRCN was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011 which repealed the Nigerian Accounting Standard Boards Act No. 22 of 2003. Required: (a) List 5 objectives of FRCN. (b) List 5 responsibilities of the Directorate of Accounting Standards of the council. **(10 marks)**

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LECTURE 6

FORMULATION OF ACCOUNTING THEORY: REGULATORY APPROACH

6.0 Introduction

Regulatory approach to formulation of accounting theory refers to the establishment of accounting standards. It focuses on determining the best mechanism to be employed in establishing uniform accounting standards. It involves determining which of the free market approach, private sector approach and public sector approach is to be employed in establishing accounting standards.

Objectives

At the end of this lecture, students should be able to:

1. Understand nature of accounting standards and reasons for establishing accounting standards
2. Appreciate approaches to setting of accounting standards
3. Contribute to the argument for or against regulation of accounting.

Pre Test

1. What is accounting theory?
2. What is regulation?

CONTENT

6.1 Nature of Accounting Standards

Accounting standards can be described as accounting principles to be applied for treatment of transactions and events and for subsequent preparation of financial statements. Accounting standards usually consists of three parts:

1. A description of the problem to be solved.
2. A reasoned discussion on ways of solving the problem.
3. The prescribed solution in line with decision theory.

6.2 Reasons for Establishment of Accounting Standards

The following are some of the reasons for the establishment of accounting standards.

1. To provide the users with relevant and reliable accounting information
2. To provide the public accountants with guidelines and rules to exercise due care, skill and diligence
3. To provide government with database on variables needed for taxation, regulation and economic planning.
4. To stimulate the interest of accounting researchers and accounting practitioners in accounting principles and accounting theory.
5. To provide auditors with yardsticks to be applied when carrying out an independent statutory audit

6.3 Approaches to setting of accounting standards

Accounting standards may benefit some stakeholders but hurt others. It is a social choice. This forces the standard setters to adopt political process in setting standards. However, there are three approaches for setting accounting standards. The first approaches favours neutral reporting and faithful representations. The second approach favors the adoption of accounting standards with good economic consequences. The third approach recognizes an explicit political economy of accounting.



6.4 Entities involved in Accounting Standard Setting

1. Individuals and public accounting firms – They are responsible through their auditors that independently certify fair and accurate presentation of corporate financial statement.
2. Professional Bodies – These are the associations of professional accountants in a country or region. Examples include ICAN in Nigeria, AICPA in USA and ACCA in UK. They set accounting standards to be observed by the members in practice.
3. International Accounting Standard Board (IASB) – This board is responsible for setting IFRS to be observed by member countries like UK, South Africa and Nigeria. The standards are principle based.
4. Financial Accounting Standard Board (FASB) – This is the body responsible for setting accounting standards in US. Their standards are rule based.

6.5 Theories of Regulation

Who should set accounting standards? This question can be answered through the theories of regulation. There are two major theories of regulation:

1. Public Interest Theories – These theories maintain that regulation is supplied in response to the demand of the public for the correction of inefficient or inequitable market prices. These theories are instituted primarily for the protection and benefit of the general public.
2. Interest Group Theories or Capture Theories of Regulation – The theories maintain that regulation is supplied in response to the demands of special interest group, in order to maximize the income of their members. One of these theories is the political ruling-elite theory of regulation. It is concerned with the use of political power to gain regulatory control. Another example is the economic theory of regulation which focuses on economic power.

6.6 Argument for or against Accounting Regulation

A debate exists as to whether accounting should or should not be regulated:

- a. Accounting should not be regulated – The school of thought that argued that accounting should not be regulated based their assertion on agency theory. They believed that financial reporting can resolve the conflict between business owners and managers by using it to monitor employment contract and to reward managers. They argued further that firms have an incentive to report voluntarily to the capital market, failure of which may be interpreted as bad news. They added that, in the absence of voluntary reporting, users of accounting information can make use of the services of experts to obtain relevant accounting information.
- b. Accounting should be regulated – The school of thought in support of regulation of accounting practice explored a public interest argument. They posit that market failure or need to achieve social goals dictate the need to regulate accounting. Market failure may stem from monopolization of corporate information by an entity, occurrence of fraud and inadequate disclosure of accounting information. Desirable social goals for regulation of accounting include fairness of reporting, information symmetry and investors' protection.



Post Test

1. Should accounting be regulated? Discuss?
2. What is accounting standard? List five purposes of establishing accounting standards?
3. Write short notes on Public interest theories and Interest group theories of regulation.

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LECTURE 7

FORMULATION OF ACCOUNTING THEORY: AGENCY THEORY

7.0 Introduction

Jensen and Meckling (1976) defined the agency relationship as a form of contract between a company's owners and its managers, where the owners (as principal) appoint an agent (the managers) to manage the company on their behalf. As a part of this arrangement, the owners must delegate decision-making authority to the management. The owners expect the agents to act in their (owners) best interests. Ideally, the 'contract' between the owners and the managers should ensure that the managers always act in the best interests of the owners. However, it is impossible to arrange the 'perfect contract', because decisions by the managers (agents) affect their own personal welfare as well as the interests of the owners. This raises a fundamental question. How can managers, as agents of their company, be induced or persuaded to act in the best interests of the shareholders?

Objectives

At the end of this lecture, students should be able to:

1. Know the author of agency theory, when formulated and the content of the theory
2. Appreciate the causes of agency conflict and how it can be reduced

Pre Test

1. What is theory?
2. Who is an agent?
3. Who is a principal?



CONTENT

7.1 Interests and Objectives of Different Stakeholders in Financial Reporting

Agency theory was developed by Jensen and Meckling (1976). They suggested a theory of how the governance of a company is based on the conflicts of interest between the company's owners (shareholders), its managers and major providers of debt finance. Each of these groups has different interests and objectives. These differences lead to agency problem.

- i. The shareholders want to increase their income and wealth. Their interest is with the returns that the company will provide in the form of dividends, and also in the value of their shares. The value of their shares depends on the long-term financial prospects for the company. Shareholders are therefore concerned about dividends, but they are even more concerned about long-term profitability and financial prospects, because these affect the value of their shares.
- ii. The managers are employed to run the company on behalf of the shareholders. However, if the managers do not own shares in the company, they have no direct interest in future returns for shareholders, or in the value of the shares. Managers have an employment contract and earn a salary. Unless they own shares, or unless their remuneration is linked to profits or share values, their main interests are likely to be the size of their remuneration package and their status as company managers.
- iii. The major providers of debt have an interest in sound financial management by the company's managers, so that the company will be able to pay its debts in full and on time.

7.2 Agency Conflicts/Problems



Agency conflicts are differences in the interests of a company's owners and managers. They arise in several ways. These include:

- a. Moral hazard: It refers to the prospect that a party insulated from risk may behave differently from the way it would behave if it were fully exposed to the risk. A manager has an interest in receiving benefits from his or her position as a manager. These include all the benefits that come from status, such as a company car, a private driver, use of a company airplane, lunches, attendance at sponsored sporting events, and so on. Jensen and Meckling (1976) suggested that a manager's incentive to obtain these benefits is higher when he has no shares, or only a few shares, in the company. The biggest problem is in large companies.
- b. Effort level: Managers may work less hard than they would if they were the owners of the company. The effect of this 'lack of effort' could be lower profits and a lower share price. The problem will exist in a large company at middle levels of management as well as at senior management level. The interests of middle managers and the interests of senior managers might well be different, especially if senior management are given pay incentives to achieve higher profits, but the middle managers are not.
- c. Earnings retention: The remuneration of directors and senior managers is often related to the size of the company, rather than its profits. This gives managers an incentive to grow the company, and increase its sales turnover and assets, rather than to increase the returns to the company's shareholders. Management is more likely going to re-invest profits in order to make the company bigger, rather than pay out the profits as dividends. When this happens, companies might invest in capital investment projects where the expected profitability is quite small, and the net present value might be negative.
- d. Risk aversion: Executive directors and senior managers usually earn most of their income from the company they work for. They are therefore interested in the stability of the company, because this will protect their job and their future income. This means that management might be risk averse, and reluctant to invest in higher-risk projects. In contrast, shareholders might want a company to take bigger risks, if the expected returns are sufficiently high. Shareholders often invest in a portfolio of different companies; therefore it matters less to them if an individual company takes risks.
- e. Time horizon: Shareholders are concerned about the long-term financial prospects of their company, because the value of their shares depends on expectations for the long term future. In contrast, managers might only be interested in the short-term. This is partly because they might receive annual bonuses based on short-term performance, and partly because they might not expect to be with the company for more than a few years. Managers might therefore have an incentive to increase accounting return on capital employed (or return on investment), whereas shareholders have a greater interest in long-term value as measured by net present value.

7.3 Reducing the Agency Problem

Jensen and Meckling (1976) argued that when the managers act in the interest of the shareholders, managers bear the entire cost of failing to pursue goals that are in their own best interests, but gain only a few of the benefits. Incentives should therefore be provided to management to increase their willingness to take 'value-maximizing decisions'. In other words, they should take decisions that benefit the shareholders by maximizing the value of their shares. Several methods of reducing the agency problem have been suggested. These include:

1. Devising remuneration packages for executive directors and senior managers that give them an incentive to act in the best interests of the shareholders: Remuneration packages may



therefore provide rewards for achieving a mixture of both long-term and short-term financial targets and non-financial targets.

2. Having a large proportion of debt on the long-term capital structure of the company: Jensen and Meckling (1976) argued that the problems of the agency relationship are bigger in companies that are profitable but have low growth in profits. These companies generate a large amount of free cash flow. Free cash flow is cash that can be spent at the discretion of management, and does not have to be spent on essential items such as a payment of debt interest, taxation and the replacement of ageing non-current assets. It is in the interest of shareholders that free cash flow should be either invested in projects that will earn a high return (a positive net present value) or paid to the shareholders as dividends. The directors and other senior managers of a company might want to invest free cash flow in projects that will increase the size of the company. These could be projects that will earn a high return. In a low-growth company, however, it is likely that managers will want to invest in projects that increase the size of the company but are only marginally profitable and would have a negative net present value. One way of reducing this problem would be to have a high proportion of debt capital in the capital structure of the company. Interest must be paid on debt, and this reduces the free cash flow. Management must also ensure that new investments are sufficiently profitable so that the company can continue to pay the interest costs on its debt capital.

3. Having a board of directors that will monitor the decisions taken for the company by its executive management: Another method for reducing the agency problem is to make the board of directors more effective at monitoring the decisions of the executive management.

a. A board will be ineffective at monitoring the decisions of management if it is dominated by the chief executive officer (CEO). This is because the CEO is the head of the executive management team. The board would be especially ineffective in a monitoring role if the CEO is also the chairman of the board. This is referred to as Board Chairman/CEO duality.

b. Fama and Jensen (1983) argued that an effective board must consist largely of independent non-executive directors. Independent non-executive directors have no executive role in the company and are not fulltime employees. They are able to act in the best interests of the shareholders.

c. Independent non-executive directors should also take the decisions where there is (or could be) a conflict of interest between executive directors and the best interests of the company. For example, non-executive directors should be responsible for the remuneration packages for executive directors and other senior managers. Jensen (1993) also argued that the board of directors becomes less effective as it grows in size. This is because a large board is often slow to react to events and will often be incapable of taking action quickly when it is needed. The directors on a large board are also less likely to be critical of each other than directors on small boards.

Post Test

1. Agency theory was developed by Jensen and Meckling (1976). They suggested a theory of how the governance of a company is based on the conflicts of interest between the company's owners (shareholders), its managers and major providers of debt finance. Each of these groups has different interests and objectives. Discuss?
2. Agency conflicts are differences in the interests of a company's owners and managers. They arise in several ways. List and explain five of ways in which agency conflict may arise.



3. Jensen and Meckling (1976) argued that when the managers act in the interest of the shareholders, managers bear the entire cost of failing to pursue goals that are in their own best interests, but gain only a few of the benefits. However, several methods of reducing the agency problem have been suggested. What is agency conflict? Explain three methods of reducing agency conflict?

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Available

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LECTURE 8

FORMULATION OF ACCOUNTING THEORY: POSITIVE ACCOUNTING THEORY

8.0 Introduction

Positive accounting theory (PAT) is concerned with predicting such actions as the choices of accounting policies by firms and how firms will respond to proposed new accounting standards. Positive accounting theory helps us reconcile efficient securities market theory with economic consequences. It asserts that the contracts which firms enter into drive management's concern about accounting policies.

Objectives

To expose the students to the rudiments of positive accounting theory

Pre Test

Differentiate between normative theory and positive theory?

CONTENT

8.1 Three Hypotheses of Positive Accounting Theory

Watts and Zimmerman have formulated three hypotheses with regards to Positive Accounting Theory. The text defines the "opportunistic" form of these hypotheses as follows:

- **The bonus plan hypothesis - Maximize compensation**
All other things being equal, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period.
- **The debt covenant hypothesis – Minimize problems with creditors**
All other things being equal, the closer a firm is to violation of accounting-based debt covenants, the more likely the firm manager is to select accounting procedures that shift reported earnings from future periods to the current period.
- **The political cost hypothesis - Minimize political heat**
All other things being equal, the greater the political costs faced by a firm, the more likely the manager is to choose accounting procedures that defer reported earnings from current to future periods.

The theory then predicts that managers will choose accounting policies to further these objectives. We cannot infer fraudulent and unethical behaviour here; rather, the accounting policies that management chooses are typically all within GAAP. However, there is considerable room to manage reported net income under historical cost accounting. This can be done through choice of amortization policy, choice of full-cost versus successful-efforts for costs of oil and gas exploration, being conservative or optimistic about provisions for warranties and bad debts, and so on. It is obvious why financial accounting policies have economic consequences. New standards or the reduction of acceptable accounting policy alternatives may interfere with management's attainment of its objectives.

PAT is an attempt to understand why, and predict which accounting policies a firm will use. A firm makes policy choices to minimize contracting costs, and accounting policies do this significantly, but firm structure, the operational environment, and corporate governance also influence these policies. Accounting policy choice should be somewhat flexible so management can respond to unforeseen contract outcomes. However, one must be aware that



with flexibility comes the possibility of opportunistic behaviour. The big picture is that changing accounting policies will draw a reaction from management. New policies that decrease firm flexibility, in terms of accounting policy choices, or interfere with existing contracts will receive strong reaction from managers.

8.2 Empirical PAT Research

This section examines the large amount of empirical research that positive accounting theory (PAT) has generated.

Healy (1985) found evidence regarding the bonus plan hypothesis. He discovered that managers of firms with bonus plans, based on reported net income, systematically adopted accrual policies to maximize their expected bonuses.

Sweeney (1994) analyzed the debt covenant hypothesis, and found that defaulting firms voluntarily made more income-increasing policy changes than a control group of firms.

In addition to voluntary changes in accounting policies, firms may be able to manipulate reported net income by the timing of adoption of new accounting standards. Sweeney found that her sample of defaulting firms did tend to adopt income-increasing standards early, and to delay adoption of income-decreasing standards.

With respect to the political cost hypothesis, most of the empirical investigation has been on firm size. However, the correlation of size with other firm characteristics, such as profitability and risk, complicates this measure of political cost.

8.3 Positive Accounting Theory and Normative Accounting Theory

In positive accounting theory, academics view a company as the total of the contracts they have entered into. The theory posits that, because companies are fundamentally about the contracts that dictate its business, a core driver of company success is efficiency. That means minimizing the costs of its contracts to unlock the most value from them. From that basis, positive accounting examines real life occurrences and seeks to understand and then predict how actual companies address the accounting treatment of those transactions. In other words, positive accounting theory looks at actual real world transactions and events, examines how companies are accounting for those events, and seeks to understand the economic consequences of those accounting decisions. With that knowledge, the theory then tries to predict how companies will account for transactions and events in the future.

Normative accounting, on the other hand, takes a fundamentally different approach. Instead of looking at what is already happening at companies today, normative accounting theory tells accounting policy makers what should be done based on a theoretical principle. Logically, normative is more of a deductive process than positive accounting theory. Normative starts with the theory and deduces to specific policies, while positive starts with specific policies, and generalizes to the higher-level principles.

Post Test

1. Positive accounting theory is built around three hypotheses, which predict manager choice of accounting policies under various conditions. Describe these three hypotheses of Positive Accounting Theory and give an example for each.
2. While Positive Accounting Theory looks at what we should expect, there are also normative theories. What is the purpose of normative theories? Do normative theories have predictive value?



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LECTURE 9

FORMULATION OF ACCOUNTING THEORY: TRADITIONAL APPROACH

9.0 Introduction

Traditional approach to formulation of accounting theory consists of non-theoretical and theoretical approaches. Non-theoretical approaches include pragmatic, authoritarian and theory of account approaches. Theoretical approaches, on the other hands, consist of deductive, inductive, ethical, sociological, economic and eclectic approaches. These approaches will be discussed in this lecture.

Objective

To expose learners to theoretical and non-theoretical approaches to formulation of accounting theory

Pre Test

List traditional approaches to formulation of accounting theory

9.1 Non-Theoretical Approaches

Non-theoretical approaches include pragmatic, authoritarian and theory of account approaches. These approaches suffer from the absence of theoretical foundation.

Pragmatic Approach: This approach involves construction of a theory that is characterized by its conformity to real-world practices that is useful in terms of suggesting practical solutions. It posits that accounting techniques and principles should be chosen on the basis of their usefulness to users of accounting information in terms of their relevance in decision-making process.

Authoritarian Approach: This approach is employed by professional organizations like ICAN and ACCA. It is in form of issuing pronouncements for the regulation of accounting practice. It also emphasizes the selection of accounting techniques and principles on the basis of utility.

The Theory of Account Approach: This approach rationalizes the choice of accounting techniques on the basis of maintenance of accounting equation (balance sheet oriented position) and accounting profit equation (profit oriented position) as shown below.

Accounting Equation: Assets = Capital + Liabilities

Accounting profit equation: Accounting profit = Revenue – Expenses

9.2 Theoretical Approaches

Theoretical approaches consist of deductive, inductive, ethical, sociological, economic and eclectic approaches.

Deductive Approach: This approach begins with basic propositions and proceeds to derive logical conclusions about the subject under consideration. From accounting point of view, it begins with basic accounting propositions or premises and proceeds to derive basic accounting principles by logical means. These accounting principles serve as guides and bases for the development of accounting techniques. This approach moves from the general basic propositions to the specific accounting principles and accounting techniques. The following steps are involved in deductive approach to development of accounting theory:

1. Specify the objectives of financial statement
2. Select the accounting postulates
3. Derive the accounting principles
4. Derive the accounting techniques



A proper testing of the resulting theory is also necessary to determine whether the theory meets the demands of the practice. If the predictions of the resulting theory are acceptable, the theory is said to be verified. Contrarily, if the predictions of the resulting theory are not acceptable, the theory is said to be falsified. Deductive theorists in accounting include Paton, Canning, Sweeney and Moonitz.

Inductive Approach: This approach begins with observations and measurements and moves towards generalized conclusion. From accounting perspective, it begins with observations of financial information and proceeds to construction of accounting principles and generalizations which are derived from these observations based on recurring relationships. This approach moves from the specific accounting principles and accounting techniques to the general basic propositions. Inductive approach to development of accounting theory has the following stages:

1. Record observations
2. Analyze the observations to detect recurring relationship
3. Derive generalizations and accounting principles from the observed relationship.
4. Test the generalizations

The validity of inductive theory depends on the observation of sufficient instances of recurring relationships. This is why sample size is significant in accounting research. Thus scientific sampling size computation technique like Slovin (1960), Taro Yamen (1968) and Rule of Thumb may be employed when conducting accounting research. Inductive theorists in accounting include Hatfield, Gilman, Littleton and Ijiri. These theorists drew theoretical and abstract conclusions from rationalization of accounting practice.

Ethical Approach: This approach is grounded in the concepts of justice, fairness and truth. Justice refers to equitable treatments of stakeholders. Fairness indicates a fair, unbiased and impartial presentation of accounting information. Truth connotes true and accurate financial statements that are free from misrepresentation. Ethical theorists include Scott, Yu, Patillo and Spacek.

Sociological Approach: This approach emphasizes the social effects of accounting techniques. It centers on broader concept of social welfare. Social approach evaluates acceptance of a given accounting technique based on its reporting effects on all groups in society. It believes that accounting data can be useful in making social welfare judgements. It determines accounting theory based on socialist theorists in accounting include Belkaoui, Ladd and Bedford.

Economic Approach: This approach involves controlling the behaviour of macroeconomic indicators that result from the adoption of various accounting techniques. It focuses on the concept of general economic welfare. It advances that the choice of different accounting techniques depend on their impact on national economic goods. It posits that accounting techniques and accounting policies should reflect economic reality and economic consequences.

The Eclectic Approach: This approach refers to combination of two or more approaches in the formulation of accounting theory and in the development of accounting principles. It results from the attempts by individuals, professionals and government to participate in the establishment of accounting concept and accounting principles.



Post Test

1. is in form of issuing pronouncements for the regulation of accounting practice.
A. Pragmatic approach **B. Authoritarian approach** C. Inductive approach
D. Deductive approach
2. approach moves from the specific accounting principles and accounting techniques to the general basic propositions. A. Pragmatic B. Authoritarian **C. Inductive**
D. Deductive
3. approach refers to combination of two or more approaches in the formulation of accounting theory and in the development of accounting principles. **A. Eclectic** B. Social
C. Economic D. Ethical
4. The theory of accounting approach to formulation of accounting theory rationalizes the choice of on the basis of maintenance of accounting equation. A. Accounting profit s B. Accounting income C. Accounting figures **D. Accounting techniques**
5. approach begins with basic propositions and proceeds to derive logical conclusions about the subject under consideration. A. Pragmatic B. Authoritarian C.
Inductive **D. Deductive**

THEORY

1. Differentiate between deductive and inductive approaches to formulation of accounting theory.
2. Write short note on the following approaches to the formulation of accounting theory: Ethical, Sociological, Economical and Eclectic Approaches.

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LECTURE 10

FORMULATION OF ACCOUNTING THEORY: EVENT APPROACH

10.0 Introduction

Accounting theory arises from the needs to provide a rationale for what accountants are expected to do and this is followed by a rigorous process of verification. In order to simplify these processes, new approaches have been developed. These new approaches use both conceptual and empirical reasoning to formulate and verify a conceptual accounting framework. The new approaches include event approach, behavioural approach and positive approach. Each approach has acquired the attributes of a distinct paradigm, causing accounting to become a multi-paradigmatic science in a constant state of crisis.

Objective

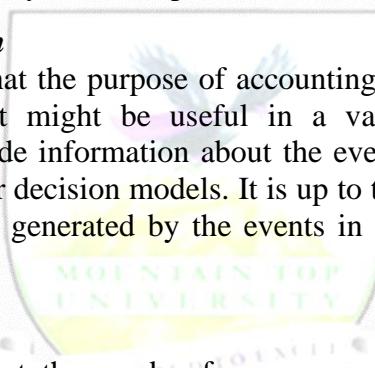
To introduce learners to event approach for the development of accounting theory

Pre Test

1. What is an event?
2. What do you understand by the concept of value in accounting?

10.1 Nature of Event Approach

The event approach suggests that the purpose of accounting is to provide information about relevant economic events that might be useful in a variety of decision models. The accountants are meant to provide information about the events and leave the users with the task of fitting the events to their decision models. It is up to the users to aggregate and assign weights and values to the data generated by the events in conformity with his or her own utility functions.



10.2 The Value School

The value school considers that the needs of users are sufficiently known to allow the deduction of an accounting theory that provides an optimal input to the specified decision models. The conventional accounting model is based on the value approach. However, it suffers the following weaknesses:

1. Its dimensions are limited.
2. Its classification schemes are not always appropriate.
3. Its aggregation level for information is too high.
4. Its degree of integration with other functional areas of an enterprise is too restricted.

10.3 Event Approach and Financial Statements

The event approach has some implications on conventional annual report. First, the balanced sheet is perceived as an indirect communication of all accounting events relevant to the firm since its inceptions. Second, the income statement is perceived as a direct communication of the operating events that occur during a given period. Third, statement of cash flow is perceived as an expression of financial and investment events.

10.4 Weakness of Events Approach

The usefulness of the events approach may depend on the following argument:

1. Psychological nature of the decisions makers should be taken into consideration. High analytic decision makers prefer aggregated report while low analytic decision makers may prefer data base inquiry system.



2. Information overload may result from the attempt to measure the relevant characteristics of all events that are crucial to the firm.
3. There is need to develop adequate criteria for the choice of the crucial events.
4. Measuring all the characteristics of an events approach may prove to be difficult
5. More research may be needed to examine the impact of different design approaches to the events approach theory.

Post Test

1. Value school and event approach school in the development of accounting theory can be said to be diametrically opposite. Required: (a) Differentiate between value school and event approach school (b) List 4 weaknesses of value school (c) List 4 weaknesses of events approach school (d) What are the implications of event approach school on the contents of financial statements (12.5 marks)

MCQ

1. The conventional accounting model is based on the A. Positive approach.
B. Event approach **C. Value approach** D. Behavioural approach.
2. Which of the following is a traditional approach to the development of accounting theory? A. Event approach B. Behavioural approach **C. Positive approach** D. Pragmatic approach.

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LECTURE 11

FORMULATION OF ACCOUNTING THEORY: BEHAVIOURAL APPROACH

11.0 Introduction

Most traditional approaches to construction of accounting theory have failed to take into consideration the behavior of the users in particular and behavioural assumptions in general. Behavioural approach emphasizes the relevance of accounting information to decision making and to the individual or group behaviour caused by the communication of the information.

Objectives

To introduce learners to behavioural approach for the development of accounting theory

Pre Test

What is behavioural sciences?

11.1 Nature of Behavioural Approach

This approach is concerned with human behaviour in relation to accounting information and problems. The approach posits that the choice of accounting techniques must be evaluated with respect to the objective behaviour of the users. The overall objective of this approach, just like that of behavioural sciences, is to understand, explain and predict human behaviour. It is meant to establish generalizations about human behavior that are supported by empirical evidence. Such evidence must be collected in an impersonal way by procedures that are completely open to review and replication. The procedures must be capable of verification by other interested scholars. Behavioural approach represents the systematic observation of man's behaviour for the purpose of experimentally confirming specific hypotheses by making reference to observable changes in behaviour.

11.2 Behavioural Accounting

Behavioural accounting is a multi-disciplinary area in the field of accounting. It focuses on the behavioural structure within which accountants perform their functions. Research studies in Behavioural Accounting have relied mostly on experimental, field or correlational techniques.

11.3 Behavioural Effects of Accounting Information

Research studies in behavioural accounting reflect the behavioural effects of accounting information. These studies can be grouped into five general classes as itemized below:

1. Adequacy of disclosures: This may involve investigating patterns of use of accounting data, perceptions and attitude of different interest groups and extent of disclosure of different items in the annual reports.
2. Usefulness of accounting information: Relative importance of investment analysis of different accounting information items and relevance of financial statements to decision making have been researched and can be reexamined.
3. Attitudes about corporate reporting practices: This research area includes examination of preferences for alternative accounting techniques and attitudes about general reporting issues.
4. Materiality judgement: The main factors that determine the collection, classification and summarizing accounting data and the items that are considered to be material in financial reporting are at the center of this research area.



5. Decision effects of alternative accounting procedures: Research of this nature is carried out within the context of the use of different inventory techniques, price level information and non-accounting information.

These are some of the research areas in financial accounting on which further research may be carried out

Post Test

1. Write short note on behavioural approach to the development of accounting theory.
2. Outline some researchable areas in behavioral accounting.

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LECTURE 12

FORMULATION OF ACCOUNTING THEORY: EARNINGS MANAGEMENT

12.0 Introduction

Earnings management is a well-known phenomenon in financial accounting and has attracted academic research attention since at least the 1950s. It has been established that earnings management could be beneficial, neutral or fraudulent (Ronen & Yaari, 2008). It is beneficial when it aids the value relevance of accounting information presented in financial reports (Beneish 2001). It is neutral when its outcome is economically efficient (Scott 2003). It is harmful when used as an instrument for concealing the real financial situation of a firm (Miller and Bahnsen 2002). Harmful effects of earnings management will be deeply felt by almost all stakeholders. It may also lead to deterioration of the quality of accounting information. This dysfunctional behaviour could mislead stakeholders in taking informed decisions.

Objectives

To introduce learners to the concept of earnings management

Pre Test

1. What is earning?
2. What is management?
3. What is earnings management?

CONTENT

12.1 Definition

Earnings management is the process by which management can potentially manipulate the financial statements to represent what they wish to have happened during the period rather than what actually happened. Healy and Whalen (1999) defined earnings management as “any decision whose primary purpose is to influence (either in form or substance) the output of the accounting system in a particular way, including not only financial statements published in accordance with Generally Accepted Accounting Principles (GAAP), but also tax returns and regulatory filings”.

12.2 Earnings Management Incentives

Different situations can lead to varied incentives for earnings management. Research literature classified earnings management incentives into five comprehensive categories namely: capital market incentives, signaling/concealing private information, political costs, increasing CEO's reputation and internal motives.

1. Capital market incentives

Although there are several possible motives for managing earnings, the focus has been on those incentives that are related to the stock market. The interaction between accounting numbers and stock markets reaction can indeed push management towards earnings management. However, listed firms have been the major focus of earnings management studies in developed economies. In several other developing countries, there are far less listed companies and privately owned companies dictate the pace of economic growth. In those countries, there might be other important reasons for earnings management that haven't been under the attention of researchers. Thus, research efforts should be directed more to non-listed companies than quoted firms in developing economies.



2. Signaling or concealing private information

Empirical studies have shown that troubled firms manage earnings to conceal their financial struggle. Some studies revealed how managers could improve financial information through earnings management. Furthermore, other studies examined how economic optimization strategy, like tax planning, could be explored to manage earnings.

3. Political costs

Political cost hypothesis is associated with decreasing earnings managements. Studies have found incentives for a decreasing earnings management to reduce costs for labour renegotiations. Additionally, it has also observed that in countries where there is a connection between the financial statement and the tax computation, earnings are managed downward to reduce taxes. Decreasing earnings management could also be explored to receive advancements from government.

4. Increasing CEO's reputation

Chief Executive Officers (CEOs) have the natural incentive to present a good score card during their tenure. A retiring CEO would have the ambition to manage earnings upwards before leaving the firm. A new CEO, on the other hand, has the incentive to blame the old management. In the first year of management turnover, the new CEO may manage the earnings downwards. In subsequent years when the CEO is responsible for the firm performance, he has incentives to manage the earnings upwards for a better picture of his performance.

5. Internal incentives

Internal incentives for managing earnings upwards through bonus plans could arise. It may also arise for the purpose of keeping top managerial jobs. In times of financial crisis, firms have incentives to manage earnings upwards to avoid debt covenant violations or to postpone insolvency. However, there could be reasons for downwards earnings management too, like avoiding exposures to litigations. Therefore, direction of earnings management depends on firm incentives.

12.3 Earnings Management Techniques

They include the following.

1. Cookie jar reserve technique
2. Big bath technique
3. Big bet on the future technique
4. Flushing the investment portfolio
5. Throw out a problem child
6. Amortization, depreciation and depletion
7. Sale/lease back and asset exchange technique
8. Operating versus non-operating income
9. Early retirement of debt
10. Use of derivatives
11. Shrink the ship
12. Change of accounting policies

Post Test



1. Healy and Whallen (1999) defined earnings management as “any decision whose primary purpose is to influence (either in form or substance) the output of the accounting system in a particular way, including not only financial statements published in accordance with Generally Accepted Accounting Principles (GAAP), but also tax returns and regulatory filings”. **Required:** List and explain ten earnings management techniques
2. Different situations can lead to varied incentives for earnings management. Research literature classified earnings management incentives into five comprehensive categories. **Required:** List and explain five incentives for earnings management.

Bibliography

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