UNIVERSITI SAINS MALAYSIA

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Accounting Theory & Research

Accounting Theory

- ‘A description, explanation or a prediction [of accounting practice based] on observations and/or logical reasoning’ (Henderson et al. 2004, p.4)

Accounting Theory

'<u>Logical reasoning</u> in the form of <u>a set of broad principles</u> that

(1) provide a general framework of reference by which accounting practice can be evaluated and

(2) guide the development of new practice and procedures'

(Hendrickson as cited in Godgrey et al. 2003)

Usefulness of theory

- Providing an explanation on what is happening
- Helping us to predict what will happen

Roles of accounting theory

- *Describing and explaining current accounting practices*.

e.g. -Capital-market theory describes how share prices react to accounting information

- researchers investigating financial reporting failures have (after identifying factors that have contributed to these problems) arrived at theories about why these failures have occurred.

- *Predicting accounting practice*

e.g. Agency or contracting theory explains why managers may change the way in which they account (i.e. the accounting policies) for items in the financial statements and makes predictions about the accounting policies that will be chosen by managers in particular circumstances

Providing principles to take into account when taking action or making decisions

e.g. Application of capital budgeting theory (which might involve calculation NPV of projects and payback periods) to help decide which projects to invest in.

A theory of assets recognition helps to determine when and how assets should be included in the financial statements

- *Helping to identify problems and deficiencies with current accounting practice and improve accounting practice*
- E.g. The conceptual framework for accounting, by providing the basic principles on which to base accounting standards, can make accounting practice more consistent
- Theories about corporate responsibility can suggest that companies also need to provide information about environmental impacts of their activities.

Accounting theory development timeline

Pre 1400s	Practice development
1400	1450 t0 1750: Pre-theory period (continued development of practice)
1500	
1600	
1700	1750 to 1920s: Formalisation of practice
1800	1800s to 1955: General scientific period – (explanations of practice and development of explanatory framework)
1900	1956 to 1970s: Normative Period – statement of ideal practices and basis for achieving such practices 1970s to 2000: Positive accounting Theory – a framework to explain and predict behaviour
2000	2000 to present: Mixed development – positive and behavioural theories

Normative Theories

- **Normatiove theories** do not describe, explain or predict what is happening, but rather make suggestions or recommendations as to what should happen or what ‘ought to be’.
- They prescribe.
- E.g. Theories that propose that fair values should be used to measure assets in the financial statements with the aim to ensure that more relevant information is provided to users of financial statements.

Normative Theories

- Two group dominated the normative period
- - the critics of historical cost accounting
- - the conceptual framework proponents

Normative Theories

- Two main factors that prompted the demise of the normative period
- The unlikelihood of acceptance of any particular normative theory (they are based on subjective opinions of individuals)
- The unavailability of financial economic principles and testing methods (it is impossible to demonstrate empirically what *ought* to be)

Positive Theories

- attempt to provide a framework for explaning the practices which were being observed
- describes what is actually happening
- to explain and predict accounting practices

e.g. theories that explain why managers prefer to choose particular accounting methods or policies over others.

Positive Theories

- Positive theories are often referred to as “empirical” theories.
- It involves developing hypotheses about reality which are subsequently tested by observing reality

Behavioural research

- mainly concerned with the broader sociological implications of accounting numbers and the associated actions of ‘key players’ such as managers, shareholders, creditors and the government as they react to accounting information.
- tends to focus psychological and sociological influences on individuals in their use and preparation of accounting

Evaluating and testing theories

There are many theories, in some cases alternative theories, about the same topic or area.

- E.g. there are alternative theories about how items should be measured
- Competing theories, theories that may not be correct

Research areas in accounting

examples:

- Capital- market based accounting research
- Accounting policy choice research
- Accounting information processing research
- Critical accounting research
- International accounting research

Research areas in accounting

Corporate Governance

- Interest in corporate governance practices has increased as a direct result of highly publicised cases of corporate misconduct and concerns over the management of corporations

Problems with management of corporations

- Managers may use the company's resources to benefit themselves
- Corporations may take actions that shareholders (or society) may not consider desirable
- Corporations may 'hide' or provide 'false' information to shareholders to avoid consequences
- Directors and executives of corporations receiving massive payments and benefits even when corporate performance is poor or declining

The need for corporate governance systems

- The separation between capital contributors and management is the source of many issues and problems relating to CG.
- A dominant positive accounting theory, agency theory provides an explanation why managers may 'bias' or distort the financial statements.
- Accounting policy choice research

Shareholder-manager relationship agency theory

Firms as a nexus of contracts

Agency contracts:

Managers-shareholders

Managers-debtholders

Agency costs:

Monitoring

Bonding

Residual lost

Manager-shareholder agency relationship

Agency problem	Bonus plan	Bonus plan hypothesis
*Risk aversion	bonus linked to	opportunistic choice of
*Divided retention	* profit	accounting policies
*Horizon problem	* share price	
	* dividend payout rate	

Key areas in CG & alternative approaches

- CG principles and practices concentrate on directing and controlling directors and management, shareholders' interests and rights, and transparency and accountability.
- Two main approaches:

- rule-based
- principles-based

Role and impact of Accounting on CG

Two key roles:

- to control and direct actions and decisions
- to inform shareholders and stakeholders

Accounting information and reports need to be correct, complete and unbiased

Accounting information can be compromised and manipulated for various reasons.

Ethics in CG

- Good CG is about people 'doing the right thing'. It can be achieved through the ethical behaviour of managers

Capital market based accounting research

- The important relationship between accounting and capital markets is embedded in the Conceptual Framework
- According to the framework: Accounting aims at providing investors with with relevant information for investment decision making, enabling investors to predict future CF and assess future risks and returns associated with particular shares.

- Capital markets have been extensively researched
- Much of this research has focused particularly on the relationship between financial performance and share prices
- Ball and Brown (1968)
- Efficient market hypothesis

Efificent market hypothesis

- Event study: Research methods that examine the changes in level of variability of share prices or trading volume around the time information is released
- Association study: Research methods that looks for correlation between an accounting performance and share returns

Events study

Earnings announcement do have information content (mostly weak evidence)

Prices lead earnings (Beaver, Lambert and Morse, 1980)

Post earnings announcement drift

Association study

- Earnings and security returns
- The value relevance of nonearnings data
- The value relevance of different accounting policies
- The value relevance of different GAAP

- Relevance and reliability
- Auditors /intermediaries
- Voluntary disclosure theory
- Cosmetic accounting choices – earnings management

Environmental and Social Reporting

Theories and social disclosure studies

- Signalling theory
- Agency Theory
- Legitimacy Theory
- Stakeholder Theory
- Institutional Theory
- Proprietary cost theory

Environmental accounting & dislosure

- Documenting the environmental disclosures made by companies and evaluating the quality of these disclosures

- Determining whether environmental disclosures have been used in decisions

E.g.

- information processing research – trying to identify how decision makers have used this information
- Capital-market based research – examining market reactions to disclosure of such information

- Examining the motivation behind companies' disclosure (or nondisclosure) of environmental information

- Critical approach - examining the impact that accounting's focus on measureable financial costs (rather than externalities such as environmental costs) has on environmental impacts made by companies

Thank you