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Accounting Theory Formulation as a TOOL for Enhancing International Harmonization of Accounting Standards *(pp. 1-14)*

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Abstract: Literature reviews show that accounting is practiced within an implicit theoretical framework composed of principles and practices that have been accepted by the profession because of their alleged usefulness and logic, it is increasingly difficult to convince the specialist of other disciplines merely by saying "this has been the practice". This difficulty is further compounded as accountants across the globe adopt different accounting standards that best suit the economic climate in which they operate. This paper focuses on the accounting theory formulation as tool to enhance uniform accounting standards. The traditional and new approaches to accounting theory formulation was discussed and the main recommendations were that a set of universal accounting standard should be developed to back already existing international accounting standard and harmonization of all local and international standards so that there will be a common basis of financial reporting globally. The theories should be adhered to by Practicing Accountant to avoid public scandal and confusion.
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Keywords: accounting standard, financial reporting, harmonization, Economic reality, economic consequences

1 INTRODUCTION.

As a result of the rapid changes in economic and social environments, accountants have to face new problem, to which traditional explanations of accounting do not seems to apply. Accountants are now liable to client and third parties. It is now more difficult to convince the specialist of other disciplines merely by saying "this has been the practice". In order to provide frame of reference on which the development of accounting techniques is base. Accounting theory which composed principles and practices was introduced.

A comprehensive theory of accounting should provide rule for recognizing certain relevant economic objects and measuring the value characteristic of these economic objects and also provide a basis for judging a given practice whether to be considered good or bad. In order words, a comprehensive theory should tell us how to measure income and capital properly.

It must be recognized at the outset that no comprehensive theory of accounting exists at the present time. Instead different theories have been and continue to be proposed in the literature. How, we assume as an article of faith that an accounting theory is possible. In this regards, Hendrickson and Eric have attempted to prove that an accounting theory is possible.

Thus, accounting theory may be defined as logically reasoning in the form of set of broad principles that (i) provide a general frame of reference by which accounting practice can be deducted and (ii) guide the development of new practices and procedures. It may also be used to explain existing practices to obtain a better understanding of them (Hendriksen, 1982).

According to Derek (1985) "it is the duties and obligations of person who manages something on behalf of other persons to give account".

2 HISTORY OF ACCOUNTING THEORY

According to Ahmed (2000) "Accounting history is the study of evolution in accounting thought, practices and institutions in response to changes in the environment and societal needs." Accounting theory is said to have progressed through a major evolution, particularly during the late 1960s, and 1970s and continuing into the 1980s. Edwards (1989) "The study of accounting history helps us to understand our past and gives us an appreciation of how our current practices and problems came into being". Historical enquiry also tells us that certain problems are enduring and may not be capable of a permanent solution e.g. accounting for intangible, uncertainty and changing price levels.

The development of accounting theory arose out of needs, and changes in accounting techniques, and concepts. However many techniques and concepts are still in use even though the conditions requiring their usage have ceased to exist.

> The development of accounting practice has been subjected to two major periods of turmoil in recent yeas- the early 1930's and 1960's. In 1930 and on 1960, considerable pressure came from individuals and groups outside the accounting profession accompanied by dissatisfaction by practicing accountants and academicians"(Hendriksen 1982).

As a result of this pressure, the American institute of Accountants (in 1957 the name was changed to the American institute of Certified Accountants) in 1930 appointed its first standing committee to consider problems of accounting procedure and to make pronouncements that might carry weight in the profession. “In the united kingdom, the Companies Act of 1929 had required sweeping reforms in the financial reporting of limited companies, including the requirement of a profit and loss account for the first time” (Hendriksen ,1982).

These events of the 1930s, however, were indicative of a desire to improve accounting practice rather than accounting theory as such. But it cannot be denied that the development of accounting theory was stimulated by the discussions that came out of these events of the early 1930s.

In short, immediately after the first world congress of accounting historians held in Brussels in 1970, accounting history has had a tremendous change. According to Haskin (1986) “accounting history is undertaken to better understand our present and to forecasting or control our future” the committee on accounting association (1970) went further to explain that accounting history is the study of the evolution in accounting though, practices and institutions in response to change in the environment and societal needs.

If we know the past interaction of the environment and change in accounting practices and institutions it may become somewhat easier to predict the consequences of currently proposed solutions.

2.1 Purpose of Accounting Theory

According to Littleton (1962), “The central purpose of accounting is to make possible the periodic matching of cost (efforts) and revenues (accomplishments). This concept is the nucleus of accounting theory and a benchmark that affords a fixed point of reference for accounting discussion”. As per Watts and Zimmerman (1979) much of accounting theory is the product of government intervention and it satisfies a “demand for excuses”. Also the study of accounting according to Hoskin (1986) is undertaken to better understand over present and to forecasting or control our future.

The Companies and Allied Matters Act (CAMA) 1990 empowers chartered accountants as external auditors, to examine financial statements to determine their objectivity and fairness as well as their conformity to accepted accounting principles. In view of these, chartered accountants have the onerous responsibility to the public in relation to the reliability and credibility of any financial reports.

Accounting environment has changed substantially. The transition has been very fast. This is caused by (i) changing social attitude (ii) phenomenal development information technology (iii) quantitative methods and behavioural sciences. Accounting has move from its almost static environment. That is from traditional procedural base of book-keeping to more areas useful for decision making and stressing its social role.

2.2 Classification of Accounting Theories

There are several ways of classifying accounting theories. They may be classified, for example, according to time, e.g. from 1915 onwards we find an emphasis on stewardship accounting, from 1945 onwards, the emphasis was on decision usefulness accounting i.e. relevance, reliability and timelines and from 1975 onwards, accountability accounting or societal responsibility accounting is becoming more prominent. Other ways of classifying theories can be (i) inductive versus deductive, and (ii) normative versus positive. Porwal (2001).

According to AAA (1978) "Accountancy, as a measurement and reporting information system, can be seen to cover both micro and macro economic activity. Glantier and Underdown (1976) are of the view that "the roots of accounting theory are decision theory, measurement theory and information theory".

Hendriksen (1982) say that "a useful frame of reference is to classify theories according to prediction levels". There are, according to him, three main levels of theory: The levels are as follows:

- ✓ "Structural or syntactical theories
- ✓ Interpretational or Semantically theories
- ✓ Behavioural or pragmatic theories".
- ✓

2.3 Approaches to the Formulation of Accounting Theory

Although there is no single comprehensive theory of accounting, various accounting theories of a middle range have resulted from the use of different approaches. For the sake of clarity, we will limit our discussion in this work to be traditional approaches and new approaches to the formulation of an accounting theory.

2.3.1 The Traditional Approaches

The traditional approaches includes among others:

- Non – theoretical, practical, or pragmatic (informal)
- Theoretical
  - ✓ Deductive
  - ✓ Inductive

- ✓ Ethical;
- ✓ Sociological;
- ✓ Economic;

2.3.2 Non – Theoretical Approaches

The non – theoretical approaches are a pragmatic (or practical) approach and an authoritarian approach. The pragmatic approach consists of construction of a theory characterized by its conformity to real-world practices that is useful in terms of suggesting practical solution. According to this approach, accounting techniques and principles should be chosen on the base of their usefulness to users of accounting information and their relevance to decision making process. Usefulness, or utility, means "that property which fits something to serve or to facilitate its intended purpose".

The authoritarian approach to the formulation of an accounting theory, which is employed primarily by professional organization, consists of issuing pronouncements for the regulation of accounting practices. Because the authoritarian approach also attempts to provide practical solution, it is easily identified with the pragmatic approach. Both approaches assume that accounting theory and the resulting accounting techniques must be predicted on the basis of the ultimate uses of financial reports, if accounting is to have a useful function. In other words, a theory without practical consequences is a bad theory.

2.3.3 Deductive Approach

This approach moves from the general (basic propositions about the accounting environment) to the particular (accounting principles first and accounting techniques second). It emphasizes on 'what ought to be'. If we assume at this point that the basic propositions about the accounting environment consist of both objectives and postulates, the steps used to derive the deductive approach according to Porwal (2001) will include:

- Specifying the objectives of financial statements
- Selecting the "postulates" of accounting
- Deriving the "principles" of accounting
- Developing the "techniques" of accounting

In a deductively derived accounting theory, therefore, the techniques are related to the principles, postulate, and objectives in such a way that if they are true, the techniques must also be true.

2.3.4 Inductive Approach

The inductive approach to the construction of a theory begins with observations and measurements and moves towards generalized conclusions. Applied to accounting, the inductive approach beings with observation about the financial information of business enterprises and proceeds to construct generalization and principles of accounting from these observations on the basis of recurring relationships. It is based on 'what is'. Inductive arguments are said to lead from the particular (accounting information depicting recurring relationships) to the general (postulates and principles of accounting). The inductive approach to a theory according to Porwal (2001) involves four stages:

- Reducing all observation.
- Analysis and classification of these observations to detect recurring relationship ("like" and "similarities").
- Inductive derivation of generalization and principles of accounting from observations that depict recurring relationships.
- Testing the generalizations.

Unlike the deductive approach, the truth or falsity of the propositions does not depend on the propositions, but must be empirically verified.

2.3.4 Ethical Approach

The basic core of the ethical approach consists of the concepts of fairness, justice, equity and truth. Accountants equate "justice" with equitable treatment of all interested parties, "truth" with true and accurate accounting statements without misrepresentation, and "fairness" with fair, unbiased, and impartial presentation. The "fairness" concept implies that accounting statements have not been subject to undue influence or bias. "Fairness" generally implies that the preparers of accounting information have acted in good faith and employed ethical business practices and sound accounting judgment. "Fairness" is a value statement that is variously applied in accounting. "Fairness" is ranked as a basic standard to be used in the evaluation of other standards, because it is the only standard that implies "ethical considerations". Fairness is a desirable objective in the construction of an accounting theory if whatever is asserted on its basis is logically or empirically verified and it is made operational by an adequate definition and identification of its properties.

2.3.5 Sociological Approach

The sociological approach to the formulation of an accounting theory emphasizes the social effects of accounting techniques. It is ethical approach that centers on a broader concept of fairness-social welfare. Accounting to sociological approach, a given accounting principles or techniques is evaluated for acceptance on the basis of its reporting effects on all groups in society. Also implicit in this approach is the expectation that accounting data will be useful in making social-welfare judgments. To accomplish its objectives, the sociological approach assumes the existence of "established social values" that may be used as criteria for the determination of accounting theory.

2.3.6 Economic Approach

The economic approach to the formulation of an accounting theory emphasizes controlling the behaviour of macroeconomic indicators that result from the adoption of various accounting techniques. While the ethical approach focuses on a concept of fairness" and the sociological approach on a concept "social welfare", the economic approach focuses on a concept "general economic welfare". According to this approach the choice of different accounting techniques depends on their impact on the national economic goals. More explicitly, the choice of accounting techniques will depend on the particular economic situation. The general criteria employed in the macroeconomic approach are firstly, that accounting policies and techniques should reflect "economic reality" and secondly that the choice of accounting techniques should depend on "economic consequences". "Economic reality" and "economic consequences" are the precise terms being used to argue in favour of the macroeconomic approach.

2.3.7 New Approaches

New approaches have been developed or revised recently, the aims of which are not yet generally accepted by the various interest groups or by the accounting profession in particular. They represent new streams of accounting research that use both conceptual and empirical reasoning to formulate and verify a conceptual accounting framework. (Belkaoui, 1993).

The new approaches include the following;

- Events approach
- Behavioural approach
- Human information processing approach
- Predictive approach
- Positive approach

2.3.8 The Events Approach

The events approach was first explicitly stated after a divergence of opinion among the members of the committee of the American Accounting Association, which issued A Statement of Basic Theory in 1966. The majority to the Committee members favoured the value approach to accounting. Only one member, George Sorter, favoured the events approach.

The value school, also called the user-need school, considers that needs of users to be known sufficiently to allow the deduction of an accounting theory that provides optimal input to the specified decision models. The events approach, on the contrary, suggests that the purpose of accounting is "to provide information about relevant economic events that might be useful in a variety of decision models". It is up to the accountant to provide information about the events and leave to the user the task of fitting the events to their decision models. It is up to the user to aggregate and assign weights and values to data generated by the event in conformity with his or her own utility function.

2.3.9 The Bahavioural Approach

Most traditional approaches to the construction of an accounting theory have failed to take into consideration user behaviour in particular and behavioral assumptions in general. The behavioral approach to the formulation of an accounting theory is concerned with human behavioural, as it relates to accounting information and problems. In this context, the choice of an accounting technique must be evaluated with references of the objectives and behavior of the users of financial information.

2.3.10 The Human Information Processing Approach

Interest in the human information processing approach arose from a desire to improve both the information set presented to users of financial data and the ability of users to use the information. Theories and models from human information processing in psychology provide a tool for transforming accounting issues into generic information processing issues. There are three main components of information processing model-inputs, process, and output.

2.3.11 The Predictive Approach

The predictive approach arose from the need to solve difficult problem of evaluating alterna tive methods of accounting measurement and from the search for a criterion on which to base the choice between measurement alternatives. Specifically, "the measure with the greatest predictive power with respect to a given event is considered to be the "best method for that particular purpose".

2.3.12 The Positive Approach

The positive approach to accounting is generally drawn from a well-known essay in which Friedman argues "for distinguishing positive economics sharply from normative economics". In fact, Friedman credits his distinction between "positive" and "normative" science to Keynes. Positive science may be defined as a body of systematized knowledge concerning what is; a normative or regulative sciences as a body of systematized knowledge relating to criteria of what ought to be, and concerned, therefore with the ideal as distinguished from the actual.

The development of a positive theory accounting will help to explain why accounting is what it is, why accountants do what they do, and what effects these phenomena have on people and resource utilization". The major thrust of the positive approach to accounting is to explain and predict management's choice of standards by analyzing the costs and benefits of particular financial disclosures in relations to various individuals and to the allocation of resources within the economy.

2.3.13 Critiques of the Accounting Theory Approaches

Looking at Eric (1963) and Hendriksen (1982) definition of accounting theory, two parts of this definition must be qualified with respect to accounting theory. First, theory does not explain all accounting practice. Theory is base on logic, and not all practice is logically conceived. But if the emphasis is placed on the explanation of concepts and results rather than on technique, the definition is generally correct. Secondly, the body of fact being explained by accounting theory can be assumed to be either (1) financial facts as represented in accounting statements, (2) concepts implied in the presentation of accounting data, or (3) economic relationships of firms with other firms, individuals and the economy as a whole as measured and summarized in accounting statement. Of these three, the first- the explanation of financial facts presented by accounts – is not the function of theory.

The events approach offers certain advantages and certain limitations. The advantages predominantly take the form of effects to provide information about relevant economic events that might be useful to a variety of decision models.

The usefulness of events approach may depend, however, on one or more of the following arguments;

- The usefulness of the events approach may depend on the psychological type of the decision maker. It has been shown, for example that structured/aggregate reports are preferable for high-analytic decision makers, but that data-base inquiry systems (the events approach) are preferable for low-analytic decision makers.
- An adequate criterion of the choice of the crucial events has not be developed.
- Measuring all the characteristics of an events approach may prove difficult, given the state of the art in accounting.

The positive approach looks into "why" accounting practices and or theories have developed in the way they have in order to explain and/ or predict accounting events. As such the positive approach seeks to determine the various factors that may inference rational factors in the accounting filed. It basically attempts to determine a theory that explains observed phenomena. The positive approach is generally differentiated from the normative approach, which seeks to determine a theory that explains "what should be" rather than "what is".

One striking criticism of the positive approach was based on following points.

- The concept of "positive theory" is drawn from an obsolete philosophy of science and is, in any case a misnomer, because the theories of empirical science make no positive statement of "what is".
- Contrary to the empirical method of subjecting theories to sever attempts to falsify them, the Rochester school introduces ad-hoc arguments to excuse the failure of their theories

Another criticism is based on the argument that positive or "empirical" theories are also normative because they usually mark a conservative ideology in their accounting policy implications. The most striking critics of positive accounting theory comes from sterling, with his comments that (a) the two pillars of value-free study and accounting practices are insubstantial, (b) the economic and scientific support of the theory is mistaken and (c) the accomplishments have been nil.

Most of the behavioral accounting research discussed in the preceding sections has attempted to establish generalization about human behaviour in relation to accounting information. The implicit objective of all these studies is to develop and verify the behavioural hypothesis relevant to accounting theory hypotheses on the corporate reporting practices, materiality judgments, the decision effects of alternative accounting procedures, and the components of an information processing model (input, process, and output). This implicit objective has not yet been reached.

3 NEED FOR HARMONIZATION OF INTERNATIONAL ACCOUNTING STANDARDS

As there has been a tremendous growth in the market place with the existing accounting practices, this leads us to question why do we need harmonization of International accounting standards, what are its advantages and what are the barriers that hinder harmonization? Although accounting may be the "language of business," a common language has never been necessary -- at least as long as the world economy consisted of a set of more or less distinct national economies.

Harmonization involves formulation of accounting regulations which in material respect are similar to those of other country. IASB is in the fore front by promoting that all countries worldwide should adopt International Accounting Standards as it is the easier way of promoting harmonization (www.cbdd.wsu.edu)

Jose (2004) Cited in (www.ladb.org/sds) states that numerous organizations have been engaged in the implementation and promotion of common accounting standards globally.

The most influential among them remains the International Accounting Standards Board (IASB), responsible for setting the International Financial Reporting Standards (IFRS) and promoting their convergence worldwide. Likewise, the International Federation of Accountants (IFAC), as well as the International Forum on Accountancy Development (IFAD) has been important forces in the course of developing and sponsoring an integrated set of international standards.

Mednick (1991) Cited in (www.wetherhead.cwru.edu) We now have a global economy and it has affected the entire business world. For instance, today's global corporation may have more than one headquarters, and its production and distribution facilities are probably scattered throughout the world. Commodity prices, interest rates and currency exchange values have become internationally linked -- with the result that governments around the world are increasingly supporting harmonization of accounting practices and national policies.

There is a need for harmonization for accounting standards in order to help the foreign investor to understand the financial statements of the foreign companies whose shares they might want to buy.

4 ADVANTAGES OF HARMONIZATION

The greatest benefit that would flow from harmonization would be the comparability of international financial information. Such comparability would eliminate the current misunderstandings about the reliability of foreign financial statements. It would save time and money that is currently spent to consolidate divergent financial information when more than one set of reports is required to comply with the different national laws or practice. It would also help in raising foreign capital as investors, financial analysts and foreign lenders will be able to understand the financial statements of foreign companies and they would be able to compare the investment opportunities which will help them to make the right investment decision.

The benefit International accounting firms will have with the harmonization of accounting practices will be the movement of staff across national boundaries will become easier and it will be less expensive to provide. It will also make it easier for financial executives to manage critical relationships with customers, suppliers and others. (www.echeat.com/essay.php?t=26969).

5 OBSTACLES IN HARMONIZATION OF ACCOUNTING STANDARDS

The most fundamental of obstacles to harmonization are the size of the present differences between the accounting practices of different countries, lack of strong professional accountancy bodies in some countries, and the differences in political and economic systems (Nobes and Parker, 2002). Mednick (1991) Cited in (www.wetherhead.cwru.edu). If accounting measurement rules were the only difference among countries, then straightforward translations would be sufficient to enable reports to be universally understood and interpreted. However, countries also exhibit substantial economic and cultural differences that preclude simple interpretations, even when the figures are generated using the same accounting principles. In addition, there may be different levels of sophistication and influence among different national accounting professions.

6 CRITICISM OF HARMONIZATION OF ACCOUNTING STANDARDS

The underdeveloped countries and developing countries see harmonization of international accounting standards as an imposition of standards by economically superior countries. Accounting is flexible in nature and can adopt to different number of situations but if accounting standards are harmonized it is believed that they won't be flexible enough and the standards set internationally cannot possibly cater for the wide range of national circumstances, legal systems, stages of economic development, and cultural differences. The harmonization of accounting standards will change the complexion and quality of financial information in ways not seen before, therefore it is vital that companies understand the extent of the impact and ensure stakeholder understand it too.

Harmonization of accounting standards has been worked on for 26 years by IASC now know as the IASB, it has representatives from many countries and it was observed a large number of companies are complying with International Accounting Standards (IAS) issued by the IASB.

7 CONCLUSION

Once the objectives of accounting are determined, one or more several approaches to accounting theory must be selected in order to derive logically conceived accounting principles. These objectives however, may be modified with the development of theory but a change in the basic objective might require a reformulation of the entire theoretical structure.

Accounting theory goal provides a coherent set of logical principles that form the general frame of reference for evaluation and development of some accounting practice.

- A set of universal accounting theories should be formulated whose application will not be affected by national economic, political, social differences.
- A set of universal accounting theories should be developed to back already existing international accounting standard and harmonization of all local and international standards so that there will a common base of financial reporting globally.

- Accounting theory and practice will probably be broadened considerably in the future. The scope should include the measurement and communication of data revealing past, present, and prospective socioeconomic activities. Thus the argument of Littleton and Zimmerman (1962:256) that says "continuity in the midst of change has typified the development of accounting".
- A possible structure of future accounting theory will be more normative and less descriptive than in the past. Academia and professionals should be a breast of latest development and challenges in the accounting world. There should be regular review of past theories to meet the current global trend. Theories should be formulated to meet the current global challenges bearing in mind the interest of stakeholders.
- The theories should be adhered to by practicing Accountant to avoid public scandal and confusion. Forensic accounting should be encouraged to that theory formulated are implemented. There is need to improve upon the control methods and decision making at all levels.
- There is need to combine the tools of economic theory and accounting history, so that a rational foundation of accounting theory may be constructed. Where economic theory is blended with accounting practice, it will likely provide as basis for sound judgments when differences between theory and practice arise.

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