# THE CONCEPTUAL FRAMEWORK, ACCOUNTING PRINCIPLES and what we believe is true

*No matter what they tell us, no matter what they do*
*No matter what they teach us, what we believe is true....* "(BOYZONE)

What we have been taught doesn't matter, what we believe is true, is apparently the view shared by many accountants, (and accounting students!) when it comes to the conceptual foundations of accounting. Do we, for instance, believe that accounting standards have now become principles-based? Does the conceptual framework represent the theory of accounting?

In this article, some misconceptions regarding some of these issues are explored with reference to the conceptual foundations of accounting and the role and function of the conceptual framework. An attempt is made to bring some context to a much-neglected area of accounting education, probably resulting in a fairly high degree of ignorance amongst average accountants regarding conceptual issues. The article has been triggered by the current joint project of the United States based Financial Accounting Standards Board (FASB) and the London based International Accounting Standards Board (IASB) to revise their respective conceptual frameworks as part of endeavours to harmonise the accounting standards issued by these bodies. Once the converged framework has been established, it is expected that (some of the) existing conflicts between concepts and standards will gradually disappear as new, converged, "principles-based" standards are developed that are based on the improved, converged concepts.

Since "principles" are essentially a theoretical construct formulated within the context of a specific philosophical approach and certain taxonomical imperatives, a body of theory underlying the framework is assumed. Such body of theory is seldom studied by accountants and scantily taught by South African universities (certainly at the undergraduate level) and often also at junior postgraduate level), yet "principles-based" standards are issued, discussed, criticised and applied.

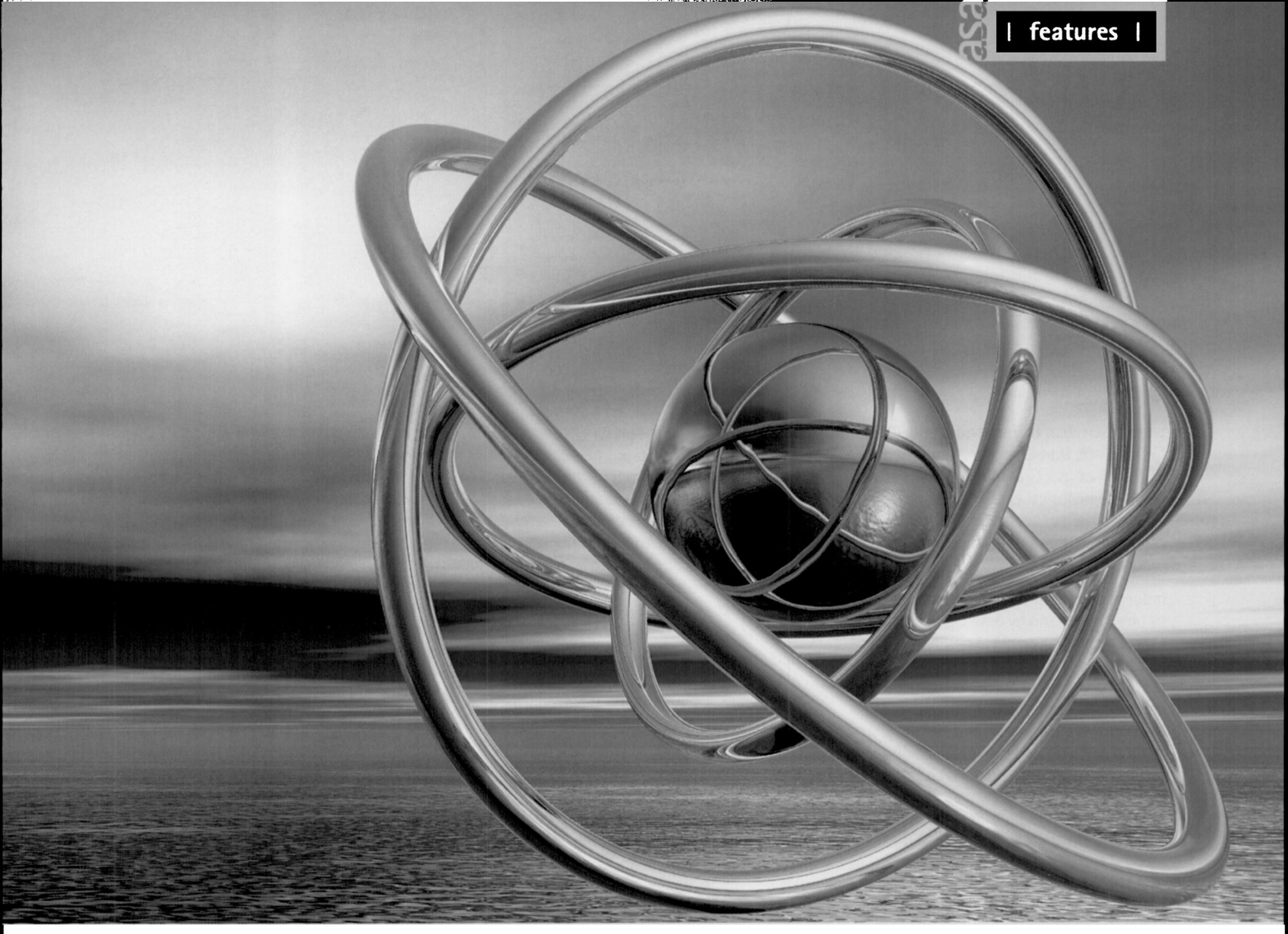
A number of observations are made regarding the nature and formulation of theories in general, followed by a brief overview of accounting theory in particular, a brief historical perspective of accounting theory and some comments on the relationship between accounting theory, accounting standards and the conceptual framework are given. The article is concluded with a (tongue-in-cheek) remark on principles-based standards.

## Theories: their nature and how they are formulated

The source, nature and limitations (epistemology) of theories are vast fields of study and cannot be explored within the scope of this article. Nevertheless, in order to contextualise the issues being discussed, a number of observations should be made in this regard.

"Theory" is defined in the New Webster's Dictionary and Thesaurus of the English Language (1992) as "an organized body of ideas as to the truth of something, usually derived from the study of a number of facts relating to it, but sometimes entirely a result of exercising the speculative imagination; knowledge of a science or art derived from such study and speculation". Riahi-Belkaoui (2004:80) quotes Mario Bunge (1967:381) as follows: "A set of scientific hypothesis is a scientific theory if and only if it refers to a given factual subject matter and every member of the set is either an initial assumption (axiom, subsidiary assumption, or datum) or a logical consequence of one or more initial assumptions".

Riahi-Belkaoui (2004:80) states that "(t)he elements included in a theory are concepts, propositions and hypotheses, linked in a systematic structure to allow explanation and prediction" and that "(t)he



degree of formalization of a theory leads to six main types of theoretical structures: deductively complete theories, systematic presuppositions, quasi-deductive theories, theoretical attempts, concatenated theories and hierarchical theories."

Two approaches in theory formulation should be noted: the deductive approach and the inductive approach.

Hendriksen (1982:7) notes that all theories must include elements of both deductive and inductive reasoning. The deductive approach essentially starts with certain generalisations regarding a particular field of study and ends with formulated rules and procedural methods regarding the chosen field of study. For financial accounting, the structure of deductive theory construction includes:

- the formulation of objectives of financial reporting;
- determining the postulates (acceptable assumptions) of accounting;
- setting constraints in order to guide the reasoning process;
- a set of symbols (or framework) within which ideas are expressed and summarised; the formulation of principles; and
- the formulation of procedural methods and rules.

While the deductive approach starts with the broad and the general (objectives, postulates) and ends with the specific (methods, rules), the inductive approach, on the other hand, generally follows the opposite pattern: it draws generalized conclusions from detailed observations and measurements. It should be noted, however, that the data that are selected for observation in order to apply inductive reasoning, are selected through *deductive* reasoning, thereby rendering theory formulation an almost endless iterative process.

## Accounting theories

Hendriksen (1982: 1) describes an accounting theory as "... logical reasoning in the form of a broad set of principles that (1) provide a general frame of reference by which accounting practice can be evaluated and (2) guide the development of new practices and procedures". According to him, an accounting theory should provide a general frame of reference against which sound accounting practices can be evaluated. A theory encompasses a set of statements or propositions "... connected by rules of logic or inferential reasoning. The statements must include testable hypotheses or premises and a conclusion, although one or more of the premises may be based on explicit value judgements. The primary test of a theory, however, is its ability to explain or predict".

There is no universally accepted single theory of accounting. By employing a combination of deductive and inductive reasoning processes, accounting theories are developed. Deegan & Unerman (2006:5) state that there is no universal agreement on how accounting theories should be developed, since there are so many different perspectives on the role of accounting theory. They nevertheless distinguish three broad categories of accounting theory, viz. prescriptive (normative) accounting theories, inductive accounting theories and predictive accounting theories. An overview of the literature indicates that these broad categories appear (in some form or another) in most works on accounting theory (Hendriksen, 1982; Ryan et al., 2002, Belakoui, 2004).

Prescriptive (normative) accounting theories are based upon what the researcher believes *should* occur in particular circumstances. These theories describe what financial accounting *should* be: what *should* be regarded as assets, liabilities and so on, and how they *should* be valued. Since these theories are not based on observation, they do not necessarily reflect accounting ≫

practice. Deegan & Unerman (2006:10) state, for instance, that Chambers advocated the valuation of assets at market values at a time that historical cost accounting was the accepted norm. The conceptual framework can be viewed as a normative accounting theory.

Inductive accounting theories are constructed by observation and by drawing generalized conclusions from practical observations and measurements. This approach is probably the oldest variant of theory construction in accounting. Accounting practices that have developed in a pragmatic and even haphazard fashion, were observed, generalisations were drawn from such observations and these generalisations were eventually documented as accounting theory. Riahi-Belkaoui (2004:113) notes that theorists such as H R Hatfield, S Gilman, A. C Littleton, W A Paton and Yuji Ijiri could be regarded as inductive theorists.

Predictive accounting theories (also called "positive accounting theories') focus on *explaining* and *predicting* accounting practice, rather than *prescribing* such practice. Such theories are also based on observation and they often lead to accounting research that is termed *positive accounting research*. Through observation of existing phenomena, they attempt to predict possible future outcomes, such as, for instance, what particular accounting policies are likely to be adopted by managers in particular circumstances.

Beattie (in Ryan et al.: 107) states that positive accounting theorists such as Watts and Zimmerman "... argue that 'scientific' research can only be concerned with 'what is' questions, it cannot be used to answer 'what ought' questions". Positive accounting theories can be contrasted with normative accounting theories. The latter describe what accounting practices *should* be pursued, the former seeks to explain and predict accounting phenomena. Examples of positive accounting theories include the use of agency theory to help explain and predict managerial choice of accounting policies (Deegan and Unerman, 2006:212).

## A brief historical perspective of the accounting framework

Accounting as a discipline developed centuries ago in an evolutionary manner from the need to keep a record of transactions between parties and to communicate the results of those transactions to interested parties. As the transactions became more sophisticated, greater demands were placed on accounting disclosure. To meet the demands, a set of "rules" was inductively developed as generalisations of existing practice to ensure the orderly processing of accounting data and a more consistent reporting framework.

The greater sophistication of business activities during the nineteenth and early twentieth centuries necessitated a concomitant sophistication in accounting practice that, nevertheless, developed in a rather pragmatic and haphazard fashion. The accounting "rules" became more voluminous and conflicting and, in general, lacked coherence. The development of railways in the USA and Europe since the second half of the nineteenth century (Salmonson 1969), the advent of the company as a form of business (Lee, 1974) and the concomitant developments in the legal world, especially with regard to taxation (Alderman et al., 1982), technological changes (Hendriksen, 1982), the development of economics as a field of study (Salmonson, 1969), the establishment of professional accounting and regulatory bodies (Beattie, 2006) and the globalisation and growth of world markets (Beattie, 2006) were all contributing factors that necessitated the development of, and the search for, a body of accounting theory and the standardisation of accounting practices.

In the USA, the Accounting Principles Board (APB) was established in 1959 as a committee of the American Institute of Certified Public Accountants. One of the objectives of the APB was to "formulate" principles, to standardise accounting practices and to take the lead in solving accounting issues. During its existence, the APB published thirty one opinions and four standards, the most controversial of which was probably *Accounting Research Study no. 1*, entitled *The basic postulates of accounting* (1961), *Accounting Research Study no. 3*, entitled *A tentative set of broad accounting principles for business enterprises* (1962) and *Accounting research study no. 4*, entitled *Basic concepts and accounting principles underlying financial statements of business enterprises* (1970).

This body was, however, heavily criticised for its apparent inability to achieve its objectives (Spacek, 1969), resulting in the establishment of two study groups, one with the objective of establishing accounting principles (the Wheat Committee), and the other to establish the objectives of financial reports (the Trueblood Committee). The report of the Wheat Committee ultimately resulted in the disbanding of the APB and the establishment of the Financial Accounting Standards Board (FASB) in 1973 the USA, with the express objective to formulate a conceptual framework of accounting, a seminal event in the history of accounting. The latter body was responsible for the conceptual framework project and soon after its inception in 1978 published its first statement, *Statements of Financial Accounting Concepts No. 1*, entitled *SFAC 1 – Objectives of Financial Reporting by Business Enterprises*. Since then, a number of SFACs have been issued by the FASB, as a whole constituting what is today known as the FASB conceptual framework.

In the UK, against the background of several public "accounting scandals", the Accounting Standards Steering Committee, later renamed the Accounting Standards Committee, ASC) was established in 1970 (Beatie 2006:98). A milestone publication of this body was *The corporate report*, published in 1975, dealing also with the objectives of financial reports. During 1990, the ASC was superseded by the Accounting Standards Board (ASB), which was responsible for the publication of a conceptual framework document entitled *Statement of Principles for Financial Reporting* in December 1999.

During 1989, the then International Accounting Standards Committee (IASC) issued a statement entitled *Framework for the preparation and presentation of financial statements*, which in 2001 was formally adopted by its successor body, the International Accounting Standards Board (IASB). This document is loosely based on the FASB's conceptual framework. The document is, however, not an accounting standard and consequently does not override any formal accounting standard, such as International Accounting Standards (IASs) or International Financial Reporting Standards (IFRSs). It does not have the same authority as an IFRS. Where there is a conflict between the framework and a specific Standard, the Standard will always prevail.

Currently, the FASB and the IASB are engaged in a joint project to revise their conceptual frameworks in order to refine, update, complete and converge them into a common framework that can be used for the development of new standards as well

as for the revision of existing standards. An important objective is for the standards to be "principles-based", implying that standards may not be a collection of conventions, but should be based on fundamental concepts or "principles" that should constitute a framework that is sound, comprehensive and internally consistent. In order to result in coherent financial accounting and reporting, the fundamental concepts need to constitute a framework that is sound, comprehensive, and internally consistent. However, as is the case today, once the converged framework has been completed, some existing FASB and IASB financial reporting standards will inevitably conflict with the concepts. Accounting standards will probably not immediately be changed to reflect the new, converged framework, because both boards' standards assume hierarchical priority over concepts, hence priority is likely still to be given to standards. It is expected, however, that conflicts between concepts and standards will gradually disappear as new, converged, principles-based standards are developed that are based on the improved, converged concepts.

The conceptual framework is therefore an attempt to assist standard setters to harmonise accounting practices, standards and procedures, and to ensure that accounting standards published by accounting bodies are inherently consistent, as they will then theoretically all conform to the framework. An important further objective of the framework is to provide a basis for reducing the number of alternative accounting treatments.

## The relationship between accounting theory, accounting standards and the conceptual framework

From the brief historical perspective above, it should be clear that that neither the framework published by the FASB, nor the Framework of the IASB or the *Statement of Principles* of the ASB could be described as the theory of accounting. This will also be true of the new converged framework, once it is finalised. The framework is merely the culmination and, as such, a relatively tiny portion of what could be considered as the body of normative accounting theory, however unstructured such body of theory may seem to be. The FASB should be commended for its definitive work in this regard. Cognisance should be taken of the vast body of literature, research and debate that underlies this framework, has ultimately influenced the later similar documents published by the IASC and the ASB, and which will probably also have a material influence on the expected converged framework.

The conceptual framework constitutes merely (a part of) the body of accounting theory, a normative theory. There is also a huge body of positive and inductive theories to be found in accounting literature. Together they constitute the body of accounting theory.

Furthermore, underlying, and indeed surrounding the framework, the postulates, principles, procedures, rules and conventions of accounting are to be found. Accounting standards do not necessarily encapsulate the *principles* (or postulates) of accounting, however, they often do describe procedures, rules and conventions.

Therefore, to term the current internationalisation of accounting standards as a move toward "principles-based standards" might be a touch ambitious. Sir David Tweedie, chairman of the IASB, as reported in *Accountancy SA* (March 2007:5), implied as much with the statement that "...(t)he IASB would be moving towards principle-based standards with vigour in the future. The need by the regulators and the audit firms for one interpretation or view on an issue had destroyed the principle-based approach to standard-setting and resulted in rules-driven standards". Principles-based standards will, *inter alia*, result in the elimination of exceptions to the scope of such standards and various accounting treatments. Application guidance will be limited.

## Good news for accounting lecturers and practitioners

Sir David Tweedie's observations are good news for accounting lecturers and practitioners!

As most lecturers, with their students, slog through each rule, each bullet, each convention in (almost) *every* standard, illustrating each with numerous examples in order to "ensure" that "everything" is "covered", while subconsciously believing they're teaching the principles (even the theory) of accounting, they may be forgiven for occasionally falling into a state of despair. The sheer volume of what is to be "covered" is truly overwhelming. They may even be forgiven for believing that "everything" is capable of being "covered".

As practitioners struggle to find the appropriate accounting treatment, usually by way of analogy, of a transaction that is not "covered" in any accounting standard, they, together the lecturers described in the previous paragraph, should take heart. Sir David's message must go out to them: although we haven't seen them yet, **real** principles-based standards, hopefully based on sound accounting theory, are apparently on their way. What we believe, may indeed eventually become true.

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