Approaches to Accounting
Theories
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INTRODUCTION

Accounting is a complete system, which includes every activity related to the measurement and recording of different economic and financial information pertaining to an organization, which can then be used by the normal people for analyzing the business and for making decisions. The American Institute of Certified Public Accountants (AICPA) defines accounting as “the art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events, which are, in part at least, of a financial character and interpreting the results thereof.” (Corina, et. al 2012)

Objectives of Accounting

Accounting is a vast system, which includes innumerable computations, problem solving, digging out of information and presenting the same in a specified format so that it can be read, analyzed and interpreted by people. Accounting has several major objectives to follow. Below discussed are some of the major objectives of accounting:

Recoridng Data in a systematic manner: For an investor or decision maker, analyzing only the present information or scenario of a company is not enough and it is crucial for them to even examine the past performances and information of a company. And that is what accounting aids by recording data and information in a systematic manner. Such systemized recording of information helps investors in analyzing options and information for any previous year as well. (Laughlin, 2006)

Determining Financial Positioning: Every organization, big or small is required to prepare its financial statements on the basis of the given information. All this information then helps companies and the stakeholders in analyzing the financial position of the company. Different entries in the financial statements represent different aspects of financial position of a firm, hence giving a clearer picture. (Laughlin, 2006)

Aid in Decision-Making: The very first step of the decision making process is to collect, analyze and interpret information related to the topic to make informed decision. And this is exactly what accounting does. The information it provides help owners, creditors, management, employees and even investors make informed decisions related to the firm. (Haka, et. al 2004)
ACCOUNTING THEORIES

An accounting theory is nothing but a framework or a set of defined rules and principles that define and guide an accountant about what should be done and what should not be done. These theories include several logical reasoning and some practical proof to demonstrate the way an accountant can best present the accounting information or the way investors can best interpret the given accounting information. There are several international boards that develop these accounting theories that are then used by the accountants in different countries.

APPROACHES TO ACCOUNTING THEORIES

The most important step when it comes to accounting theories is their formulation. There are numerous approaches that go into the study and formation of these theories. We would thus now look at the different approaches that are used for the formulation and development of these different accounting theories:

THEORETICAL APPROACH

Theoretical approach includes the adoption of different theories and qualitative analysis for the development of different theories. The policy makers make use of different theories and theoretical contexts for the development of different accounting theories. The theoretical approach to the formulation of accounting theories includes several different approaches and contexts. Some of the commonly used theoretical approaches for the formulation of accounting theories are discussed as below: (Cluskey, et. al 2007)

- Inductive Approach: This approach is nothing but the description of what the accountants should do. On the basis of past experiences and the existing problems, new rules and regulations are devised that explain the different things and activities that the accountants should do ideally.

- Deductive Approach: The principles of accounting theories are also based on the deductive approach, in which the policy makers first establish the different objectives of accounting and the accounting theory and on the basis of these objectives, the theories are formulated.
- Ethical and Sociological Approach: The people responsible for the formulation of accounting theories keep in mind different ethical and sociological contexts and theories for the development of these accounting theories.

**NON THEORETICAL APPROACH**

In addition to the theoretical approach, the policymakers also make use of several different non-theoretical approaches for the formulation and development of the different accounting theories. This approach includes different non-theoretical contexts according to which new and different accounting theories are developed and then implemented by the accountants. Different non-theoretical approaches developed towards formulation of accounting theories are discussed below: (Gaffkin, 1987)

- Pragmatic Approach: This is the most practical approach that is adopted towards the development of the accounting theory. This approach includes logics and reasoning. The theories are developed completely based out of logic and practical rules. This approach includes the amalgamation of theory with the operational context and operational utilities. It is more of a problem solving approach, which helps in transforming the theory into practical usefulness.

- Authoritarian Approach: This approach includes the authoritative value of the government and regulatory bodies who decide the operational utility of a given theory. Based on the utility and given situation, the policy makers decide on the approaches that are to be used and these approaches are then combined to form the accounting theory.
The normative approach to accounting theories is a special approach, which is based on defining the things that should be instead of defining what actually is. Different approaches to accounting theories include the analysis of different elements and carrying out studies in different ways, which the help in the formulation and development of different accounting theories that define the basis and construct of accounting practices. In the normative approach, the policymakers discuss their opinions and judgment on different accounting practices and explains what a theory should include. The theorists make use of their past experiences and analyses and thus depending on that they explain and define the things that the accounting theories should include. Some of the main things included in the normative approach are the personal outlooks, deductive reasoning and use of inductive techniques. (Mattessich, 1992)

A very common and well versed example of the normative approach to accounting theory is the Contextual Framework of Accounting. Conceptual framework of accounting is nothing but the definition of different rules and regulations that are established by different accounting boards and institutions to define the different methodologies and rules that are to be followed for the purpose of accounting. The Financial Accounting Standards Board (FASB) defined a set of rules based on the problem on problem approach and developed a conceptual framework. The contextual framework of accounting includes several approaches to be used for the recording of assets, liabilities etc. in the financial statements on the basis of logic and personal opinions. The framework explains the different ways in which the elements of financial statements, like income, expenses and income can be defined and expressed and also the tools that can be used for measuring the same. Another commonly used normative approach theory of accounting is the current-cost accounting theory. The current-cost accounting theory defines the different ways in which the accountants can calculate the income that if taken away from the entity, would not affect its physical capital. Basically, the theory helps in determining the real and true measure of the income of any given entity. (Miller, et. al 2010)
CRITICAL EVALUATION OF THE APPROACH

The normative approach has been there since long time and has been adopted for the formulation of different accounting theories. Theorists make use of the approach because of one main reason and that is to match up to the changing world environment and the accounting procedures. The world, operations of businesses and everything else related to an organization are highly dynamic in nature and nothing remains stagnant after a point of time. And hence normative approach is expected to help the accountants keep up with the current changes and make changes in the established accounting theories according to current observations and analysis. But at the same time, there is also a possibility that there may occur some major changes in the existing theory without any sound basis. The accountants may analyze the changing environment in different ways, thus causing major impact on the existing practices and theories. (Demski, 1976)

Despite of using logics and logical reasoning for the development of different theories, one question that always arises while using the approach is if it actually reflects the actual accounting practices. Most of the normative theories are completely based on observations and hence it is not always possible to determine if they actually make sense in the accounting world. For example, a simple methodology of the valuation of assets would be interpreted and seen in different ways. Some accountants would focus more on the social and environmental impacts whereas some would focus more on the historical costs.

Some theorists believe that the normative approach is the most logical way because it is not based on what is happening but provides a clear picture of what and how the accounting practices should be. But then again the assumptions behind each accounting theory and the development of practices would depend on the policymaker’s opinions. One wrong assumption or one loophole in the reasoning and logical analysis can cause serious problems and hence this demonstrates the possibility of manipulating accounting theories. (Hakansson, 1969)

Thus, it is clear that though the normative approach presents an extremely practical way and methodology for the development and formulation of the accounting theories, it still has some severe drawbacks and hence whether to be used or not is still a question that needs to be answered.
POSITIVE APPROACH TO ACCOUNTING THEORIES

On one hand, accountants make use of the normative theory to elaborate on what the accounting theories and principles should be. And in contrast to that, there is one approach that explains the current accounting practices and theories to explain their value and impacts. Positive approach to accounting theories presents an explanation of the different practices that are currently being adopted so that the best can be chosen. Unlike the normative approach, it does not evaluate options on the basis of observations but in turn carries out an empirical analysis of the different theories and accounting practices that already exist. (Kinney, et. al 1989) Normative approach is based on one’s observations but positive approach is based more on scientific reasoning and empirical analyses. It does not really highlight the efficiency of the practices that are being used but in turn presents a justification and explanation of reasons that lead to the implementation of practices in question.

EXAMPLE

A very commonly used positive theory in the world of accountancy is the legitimacy theory. Legitimacy theory is derived from the positive approach to the development of accounting theory and helps in explaining and determining the legitimacy of the behavior of organizations. Unlike a normative approach, the theory in no way prescribes or makes suggestions as to what organizations should adopt as legitimate but analyzes the current practices of a business to explain if what the companies are doing are legitimate or not. This theory is also defined as a systems theory and comes under the umbrella of a positive approach. (Sterling, 1990)

Another theory that is commonly known as the positive theory of accounting is the stakeholder theory. The stakeholder theory includes an analysis of the impacts of different accounting principles on the stakeholders. Again, the approach does not define what a company’s approach should be towards their stakeholders but in turn presents an analysis of the existing relationship to determine if the policies and accounting approaches being adopted by organizations are in favor of the stakeholders ethically and managerially.
CRITICAL EVALUATION OF THE APPROACH

Large number of academicians and theorists consider positive approach to be much more practical and sensible than the normative approach because the positive approach is based more on theory and real time data as opposed to the normative approach but one thing that again raises question towards the credibility of the approach is the possibility of the capitalization of personal conveniences and benefits by the management, shareholders and controllers of a firm. There is no determination of why an organization chooses one alternative over another and hence it is obvious that the decision makers of the firm would include their own conveniences while making a selection. (Boland, et. al 1992)

Positive theory helps in evaluating the pros and cons of the alternatives adopted by any firm or institution but while doing so, it fails in establishing the efficiency of any option or methodology adopted. The approach only helps in analyzing and assessing the nature of the methodologies adopted but does not really provide any evidence if the approach is efficient or not. There is hardly any evidence that proves and establishes if the adopted practices are fruitful or not. And hence it still leads to the generation of suspicion and speculation in terms of the efficacy of the approaches being used.

The positive approach to the development of accounting theory relies on one basic assumption and that is that all the policy makers and decision makers of an organization are completely rational in nature. It assumes that all the decisions that are being made would be a result of rationality where the accountants can follow the best of options. But that is not what actually happens. The decision makers always have some factors that act as biases in the development of the required theories and approaches. (Sinha, 2008) The positive approach does not even provide alternatives to the existing approaches or principles in case they are considered as irrelevant. Where the normative approach presents an explanation of the things that the companies should do, the positive accounting approach only examines and analyzes the existing principles and makes no recommendation for the principles that need to be used.
NORMATIVE VS. POSITIVE APPROACH TO ACCOUNTING THEORY

We analyzed and evaluated the two approaches that are commonly used for the formulation of different accounting theories. Accountants and theorists have widely made use of these theoretical approaches for devising and developing new and practical accounting theories but the two approaches differ significantly in their approach towards the development of new theories and towards the analysis carried out by them. We would hence analyze the differences and similarities between them to figure out the situations they can fit in the best.

Despite of several criticisms and accolades received by both the approaches, one similarity that exists in both is the presence and existence of personal and opinion bias during the formulation of different theories. In normative approach, the theorists and policy makers base their decisions on their opinions and judgments whereas in positive approach the analysts examine the relevance of the existence practices. Thus both the approach includes and involves personal bias of the decision makers, as under both circumstances the personal views, opinions and conveniences of the decision makers come into the picture.

The approaches have one major difference and that is suggesting methodologies to be used. The normative approach clearly does not focus on what exists and just involves defining things that should be done or the way the accounting theories should be for maximum efficiency. But in contrast to that, the positive approach focuses on what exists and make no suggestions whatsoever for improving the current practices or for introducing new practices. The organizations are not going to benefit from simple evaluation of the existing practices but in turn it is important that they are given options and alternatives of principles to choose from so that the firms can gain maximum efficiency in terms of its operations and accounting principles.

Hence, both the approaches have their own pros and cons and have different ways of coming up with new and sound accounting theories. These approaches are praised and criticized at the same time and hence the choice of the approach would depend completely on the situation or the personal opinion of the person making the decision.
APPLICATION OF THESE APPROACHES UNDER CURRENT ENVIRONMENT

NORMATIVE APPROACH

The normative approach has already been applied at several places and has proved its worth under different scenarios. It has been used for the development of conceptual framework for accounting, which explains how and when different entries of the financial statements should be entered or modified for getting the best possible results. Despite of all the criticisms, the approach has still not lost its efficiency and can still prove to be extremely helpful when applied under different circumstances. One area where the approach can be helpful in the current economic and business scenario is social accounting. (Bassam, et. al 2006) All organizations are moving towards the adoption of more social changes, wherein they include social actions in their operations. Social corporate responsibility is becoming an essential part of the working of all companies. And hence social accounting is becoming more and more in demand. This is one area where normative approach can be included to determine what is the best way for a company to include social accounting.

Product management is also a crucial area where the accountants need to adopt the principle of normative approach for making decisions. Managerial accounting involves the development of different accounting techniques and methodologies that can be used for the purpose of product management. This includes the development of new and different strategies that can be applied for different companies. And hence, this is where the normative approach can be included in managerial accounting for developing the best strategic accounting measures to define the things that should be done. (Back-Hock, 1992)

POSITIVE APPROACH

The positive approach to accounting theory has gained lot of appreciation from the accountants. And one area where the approach has already been adopted and proved to be beneficial is the environmental disclosure of corporate. A study of the Indonesian firms demonstrates that the Indonesian companies adopt a positive approach for the accounting of environmental disclosures and the approach has been proven to be extremely beneficial. And hence the same approach can
be used even for other companies to make sure that the companies are told what to do for their environmental accounting. (Setyorini, et. al 2012)

Under the current business and global integration scenarios and mechanisms, one technique that is applied by all companies is the translation of foreign currency. This is one of the most important parts of the accounting of all big firms, which operate in the global market. Whether the organization is small or big, till the time it is trading with the foreign markets, it has to determine an efficient methodology for translating foreign currency. And hence this is where positive theory can be put to use. In order to determine the techniques for translating foreign currency, the companies can examine the existing methodologies to choose the ones that suit their requirements the best. (Pinto, 2010)

**CHOOSING AMONG THE TWO APPROACHES**

We have examined the benefits, characteristics and implications of two distinct approaches used for the formulation of accounting theories. These two approaches have some similarities and several differences between themselves but both are crucial and useful under different circumstances and hence need to be selected and used carefully. Looking at the implications and characteristics of both the approaches, the positive approach seems to be more preferable as compared to the normative approach.

Positive approach is more practical and gives a clear understanding of what is already happening. The normative approach just presents the views and opinions of the people involved in making the decision and hence it is not compulsory that it can be applied to all situations in an effective manner. But the positive approach presents an overview of things that are already there and thus it can be proven whether a particular technique or methodology is beneficial or not. This seems to be a more realistic approach, which is better connected to the real world scenarios and the practices that are already being used and employed by companies for different purposes. Ultimately, the choice of the approach for formulating the accounting theory highly depends on the context and the decision maker also but adopting an approach that is more practical in several ways makes more sense.
CONCLUSION

Accounting is a system, which incorporates numerous special activities and information management techniques to make the available information more presentable to the readers and users of the information. There are several accounting theories that have been developed and keep developing for enhancing the current accounting system or for introducing something new in the system. And hence in order to efficiently develop these accounting theories, theorists and academicians usually adopt different approaches to reach to their conclusions.

Two approaches that are commonly used for the formulation of accounting theories are normative and positive approaches. Where normative approach believes in elaborating on the things that should be done, positive approach is focused more on the existing techniques and principles. Both the approaches have different pros and cons and hence can be used under different circumstances. However, the final selection of one of the two approaches depends on the given scenario and even on the people involved in making the decision.
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