**NOTE:** This is the final version of Chapter 4 of Carien van Mourik & Peter Walton (eds) *The Routledge Companion to Accounting, Reporting and Regulation* (Abingdon: Routledge, forthcoming 2013). This version may differ slightly from the printed text, which should be regarded as definitive.

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# Chapter 4: English-language theories of financial reporting

## 4.1. Introduction

In Chapter 2, different notions of ‘theory’ were introduced and applied to financial reporting. The various theories can be divided into two broad but overlapping groups, reflecting the main purpose for which the theories have been developed. Some theories are intended to provide a structure for understanding existing accounting practice, usually with a view to its improvement. Such theories may be labelled ‘prescriptive’ or ‘normative’, and have sometimes been classified as ‘theories *of* accounting’ (for example, Kinney, 1989: 121). Other theories also aim for an understanding of existing accounting practice, but here the objective is to explain the behaviour of those who prepare and use financial reports of businesses and not-for-profit entities, and to predict the accounting choices that preparers and users may make. Such theories may be labelled ‘descriptive’ or ‘positive’, and come within the classification ‘theories *about* accounting’ (Kinney, 1989: 121). However, as is argued in Chapter 2, these classifications are not always helpful, as they often mask presuppositions as to what a theory should be. Writers of textbooks with titles such as *Accounting Theory* (for example, Hendriksen and van Breda, 1992; Riahi-Belkaoui, 2000) sometimes evade the provision of a single definition and claim that there are multiple approaches to accounting theory, perhaps appealing to the American Accounting Association’s *Statement on Accounting Theory and Theory Acceptance* (AAA, 1977), which argued that a collection of theories was required to address the different contexts of accounting.

In broad terms, financial reporting theories seek to provide a framework of principles or general concepts that abstract from financial reporting practice. The purpose of such a framework may be to ensure the consistent and systematic development of practice, to improve practice, or to understand, explain and predict practice. The framework may come from within accounting, or it may draw on another field of knowledge, such as economics, information theory, psychology, political theory or law. This eclecticism may be observed in two current textbooks, both entitled *Financial Accounting Theory*. The book by Scott (2012), widely used in North America, is almost entirely grounded in economics. This book refers to ‘theories *of* accounting’ only in a brief historical sketch. The book by Deegan and Unerman (2011), popular in many countries within the British Commonwealth, makes use of a wider range of theories, including behavioural and critical perspectives. The authors give equal weight to ‘theories *of* accounting’ and ‘theories *about* accounting’. So, even among leading textbooks, there is no consensus as to what constitutes financial reporting theory.

Whittington (1986) offers a study of financial accounting theory that combines a taxonomy with a historical narrative. He identifies three main ‘approaches or strata’, which he labels ‘empirical inductive’, ‘deductive’ and ‘the new empiricism based on positivism’ (Whittington, 1986: 6-7). However, his taxonomy illustrates how the boundaries between different approaches to financial accounting theory are blurred: his ‘deductive’ category includes what he calls ‘true income’, ‘user needs’ and ‘information economics’ approaches, the first two of which are often labelled as normative while the third provides the theoretical underpinning for the ‘new empiricism’. Beattie (2002) adopts a similar historical approach, seeing financial accounting theory as originally emerging from, and helping to shape, corporate financial reporting practice, then moving through a deductive or *a priori* period, before settling on a decision-usefulness framework to shape practice and an empirical research tradition grounded in neo-classical economics to shape academic enquiry. Unlike Whittington, however, Beattie also acknowledges the growing interdisciplinary and critical stream of financial accounting research, drawing on a wide range of social, political and economic theories. Another historical review of financial accounting theory is that of Lee (2009), who identifies an exploratory period before 1940, a period of ‘classical theory’ from 1940 to 1970, and finally a period of ‘scientific theory’ after 1970.

This chapter also adopts a historical approach, examining five main periods. The first of these covers the long period from the emergence of accounting as a practice in English-speaking countries to the early 1920s. At that point, accounting was no longer simply a practice, but was the object of university education and academic study. The 1920s and 1930s saw some early attempts at providing both descriptive and deductive theories of accounting, but the so-called ‘golden age’ of *a priori* research in accounting (Nelson, 1973: 4) was to come later, in the 1950s and more particularly the 1960s. By the end of that decade, what was to become ‘market-based accounting research’ had emerged, while the 1970s and 1980s experienced a radical split in financial accounting research, with accounting standard setters attempting to develop and apply conceptual frameworks and statements of accounting principles in order to improve financial reporting, while academic researchers concentrated on social science-based empirical research. More recently, scholars and practitioners of financial reporting have continued to draw on an eclectic range of theories to guide their research and practice.

## 4.2. The emergence of financial accounting theory

### 4.2.1. Early theoretical ideas about accounting

Textbooks and treatises on accounting (specifically double-entry bookkeeping) were printed and published in the English language from the 16th century onwards. The writers of textbooks were often teachers of bookkeeping, and although they often speculated as to whether accounting should be regarded as an Art or a Science, their main goal was to educate merchants and their children into the mysteries of debit and credit. Jackson (1956) observes that many of the textbook writers attempted to develop one or more rules for determining which account would be debited and which credited, either in general or for specific transactions. Jackson (1956: 288) quotes the earliest surviving English-language textbook (the edition by John Mellis of Hugh Oldcastle’s *A Briefe Instruction and Maner how to Keepe Bookes of Accompts*, published in 1588) as establishing the rule that ‘all things received, or the receiver, must owe to all things delivered, or the deliverer’, a rule that survived well into the 20th century as ‘debit the account that receives value and credit the account that gives value’.

Early British writers attempted to provide a general structure for double-entry through ‘personification’ of accounts. Although many accounts in a merchant’s ledger would relate to people with whom the merchant transacted, others, such as income and expense accounts, were more abstract. Personification encouraged the merchant to think of such accounts as representing either independent living entities or aspects of the merchant’s own personality. By the 19th century, personification had mutated (particularly in early US textbooks) to an early form of the ‘proprietorship theory’ of accounts, where transactions are regarded primarily as affecting the owner’s interest in the business rather than as simply giving rise to debits and credits. Jackson (1956: 307) traces this approach back to Hustcraft Stephens, writing in 1735, and he notes how Stephens began his book by stating that he planned ‘to offer no rules, until he has shown them to be consequences of conclusions, plainly drawn from self-evident principles.’ Here we see a forerunner of the ‘deductive’ approach to accounting theory. The proprietorship approach placed emphasis on what was to become known as the ‘balance sheet equation’, where ownership interest was equated to assets less liabilities, and this equation approach was expressed algebraically by F. W. Cronhelm, in *Double Entry by Single* (published in 1818). However, as Jackson (1956: 312) notes, the proprietory approach, with the balance sheet equation, was to disappear from British textbooks before being rediscovered in the latter part of the 19th century in the USA.

### 4.2.2. Professional theorising in Britain

A demand for systematic thinking about financial accounting and reporting emerged with the growth of the corporate economy and the establishment of professional accountancy bodies, whose roles included training and examining accountants. The earliest professional body in the English-speaking world was the Society of Accountants in Edinburgh, founded in 1854, while professional bodies began to be established in England from 1870 (Poullaos, 2009: 250-1). A weekly magazine, *The Accountant*, established in London in 1876, provided an outlet for articles and lectures, often by leading accountants of the day such as Edwin Guthrie and Ernest Cooper, some of which have been collected by Brief (1976). Their articles ‘show an originality and an emphasis on *principle*’ (Kitchen and Parker, 1980: 22) rather than being merely ad hoc responses to issues of current interest. Moreover, textbooks oriented towards the aspiring professional accountant rather than the bookkeeper began to be published. Francis Pixley, an eminent chartered accountant, wrote the first textbook on auditing, published in 1881 (Kitchen and Parker, 1980: 23), while Lawrence Dicksee combined a professional practice with both writing and teaching, becoming the first professor of accounting at a British university in 1902 (Kitchen and Parker, 1980: 60) and subsequently going on to hold the first chair in accounting at the London School of Economics (Napier, 2011: 188).

As well as writing a standard textbook on auditing, which was to inspire the leading US auditing textbook by Montgomery (Power, 1992), Dicksee was the author of *Advanced Accounting* (Dicksee, 1903), which he intended for both professional and university students. Dicksee stressed the importance of principles, but his main framework was the distinction between capital and revenue. This was important in determining when profits could be recognised in financial statements, and the amounts at which assets and liabilities should be stated in the balance sheet, but it drew mainly on legal notions, developed over decades in the British courts, but not necessarily in a systematic and rational way. Dicksee often supported his recommendations with little more than the instinct for ‘good practice’ that he had developed over his professional career. For example, he rejected annual revaluations to determine the expense to recognise for the use of assets (a method that he described as ‘theoretically the most perfect’) because it would lead to uneven amounts being charged from year to year (Dicksee, 1903: 227).

Dicksee’s books, together with other studies (such as Garcke and Fells’ *Factory Accounts* of 1887 and Ewing Matheson’s *The Depreciation of Factories* of 1884 – see Napier, 1996: 455), provided some systematic understanding of financial accounting and reporting, but they are only rudimentary attempts at developing an accounting *theory*. Principles were not always stated explicitly, although it is possible to discern a general belief that dividends should be paid out of income but that capital should be maintained – what ‘capital maintenance’ actually involved in practice, though, was debated. Moreover, the professional accountants who contributed to the early British theoretical literature were influenced by their experience of corporate failures and tended to advocate conservative accounting, with a strong realisation concept and prudence in asset measurement. Prudence was, however, tempered by an acknowledgement that accounting should regard most businesses as going concerns, so assets could in most cases be measured using a cost-based approach rather than in terms of current market values.

### 4.2.3. Emergence of theory in the USA

 In the USA, writers had been discussing ‘the science of accounts’ since the mid-19th century (McMillan, 1998: 3). Early textbook writers, such as Thomas Jones and Benjamin Franklin Foster (Previts and Merino: 1998:78-80) rejected the rote learning of rules of bookkeeping and argued that a genuine understanding of accounting could come only through a grasp of principles. Just as the establishment of *The Accountant* provided a forum for British accountants to discuss conceptual issues, so the creation of *The Book-keeper* in 1880 furnished an outlet for writers such as Charles E. Sprague, whose articles under the title ‘The algebra of accounts’ presented accounting as a branch of mathematics (McMillan, 1998: 9) and used the balance sheet equation to derive specific bookkeeping entries for various classes of transaction. This periodical was published by an early US professional body, the Institute of Accountants and Book-keepers of the City of New York (subsequently known simply as the Institute of Accounts), founded in 1882 with the aim of establishing the practice of accounting on a ‘scientific’ basis (McMillan, 1999). The Institute modelled itself on the American Society of Mechanical Engineers, and, by analogy with the science of mechanics, advocated a science of ‘accountics’. Although this term did not catch on, the notion that accounting should be understood as a system grounded in logic rather than as a collection of specific and arbitrary practices stimulated a way of studying accounting that was quite alien to British accountants.

Among the important early theoretical studies was Sprague’s *The Philosophy of Accounts* (1908), which proposed a proprietory theory of accounting, with income regarded as the change in owners’ capital. Of more lasting influence was the work of Henry Rand Hatfield, one of the earliest professors of accounting in the USA (Mills, 1994; Zeff, 2000; Parker, 2002). Hatfield did not come from a professional accounting background, but rather had studied economics and later worked in banking. His major theoretical work, *Modern Accounting: Its Principles and Some of its Problems* (Hatfield, 1909), emphasised the balance sheet as a statement of financial position, with income being determined as the by-product of asset and liability measurement. Asset valuation should be based on an assumption that the business was a going concern, rather than reflecting liquidation value, and accountants could disregard fluctuations in the market value of property, plant and equipment. Hatfield also stressed the need to provide for depreciation, viewing this as a measure of the cost of using an asset rather than as an optional provision for asset replacement. Although Hatfield did not disapprove of the upward revaluation of land to reflect current market values, his overall approach provides a paradigm of what was later to be called ‘historical cost accounting’.

## 4.3. Applying economics to accounting

### 4.3.1. 1920s and 1930s – USA

 By the early 1920s, accounting in English-speaking countries was being taught and studied at universities as well as within the profession, but with an emphasis on practice rather than theory. To the extent that a coherent theoretical position was articulated, it tended to be based on making sense of existing practice rather than deduction from general principles. Perhaps reflecting the importance of stock markets in the UK and USA, businesses were viewed from the owners’ perspective (proprietory theory) rather than as pools of assets against which various stakeholders had claims (entity theory). This was to change in different ways during the 1920s and 1930s, as entity theory was developed as a potential counterbalance to proprietory theory, while various scholars drew on economic theory and employed methods of logical deduction to make recommendations about improvements to accounting practice.

The scholar most associated with entity theory was William A. Paton, author of *Accounting Theory: With Special Reference to the Corporate Enterprise* (Paton, 1922; see also Previts and Robinson, 1994). Rather than seeing the role of financial reporting as showing the financial position of the business to its owners, Paton argued that managers needed information to allow them to maintain the assets of the business (‘properties’) and hence protect the claims of creditors as well as owners (which Paton referred to collectively as ‘equities’). This led Paton to advocate replacement costs rather than historical costs, to enable managers to maintain the physical capital of the business by retaining sufficient resources to allow for replacing assets as they were used. Paton also used an approach that was to recur in the 1960s, when he attempted to identify various fundamental principles – ‘postulates’ – of accounting. Paton’s ideas were taken further by Henry W. Sweeney, who also drew on theoretical approaches from Germany (including the work of Schmalenbach and Schmidt; see Chapter 3). Sweeney’s book *Stabilized Accounting* (Sweeney, 1936; see also Tweedie and Whittington, 1984: 32-34) advocated the use of general price level adjustments to restate the amounts in financial statements in units of constant purchasing power, thus correcting for the impact of general price change (inflation and deflation) on costs and values measured at different points in time. Sweeney distinguished between general inflation and the change in prices of specific goods and services, and proposed the use of replacement costs to show how individual items in the financial statements were affected by changing prices. He also called for an income statement that separated gains and losses that were realised, through actual transactions, from gains and losses that arose through remeasurement and hence were unrealised.

Although the proprietory theorists stressed the importance of the balance sheet, the stock market boom in the 1920s saw investors increasingly looking to the income statement as a measure of business performance. Because assets and liabilities in the balance sheet were measured using different bases, with some items shown at original cost, others at cost less depreciation and still others at valuations, and because many businesses used ‘income-smoothing’ accounting methods such as spreading the recognition of various expenditures over several periods, the number shown as owners’ equity in the balance sheet often bore no systematic relationship to the value of the business to its owners. Similarly, the net profit shown in the income statement was the outcome of applying often arbitrary accounting policies. One scholar who attempted to overcome this by going back to economic principles was John B. Canning, whose *The Economics of Accountancy* (Canning, 1929) drew on the ideas of economists such as Irving Fisher to propose a view of assets as embodying ‘future services in money’. On this basis, the income of a business was, in principle, the amount by which the value of the business (conceptualised as the discounted net present value of its future cash flows) had increased during a period, with assets and liabilities being measured in terms of expected future cash flows (which would often be equivalent to current market values). Canning believed that income was a real phenomenon capable of objective measurement, and claimed of conventional accounting that: ‘What is set out as a measure of net income can never be supposed to be a fact in any sense at all except that it is the figure that results when the accountant has finished applying the procedures which he adopts’ (Canning, 1929: 98).

### 4.3.2. 1920s and 1930s – UK

Canning’s study was to influence some young scholars at the London School of Economics, including Ronald Edwards and Ronald Coase. These theorists also took on board ideas of economists working in the UK in the 1930s, including Lionel Robbins, Friedrich von Hayek and John Hicks (Napier, 1996: 464). These economists emphasised the notion of economics as the science of choice among alternatives where resources are limited but wants are unlimited. Making the best possible choices requires appropriate information, and Edwards saw the object of published accounts as being ‘the provision of information for a judgement of net worth [to allow] the shareholder to calculate his income’ (Edwards, 1977: 139). Edwards endorsed the use of discounted cash flow for asset measurement, and was highly critical of existing accounting practices such as the use of mechanistic depreciation methods. Coase (1973) argued for the use of opportunity costs for decision-making, where the ‘cost’ of an action is regarded as the incremental revenues foregone by not taking the best alternative action. Both Edwards and Coase considered that information for decision-making within the enterprise should be consistent with information for decision-making by the owners of the enterprise (they took for granted the view that the duty of managers is to maximise returns to owners, although they were aware that this duty was not always put into practice). Hence, measurement methods that were rational for internal decisions should also be appropriate for external financial reporting. The opportunity cost of using an asset was often, though not always, the cost of replacing the asset, so if opportunity cost were rational for business decisions, then replacement cost would generally, but not always, be appropriate for financial reporting.

A more nuanced version of replacement cost, reflecting those situations where it would not be rational to replace a resource used by the business, was available in the form of ‘value to the owner’ (also referred to as ‘value to the business’ and ‘deprival value’), a concept usually attributed to Bonbright (1937). This is equal to replacement cost when it is rational for the business to replace, which will be whenever the replacement cost is less than the amount that the business expects to earn from selling the resource (net realisable value) or from using the resource on an ongoing basis in the business (‘economic value’, usually measured as the present value of incremental net cash inflows from using the resource). If it is not rational to replace the resource, then the resource is valued at net realisable value or economic value, whichever is greater. This approach to valuation is equivalent to opportunity cost, but it suffers from the practical difficulty that some or all of the three measurement bases (replacement cost, net realisable value and economic value) may not be easily observable, and all of them may involve some element of estimation.

### 4.3.3. The quest for accounting principles

Theoretical ideas in accounting often reflect the economic background against which they are developed. In the late 19th century, the growth of the corporate economy in the UK and USA gave rise to a demand for external financial reporting. This came against a background of long-term deflation, where the use of current values rather than cost-based measures for assets was perceived as introducing an undesirable element of volatility into profit determination. The 1920s were a period of inflation, when historical costs were increasingly out of date as indicators of asset values. The 1930s, on the other hand, were a time of economic depression, when investors and financial regulators reacted against what was seen with hindsight as the excessively optimistic financial reporting of the 1920s. This led to both a ‘mainstream’ and a ‘minority’ reaction. In the USA, the American Accounting Association published a short document containing various ‘accounting principles’ (AAA, 1936). This document proposed an ‘unexpired cost’ approach to measuring physical assets – the amount at which such assets were to be shown in the balance sheet was that part of the original cost that had not yet been treated as an expense relating to the use of the asset. The income statement was to show the period’s operating profit separately from capital gains and losses and extraordinary items, and accurate calculation of earnings per share was explicitly mentioned as a key aim of financial reporting. This was a system of strict historical cost, with profit determination being the main aim of financial accounting.

The AAA’s historical cost approach was to be largely endorsed by the US accountancy profession, and it was expanded upon by two important studies. The first of these was *A Statement of Accounting Principles* (Sanders, Hatfield and Moore, 1936). This was significant in introducing the notion of ‘generally accepted accounting principles’ (GAAP), which could be deduced from observation of accounting practice or from authoritative statements by recognised organisations or leading accountants (themselves likely to be distilling current practice). The second study, *An Introduction to Corporate Accounting Standards* (Paton and Littleton, 1940), is heavily focused on income measurement (the balance sheet is scarcely mentioned), driven by recognition of revenues, to which costs are matched (‘costs attach’ – Paton and Littleton, 1940: 13), while ‘unexpired costs’ are carried forward to later periods. Paton and Littleton propose an entity theory: ‘Accounting theory . . . should explain the concepts of revenue and expense in terms of enterprise asset-changes rather than as increases or decreases in proprietors’ or stockholders’ equities’ (Paton and Littleton, 1940: 9), with a presumption that the business entity is a going concern. Accounting is not about valuation: assets are acquired and paid for as sources of potential services, which are then utilised over time, so measures of current value are normally irrelevant.

However, acceptance of this historical cost approach was not unanimous. One important exception was Kenneth MacNeal, author of *Truth in Accounting* (MacNeal, 1939; see also Zeff, 1982). MacNeal argued that the use of historical costs provided managers with wide opportunities to manipulate reported earnings, for example through the timing of transactions and consequential recognition of gains and losses. Historical cost accounting also allowed for both understatement and overstatement of assets and liabilities: the amount at which an asset was shown in the balance sheet might bear no relationship to its current value. MacNeal saw the remedy as lying in the use of market values for items in the balance sheet. Market values, which MacNeal (1939: 87) emphasised were the prices at which commodities were actually being bought and sold, had the virtues of objectivity and verifiability (virtues that were also admired by Paton and Littleton, 1940: 18, but regarded by them as attributes of historical costs), and limited scope for managerial manipulation. As Zeff (1982: 539) observes, MacNeal was not an unqualified advocate of market prices: “MacNeal applies market prices only to marketable securities and raw materials. It was evidently his belief that other classes of assets could not normally be found to trade in acceptable markets.’ In such circumstances, MacNeal tended to favour replacement cost as a surrogate for market price.

By 1940, therefore, most of the elements of accounting theory that would be debated over the next 40 years or so were already in place. In the USA, statements of accounting principles were being promulgated, based on a combination of induction from existing practice and scholarly reflection, and these tended to uphold a conservative, historical cost-based form of financial accounting. On the other hand, some theorists found within economics a body of ideas and concepts that led them to advocate alternative measurement approaches, including replacement cost, discounted cash flow, market value and combinations of these. Issues of the measurement unit (money or purchasing power) and the components of income were associated with different views as to the objectives of corporate financial reporting, the stakeholders to whom businesses were deemed accountable, and the concepts of capital to be maintained. Over the following decades, these ideas were to be mobilised in different combinations by various ‘grand theorists’ seeking either general theories of accounting or more specific theoretical foundations for financial reporting.

## 4.4. Grand theories of financial reporting

### 4.4.1. Induction or deduction? Littleton versus Chambers

The late 1930s and early1940s saw the beginnings of formal involvement by professional accountancy bodies in the development of statements of accounting ‘principles’, although this term usually implied the provision of guidance on how to account for particular transactions and situations rather than general foundations for financial reporting. In the USA, the American Institute of Accountants started to issue Accounting Research Bulletins in 1939 (Previts and Merino, 1998: 284). In the UK, the Institute of Chartered Accountants in England and Wales began issuing its Recommendations on Accounting Principles in 1942 (Zeff, 2009). With a few exceptions, these pronouncements did little more than legitimise existing practice, and the recommendations and bulletins often lacked a statement establishing the reasons why the issuing bodies had reached the conclusions expressed in the documents. The dominant role played by preparers and auditors of financial statements in the development of these pronouncements meant that changes to current practice were resisted. To some extent, this resistance to change was endorsed by Littleton (1953), whose *Structure of Accounting Theory* put forward a ‘survival of the fittest’ view: accounting methods found in practice were likely to have survived because they were most appropriate. Hence, current practice should be the starting point for the accounting theorist, whose main role would be to extract the underlying principles and postulates that help to explain and structure observed practice. Given that existing practice in the 1950s was grounded in historical cost, matching and income measurement, which was consistent with the earlier Paton and Littleton (1940) study, Littleton’s approach defended rather than challenged the status quo.

However, several academic writers developed general critiques of existing financial accounting practice and often provided alternative systems. An early contributor not only in substantive terms but also in his analysis of what a theory of accounting should be was the Australian accounting professor Raymond Chambers (Gaffikin, 1994). In an early publication, ‘Blueprint for a theory of accounting’ (Chambers, 1955), he denounced those who described systematic descriptions of existing practice as ‘theories of accounting’, and suggested that a theory should involve ‘building up a series of relevant propositions from a few fundamental axioms’ (Chambers, 1955: 19). These propositions would enable ‘the development of ideal systems of accounts’ (Chambers, 1955: 24), and hence allow accountants not only to identify the flaws in current accounting practice but also to correct the flaws in a logical rather than ad hoc way. Chambers considered that the entities that carry on organised activities (including but not limited to businesses) are managed rationally, that ‘statements in monetary terms of the transactions and relationships of the entity’ help to achieve rational management, and that deriving such statements is a service function (Chambers, 1955: 19). To Chambers, an effective theory of accounting had to be ‘scientific’ in the sense that it was grounded in sound assumptions and principles from which hypotheses about the real world could be derived and tested. Although this provided a conceptual model of how Chambers saw the structure of an accounting theory, it needed to be fleshed out, and over the next ten years he drew on ideas from a wide range of disciplines, including management science, economics and psychology, to develop the system of Continuously Contemporary Accounting. His book *Accounting, Evaluation and Economic Behavior* (Chambers, 1966) represents a *tour de force* of eclectic scholarship, moving from multi-disciplinary theoretical foundations to practical recommendations. Chambers considered that the main requirement for financial reporting was to provide information about the ability of organisations to respond to changes in their circumstances, and this led him to favour the use of realisable values for assets (and settlement values for liabilities), with a stable purchasing power measuring unit to overcome the problem that measurements undertaken in previous periods were not directly comparable with contemporary measurements because of general price change.

### 4.4.2. The North American contribution

The 1960s saw a range of monographs and reports addressing the objectives of financial reporting and what these might imply for the detailed form and content of financial statements. Edwards and Bell (1961) attempted to develop a system for the measurement of enterprise income that would be useful for a wide range of users and that would overcome the problems of financial reporting in conditions of changing prices. Their system had similarities with that of Sweeney, with use of replacement costs for most assets (though with realisable values for short-term assets) and adjustments for general price change. Edwards and Bell focused on income rather than on the balance sheet, and critics regarded the use of a mixed measurement system as theoretically incoherent, but their income statement drew clear distinctions between profits from operations and from holding assets, ‘nominal’ gains (where the economic impact of general price change is disregarded) and ‘real’ gains (where the ‘fictitious’ profits generated purely by inflation are removed), and realised and unrealised gains (Tweedie and Whittington, 1984: 54). Separately measuring and reporting all these elements would make it possible for different users, with different perceptions of what constitutes income, to combine components of comprehensive income in the way they found most useful. The information perspective was taken further by Staubus, who asserted that ‘The purpose of accounting is to provide information which will be of assistance in making economic decisions’ (Staubus, 1961: 11). He focused on what he called the ‘investment’ decision, which related to granting credit to or investing in an economic unit, while sidelining other uses and users. Staubus argued that investors would be particularly interested in what he called ‘residual equity’: assets minus liabilities. This led him to emphasise the balance sheet over the income statement, with income being conceptualised as the change in residual equity. Staubus (1961: 51) ranked various measurement techniques in terms of their ‘relevance to residual equity holders’, preferring discounted future cash flows and net realisable values to replacement costs, with historical costs given the lowest ranking.

Other ‘grand theories’ were proposed by Mattessich (1964), who, like Chambers, drew on a wide range of disciplines, including management science, to develop an analytical framework for financial reporting, and by Ijiri (1967), who advocated the provision of ‘objective’ information and saw historical cost accounting as the best way of achieving this. Ijiri argued that the double-entry system, by recording transactions as they happened in a systematic way, provided the most appropriate basis for the provision of objective information. Sterling (1970), on the other hand, considered historical cost information to be effectively meaningless, and favoured current market prices as providing all of the information that would be relevant to the key economic decisions that he believed were fundamental to the use of financial statements. Moonitz (1961) and Sprouse and Moonitz (1962) used the approach of stating ‘postulates’ and deriving ‘principles’ to advocate a movement away from historical cost accounting and the then prevalent emphasis on income measurement.

### 4.4.3. Applying theories of accounting – standards and inflation

By the end of the 1960s, a wide range of theories of accounting existed. These theories almost always criticised existing accounting practice, which antagonised those practitioners who saw little if anything wrong with existing practice. However, they offered a wide range of remedies, which were often inconsistent with those of rival theories. For the remedies to be considered, the ‘patient’ – preparers, users and auditors of financial statements – needed to accept that accounting was ‘sick’, which would then provide a context for attempts to ‘make accounting better’ (Napier, 2006: 468). Two factors encouraged such self-awareness: financial scandals in the late 1960s in the USA, UK, Australia and other countries that exposed financial accounting as open to manipulation by unscrupulous managers, and the rapid increase in the rate of general inflation in the early 1970s, which seemed to suggest that historical cost accounting needed to be replaced by a system that dealt properly with changing prices. The solution to the first problem, improved procedures for issuing accounting standards, provided some promise to grand theorists of accounting that their ideas would be reflected in more rigorously grounded pronouncements, ultimately developed within a conceptual framework. An important catalyst for this was *A Statement of Basic Accounting Theory* (AAA, 1966), which endorsed the user needs/decision usefulness approach of Staubus and argued that this was best fulfilled through the provision of information on different bases, not just historical cost but also ‘current cost’ (essentially replacement cost) numbers. After the establishment of the Financial Accounting Standards Board in the USA in 1973, and other standard-setting bodies in predominantly English-speaking countries, financial accounting theory took the form of the development of a conceptual framework for financial reporting (this is considered later in this chapter).

Attempts to address the impact of inflation on accounting gained particular prominence in the UK. Academics at the London School of Economics, including William Baxter, Harold Edey and David Solomons (the so-called ‘LSE triumvirate’ – Whittington, 1994), had evinced a particular interest in accounting for price changes, with their ideas often communicated through teaching (many of the first generation of UK accounting professors studied at LSE) and articles in the professional accountancy press rather than monographs. Baxter’s major book, *Accounting Values and Inflation* (Baxter, 1975) summed up several decades of developing thought, and proposed a system combining the use of ‘deprival value’ for measurement of assets with general price level adjustment to address what Baxter called the ‘time-lag error’ arising from inflation. As Whittington (1994: 259) notes, Baxter’s more radical proposals were combined ‘with the traditional prudence of the professional accountant (in avoiding recording unrealised real holding gains in the profit and loss account).’ The rapid rise in general inflation in the early 1970s in the UK led the recently established Accounting Standards Steering Committee to propose a supplementary system of financial reporting based on a current purchasing power approach (basically historical cost adjusted for inflation using a general price index). The British government, which resisted the use of widespread indexation of prices and incomes for fear that this would lead to ever-increasing rates of inflation, set up a committee of enquiry into accounting for inflation (known, after its chairman, as the Sandilands Committee). The committee recommended a system of current cost accounting, with assets measured at ‘value to the business’ (that is, deprival value), but without any indexation of amounts in the financial statements to reflect general price change (Inflation Accounting Committee, 1975). Attempts to implement the recommendations of the Sandilands Committee met with resistance from accountants in practice and industry. A version of the proposals that incorporated some ad hoc adjustments was eventually to become a requirement for UK listed companies, as supplementary financial statements. The requirement lasted only for a few years, until the rate of inflation fell and an interest in adjusting financial statements to reflect the impact of price changes diminished.

The Sandilands Committee’s report is interesting for its attempts to base its recommendations on discerning ‘the requirements of users of accounts’ (Inflation Accounting Committee, 1975: para. 144), without necessarily providing specific empirical evidence of what users actually wanted. The style of reasoning, where conclusions are arrived at through the use of discursive arguments that are presented in a way that challenges readers to dare to disagree, echoes the writing style of many of the ‘grand theorists’ of accounting. But the debate over inflation accounting was perhaps the swan-song of grand theory, at least as a central factor in accounting discourse. This is not to suggest that theories *of* accounting disappeared; rather, it is to acknowledge that such theories became increasingly marginalised in academic accounting discourse. Instead, leading academic accountants in English-speaking countries began to claim that theories *of* accounting were not really ‘theories’ at all, and to advocate greater use of theories *about* accounting.

## 4.5. Theorising financial reporting within a (social) science framework

### 4.5.1. The rejection of grand theories

With few exceptions, the grand theorists believed that current financial reporting practice was deficient, and aimed for the improvement of accounting. But companies continued to use traditional accounting methods and reject what the grand theorists believed to be almost self-evidently superior approaches. Was there evidence that traditional methods actually served important functions? In other words, did traditional financial reporting meet the needs of relevant users better than alternative approaches? From the late 1960s, accounting researchers, particularly in the USA, attempted to explore these issues through research into the statistical relationship between information in financial statements and variables such as security prices and returns. A huge body of research followed the study by Ball and Brown (1968) of the extent to which variations in corporate earnings were associated with variations in stock market returns. Ball and Brown had begun their paper with a denunciation of grand theory, suggesting that theories *of* accounting could not be assessed independently of their own assumptions: ‘and how does one explain the predictive power of propositions which are based on unverifiable assumptions such as the maximization of utility functions?’ (Ball and Brown, 1968: 159). They set out to demonstrate that claims of grand theorists ‘that income numbers cannot be defined substantively, that they lack “meaning” and are therefore of doubtful utility’ (Ball and Brown, 1968: 159), had no empirical basis, and they were able to find a statistical association between the reporting of higher than expected earnings with super-normal share price returns, and between the reporting of lower than expected earnings with sub-normal share price returns.

The Ball and Brown study can be read as actually vindicating rather than refuting the claims of the grand theorists, as the researchers found that only a small amount of the variation in returns was explained by variation in reported earnings. They suggested that this was because most of the ‘information content’ of earnings announcements was already known to investors from other sources, so that annual financial statements largely functioned as confirmations of other information rather than news in their own right. However, theorists such as Chambers and Sterling were slow to respond to the new empiricism in financial accounting research. Perhaps this was because they saw this trend not as rejecting their general methodological approach but rather as putting it into practice. Chambers regarded the way he thought about accounting as ‘scientific’, and Sterling was subsequently to write a monograph with the title *Toward a Science of Accounting* (Sterling, 1979), so the claims of the new empirical researchers that they were ‘doing science’ could have been regarded as building on rather than as rejecting grand theories. But, by the mid-1970s, the grand theorists were increasingly marginalised in academic research (though they continued to be influential in standard-setting contexts).

### 4.5.2. Positive accounting theory

The research of Ball and Brown and their followers used economic theory, more specifically the new theory of finance that was emerging in the 1960s, to provide a justification of how accounting disclosures could be expected to affect security prices. When the empirical evidence supported theory-based predictions and hypotheses, this was interpreted as establishing the use (and hence usefulness) of accounting information. But the rapidly expanding programme of ‘market-based accounting research’ was, in the opinion of some researchers, not actually ‘accounting theory’ at all, but rather an application of finance theory. To count as ‘accounting theory’, within the social science model, theory should be explaining accounting practice, such as the choices made by firms and managers as to how to account for particular types of transaction and event, or the preferences of different individuals and groups for particular forms of accounting regulation, such as accounting standards. In short, accounting theory should explain and predict accounting choices. This implied that accounting theory should be a theory of human choice, and the dominant theory that attempted to explain human choice was neo-classical economic theory.

As this chapter has demonstrated, many of the grand theories of accounting appealed to economics, usually seeing the primary role of accounting as the provision of information useful for making economic decisions. But theorists had often characterised the information process as one of neutral and objective measurement of real-world phenomena. The new economic theory *about* accounting rejected this assumption of neutrality and objectivity, and argued that accounting numbers made a difference to the income and wealth of various individuals and groups involved in organisations. For example, managers were frequently rewarded through profit-related pay and through shares and options whose value depended on investors’ perceptions of a company’s financial position and future prospects. If financial statements provided information to investors in assessing these (and this was a core belief not only of grand theorists but also of accounting standard-setters), then managers would have a clear economic incentive to choose accounting practices that would be likely to lead to the reporting of higher profits. On the other hand, other stakeholders, such as lenders, might have an incentive to insist on accounting policies that led to reporting of lower profits and more conservative asset values, as this could enhance the security of their loans by restraining risky management behaviour. Ideas of how economic incentives and constraints, built into regulatory structures and contracts, could be predicted to influence accounting policy choices and preferences became formalised as positive accounting theory, associated in particular with Watts and Zimmerman (1978, 1986).

Advocates of this approach to accounting theory reject theories *of* accounting as ‘normative’, tainted because they lead to value judgements over which accounting methods are ‘better’ or ‘worse’ than others. A ‘positive’ theory, on the other hand, is seen as capable of escaping from value judgements. It ‘takes the world as it is’, assuming that economic actors such as managers and investors behave rationally, and that the outcome of rational economic choices is the best possible within the constraints of available knowledge, technology and institutions. The role of theory is to allow researchers to deduce hypotheses – predictions about the relationships between variables that can be tested by reference to real-world data. Positive accounting theory may provide predictions of how accounting regulators and standard-setters are likely to respond to self-interested lobbying by preparers, auditors and users of financial statements, and what may be the consequences of adopting particular accounting standards: it is not, however, the role of a positive theory of accounting to determine what those standards ought to be.

Positive accounting theory has been heavily criticised (often by grand theorists such as Chambers, 1993, and Sterling, 1990, but also by more radical scholars such as Tinker, 1988) for mistaking the important roles of theory in shaping a practical activity. To critics, accounting theory that does not help to guide accountants towards ‘better’ practices is of little value (although the critics do not agree on which practices are ‘better’). Moreover, positive accounting theory is criticised for hypocrisy – its use of neo-classical economic theory, privileging investors and creditors over other stakeholders, is claimed to be far from value-free. Accounting research within the positive tradition has become increasingly sophisticated in terms of its use of statistical techniques and mathematical analysis, but genuinely surprising findings emerge only rarely. However, positive accounting theory is not the only theory *about* accounting. Researchers have drawn on many different intellectual traditions and academic disciplines to provide theoretical frameworks for understanding aspects of financial reporting. For example, legitimacy theory (Suchman, 1995), which suggests that companies are granted an implicit ‘licence to operate’ by society that will be withdrawn or curtailed if companies are viewed as behaving in ways regarded by society as ‘illegitimate’, has been used widely as a way of explaining corporate social and environmental disclosures (see for example Deegan, 2002). Accounting researchers have moved beyond the financial statements to investigate and analyse corporate disclosures not just in printed annual reports but also through the internet (see for example Craven and Marston, 1999). There appears to be no limit to the disciplines from which theories *about* accounting may be drawn: for example, Davison (2007) uses the ideas of the French cultural theorist Roland Barthes to ‘decode’ photographs appearing in the financial reports of a non-governmental organisation.

There is no doubt that the wide range of theories *about* accounting, often applied in ways that their originators, in fields far from accounting, would not have predicted, has provided many insights into accounting and financial reporting practice in its widest sense. However, these theories are of little use to those who still see the main role of theory as lying in its capacity to improve accounting. Hence, theories *of* accounting, while out of favour for a long time in the academy (at least in English-speaking countries), insinuate themselves into the process of accounting regulation, through the need for accounting standards to be adequately grounded in a rational structure of principles –a conceptual framework. Hence this chapter concludes with a brief review of the tenacity of theories *of* accounting, while suggesting that the dichotomy between theories *of* and theories *about* accounting may be losing its relevance.

## 4.6. Conceptual frameworks

While much accounting research went off in an ‘archival-empirical’ direction from the late 1960s, accounting standard setters needed to have theoretical justifications to rationalise their pronouncements. Many of the leading theorists *of* accounting became involved as members or advisers of standard-setting bodies, while professional accounting organisations increasingly sponsored fundamental research. In the USA, the Trueblood Committee, established by the American Institute of Certified Public Accountants, reported in 1973 on the objectives of financial statements, endorsing the widely-accepted theoretical position that ‘The basic objective of financial statements is to provide information useful for making economic decisions’ (AICPA, 1973: 61). The Financial Accounting Standards Board regarded the establishment of a ‘conceptual framework for accounting and reporting’ as one of its main objectives, and the influence of theorists such as Staubus, Sterling, Solomons and other theorists may be detected in the various Statements of Financial Accounting Concepts that emerged from the Board over subsequent years (for an overall review, see Macve, 1997).

The Conceptual Framework embodied a range of theoretical notions, including the user needs/decision usefulness approach, a core belief that useful accounting information should be both relevant and reliable (later this was to develop into the notion of representational faithfulness), and an emphasis on the balance sheet (or statement of financial position) over the income statement. However, specifying a conceptual framework was not sufficient in itself to provide a mechanistic way of addressing financial reporting problems – the conceptual framework provided the language through which the problems could be analysed and debated, but not the ‘right answers’. This suggested to some theorists, for example Edward Stamp (CICA, 1980), that the nature of a conceptual framework had been misunderstood – it was not an axiomatic system of principles from which accounting practices could be deduced, but rather it was more like a legal constitution, which needed constant interpretation and reinterpretation. Arriving at solutions to accounting issues was more like the process by which judges reached verdicts and lawyers provided advice than like the activities of a mathematician or logician. Stamp’s understanding of the nature of a conceptual framework can be seen in the ways in which conceptual ideas are mobilised in accounting debates, for example the ongoing debate over fair value measurement. A distinguished example of this is provided by the analysis of fair value in the light of the current joint project to update the conceptual framework, being undertaken by the Financial Accounting Standards Board and the International Accounting Standards Board, where Whittington (2008) teases out the assumptions that he considers are implicit in the standard-setters’ position and proposes alternative assumptions, that would lead to different conclusions. This study demonstrates clearly the continuing relevance of theories *of* accounting.

To those who reject such theories, however, such assumptions are, in the words of Ball and Brown already quoted, ‘unverifiable’. To Watts and Zimmerman (1979), accounting theories were economic commodities that were demanded by regulators and others to provide rationalisations for their own self-interested positions on accounting practices, and supplied by professional and academic accountants seeking money and fame. To Hines (1991), accounting theories were a means by which accountants established and maintained their role in society and provided legitimacy to accounting as an occupational category. The mere existence of a conceptual framework, on this analysis, is as important as its substantive content. Theories *of* accounting tend to see the function of financial reporting as representing an economic reality that may be complex and difficult to discern but nonetheless exists independently of accounting. Hines (1988) denies this, claiming that accounting actually helps to construct the reality that it reports. This provides interesting opportunities for the future direction of financial accounting theory – the use of theories *of* accounting in addressing accounting issues can itself be an object of study that can be understood through the application of theories *about* accounting, while accounting standard-setters can use theories *about* accounting to make explicit the assumptions they make and pressures they react to when developing accounting proposals, rather than applying theories *of* accounting without being fully aware of what they are doing. To paraphrase Keynes (1936: 383), practical accountants, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct accounting theorist. The future role for theory in financial reporting may be to expose such slavery and at the same time provide the means for emancipation.

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