

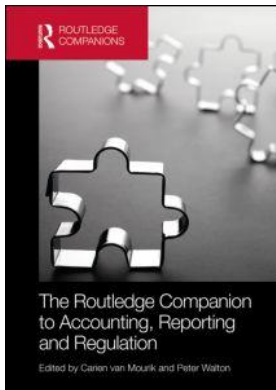
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### **Methodology in Financial Accounting Theory**

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# Methodology in Financial Accounting Theory

*Carien van Mourik*

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## 1. Introduction

Recently,<sup>1</sup> Baruch Lev outlined how accounting research has produced research findings that are relevant to society in the areas of regulations (e.g. related to the consequences of Sarbanes Oxley), investors (with respect to determining managerial quality) and managers (regarding the advantages of providing earnings guidance). He also noted that there has been a remarkable lack of progress in research, or even serious efforts, to improve the accounting model, its framework or its practices.

Similarly, Singleton–Green (2010) asked why accounting research doesn't make a greater contribution to debates on accounting policy. Singleton–Green (2010: 132–7) discusses eight causes. First, the volume and dispersion of research causes the outsider to not know where to begin. Second, non-academics often find research methodology, particularly quantitative studies using statistics and econometrics incomprehensible. This makes a large chunk of research indigestible to many with an interest in particular accounting policy issues. Third, there is much disagreement among researchers, particularly on the validity of the methodology or the relevance of evidence presented. Fourth, accounting research has become increasingly remote from practice so that policy makers and practitioners have come to regard academic research as irrelevant to their tasks. Here, Singleton–Green (2010: 134) also mentions what he calls 'the problem of ideology'. Fifth, policy makers and practitioners do not find research useful because the descriptive research has been dominant for the past four decades or so and does not and cannot present prescriptive conclusions. The last three causes can be found in the politics of accounting research and policy, the nature of the public debate and the nature of the existing academic incentives that push researchers towards attempting to publish in highly ranked journals which appear to prefer quantitative research and eschew any topic and research method deemed unscientific. As a consequence, one can have a career as an accounting academic without thorough knowledge of accounting theory or practice.

Of the eight causes described by Singleton–Green, the third, fourth and fifth relate to methodology as it is used in this chapter: 'the logic of scientific procedure' (Merton, 1967: 140). In social science, this logic takes the form of philosophical assumptions about the social phenomena

we study and about the basis on which and the way in which we justify our knowledge claims. What Singleton-Green calls ‘methodology’ this chapter regards as ‘research methods’. Many people use the terms ‘methodology’ and ‘methods’ more or less interchangeably. Accounting PhD students, depending on their specialist subject area, will often receive a thorough training in either quantitative or qualitative research methods (or both), but rarely receive even a rudimentary grounding in social science research methodology. As the emphasis is on technical skills, it is likely that few see themselves as social science researchers. An important challenge in the social sciences is how to deal with something as subjective, context-specific and generally unscientific as value judgements.

This chapter discusses positions and developments in social science methodology, and how they are relevant for financial accounting and reporting theory and research today. An understanding of social science methodology is useful for understanding the assumptions we often make without being aware that we do, or when we intend to follow other researchers’ methods and wish to know on which implicit assumptions their research questions and their methods are based. Understanding methodology can help us identify which, if any, of the assumptions we hold are inconsistent with one another. As there is no absolute basis on which to judge the value of one methodological paradigm over another, methodology cannot prescribe what assumptions to make.

Section 2.2 starts with different definitions, purposes and scope of theory. It then defines methodology and discusses ontological assumptions with respect to the nature of social reality, and epistemological assumptions with respect to different types of knowledge and the criteria that beliefs and statements would need to meet to be accepted as propositional knowledge of phenomena studied in the social sciences. Section 2.3 illustrates how different ontological and epistemological assumptions form the basis for some important theories in sociology and other social sciences which have also influenced different strands of accounting theory. The different assumptions form the basis for methodological debates in the social sciences. Section 2.4 discusses different types of financial accounting theory by their objectives and introduces the literature on financial accounting theory typologies. Section 2.5 concludes.

## 2. Theory and methodology

### 2.1 *What are theories?*

A theory consists of a propositional claim supported by an argument, which allows the claim to be evaluated and substantiated. An argument is a presentation of one or more reasons (premises) offered in support of a claim (conclusion). An argument can be distinguished from an opinion because an opinion is not backed by evidence. An argument will first need to be evaluated with respect to the clarity, truth or falsity, and plausibility of the reasons. Then it will need to be evaluated with respect to cogency. ‘A cogent argument will be either (1) a valid deductive argument with acceptable premises, or (2) an inductive argument with acceptable premises in which the reasoning from the premises to the conclusion is legitimate and sensible’ (Murray and Kujundzic, 2005: 10–11). ‘A deductive argument asserts that the conclusion necessarily follows from the premises. . . . An inductive argument, on the other hand, asserts that there is (merely) a good chance that the conclusion follows from the premises’ (ibid.: 307). The validity of a deductive argument will need to be tested using logic, whereas an inference based on inductive generalization will need to be assessed using probabilistic reasoning and empirical data.

In their textbook on critical thinking, Hughes and Lavery (2008: 212–13) define a theory as:

a systematically integrated set of general principles, methods of investigation, and concepts whose function is to explain a wide array of phenomena. Theories generate hypotheses about specific phenomena, but, significantly, they also provide the filter or lens through which we interpret the observations that test hypotheses. . . . The interpretive role performed by a theory in formulating a precise observation statement is the ultimate source of some of the most profound controversies in science.

At least partly, the interpretive filter of a theory in any of the social sciences, stems from the methodology, which is ‘the logic of scientific procedure’ (Merton, 1967: 140) embodied in philosophical assumptions with respect to social reality, ‘scientific’ knowledge and the role of the researcher and his or her relation to the phenomenon to which the theory pertains.

Theories will vary in nature, depending on the underlying methodology, objective and scope. Some theories are meant to describe an observed phenomenon or to classify phenomena into groups based on shared characteristics. Others are intended to explain a phenomenon and make predictions about future phenomena in the form of testable hypotheses. Yet other theories seek to understand and interpret an individual action or phenomenon. In terms of scope, theories may range from the small, specific and sharply delineated, to the generalizing and more broadly defined middle-range, all the way to ambitious grand unifying theories.

In accounting and other social sciences, theories often have a normative or even moral dimension. Strictly speaking, such theories are not scientific theories because their evaluation depends on epistemic criteria and methods of evaluation as well as moral, practical and prudential/political criteria and methods of evaluation. As a consequence, different theories, methodologies and research paradigms may be incommensurable and have to co-exist because, as of yet, ‘they are not capable of being measured by a common standard’ (Hughes and Lavery, 2008: 213). In this case, the dominance of one particular theoretical paradigm will in practice depend on other factors than purely epistemic criteria.

## 2.2 What is methodology?

The interpretative filter of a theory stems partly from the methodology or ‘the logic of scientific procedure’ (Merton, 1967: 140). This logic depends on the philosophical assumptions regarding the nature of social reality, knowledge and the role of the researcher in relation to the phenomenon to which the theory pertains. It is important to keep in mind that both the logic and the problems of social science methodology ‘transcend those found in any one discipline’ (Merton, 1967: 140).

### Ontology: assumptions about the nature of reality

Ontology refers to assumptions about the nature of reality. Many researchers distinguish between the natural sciences and the social sciences because they believe that natural phenomena and social phenomena are fundamentally different. Theories in the natural sciences are generally aimed at the description, categorization, explanation and prediction of natural phenomena. They are often based on the ontological assumptions of materialism and realism:

Materialism is the view that everything in the world is made of matter. . . . Idealism is the view that what is real depends on the mind, and in the philosophy of perception it amounts to the claim that the material world does not exist outside of the mind (Cardinal *et al.*, 2004: 106).

Table 2.1 Ontological assumptions about the nature of reality

	<i>Natural sciences</i>	<i>Social sciences</i>
Materialism	Reality consists of matter → Realism	Ultimately, it is material wants and needs that drive social development → Realism
Idealism	Reality does not exist outside the mind that perceives it → Relativism	Ultimately, it is values and ideas that drive social development → Relativism
Dualism	Reality consists of both matter and ideas → In between Realism and Relativism	Social development is driven by both material wants and needs and by values and ideas → In between Realism and Relativism

Dualism claims that reality consists of both matter and mind. Realism is rooted in the belief that natural phenomena exist independently of the researchers who, therefore, are able to observe them from an objective spectator's view. The above is summarized in Table 2.1.

'The natural sciences are concerned with contingent regularities between two phenomena out of which we construct universal laws of nature' (Benton and Craib, 2011: 89). For the purpose of prediction, research methods will often approximate causality with statistical regularity and will make use of inductive reasoning. That is, generalizations are made on the basis of observed regularities. Social science researchers taking a naturalistic stance believe that the logic of explanation and research methods of the natural sciences (naturalistic methods) are generally suitable for application to social science questions as well. Others simply reject the use of anti-naturalistic methods as unscientific and will limit themselves to questions that are deemed answerable using naturalistic methods, i.e. 'scientific'.

Social science researchers taking an anti-naturalistic stance believe that observing society and individuals is complicated by the fact that the observer is also an individual with beliefs and values, and is part of a society. Furthermore, the observers and the observed possess self-consciousness, creating a 'double hermeneutic' which can lead to reflexivity where the observer and the observed tend to influence each other in the process (Benton and Craib, 2011: 76). Consequently, it is important to understand the reasons behind social science phenomena as well as the meaning and purpose of actions of both the observed and the observers. Relativism as an ontology requires a logic and research methods that take into account that theories are often value-laden and that objective observation is not always possible or even desirable. According to relativism, what counts as knowledge is often dependent on cultural and historical context (Boumans and Davis, 2010: 126). The above is summarized in Table 2.2.

It is important to note that there are many positions in between naïve or direct realism as the extreme realist position and radical relativism as the extreme relativist position. Direct realism assumes that the world is as it appears, or, in other words, that we perceive things as they are, which presupposes that we already know what they are like. Indirect or representative realism distinguishes between the objects we perceive and our perception or sensation of these objects (Cardinal *et al.*, 2004: 98–104). Further forms of realism include structural realism (Worrall, 1989, in Bortolotti, 2008: 108), internal realism (Putnam, 1987, in Bortolotti, 2008: 109) and critical realism (Bhaskar, 1975, 1978, in Benton and Craib, 2011: 202–17) among others. On the other side of the continuum, Paul Feyerabend's radical relativism holds that in the absence of theory-neutral tests to choose between incommensurable research paradigms, 'there are no methodological principles which distinguish science from non-science, and so no reason for thinking science is superior to other forms of understanding the world' (Benton and Craib, 2011: 61).

Table 2.2 Naturalism and anti-naturalism in the social sciences

	<i>Naturalism</i>	<i>Anti-naturalism</i>
Researcher	<i>Realism</i> : Phenomena exist independently from the researcher who can and must be an objective observer ( <i>Objectivism</i> ).	<i>Relativism</i> : Researchers cannot perceive phenomena objectively. Researchers will to some extent construct the reality they are observing ( <i>Constructivism</i> ). Observations will be subject to the double hermeneutic.
Task	Researchers must seek to discover empirical regularities in order to explain and predict phenomena.	Researchers must seek to interpret actors and actions in order to understand individual actors' intentions and the meaning of individual actions.
Paradigm	Positivist paradigms.	Interpretivist paradigms.

### Epistemology: assumptions about knowledge, truth and justification

In *Nicomachean Ethics*, Book Six, Aristotle defines five intellectual virtues as the 'ways in which the soul arrives at truth' (Aristotle, 1976: 206). These include *episteme* (propositional, factual or scientific knowledge), *techné* (art or technical skill), *phronesis* (prudence or practical wisdom), *nous* (intelligence or intuition) and *sophia* (wisdom) (Aristotle, 1976: 207–13). Flyvbjerg (2001: 53) sees *phronesis* as the practical knowledge of how to balance instrumental rationality with value-rationality, and advocates a phronetic social science. A phronetic social science would give due consideration to:

- values and ethics (Flyvbjerg, 2001: Chapter 5);
- balancing conflicting interests; and
- preventing the abuse of power (Flyvbjerg, 2001: Chapters 7 and 8).

Phronetic knowledge is the kind of knowledge that Aristotle saw 'as the necessary basis for political and social enquiry . . . because such balancing is crucial to the sustained happiness of the citizens in any society' (Flyvbjerg, 2001: 4).

Epistemology is the theory of propositional (scientific) knowledge and its criteria. According to what is called the traditional justified true belief (JTB) view<sup>2</sup> of propositional knowledge, 'knowledge requires epistemically justified true belief' (Lemos, 2007: 3). A stricter definition holds that that factual knowledge requires an 'indefeasibly justified, true belief' (Cardinal *et al.*, 2004: 141). In other words, only true beliefs which cannot be defeated by further evidence count as propositional knowledge. According to this definition, much of what we currently use as knowledge in our daily lives is not actually *episteme* although it may be very useful. A problem with the JTB view of knowledge is that some cases of epistemically justified true belief are not instances of knowledge because they are a matter of luck or sheer coincidence.<sup>3</sup>

Although phronetic knowledge differs from epistemic knowledge in terms of its purpose, it also depends on evidence and logic for its epistemic justification. A difference is that, in addition to epistemic justification, it also requires explicit moral and prudential (i.e. self-interested and political) justification which is necessarily context-dependent.

Agrippa's trilemma suggests three unpalatable options for the justification of beliefs (Pritchard, 2010: 33). The first is that we do not support our beliefs, in which case a sceptic might argue that we probably do not have propositional knowledge. A foundationalist, however, believes that there is knowledge in the form of beliefs that justify themselves or beliefs that need no further

justification because they are axiomatic and therefore do not require proof. This type of foundational knowledge forms the bedrock for all other knowledge that is built on top of it. Foundationalists believe that knowledge ultimately comes through perception and observation (empiricism) or through logical thought (rationalism), or perhaps through both. Rationalism searches for universal laws and truths deduced from general axioms which hold with necessity (Hollis, 2002: 29). Rationalism in science assumes that logical necessity equals causal necessity, but logical necessity cannot be proved because all proof presupposes the necessary laws of thought (Hollis, 2002: 36). Rationalists will look for the equivalent of natural laws underlying either the structures of society or causing the behaviours of the individuals in it, using deductive logic. Empiricism in science starts from the experience of sense perception of particulars, and uses inductive generalization to infer relations between cause and effect based on probability. Empiricists will attempt to infer the social equivalent of natural laws on the basis of statistical regularities. When inspired by the ideas of logical positivism (see below) in the natural sciences, empiricism applied to the social sciences or humanities is often referred to as Positivism (Hollis, 2002: 41–2).

There are at least two anti-foundational views on the justification of beliefs in answer to Agrippa's trilemma. One is to assume that our beliefs are justified when they are supported by another belief, which is in turn, inferred on the basis of another belief *ad infinitum* (infinetism). The other is to assume that a coherent chain or system of beliefs (coherentism) can justify our belief in a proposition (Pritchard, 2010: 33–6). However, even if this chain of beliefs is circular instead of infinite, the infinite regress argument shows that 'if all justification is inferential, no belief is ever more than conditionally justified' (Dancy, 1985: 56). Pragmatism is another anti-foundational approach to the justification of beliefs based on the criterion of usefulness.

If propositional knowledge requires one's belief to be both justified and true, what is the nature of truth? Correspondence theory holds that the truth of a proposition depends on its correspondence with reality.<sup>4</sup> Coherence theory, on the other hand, claims that the truth of a proposition depends on its coherence with other beliefs we have.<sup>5</sup> The coherence theory of truth takes coherence to be a condition of truth as well as a source of justification. The pragmatic theory of truth holds that usefulness is a good criterion to distinguish a true belief from a false belief.<sup>6</sup> The above is summarized in Table 2.3.

Table 2.3 Examples of epistemological assumptions about knowledge

	<i>Foundationalism</i>	<i>Anti-foundationalism</i>
Knowledge	The foundations of knowledge are axiomatic beliefs and beliefs that justify themselves. Other knowledge is built on those foundations.	<i>Infinetism</i> : Beliefs are justified by other beliefs <i>ad infinitum</i> . <i>Coherentism</i> : A coherent system of beliefs can justify our beliefs in a proposition.
Sources of knowledge	<i>Rationalism</i> : Knowledge increases through logical deduction. <i>Empiricism</i> : Knowledge increases through inference based on perception and observation.	Beliefs can only be conditionally justified. If the premises or conditions change, beliefs may need to be discarded or adjusted.
The nature of truth	<i>Correspondence theory of truth</i> : A proposition is true if it corresponds with reality.	<i>Pragmatic theory of truth</i> : Usefulness is a good criterion for justification. <i>Coherence theory of truth</i> : Coherence with other beliefs is a condition of truth as well as a source of justification.

## Demarcation attempts and research paradigms

In the late nineteenth and early twentieth centuries, logical positivists argued for a demarcation between scientific statements (which are synthetic statements that can be verified through experience), and analytic and synthetic statements of logic, philosophy, religion, literature, etc., which are not empirically verifiable (Bortolotti, 2008: 8). More recently, Karl Popper believed that ‘science differs from pseudo-science in that it aims at falsifiable hypotheses’ (Bortolotti, 2008: 14). Popper presented his falsification theory as a rejection of the logical positivist’s belief in foundational knowledge (Hollis, 2002: 72–3). However, it was the distinction between science and pseudo-science that caused social scientists, particularly in economics and later in accounting, to go on the defensive and try to make their social sciences appear as scientific as possible.

### 3. Methodological debates in the social sciences

Below is a very brief discussion of some important social science research paradigms, which illustrates the importance of the ontological and epistemological assumptions for the formulation of theories in social science. The discussion starts with the Enlightenment where the groundwork for future naturalistic paradigms was laid, and Romanticism which developed in response to the Enlightenment’s rationalism and empiricism and bore the seeds of anti-naturalistic paradigms. It then moves on to naturalistic paradigms characterized by methodological holism (functionalism and conflict theory) and anti-naturalistic paradigms characterized by methodological holism (critical theory and various forms of Marxism). From there it moves to naturalistic paradigms characterized by methodological individualism (rational choice and exchange theory) and anti-naturalistic paradigms characterized by methodological individualism, and ends with globalization paradigms.

#### 3.1 *Enlightenment and romantic paradigms*

Enlightenment thinking came to prominence in the eighteenth century, particularly in France, and had three main themes. First, advances in the natural sciences led to an emphasis on scientific reasoning instead of reliance on the authority of the Church when trying to understand the universe and the place of individual humans in it. Second, the power of rational thought came to be used to expose the abuse of power by the aristocracy and the Church. Finally, there was a belief in progress ‘from simple social orders to more complex ones, and away from more despotic and exploitative political and economic systems towards more egalitarian ones’ (Inglis with Thorpe, 2012: 28–9). Romanticism arose as a critical response to Enlightenment thinking. It criticized materialist values and a social order that destroyed any sense of community, it defended traditions, cultural diversity, and it ‘regarded human mental capacities as being a mixture of more rational and more imaginative and emotional characteristics’ (ibid.: 30).

Positivism (which seeks to explain and predict phenomena) has its origins in Enlightenment thinking, whereas interpretivism (which seeks to interpret and understand reasons, motivations and actions) finds its origins in Romanticism. Similarly, the ontological dispute between materialism and idealism stems from Enlightenment and Romantic thought. Materialism (and Enlightenment thought) holds that social order is driven more by material, economic and technological factors, whereas idealism (and Romanticism) maintains that social order is more dependent on ideal phenomena such as culture, values and ideas (ibid.: 32).



### 3.2 *Naturalistic paradigms characterized by methodological holism: functionalism and conflict theory*

Inspired by the natural sciences, and in particular biology, sociologists such as Talcott Parsons and Robert Merton saw society as ‘a kind of *system* comprised of interrelated parts’ (O’Byrne, 2011: 14), and developed a theoretical approach based on ontological holism (the idea that social structures rather than individual actors and actions are the real building blocks of social reality) named structural functionalism. Functionalism derives from Herbert Spencer’s ideas about evolution towards increasing structural complexity through the process of differentiation and Emile Durkheim’s idea that complex social systems are held together by a common culture including shared norms and values (Inglis with Thorpe, 2012: 38–42). Research questions within this paradigm tended to centre on the problem of socialization (or social integration) and modernization from a top-down perspective. Individual agents, their motivations, choices and actions did not receive much attention.

Parson’s optimism about modern societies and the USA in particular (ibid.: 53) was apparent in the presumption was that social change was necessarily progressive (O’Byrne, 2011: 40) and leading towards a better, more modern future embracing free market capitalism and political democracy. Criticism of the functionalist approach derived from its tendency to define the ideal state or ideal society based on pro-Western values, and its view of disagreement, conflict and violence as a malfunction of the system which needs to be fixed rather than accommodated (O’Byrne, 2011: 46–7).

Conflict theory developed in response to functionalism and was inspired by Weber and Marx (Inglis with Thorpe, 2012: 54). It assumed that ‘conflict exists as a basic property of society, and forms the arena in which rival interest groups compete’ (O’Byrne, 2011: 48). Unlike Marxism, which holds that the conflict in society is based on class relations defined in economic terms (named dialectic materialism), the conflict theorist Ralph Dahrendorf held that class relations were ‘defined by an uneven distribution of *power*’ [italics in original] (ibid.: 49).

### 3.3 *Anti-naturalist paradigms characterized by methodological holism: Marxism and critical theory*

Marxism is anti-naturalist because it assumes that researchers, confronted with the objective reality of class struggle and other social phenomena they associate with the ills of capitalism, will take an ideological position from which to conduct their analyses in order to either defend the status quo or to try and change it. In the twentieth century, many different types of Marxism appeared. ‘Two of the most important versions of Western Marxism are the ‘critical theory’ associated with the Frankfurt School, and hegemony theory, first formulated by Antonio Gramsci’ (Inglis with Thorpe, 2012: 63).

Central in the early Frankfurt School (about 1920–60) was Adorno and Horkheimer’s critical theory, which had the intention of identifying and overcoming the ideological repression mechanisms of capitalist society (ibid.: 69). From the 1960s, the later Frankfurt School under Habermas developed ideas about ‘discursive democracy’ and ‘communicative rationality’ as means to use rationality to bring about emancipation and freedom (ibid.: 73–80). Gramsci’s hegemony theory is about how, under capitalism, political and cultural processes serve to manufacture consent from those it exploits (O’Byrne, 2011: 72) and how ruling class hegemony is always potentially fragile because ideological domination is rarely complete and stable (Inglis with Thorpe, 2012: 80–84).

### 3.4 *Naturalistic paradigms characterized by methodological individualism: rational choice theory and behavioralism*

Exchange theory in sociology and rational choice theory in economics are characterized by the methodological individualism also found in utilitarianism in ethics and behaviourist psychology. These have in common that they assume that all humans are motivated by self-interest, the maximization of their happiness (or utility or wealth), and are rational in the way they pursue their self-interests. This leads to the idea that, in all aspects of our lives, we behave more or less the way we do in market situations (Hollis, 2002: 115). ‘Rational action is thus instrumentally rational action’ (ibid.: 118). Hence, exchange theorists believe that in order to understand how individual actions shape society (i.e. the total outcome of all individual choices), it is necessary to observe the outcomes of the choices made by individual agents.

When looking at society as a functional structure, or as dominated by class structures or interest groups, society determines the fate of the individual. Although an individual agent has the capacity to freely make choices, the scope of these choices is largely determined by the opportunities inherent in the structure of society. Somewhat surprisingly because of their focus on the individual, utilitarianism, behavioralism, rational choice theory and exchange theory treat the individual as largely predictable (O’Byrne, 2011: 138). ‘By stating what conditions preferences ought to satisfy, rational choice theory prescribes how individuals ought to choose in order to be rational’ (Boumans and Davis, 2010: 177). Hence, although under rational choice theory, society is not assumed to limit the scope of the choices available to the individual, the individual’s actual choice is severely limited by a value-laden interpretation of rationality (ibid.: 177–80). Similarly, in behavioralism, the individual’s choices are deemed predictable because of behavioural biases that are either innate or the consequence of conditioning. In sum, some level of determinism is inherent in naturalistic approaches to social science irrespective of whether they are based on ontological and methodological holism or ontological and methodological individualism.

### 3.5 *Anti-naturalist paradigms characterized by methodological individualism: symbolic interactionism, ethnomethodology and phenomenology*

Anti-naturalistic approaches to social science characterized by methodological individualism are likely to be rooted in the ontological assumptions of idealism and relativism. Relativism as an ontology presupposes that social phenomena and social actions need to be understood, interpreted and explained from the point of view of actors and participants in specific context. Truth and knowledge are seen as context-dependent rather than absolute concepts. Symbolic interactionism, associated with George Herbert Mead, is a sociological approach to understanding how an individual’s concept of self is formed through social interaction. It is rooted in the pragmatist theory of knowledge, which sees truth as a convenient fiction (O’Byrne, 2011: 139–47). Symbolic interactionism often applies case studies and ethnographic research methods and uses grounded theory (theory that emerges from and is useful in a particular situation, see O’Byrne, 2011: 141). Important insights include the way social ‘labels’ and roles influence an individual’s concept of self.

Ethnomethodology is another theoretical approach in sociology based on relativist ontology. It seeks to understand how social reality is the product of human perception instead of the other way around. Important insights include the idea that social structure is a negotiated order which is inherently unstable. Individuals develop ways of dealing with the complexity of life, for example by devising techniques of neutralization (leading to cognitive dissonance) and strategies to legitimize their actions (O’Byrne, 2011: 173–4).

### 3.6 Globalization and institutional paradigms

In most social science disciplines, the notion of society was and still is decidedly territorial. However, economic, political, technical, social and cultural facets of globalization manifest themselves at distinctly different paces creating the need to transform the nature of theorising (Inglis with Thorpe, 2012: 259–61).

Those working within a positive economics paradigmatic framework tend to stress the positive potential and benefits of globalization. For example, Mishkin (2006: 5) claims that economic and financial globalization leads to a reduction of poverty in developing countries that are willing and able to become export-oriented (see Chapter 10). On the other hand, Hymer (1970) predicted two consequences of the fact that political globalization is trailing behind economic globalization, which Basu (2010) in *Beyond the Invisible Hand* identifies as having materialized. One is erosion of democracy. Reich (2009), too, presents an account of the erosion of democracy in democratic capitalist countries in the current age of big business. The other is ‘the tolerance of global inequalities that would not have been tolerated in any economy under any single government’ (Basu, 2010: 182–3).

In business history research has been conducted from a comparative institutional perspective since the early 1980s (e.g. Chandler, 1980). In economics, new institutional economics gained traction from the early 1990s. In financial accounting, a comparative institutional perspective initially served to describe and classify accounting practices across the world (e.g. Mueller, 1967; Nobes, 1983 and Mueller *et al.*, 2004). Classification was criticized by Roberts (1995). The search went on to explain these differences, first in terms of culture (e.g. Gray, 1988) and later in terms of predominant modes of financing (e.g. Nobes, 1998).

The legal systems, financial systems, corporate governance systems and other institutional factors analyses by La Porta *et al.* (1997, 2000) inspired comparative institutional analyses, such as Ali and Hwang (2000), Ball *et al.* (2001), Bushman *et al.* (2004) and Leuz *et al.* (2003) opening the door to new institutional accounting research. However, it was the realistic chance of worldwide adoption of IFRS after 2005 that necessitated consideration of international differences in institutional environment in earnest. Examples of neo-institutional international accounting research, which is intentionally based on the ideas of new institutional economics, include Leuz (2010) and Hail *et al.* (2010). An example of the new institutional perspective that does not have either an international or a managerial/organizational focus is Bealing (1994).

‘The central message of new institutional economics is that institutions matter for economic performance’ (Furubotn and Richter, 2000: 1). It is about ‘designing effective and efficient institutions to structure behavior in such a way that the system performs well’ (Groenewegen *et al.*, 2010: 32). Recognizing that neoclassical theory neglects institutional constraints and transaction costs, new institutional economics, often associated with Williamson (1975) and North (1990), is based on similar methodological assumptions and uses similar methods of analysis to extend microeconomics. These assumptions include:

1. methodological individualism;
2. utility maximization;
3. individual rationality;
4. opportunistic behaviour;
5. a society where the transfer of property rights by physical force or other forms of compulsion does not exist;
6. the society’s governance structure protects private property rights; and
7. the definition of institutions as ‘a set of formal and informal rules, including their enforcement arrangements’ (Schmoller, 1900, in Furubotn and Richter, 2000: 6).

For a detailed overview of these methodological assumptions, see Furubotn and Richter (2000: Chapter 1) or Groenewegen *et al.* (2010: Chapter 2) for an informative comparison of the methodological assumptions of both schools of thought.

The original or ‘old’ institutional economics paradigm, is often associated with Thorstein Veblen (1899) and Commons (1931). Veblen criticized orthodox theories from the classical theory of Smith to the neoclassical theory of Marshall as ‘contaminated by taxonomic, hedonistic and teleological theoretical attitudes’. He regarded the orthodoxy as taxonomic because it classified economic problems without really explaining them, hedonistic because the utility maximising *homo economicus* was invented without regard for the psychological causes of human behaviour, and teleological because the use of concepts such as ‘equilibrium’ was normative and convenient for developing static models that detract from the evolutionary ways in which economic society develops (Screpanti and Zamagni, 2005: 302–3). Commons believed that the study of ‘collective action’ should be at the centre of economics because society is formed by individuals who must maintain ‘strong relations of interdependence, both in conflict and in co-operation’ (ibid.: 306). He assumed that power relationships among contracting parties often influence bargaining outcomes more strongly than demand and supply in competitive markets.

The original or ‘old’ institutional paradigm is therefore based on the following methodological assumptions:

1. methodological holism;
2. satisficing behaviour;
3. bounded or perhaps procedural rationality, such as habits and due process;
4. opportunism must be balanced by trust;
5. property rights are not distributed equally and the institutions to protect them are shaped by a political system which reflects the power structures in a society (or international society); and
6. the human environment necessitates increasingly complex institutions, which include shared mental maps and learning in order deal with both complexity and uncertainty (see Groenewegen *et al.*, 2010: 72–7).

In financial accounting research, examples of research based on methodological assumptions of old institutional theory would be the political economy view of A. M. Tinker (1980) and Cooper and Sherer (1984), the socio-historical approach by Merino and Neimark (1982), research based on Di Maggio and Powell’s (1983) idea of institutional isomorphism<sup>7</sup> such as Carpenter and Feroz (2001) or the socio-economic consequences view of Someya (1993). In international financial accounting standard setting research, examples of studies based on the assumptions of the original institutional economics include Mattli and Bütke (2005), Botzem and Quack (2009), Chiapello and Medjad (2009), and Arnold (2012).

### 3.7 What might methodological debates mean for financial accounting and reporting theory and research?

Paradigm clashes and methodological debates in financial accounting research have become rare. An example from the early 1990s is Solomons (1991a) criticising Tinker (1985), Tinker’s (1991) response and Solomons’ (1991b) rejoinder. This exchange clearly illustrates the incommensurability of a paradigm that sees accounting as a technical discipline where the practitioners and standard setters can and must be neutral between competing interests and a paradigm that regards accounting practice and standards as shaped by dominant vested interests. It also shows

the investment of personal values in so-called intellectual positions, and illustrates the confusion that results when we lack understanding of methodological issues and assumptions.

Superficially, financial accounting (like economics) displays a misleading image of being scientific and technical and therefore neutral, objective and value-free. Yet, at the same time, there are few disciplines that share financial accounting's importance in decisions on allocating resources and distributing income and wealth. This tension between the image of objectivity and neutrality and the reality of economic and political interests manifests itself most clearly in the areas of accounting regulation, standard setting and auditing, and particularly in an international context.

A better understanding of methodology might help (international) financial accounting and reporting research move beyond the damage that was done by the demarcation attempts. Debating methodological assumptions might help mainstream financial accounting and reporting research to acknowledge its hidden value judgements. It might help interpretive research to search for general principles across multiple contexts rather than regard everything as context-dependent. It might help critical accounting research be constructive as well as critical. It is unlikely that there is one methodological paradigm that has a monopoly on epistemic knowledge that helps improve the allocation of financial, natural, human and knowledge resources and the distribution of income and wealth across the globe. However, leaving accounting policy, standard setting and regulation decisions to public choice processes without a structural and balanced input of both epistemic and phronetic knowledge appears to be asking for trouble.

## 4. Financial accounting theory

### 4.1 *What is the goal of financial accounting theory?*

On the mainstream, positivist view,

[t]he goal of accounting theory is to provide a set of principles and relationships that provide an explanation for observed practices and predict unobserved practices. That is, accounting theory should be able to explain why business organizations elect certain accounting methods over other alternatives and predict the attributes of firms that elect various accounting methods. Accounting theory should also be verifiable through accounting research (Schroeder *et al.*, 2001: 1).

This view ignores the interpretive role of theory in choosing and framing a particular research problem. It is rather limited because, as in any discipline, financial accounting theories will vary in nature, depending on the underlying methodology, objective and scope. In sum, there is not one single objective of accounting theory.

### 4.2 *Types of financial accounting theory by objective*

The body of financial accounting and reporting theory incorporates many types of theories. In terms of their objectives there are, among others, descriptive theories, prescriptive theories, inductive (predictive) theories, interpretive theories, critical and institutional theories. Descriptive accounting theories will often aim to provide a precise descriptive definition of something or identify and describe phenomena or methods used in practice. An example of the former would

be descriptive definitions of accounting such as those found in Sanders *et al.* (1938: 4) or the somewhat broader definition in AAA (1966: 1). An example of the latter would be *Accounting: Its Principles and Some of its Problems* by Hatfield (1909). The above three represent descriptive definitions based on observation. Sprouse and Moonitz (1962: 6–7) represent a deductive approach to the identification of the functions of accounting based on five postulates.

Prescriptive theories may come in the form of prescriptive definitions, or in the form of rules or prescriptive methods. Rationalism is the epistemological approach to gaining knowledge using deductive logic and basic propositions which are assumed to be fundamental truths. An example of a prescriptive definition is the objective of general purpose financial reporting in the IASB Conceptual Framework (IASB, 2010: OB2). This definition is not based on deductive logic or any other explicit form of epistemic justification in the Conceptual Framework. Presumably, it derives its justification from the authority of the IASB members or is assumed to be a fundamental truth as it has been adopted from the FASB Conceptual Framework (FASB, 1978). Prescriptive income and capital concepts and income determination theories are discussed in Chapters 3, 4 and 5.

Positive or inductive theories ‘seek to explain and predict particular phenomena’ (Deegan and Unerman, 2006: 206). In the social sciences and philosophy ‘positivism’ is a term used in broad and narrow meanings and everything in between. Broadly speaking, the positivist epistemological approach to gaining knowledge about human affairs is naturalistic. In other words, it is based on roughly the same metaphysical assumptions as the natural sciences and applies similar empirical scientific methods. Positivism in the narrow sense is rooted in ‘Logical Positivism, the ferocious version of empiricism which emerged from the Vienna Circle in the 1930s’ (Hollis, 2002: 42).

Positive theories are inferred based on empirical observations which are generalized into predictive statements in the form of testable hypotheses using an inductive method. Capital markets based on accounting research became the mainstay of mainstream accounting journals with studies predicting and testing the stock price effects (i.e. the wealth effects on investors) of changes in accounting policy. The idea was to identify accounting policies that would yield useful information for investors. Watts and Zimmerman’s (1978) positive accounting theory sought to provide a theory of how interest groups are likely to try to influence accounting regulation based on empirical observation of their behaviour.

Interpretive financial accounting theories seek to understand rather than to predict particular phenomena. The ‘aim would be to understand the subjective experience of individuals in the preparation, communication, verification, or use of accounting information’ (Riahi-Belkaoui, 2004: 317). Instead of seeking to explain the objective causes of behaviour interpretive research seeks to understand what an action means to the agent, i.e. the subjective meaning of an action (Hollis, 2002: 17). In financial accounting research, ethnography is mostly used to understand accountants’ and auditors’ understanding of professionalism and ethics. See, for example, Grey (1998), Power (1991), Coffey (1994), and Gill (2009). Benton and Craib (2011) distinguish between interpretive approaches that seek to understand the subjects’ instrumental rationality (e.g. rational choice theory and game theory, which often make use of laboratory studies), and interpretive approaches that seek to understand rationality as culture and context dependent (e.g. hermeneutics and other linguistic approaches as well as grounded theory based on ethnographic methods).

Critical financial accounting theories also come in different varieties. To name two, researchers influenced by Marxist sociological thought seek to demonstrate how financial accounting is instrumental in perpetuating class structures and class struggle using an epistemological approach

based on a combination of empiricism and deduction. Examples include Tinker (1980), Tinker *et al.* (1982), Galhofer and Haslam (1997), Researchers influenced by Habermas and Foucault seek to demonstrate how those in power try to establish knowledge and theories as neutral and objective in order to further their own self-interests. Examples include Miller and O’Leary (1987), Dillard (1991), Roslender and Dillard (2003), Laughlin (2004). Here the epistemological approach is a mix of the former combined with hermeneutics.

Institutional and contextual perspectives in international financial accounting research are important for understanding and analysing the issues that may arise as a consequence of the adoption of IFRS across different institutional environments. See, for example, Leuz (2010) and Hail *et al.* (2010) as representative of the new institutional paradigm in international financial accounting, and Perry and Nölke (2006) and Arnold (2012) as more representative of the old institutional perspective.

### 4.3 Financial accounting typologies

#### The positive versus normative distinction

A conveniently simplistic manner to classify financial accounting theory is into normative accounting theory and positive accounting theory. For most purposes, this dualistic classification is somewhat misleading. First, few theories will be purely prescriptive (i.e. normative) or purely descriptive (i.e. positive). As pointed out by Christenson (1983: 2), ‘(l)ike other normative judgements, methodological ones may be made with varying degrees of self-consciousness.’ Second, positive accounting theory does not have a monopoly claim on being ‘scientific’. Third, positive accounting theory has ‘the major aim of *explaining* and *predicting* accounting practice, rather than *prescribing* particular approaches’ [italics in original] (Deegan and Unerman, 2006: 8). Although classification of accounting theories was probably not their primary goal, Watts and Zimmerman (1978, 1979) and Jensen’s (1983) dualistic classification neatly served to make much of the accounting literature that was not positive being regarded as ‘unscientific’ (Watts and Zimmerman, 1979: 273 n.1).

So what role does positive accounting theory have in accounting standard setting? Watts and Zimmerman’s (1979) answer is twofold. First,

[the] predominant role of accounting theories is now to provide excuses which satisfy the demand created by the political process; (and second) ... the only accounting theory that will provide a set of observations that is consistent with the observed phenomena is one based on self-interest. ... While a self-interest theory can be used to explain accounting standards such a theory will not be used to justify accounting standards because self-interest theories are politically unpalatable. As a consequence, *not only is there no generally accepted accounting theory to justify accounting standards, there will never be one* [italics in original] (Watts and Zimmerman, 1979: 300–301).

There are at least two problems with this argument. First, their methodological assumption that a valid theory to (epistemically?) justify accounting standards will have to be a theory based on self-interest is not self-evidently true, nor is the evidence presented convincing. Second, they do seem to commit the naturalistic fallacy by suggesting that a theory that can be used to explain a phenomenon ought to be used (epistemically, prudentially or morally) to justify that phenomenon as well. In spite of Tinker *et al.* (1982) and Christenson’s (1983) important critiques of the

methodology of positive accounting, positivism became hugely influential in financial accounting research and remains so in the second decade of the twenty-first century.

### Hopper and Powell's classification

Hopper and Powell (1985) based on Burrell and Morgan's (1979) classification of organizational research is possibly the second most influential and the first multidimensional. It classified management accounting research along the dimensions of 'the nature of the social sciences' (ranging from subjectivism to objectivism) and 'the nature of society' (ranging from orderly to characterized by fundamental conflicts) (Hopper and Powell, 1985: 431–2). It was meant to help 'researchers into the management sciences (to) consider their own values and beliefs concerning the nature of society and the social sciences' (ibid.: 429).

### Chua's classification

The next year, Chua (1986) produced a three-way classification based on assumptions with respect to knowledge, beliefs about social and physical reality, and the relationship between theory and practice into interpretive, critical and mainstream accounting research. Chua (1986) described the worldview and assumptions underlying what she calls 'mainstream accounting research' and introduced the 'interpretative' and 'critical' worldviews as two alternatives to the mainstream. She briefly mentioned Hopper and Powell (1985) and in the appendix she critiqued Burrell and Morgan (1979). Both Hopper and Powell (1985) and Chua (1986) were intended to place the dominant positivist research paradigm in a broader perspective, thereby also pointing to its limitations.

Ironically, and somewhat disrespectfully, in their textbook on research method and methodology in accounting and finance, Ryan *et al.* (2002: 39–44) collapsed Hopper and Powell's (1985) model and Chua's (1986) classification into one. Here, the classification of critical accounting research ranges from radical humanism to radical structuralism, where the objective is to induce radical change to society, and whereby the research methodologies range from those agreeing with subjectivism to objectivism. It characterizes mainstream accounting research, which Chua had characterized as using the hypothetico-deductive methodology of the natural sciences, as based on a functionalist theory of society aimed at holding society together through regulation. Finally, Ryan *et al.* (2002: 40–41) characterize interpretive research based on subjectivist research methodologies that are not aimed at changing society, but rather at interpreting society from the point of view of individual participants.

### Laughlin's classification

Laughlin (1995) characterizes accounting research along the three dimensions of the level of prior theorization about social reality, the level of prior theorization in the methodology and the strength of the view that society needs to be changed, all into high, medium and low.

In his Dutch PhD thesis, Knoops (2010: 42–62) uses Laughlin (1995, 2004) to develop a classification of financial accounting theory into four groups based on ontology, epistemology, research methodology<sup>8</sup> and philosophical assumptions with respect to society. The first group consists of the positivist and post-positivist research perspectives which include: normative approaches, economic approaches such as positive accounting theory and market-based financial accounting research. In the second group we find the interpretative



perspectives which include phenomenological and hermeneutic approaches as well as constructivist approaches to financial accounting theory. A third group consists of the critical perspectives which include financial accounting research based on critical theory and the political economy of accounting. Finally, there are the postmodernist perspectives on financial accounting theory.

Typologies of financial accounting theory are useful for gaining an understanding of the philosophical assumptions that each of us must make in order to be able to decide what to accept as knowledge and how to gain knowledge about financial accounting and external reporting phenomena. Understanding the relevant methodological issues and debates in the different social sciences helps us to trace the source of conflicting ideologies and their influence on financial accounting thought today.

## 5. Conclusion

At the end of the chapter we may conclude that having an understanding of social science methodology will not help researchers much when trying to solve specific research problems. Furthermore, the existence of different accounting journals for different paradigms has mitigated the consequences of researchers' paradigm choice for their careers.

However, when it comes to making progress in research needed to improve the accounting model, its framework and its practices, methodology provides a framework for looking critically at our own (and others') explicit and implicit assumptions with respect to the phenomena that we study, the research questions we ask, the sources we use, the data we collect and the methods we apply. Such an understanding breeds respect for the methodological assumptions and value judgements of others. Mutual respect enables us to bridge methodological paradigms and to reappraise the things we take for granted in search of answers and solutions to the fundamental and the practical problems faced by accounting standard setters, practitioners, auditors, teachers and financial regulators.

## Notes

- 1 On 30 August 2012 at the Japanese Accounting Association Congress in Tokyo.
- 2 The JTB view of propositional knowledge is not the only view on the nature of knowledge. Alternatives include coherentism, reliabilism and virtue epistemology which are also important for understanding the justification of knowledge claims.
- 3 This problem is called the Gettier problem and it has not yet been satisfactorily solved (Lemos, 2007: Chapter 2).
- 4 The correspondence theory of truth claims that a proposition is true if it corresponds to the facts, and false if it does not correspond to the facts. Furthermore, it holds that one and the same proposition cannot be both true and false, and neither is the truth relative in that it is true for you but not for me. Some object that, without a clear notion of what a fact is, it is not possible to know if a proposition corresponds with it. As such the theory may be circular (Lemos, 2007: 9–10).
- 5 Critics are usually willing to accept coherence as a source of justification, but they object that a coherent set of propositions is not necessarily true (Lemos, 2007: 12–13)
- 6 Critics object that even if true beliefs usually provide a good basis for action and false beliefs often provide a bad basis for action, it does not follow that we should identify true belief with useful belief (Lemos, 2007: 11).
- 7 More often used in managerial accounting from whence it derives.
- 8 Knoops (2010: Section 3.3) refers to methodology as the combination of the place and task of the researcher, the research methods, research style and assumptions regarding human nature. This is based on a combination of Laughlin's (1995, 2004) three-way characterization based on level of theorizing, methodology and change.

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