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Normative theories of accounting: The case of conceptual framework project

Kurnia Dewi [1], Marta Paulina Pasaribu [2], Iskandar Muda [3]
[1-3] Master of Accounting, Universitas Sumatera Utara, Medan, Indonesia

Corresponding Author: **Kurnia Dewi**

Abstract
For many years the practice of financial accounting lacked a generally accepted theory that clearly stated the objectives of accounting reporting, the qualitative characteristics of financial information required, or provided clear guidelines as to when and how to recognize and measure the various elements of accounting. In the absence of an acceptable theory, accounting standards tend to be developed in a slightly ad hoc manner with various inconsistencies among the standards. For example, various accounting standards relate to different classes of assets using different recognition and measurement criteria. It has been argued that the development of a conceptual framework will lead to improved financial reporting, and this better reporting will benefit various financial statement readers as it will enable them to make better resource allocation decisions.

Keywords: Normative Theories of Accounting, The case of conceptual framework projects

Introduction

The FASB defines a conceptual framework as a coherent system of interrelated objectives and fundamentals that are expected to lead to consistent standards (Financial accounting concept statement Number 1: Objectives of Financial Reporting by Business Firms, 1978). The conceptual framework seeks to provide accounting theory. The conceptual framework provides prescriptions so that they are considered normative theories of accounting. The conceptual framework establishes the nature, function, and boundaries of financial accounting and reporting. The rationale for the conceptual framework for developing financial reporting practices in a logical and consistent manner, we need to address issues such as: what do we mean by financial reporting and what should be its scope, organizational characteristics that indicate that an entity should produce financial statements, the purpose of financial reporting, what are the qualitative characteristics of financial information that should be owned, what are the elements of financial reporting, what measurement rules should be used. Proponents argue that without agreement on fundamental issues, accounting standards will be developed on an ad hoc basis with limited consistency between accounting standards in the absence of a conceptual framework. The framework must be developed in a certain order with several problems to be solved before moving on to the next "building blocks". A brief overview of the history of the Development of Conceptual Frameworks, Conceptual frameworks were developed in a number of jurisdictions including US, UK, Canada, Australia, New Zealand, International Accounting Standards Committee. In recent years many countries have adopted the IASB framework given that they have decided to adopt the accounting standards released by the IASB. No standard setters develop a complete conceptual framework, measurement problems are usually not addressed. Moonitz (1961) and Sprouse and Moonitz (1962) determined that accounting practices should be based on current values. Grady (1965) developed an accounting theory based on a description of existing practice which led to the release of Accounting Principles.

Board (APB) No. 4, but the accounting profession is under criticism for its lack of a tangible framework. a. Trueblood Report The AICPA formed the Trueblood Committee in 1971 which produced the Trueblood Report, which is a report outlining 12 accounting objectives and seven qualitative characteristics that financial information should have. Objective 1 focuses on the information needs of users of financial statements. Objective 2, it is necessary to serve users with limited ability to request financial information. b. FASB Conceptual Framework Project In 1974 the APB was replaced by the FASB which then started its conceptual framework project. Six Statements of Financial Accounting Concepts (SFAC) were released from 1978 to 1985. Early SFACs were quite normative, but SFAC No. 5 relating to recognition and measurement is largely descriptive of current practice receiving much criticism. Since 2005 the FASB and the IASB have been working together towards the development of a revised conceptual framework, which will be used by both parties in what is known as the convergence project. c. The Development of a Conceptual Framework in the UK In the UK the first step towards guidance related to objectives and user identification is provided by The Corporate Report (1976). The Corporate Report is concerned with addressing people's rights in terms of their access to financial information (more broadly than users' assumptions are adopted in other frameworks). Finally the content is generally not accepted by the accounting profession. In 1991 the Accounting Standards Board (ASB) adopted the IASC conceptual framework. The IASC framework is generally consistent with the US and Australian framework which has come to be known as the IASB framework. d. Development of the Conceptual Framework in Australia The rate of development is slow. Only four Statements of Accounting (SAC) were released. SAC 1 (definition of reporting entity), SAC 2 (general purpose financial reporting), SAC 3 (qualitative characteristics of financial information), SAC 4 (definition and recognition of elements of financial statements), SAC 5 which relates to measurement.

Never released. In 2005, Australia adopted the IASB framework as a result of the Financial Reporting Council's decision that Australia would adopt IAS/IFRS in 2005. SAC 3 and SAC 4 were abandoned. SAC 1 and SAC 2 were maintained until the time the revised IASB framework was developed. BUILDING A CONCEPTUAL FRAMEWORK BLOCK a. Definition of Reporting Entity The conceptual framework provides a definition of the entities required to generate the GPFR which are known as reporting entities. General Purpose Financial Report (GPFR) is defined as a report: Intended to meet the general information needs of users who are unable to master the preparation of customized reports so as to satisfy, in particular all their information needs (SAC 1 paragraph 6) GPFR is a report that complies with accounting standards and other generally accepted accounting principles (GAAP). Meanwhile, special purpose reports are provided to fulfill requests for information from certain users, or a group of users. Not all entities are classified as reporting entities. SAC 1 states that the GPFR should be prepared when there are users. Their information needs have the same elements, and those users cannot order the preparation of information to meet their individual information needs' (para. 8). Factors indicating a reporting entity (SAC 1) 1. Separation of management from those who have an economic interest in the entity 2. Economic/political interest/influence of the entity to other parties 3. Financial characteristics of the entity b. Purpose of General Purpose Financial Reporting (GPFR) The objective has traditionally been to enable outsiders to assess management's management. The latest objective of financial reporting is to assist reporting to users in making economic decisions. The purpose of General Purpose Financial Reporting in SAC 2 is considered to provide information to users that is useful for making and evaluating decisions about resource allocation.

2. Literature Review

2.1 Pre-Theory

Before formalization of the double-entry system in the 1400s, very little was written about the theory underlying accounting practice. During the developmental period of the double-entry system the main emphasis was on practice. Until 1494 a Franciscan friar, Fra Pacioli, wrote the first book to document the double-entry accounting system as we know it. The title of his work is Summa de Arithmetica Geometria Proportioni et Proportionalita (A review of arithmetic, geometry and Proportions). For 300 years after Pacioli's 1,494 treatises, the development of accounting. It is referred to as the 'pre-theory period'. No accounting theory has been created from Pacioli's time in the early nineteenth century. Theoretical suggestions emerge from various aspects, but not to the extent necessary to place accounting in a systematic way. Until the 1930s the development of specific accounting theory began to develop. This development was due to justify certain practices. However, developments in the 1800s led to the formalization of existing practice in textbooks and teaching methods. The rapid expansion in technology, accompanied by a massive separation of ownership from control over the means of production, increased the demand for management and financial accounting information.

2.2 Pragmatic Accounting

The period 1800-1955 is often referred to as the 'general scientific period'. During this period the development of theory was most concerned with providing practical explanations. The emphasis is on providing an overarching framework for explaining and developing accounting practice. Theories developed are mainly based on empirical analysis, the method most often adopted in the physical sciences. Empirical analysis relies on real-world observations rather than relying solely on logic. It involves developing theories based on what is observed. For example, during the general scientific period of accounting theory, theories about how the accounts were developed using empirical analytical methods. Because theories aim to provide an overall framework for all accounting problems and because they were developed empirically, they are labeled 'general science'. The general scientific method gave rise to well-known publications. In 1936 the American Accounting Association (AAA) released a Tentative Statement of Accounting Principles Affecting Corporate Reports. In 1938 the American Institute of Certified Practicing Accountants (AICPA) made an independent study of accounting principles and released A Statement of Accounting Principles written by Sanders, Hatfield and Moore. In the same year, the AICPA formed the Accounting Procedures Committee, which published a series of accounting research bulletins. The nature of the bulletins that published accounting theory at that time is summarized in the introduction to Bulletin No. 42. Forty-two bulletins issued during the period 1939-1953, eight of these reports are terminology. The other 34 was the result of research conducted by the accounting procedures committee which was directed to the segments of accounting practice with which problems were most demanding and with which business and the accounting profession were most concerned at the time.

2.3 Normative Accounting

The period 1956-1970 is labeled the 'normative period'. It is called the normative period because it is the period when accounting theory seeks to establish norms for best accounting practice. In contrast to the general scientific period, during this period, researchers were less concerned about what actually happened in practice and more concerned about developing new theories. determined what should happen. In the period prior to 1956 several authors produced early normative work dealing mainly with issues surrounding the proper basis for asset valuation and owner claims. Normative theory adopts goals, attitudes and then determines how to achieve stated goals. They provide resolutions on what must be done to achieve the stated goals. The main focus of normative theory of accounting during 1956-1970 was the impact of price changes on asset values and earnings calculations. Two groups dominated the normative period of historical cost accounting critics and proponents of conceptual frameworks. There is some overlap between the two groups, especially when historical cost critics seek to develop an accounting theory in which the measurement of assets and the determination of income are dependent on inflation and certain price movements. During the normative period, the notion of a 'conceptual framework' was a structured theory of accounting. The framework is intended to cover all components of financial reporting and is intended to guide practice. For example, in 1965 Goldberg was commissioned by the AAA to investigate the nature of accounting.

The result was the publication of An Inquiry into the Nature of Accounting which aims to develop a theoretical framework for accounting by providing a discussion of the nature and meaning of accounting. One year later the AAA released A Statement of Basis Accounting Theory, with the stated aim of providing a unified statement of basic accounting theory that would serve as a guide for educators, practitioners and others interested in accounting. The normative period began to draw to an end in the early 1970s. It has now been replaced by the period of the 'certain scientific theory' or 'positive era' (1970).

The two main factors that led to the collapse of the normative period were:

- Unlikelihood of acceptance of any particular normative theory
- Availability of financial economics principles and test methods

Because normative accounting theories define how accounting should be done, they are based on subjective opinions of what accounts should be reported, and the best way to do it. Opinions regarding the appropriate objectives and methods of accounting vary between individuals and a large part of the dissatisfaction with the normative approach is that it does not provide a means to resolve differences of opinion.

Henderson, Peirson and Brown outline two major criticisms of normative theory in the early 1970s:

- Normative theory does not involve hypothesis testing.
- Normative theory is based on the assessment of a value.

Normative theory cannot be tested empirically because it is impossible to empirically prove what it should be. Furthermore the assumptions underlying some of the normative theories are untested, and it is not clear whether the theories have a solid foundation. The fact that normative theory is based on discontent judgments increases with the normative approach as it becomes clear that it is difficult, and perhaps impossible, to gain general acceptance of any particular normative accounting theory.

2.4 Positive Accounting

Dissatisfaction with normative theory combined with increasing access to empirical data and increasing recognition of economic arguments in the accounting literature led to a shift to a new form of empiricism operating under the broad label of positive theory. The purpose of positive accounting theory is to explain and predict accounting practice. An example of positive accounting theory would be the theory that leads to what is known as the bonus plan hypothesis. The theory relies on managers to maximize more wealth, even at the expense of shareholders. If managers are paid in part with bonuses based on reported accounting earnings then managers have incentives to use accounting policies that maximize revenue. The theory also leads to the prediction that managers who are paid through bonus plans use the income-increasing accounting method more than managers who are not paid through bonus plans. . Theories are important because they explain economic or wealth effects, accounting and accounting reasons are important for various parties such as shareholders, creditors and managers.

By explaining and predicting accounting practice, Watts and Zimmerman consider that positive theory has given rise to clear confusion regarding the choice of accounting technique. They argue that positive accounting theory helps in predicting the reactions of market players such as shareholders to management actions and reported accounting information. One benefit of such research is that it allows regulators to assess the economic consequences of various accounting practices they perceive. Positive literature involves developing hypotheses about reality which are then tested by observing reality. The approach has drawn criticism that is based largely on a seemingly biased fashion in which positive theory ignores alternative viewpoints. This resulted in a particularly revival in the 1980s in behavioral research. Behavioral research is primarily concerned with the broader sociological implications of accounting numbers and the related actions of key actors such as managers, shareholders, creditors, and governments as they react to accounting information. Behavioral accounting theory tends to focus on the psychological and sociological influences on individuals in the use and preparation of accounting. While behavioral research has grown in acceptance, positive accounting theory still currently dominates the accounting research literature. The trends in accounting theory that have been described so far relate to both:

- Academic, research conducted and emphasized by academic researchers
- Professional, research that has been emphasized and either sponsored or carried out by those in practice, who seek theory to explain or prescribe accounting practice

Based on observations there is no logical assessment of what accountants do. It does not allow for endless changes and tends to focus more on the behavior of accountants than on measuring company attributes.

3. Methodological Issues

3.1 Fundamental qualitative characteristics

Fundamental qualitative characteristics include relevance and exact representation. Relevance Relevant financial information is capable of making a difference in the decisions made by users. Information may be able to make a difference in decisions if some users choose not to take advantage of the information or have become aware of the information from other sources. Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value, or both. Financial information has predictive value if it can be used as input by users to predict future outcomes (future outcomes. Financial information does not have to be a prediction or forecast to have predictive value. Financial information with predictive value is used by users to make their predictions). itself. Financial information has confirmation value if it provides input (confirmation or change) about previous evaluations. The predictive value and confirmation value of financial information have an interrelated relationship. Information that has predictive value often also has confirmation value. For example, revenue information for the year current year, which can be used as a basis for predicting revenue in future years, can also be compared with revenue predictions for the current year made in the previous year. The results of the comparison can help users to determine correcting and improving the processes used in making such earlier predictions of Materiality. Information is material if it is missing or misstated so as to influence decisions that users make based on financial information about a particular reporting entity. In other words, materiality is the aspect of relevance of a particular entity based on the nature or magnitude, or both, of the items to which the information relates in the context of each entity's financial statements. Therefore, a quantitative range for materiality or a preliminary determination of what may be material in a given situation cannot be established.

3.2 Comparability-enhancing qualitative characteristics

verifiability, timeliness, and understandability are qualitative characteristics that enhance the usefulness of relevant and appropriately represented information. The enhancing qualitative characteristics can also help in determining which of the two methods should be used to describe a phenomenon if they are considered equally relevant and properly represented. Comparability User decisions involve selecting several alternatives, for example selling or owning an investment, or investing in a reporting entity or another. Therefore, information about the reporting entity is more useful when it can be compared with similar information about other entities and with similar information about the same entity for other periods and dates. Comparability is a qualitative characteristic that enables users to identify and understand similarities in, and differences between, items. In contrast to other qualitative characteristics, comparability is not related to a single item. A comparison requires at least two items. Consistency, although related to comparability, is not the same. Consistency refers to the use of the same method for the same items, either from period to period within a reporting entity or in one period between entities. Comparability is the goal, while consistency helps to achieve the goal. Comparability does not mean uniform. For information to be comparable, similar things must look similar and different things must look different. Comparability of financial information will not be increased by making different items look similar nor can it be increased by making similar items look different. Some degree of comparability may be achieved by meeting the fundamental qualitative characteristics. A precise representation of a relevant economic phenomenon, naturally also has some degree of comparability with a faithful representation of a relevant economic phenomenon similar to that of other reporting entities.

3.3 Improved Qualitative Characteristics

The enhancing qualitative characteristics should be maximized as much as possible. However, enhancing qualitative characteristics, either individually or as a group, cannot make information useful if the information is irrelevant or not properly represented. The application of enhancing qualitative characteristics is an iterative process that does not follow any particular order. Sometimes, one enhancing qualitative characteristic may be subtracted to maximize another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying new financial reporting standards may be useful for increasing relevance or faithful representation in the long term. Partially appropriate disclosures can compensate for incommensurability.

4. Result and Discussion

4.1 Result

Cost is a major constraint to the information that can be presented in financial reporting. Reporting financial information incurs costs, and it is important that these costs be justified by the benefits of reporting that information. There are several types of costs and benefits to consider. Financial information providers devote most of the effort to collecting, processing, verifying, and disseminating financial information, but users ultimately bear all associated costs in the form of reduced returns. Users of financial information are also charged for analyzing and interpreting the information provided. If the required information is not available, the user incurs additional costs to obtain the information from other sources or estimate from the existing information. Reporting financial information that is relevant and faithfully represents what it represents helps users to make decisions with more confidence. This results in a more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. Investors, lenders, or other creditors also benefit by making better-informed decisions. However, general purpose financial statements may not provide all relevant information for every user. In applying the cost constraint, DSAK IAI assesses whether the benefits of reporting certain information tend to be balanced with the costs incurred to provide and use the information. When applying cost constraints in the development of financial reporting standards, DSAK IAI seeks information from financial information providers, users, auditors, academics and others regarding the nature and quantity of the expected benefits and costs of these standards. In most situations, the assessment is based on a combination of quantitative and qualitative information. Due to inherent subjectivity, individual assessments of the costs and benefits of reporting certain items of financial information will vary. Therefore, DSAK IAI considers costs and benefits related to financial reporting in general, and not just those related to individual reporting entities. This does not mean that cost and benefit assessments always justify the same reporting requirements for all entities. Differences are understandable due to different entity sizes, different ways of raising capital (from public or private), different user requirements or other factors.

4.2 Discussion

A conceptual framework of accounting can be considered to be a normative theory of accounting. A conceptual framework makes prescriptions in regards to what the objectives of accounting are, what qualitative characteristics general-purpose financial information should possess, how the elements of accounting should be defined and when they should be recognised and how the elements of accounting should be measured. Within the United States, the conceptual framework has been defined as ‘a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards’. It is further stated that the conceptual framework ‘prescribes the nature, function and limits of financial accounting and reporting’ (Statement of

Financial Accounting Concepts No. 1: Objectives of Financial Reporting by Business Enterprises, 1978). In May 2008, an exposure draft entitled Exposure Draft of an Improved Conceptual Framework for Financial Reporting was released jointly by the IASB and FASB and, according to the exposure draft, the conceptual framework is: a coherent system of concepts that flow from an objective.

The objective of financial reporting is the foundation of the framework. The other concepts provide guidance on identifying the boundaries of financial reporting; selecting the transactions, other events and circumstances to be represented; how they should be recognised and measured (or disclosed); and how they should be summarised and communicated in financial reports. As this definition indicates, the objective of financial reporting is the fundamental 2 building block for the conceptual framework being developed by the IASB and the FASB. Hence, if particular individuals or parties disagreed with the objective identified by the IASB and the FASB, they would most likely disagree with the various prescriptions provided within the revised conceptual framework.

As Chapter 6 has discussed, because Australia adopted accounting standards issued by the IASB (and its predecessor, the IASC) and because those accounting standards were developed from the IASB Conceptual Framework, it would have been somewhat inconsistent to retain the Australian Conceptual Framework which was used to develop the superseded Australian standards. Hence the decision to adopt standards issued by the IASB effectively meant we also had to adopt the IASB Framework.

Some of the advantages that have been advanced in relation to conceptual frameworks of accounting include:

- Accounting standards developed by applying the contents of a conceptual framework should be consistent and logical.
- Because many countries have adopted the IASB Conceptual Framework there should be greater international compatibility between various countries' accounting practices, and this should lead to greater consistency and comparability between international financial reports (which some people have argued is important for flows of foreign investment capital).
- Because conceptual frameworks provide the fundamentals of an accounting system, standard-setters should be more accountable for their decisions. If they deviate from key issues addressed in a conceptual framework this should be clear and some explanation would be necessary.
- Conceptual frameworks provide a means of communicating key concepts to financial report preparers and users, as well as providing guidance to reporting entities when no specific standards address a particular issue.
- Because issues such as the objective of financial reporting, recognition criteria (and so on) have been determined when developing a conceptual framework, then accounting standard-setters will be subject to less political pressure when developing new standards.
- Because standard-setters will have consensus on many key issues, the development of accounting standards should be more economical. There will be no need to go back to the 'drawing board' on many fundamental issues. While not directly asked within Question some of the disadvantages that have been associated with conceptual frameworks of accounting include: • Conceptual frameworks are costly to develop.
- The development of conceptual frameworks is subject to political interference— some people (for example, Hines) argue that conceptual frameworks are no more than residue of a political process.
- Tied to the above point, when conceptual frameworks have attempted to consider issues in which there is much underlying disagreement (for example, measurement issues), they have tended to lose progress.
- Following on from the above point, conceptual frameworks have tended not to tackle difficult issues.
- Conceptual frameworks focus on economic (financial) performance alone. As such, they tend to ignore other aspects of performance (for example, the social and environmental performance of a reporting entity). Further, by focusing on financial performance alone and by giving it prominence, conceptual frameworks tend to deflect attention away from other important areas of corporateperformance

5. Conclusion

Accounting practice is neither wholly customary nor wholly theoretical (Littleton 1953) [4]. Both customs and theory have shaped accounting practice. As noted in footnote 1, accountants were primarily concerned with developing accounting practice prior to the twentieth century. Accounting practice evolved during the last few centuries. Starting with the twentieth century, accounting academics and practitioners have concerned themselves with development of accounting principles. Now accounting theory is dominant in shaping practice. Standard setters around the globe are now setting accounting standards, thus influencing accounting practice. Two standard setting bodies deserve special mentioning. One is the Financial Accounting Standards Board (FASB) in the U. S. A. and the other is the International Accounting Standards Board (IASB) that sets international accounting standards. Both FASB and IASB have developed and adopted conceptual frameworks for external financial reporting. These bodies now use the frameworks as a basis of setting new accounting standards and amending the current ones. Specially, FASB and IASB have concentrated their attention on removing inconsistencies in the light of the frameworks. Reliability and conservatism are still dominant themes in accounting practice. For example, both FASB and IASB frameworks require that an item must be capable of being reliably measured in order to be recognized in the financial statements. Though FASB puts relevance as one of the four conditions of recognition, no such condition is put in IASB framework. Again, conservatism is evident in the asymmetric treatment of contingent gains and loss. To recognize a contingent gain, it must be certain that the gain occurs. To recognize a contingent loss, however, it is sufficient for the loss to be probable only. It is to be noted that FASB (1980) tries to redefine conservatism in the framework and clarifies its rationale. Its impact on practice, however, is yet to be seen. Present accounting and reporting framework retains some important elements of those of P & L (1940) and Littleton (1953) [4]. Income determination is central to present accounting practiceand historical cost is the basis of initial measurement in most of the cases. This emphasis on reliability and objective evidence seems to be the product of the need for the same that arose because of the proliferation of accounting techniques and procedures during the 1920s and 1930s in the United States of America.40 And reliability is expected to continue to be a major requirement in future accounting practice as a deterrent to managers' propensity to manipulate accounts. Current accounting practice adopts an eclectic approach to valuation. And, the trend seems to be away from the historical cost principle and towards fair value where such value is reliably determinable. For example, FASB (2001) requires that an impaired asset be measured at its fair value. Originally Statement of Financial Accounting Standards (SFAS) No. 121 had this requirement.41 Two members of FASB- Messrs. Anania and Northcutt, who were members at the time issuing Statement of Financial Accounting Standards No. 121- criticized this as not being within the historical cost model (FASB 1995). This is because measurement of an impaired asset at its fair value is a departure from the actual transactions-based accounting-a hallmark of the historical cost model. FASB defends it on the ground that the fact that an asset has been impaired is equivalent to fresh purchase of the asset by the entity and hence fair value is the appropriate basis of measurement of the impaired asset. And, the cry for market price-based information has not gone totally unheeded. Specially, Chambers' concern for information relevant to adaptive choice has some place in accounting. Though the primary focus of financial reporting is information about earnings and its components, FASB (1978) [2] recommends that financial reporting should provide cash flow information. Now both FASB (1987) and IASC (1997) require the provision of cash flow statement. FASB (1984: para 52) describes the usefulness of cash flow information in the following words: It [the cash flow statement] provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividends, or reinvest to maintain or expand operating capacity; about its financing activities, both debt and equity; and about its investing or spending of cash. Important uses of information about an entity's current cash receipts and payments include helping to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk. Thus, by providing the cash flow statement, present accounting practice takes care of some of Chambers' concerns.

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