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# Development of Accounting Theory with a View to Assisting Corporate Governance: Proposals for Research Opportunities

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**ABSTRACT**

Currently, the separation between providers of capital and their administrators is a common fact. This separation can generate a series of adversities to organizations, and this phenomenon is explained by the Agency Theory. In this context, Corporate Governance (CG) is used with the aim of preventing and settling agency problems, making use, among other means, of Accounting. One can identify the relationship between Accounting, which provides financial statements, GC, which uses this information to perform its actions, and agency problems, which GC seeks to prevent and resolve. Based on the awareness of the existence of such a relationship, the present study is theoretical and has the overall objective of proposing ways for the development of accounting theory and, consequently, collaborating with GC. It is advocated that accounting theory will evolve in order to improve: (a) the ability to measure intangible resources; b) the definition of profit and its components; c) the intelligibility of financial statements; (d) the concepts of value, imputed costs, economic costs, opportunity cost and sunk costs; (e) the ability to decrease the subjectivity of accounting statements; f) the plurality of results, in addition to financial; g) the scope of financial statements, so that one can inform the whole of society; and h) the theory of market imperfections. The researchers have a vast field for exploring accounting theory and they need boldness to think beyond established standards. Finally, one should be emphasize the importance of social responsibility and ethics in the development and use of accounting.

**Keywords:** Corporate Governance; Agency Theory; Accounting Theory; Theoretical.

## 1. INTRODUCTION

Many research works have given attention to the objective of understanding and improving the Corporate Governance (CG) phenomenon. The increasing number of publications on this topic (CORREIA; AMARAL, 2008) is in part related to changes that occurred in the firms' ownership structure, which before was on the hands of one person only and today is held by several stockholders (ARRUDA; MADRUGA; FREITAS JR., 2008). Added to this change, there was a shift in the organizational management model. In the past, the owner himself ran the organization. Today, there is a separation between equity investors and managers (MARTIN; SANTOS; DIAS FILHO, 2004; ARRUDA; MADRUGA; FREITAS JR., 2008).

When this situation arises, a series of problems may take place, which are explained by the Agency Theory (JENSEN; MECKLING, 1976). CG uses various means to mitigate the agency problems such as the information asymmetry, loss of the organization's value and inconsistency between the principals' and agents' interests (SILVEIRA; BARROS; FAMÁ, 2008; DALMÁCIO; REZENDE, 2008; HOLM; SCHOLER, 2010; CORREIA; AMARAL; LOUVET, 2011; LORENCINI; COSTA, 2012; KRIECK; KAYO, 2013).

The agency problems are influenced by unequal information distribution, since managers know better than their stakeholders how the organization works (MARTINS; FAMÁ, 2012). In this regard – to reduce information asymmetry – Accounting plays a key role. According to the American Accounting Association (AAA), Accounting is the "process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information". It is possible to identify a relationship between Accounting, which provides the financial statements, the CG, which utilizes such information to take actions, and the agency problems, which CG aims to avoid and diminish.

The present study is theoretical and has the general objective of proposing ways for the development of the Accounting theory. To this end, this paper discusses the importance and responsibility of Accounting, as a social science, and its contribution to CG. This kind of research has a discursive approach, presents a logical and reflexive discussion of a topic and arguments that have a high level of interpretation and judgment on the part of the author (SEVERINO, 2013). When building a theoretical study, the author is free to defend an idea, without relying on a rigorous scientific and bibliographic apparatus (SEVERINO, 2013).

Despite these characteristics, the study does not dispense with logical rigor and sound reasoning. To this end, the study is structured in the following sections: a) Agency Theory – it describes the organizational changes occurred, presents concepts and points out how the theory relates to CG; b) Corporate Governance – it explains the origin and concepts related to the theme and describes its importance to the economic outcomes of an organization and society; c) Accounting: Past and Present – presents a brief overview of the history of Accounting and discusses the changes that are occurring in the world and, of course, in Accounting; d) Paths for Accounting – it proposes courses of action for the development of the Accounting theory; and e) Final Considerations – it concludes the debate.

## 2. Agency Theory

The classical economic theory was based on the assumption that firms were rational organizations that optimized economic profits and had only one owner – proprietor and manager (VARGAS; ALMEIDA; MARIA JR., 2014). This reality has changed and broke these paradigms (LOPES; MARTINS, 2005). The Agency Theory states that the relationship between agents – those who run companies – and the principals – the equity holders –, can be disrupted by existing conflicts of interests or even by opportunistic actions taken by managers who seek to maximize their earnings in detriment of the organizational goals (ROSS, 1973; JENSEN; MECKLING, 1976). The more divergent the parties' interests, the more difficult for the principals to induce managers to behave favorably to the organization (CALVE *et al.*, 2013), since managers demand a compensation for making decisions that would benefit the firm's owners (GROSSMAN; HART, 1983).

The change in social reality required improvements in the firms' governance and accounting. In1986, Watts and Zimmerman already attempted to explain and foresee changes in accounting practices to cope with agency problems. Accounting plays a major role in the relationship between principal and agent and must be able to deal with some predictable situations and behaviors such as (JENSEN; MECKLING, 1976; WATTS; ZIMMERMAN, 1986; BOTINHA; LEMES, 2016): firstly, managers who earn benefits based on the company's net profits will likely employ accounting procedures to increase them. Secondly, firms that have a high level of indebtedness are likely to employ accounting procedures that improves net profits to obtain external capital. Finally, large-sized firms will likely employ accounting procedures to diminish profits in order to reduce pressure and demand for attitudes by the government and society.

The parties involved in the agency relationship seek to potentialize their earnings, and contracts and mechanisms to ensure a fair relationship become necessary (JENSEN; MECKLING, 1976). Contracts, mechanisms, policies for managers' compensation and incentives aim to establish a connection between the wealth of agents and principals, making that decision-makers would benefit from the firm's value creation (CORREIA; AMARAL; LOUVET, 2014).

Transparency in managers' actions is a way to prevent and reduce the agency problems. Investors use Accounting as an instrument to assess the business conditions and reduce information asymmetry (LOPES; MARTINS, 2005), which can result either from the principal's inability to monitor the agent or by the agents' deliberate action to disclose flawed information through incomplete reports and financial statements (CRUZ *et al.*, 2012; QUEIROZ *et al.*, 2013), a view shared by Lopes and Martins (2005, p. 55):

> [...] as disclosure of information is discretionary, managers can manipulate the information, providing figures that aim to deceive users about the "real" business situation. On the other hand, it is this very discretionary feature that allows that information is brought to the public. (Author's translation).

It is worth noting that not all accounting choices can be configured as bottom-line management or manipulation of information. The choices and judgements are present in accounting routines, since business situations change, requiring changes in Accounting, and, therefore, it is not possible to anticipate the creation of rules for all facts and circumstances (FIELDS; LYS; VICENT, 2001).

Briefly stating, the Agency Theory is a major approach that is used to understand the application of accounting practices, information asymmetry and agency conflicts. It is a conceptual structure widely used by researchers interested in issues that involve choices of accounting methods, incentive policies and mechanisms to manage them (TAPLIN; YUAN; BROWN, 2014; BOTINHA; LEMES, 2016). This theory has been one of the main theoretical frameworks used in researches on organizational environment (HOLMSTROM, 1979; CALVE *et al.*, 2013).

## 3. Corporate Governance

Corporate governance can be understood as a set of mechanisms that an organization use to engage managers to the interests of their capital suppliers (SHLEIFER; VISHNY, 1997). It covers a series of managerial principles and practices that aim to minimize disputes between the parties, increase the firm's value and the return to stockholders (ANDRADE, 2008). Referring only to publicly-held companies, Blair (1995) states that CG encompasses the whole legal, cultural and institutional structure that determines who must control the organization, what he can do, how such control will be exercised and how the risks and returns of the activities will be allocated. However, it should be noted that CG is a phenomenon that can be applied to all types of organizations, either publicly- or privately-owned companies, profits-oriented or nonprofits-oriented (TURNBULL, 1997; BORTOLON; SILVA JR., 2015).

Originally, this phenomenon was called Corporate Governance and has grown in importance after the 1929 crisis with more emphasis in the US and England, due to the relevance and development of their stock markets (SOUZA; BORBA, 2007). However, only in recent decades the CG-related concepts have been transformed in important practices (CARVALHAL DA SILVA, 2004). The attention given to CG has intensified after numerous cases of financial frauds that occurred in the first decade of this century, which resulted, among other situations, in Enron bankruptcy – a giant company in the US energy sector –, in the closure of big US auditing firms and in the housing market disruption in 2008 (MARQUES *et al.*, 2015). In this context of creative accounting and evidences of economic and social damages that it may cause, CG practices have been demanded earnestly by investors and governments and institutionalized in publicly-traded companies worldwide (GRÜN, 2005; ROSSONI; MACHADO-DA-SILVA, 2013; RIBEIRO; SANTOS, 2015).

Particularly in Brazil, two events were critical and emphasized the importance of CG in companies. First was the creation of the Brazilian Institute of Corporate Governance (IBGC) in 1995. This organization was a pioneer in the disclosure of information, promotion of events and publication of works that encourage discussions on this topic (IBGC, 2015). The second key move toward the promotion of CG was the creation of different levels of Corporate Governance by BM&FBOVESPA in 2000 (SANTANDER, 2010; MAPURUNGA *et al.*, 2011). BM&FBOVESPA started to have three different levels of CG – Level I, Level II and New Market –, which has the aim of ranking organizations based on their CG practices (SOUZA *et al.*, 2015).

For firms, there are many advantages in developing good CG practices, since they help increase the chances to create a favorable environment for the stakeholders and contribute to the creation of value for investors, making it easier to obtain external capital (LEAL; CARVALHAL DA SILVA; VALADARES, 2002; LAMEIRA JR.; NESS; MACEDO-SOARES, 2007; ALMEIDA *et al.*, 2010; RIBEIRO; SANTOS, 2015). In addition, good CG practices contribute to the reduction of agency problems and promote a more transparent and ethical management (SILVEIRA; BARROS; FAMÁ, 2003; HALTER; ARRUDA, 2009; MOSTOVICZ; KAKABADSE; KAKABADSE, 2009; RIBEIRO; SANTOS, 2015).

## 4. Accounting – Past And Present

Firstly, we present a brief overview of the history of Accounting, starting from the fourteenth century. At that time, Accounting was restricted to the activity of recording the financial information and transactions made by Venetian merchants, being therefore limited to practice. The act of recording events using double-entry accounting was viewed as a synonym of Accounting application. The bookkeeping techniques used were influenced by authors such as Leonardo Fibonacci (1202) and Luca Pacioli (1494) (IUDÍCIBUS; MARTINS; CARVALHO, 2005).

Accounting evolved as society required solutions for actual problems. Many historical factors fostered the Accounting Science, even some that were “unlikely”, i.e., which apparently had no relation with Accounting. Among these, Hendriksen and Van Breda (1999) mention the invention of the triangular (lateen) sail, which replaced the square (Roman) sail and enabled ships to sail against the wind, which intensified commerce at that time; and the bubonic plague (or black plague), which killed about a third of the European population, reformulating the social structure and businesses of that time.

Martin (2002) lists a series of events that made that the accounting-financial model needed to evolve: the industrial revolution ($18^{th}$ century); the emergence of big companies with physically-separated business centers ($19^{th}$ century); the emergence of the first business conglomerates ($19^{th}$ century); the advent of the scientific management created by Taylor and Fayol ($20^{th}$ century); the development of stock markets and emergence of publicly-traded companies ($20^{th}$ century), among other factors.

Although Accounting has shown its usefulness and capacity to solve problems, adapt to new scenarios and reveal its utilitarian character, one should question what the researchers in this area have done to strengthen it as a science. From the second half of the $20^{th}$ century, Accounting, as an academic discipline, broadened its objective of training professionals on the application of accounting procedures to that of developing scientific knowledge (MATTESSICH, 1996; FARIAS; MARTINS, 2015). Thus, the Accounting students’ activities expanded to typically-scientific processes, e.g., solving research problems, creating precise definitions for Accounting elements, explaining facts related to its research context, among others (FARIAS; MARTINS, 2015). Accounting should be able to establish cause-effect relationships, identify laws and behavior patterns of phenomena, develop theories, and provide to the field of knowledge a wide conceptual “umbrella” (IUDÍCIBUS; MARTINS; CARVALHO, 2005; FARIAS; MARTINS, 2015). Developing and contextualizing theories is necessary to the Accounting Science.

The few debates conducted by researchers of the accounting area about theories hinder the creation of knowledge (HOLTHAUSEN; WATTS, 2001; FIELDS; LYS; VINCENT, 2001). How can a science develop without being grounded on theoretical debates? In the same direction, Borba, Poeta and Vicente (2011) argue that there is a need for development of the accounting theory, as well as Marion (1997, p. 4) points out: "getting out of the routine of usual norms makes that some of the professionals of this area seek help from diverse sources. Would those new approaches be so complex or would there be a lack of theoretical foundation to interpret them?" (Author's translation). Still in this direction, Kam (1990) states that it is from the development of new theories that Accounting researchers will obtain responses and, then, will achieve good practices. For this author, it is surprising the difficulty that many Accounting professionals encounter to explain certain situations that would otherwise be easily elucidated if theories were used.

An explanation that can be used for the lack of theoretical works on Accounting is the fact that many times it must comply with regulatory bodies, accounting provisions and use of Financial Accounting to meet the requirements of tax authorities. Martin (2002) explains that tax authorities require that financial statements be prepared based on certain guidelines of their interest, given that such statements form the basis of the firms' accountability to tax collectors. The excessive subordination to fiscal interests and the shift of focus of the managerial Accounting makes that many professionals sit back, wait for tax regulations and stop reflecting on the development of accounting as a science. "Why theories if all we have to do is what the tax authority requires?", many of them wonder.

Accounting, as a science, is much broader and has more responsibilities than just calculating taxes to be paid. It has responsibilities and obligations to society. This argument – responsibilities and obligations to society – must be justified, recalling some facts that strengthens the idea that Accounting should not be just a follower of orders and norms. Accounting requires reflections and insights on its social obligations and should look at itself as a science, discussing theories that are applicable to it. Just following orders, without due reflection, is a risky attitude. It should be kept in mind the recent cases of manipulation in financial statements with the purpose of maximizing executives' earnings.

Recently, as Iudícibus *et al.* (2011) pointed out, the financial and corporate scandals that occurred in the US had a direct participation of accountants and auditing firms and made that then president of the country, George W. Bush, stated that it was necessary to move Accounting out of the shadows. A great debate was promoted about the academic education of Accounting Science, considering three main approaches: exploitation of the rhetorical, political and ideological nature of Accounting, checking for poor level of discourse in the curricula of Accounting Science courses, and the promotion of a better understanding of the Accounting history and its theories through readings and debates on previous literature provided by intellectuals (IUDÍCIBUS *et al.*, 2011). It is interesting to note that after the financial scandals that affected the lives of million people and having been proved that, in many cases, the accountants deliberately acted against the interests of employees and investors of companies that went bankrupt, the actions taken to improve accounting standards have not been the development of technically superior accounting practices but rather actions aimed to the education of more critical professionals (IUDÍCIBUS *et al.*, 2011).

Was it right for accountants to just "follow orders"? Have accountants not been ethical? Have they been aware on how their work affects the entire society and people's lives, or have they been only interested in applying established norms? Before thinking of responses, we should move back in time to remember two shameful events in mankind history.

First, the Holocaust period, the time when Nazi Germany conducted a State policy that aimed to exterminate the Jewish people. In this scenario, Accounting made a major contribution by participating in all Holocaust stages (FUNNELL, 1998; MENDONÇA *et al.*, 2008; SILVA, 2014). Many accounting techniques were used to give management responses to the Nazis, since the Jews were treated by that regime as objects, many times used as slave labor. Hilberg (2006) explains that from 1940 on, Jewish prisoners were forced to work in companies that used accounting techniques such as budgeting and auditing reporting. The prisoners were tattooed with numbers and recorded in a control book (FUNNELL, 1998).

Lippman and Wilson (2007) explain that the concentration camps were administered as profit centers, which prepared their income statements and analyzed how much each Jewish prisoner contributed to the Nazi firms. Accounting techniques were employed for these prisoners, such as their estimated useful life with depreciation (about nine months of life) and their residual value (LIPPMAN; WILSON, 2007). After the prisoners' death, the Nazi accountants considered residual gains and byproducts such as the sale of their clothes, food savings, dental gold, body fat (when there was any) for the production of soap and the use of ash of incinerated bodies as fertilizers (HILBERG, 2006; LIPPMAN; WILSON, 2007). Cost-benefit analysis was used in all these procedures. Perhaps the most horrible analysis was related to the most economical way of executing Jewish children. The cost of killing children with gas and then burning their bodies was compared to the cost of burning them alive and conscious (GREENBERG, 1975; FLEISCHNER, 1977; LIPPMAN; WILSON, 2007). Although the second choice was more inhuman and cruel and generate screams all over the concentration camp, the accountants chose it for being less expensive and for yielding savings of some cents of *Reichsmarks* (LIPPMAN; WILSON, 2007).

Other example of the use of Accounting by authoritarian regimes as a way to exploit human dignity was the slavery of black people (SILVA, 2014). The author explains that slaves were treated as merchandise and could be rented, sold, exchanged or even mortgaged. Monetary values were given to the slaves, which could then be used in credit operations (FLEISCHMAN; TYSON, 2004; SILVA, 2014). Slaveholders had record books where they documented the transactions made (HOLLISTER; SCHULTZ, 2010) and the slaves were categorized (FLEISCHMAN; TYSON, 2004). Accounting contributed significantly to slavery and facilitated slave transactions and systematized exchanges, making slavery a business (FLEISCHMAN; TYSON, 2004).

The Holocaust and slavery are just two examples of the social responsibility that Accounting and its professionals have. They are themes that serve as an opportunity for reflections on the social meaning of Accounting, being it a significant tool that may – and should – be used ethically. Accountants in those times (Holocaust and slavery) could argue in their own defense that they were “only following orders”. But aren’t there today companies that have employees working in situations analogous to slavery? Or, when an accountant manipulates information for the benefit of a group in detriment of others, isn’t it a way of promoting inequality? The “I-only-followed-orders” defense has increasingly lost legitimacy for the professionals of this area.

## 5. PATHS FOR ACCOUNTING

It is possible to suggest some improvements for Accounting. Lack of theories on Accounting Science is a fact that prevents its advancement, limits the accomplishment of empirical tests and interpretation of findings of researches that analyze associations between accounting variables and other economic variables (HOLTHAUSEN; WATTS, 2001; FARIAS; MARTINS, 2015).

Accounting can enhance its capacity to measure intangible resources of an organization such as intellectual capital and goodwill (IUDÍCIBUS, 2007, 2012; IUDÍCIBUS; MARTINS, 2015). As it is well known, there are difficulties and subjectivity in measuring the value of these assets, and their importance to organizations is recognized. Many firms present an expressive difference between its market value (recognized by the stock market) and its value recorded in Net Worth, the intangible assets being the main factors accountable for the organizational success (HITT *et al.*, 2000). Advancements in the capacity to measure intangible resources may contribute to a better CG. As pointed out by IBGC (2015, p. 20), one of the key principles for a sound governance is transparency, which “cannot be limited to the economic-financial performance but should consider other factors (including intangibles) that drive management actions and lead to the preservation and optimization of the organizational value”. (Author’s translation).

Another advance that would contribute to this science and, at the same time, the agents involved in governance, would be the construction of theories that define profit and its components (FARIAS; MARTINS, 2015). A better understanding and representation of the concept of profit and its components would help agents fulfill their obligation to give an account of their actions in a clear and comprehensive manner. Many researchers are conducting their studies on profit and its components based on proposed standards instead of observing the phenomenon as it occurs (HOLTHAUSEN; WATTS, 2001).

Good governance practices are driven, as already mentioned, by the transparency principle. High level of transparency in the organization’s operations contributes positively to its image and of their managers, and, furthermore, “a positive image can minimize transaction costs and capital costs by building trust” (IBGC, 2015, p. 73) (Author’s translation). However, the correct application and disclosure of current accounting procedures do not always secure the users’ understanding, and the Accounting Science must develop means to make it more intelligible. It is suggested that Accounting improves the concept of value (not only recording costs), develops the theory about the notion of imputed costs, economic costs, opportunity costs, committed costs, and the analysis of the assets elements by its Value at Risk, shows a plurality of results; then it will be able to effectively rise scientifically (IUDÍCIBUS, MARTINS; CARVALHO, 2005). Improving the capacity to evaluate and diminish subjectivity means collaborating to corporate governance.

Still in the direction of advancement opportunities, Accounting needs to develop other kinds of measurement, in addition to the financial one, and so it will be able to analyze the productivity of an organization in terms of wealth generated for itself and the other interested parties (MARTIN, 2002). It has been suggested the development of Integrated Corporate Reporting models with the purpose of associating the economic-financial dimension with the economic, social and environmental impact of the actions of an organization. It is the managers’ responsibility to watch over the economic-financial feasibility of the organization and must consider its most diverse resources – financial, manufactured, intellectual, human, social, environmental, among others (IBGC, 2015).

The scope of financial statements should be expanded so that its focus would not be restricted to informing creditors, investors and taxation agents, but rather the entire society. The Value-Added Statement (VAS) is a good example of an instrument used for this purpose. The agents involved in governance should find means to inform society about their actions, given that they are accountable for topics such as “sustainability, corruption, fraud, abuses in short-term incentives to executives and investors, as well as for the complex and multiple relationships that organizations establish with the most varied agents" (IBGC, 2015, p. 13). (Author's translation).

Farias and Martins (2015) mention that the lack of a comprehensive theory about market imperfections hinders the investigation of the determinants and consequences of the choices of accounting methods. In addition, Accounting should evolve in the assessment of the recoverable amount of an asset and be more dynamic, and so it will be better applied in the organizational context (TUOMINEN, 2000). It can be observed that some accounting techniques are related to the immobility and inefficiency of vertical organizational structures, based on principles such as hierarchy and functional specialization (MARTIN, 2002). In contrast, the governance structure of an organization is dynamic, being formed by many members such as shareholders, board of directors, executive officers, supervisory and control bodies, audit committee, fiscal council, among others.

Finally, standardization may be hindering the evolution of this science and leading researchers to an erroneous interpretation of the financial statements and, consequently, the real situation of the firms (IUDÍCIBUS; LOPES, 2002). The academy should question this situation and conduct studies to verify the advantages and disadvantages of adhering to the standardization of national and international norms, as well as if the standardization already accomplished has brought the promised advantages. It is known that standardized procedures facilitate the work and comparability of the performance of the agents involved in governance. In other words, standardizing accounting procedures means gaining more opportunities of comparison and, in turn, preventing the advance of the science by inhibiting the creativity and freedom of professionals of this area (NIYAMA; SILVA, 2008).

## 6. Final Considerations

For Accounting professionals, "What is Accounting, what is it for?" can be a difficult question to be answered. Even more complex questions would be, "How does Accounting function and what is the 'logic' of its functioning?" and "How does Accounting affect people's lives?" To answer the questions about the functioning of Accounting using the argument "because tax authorities demand" is as vague to science as the argument "because God wanted". It is really difficult to explain how Accounting works, probably because questions like these are hardly ever asked.

To conclude the debate, some considerations are relevant. It should be emphasized the importance of intellectuals in the area to develop Accounting theories. Understanding the logic of the Accounting Science is important, among other reasons, because regulations are not always clear, leaving accountants in situations where only based on theoretical fundamentals they would be able to justify their actions. Much has been said about CG as an option to solve the problems pointed out by the Agency Theory; however, one should remember that management of companies and the information used to support the use of CG are strongly based on the Accounting Science and its theories.

In a perfect (utopic) scenario, Accounting and its theories could explain all phenomena (financial and managerial) related to the managers' performance and, consequently, to the organization's value; therefore, there would not be information asymmetry. Every variation in the net worth, considering tangible and intangible values, would be explained by Accounting. In this scenario of maximum development of the Accounting Science and its theories, any action against the principals' interests and all opportunistic actions by their agents would be easily identified. It is claimed that the development of Accounting and its theories is an option to collaborate with CG and reduce most of the agency problems.

In fact, Accounting has always evolved when society has changed and created scenarios, seeking to solve imposed demands, but a few times it has acted in anticipation to future changes. The field that Accounting researchers can explore is vast, but they need courage to think beyond established norms and, so, they might be able to succeed in solving current problems and anticipate scenarios that society will demand, always with social responsibility and in an ethical manner.

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