

# ACCOUNTING THEORY AND FINANCIAL DECISION-MAKING: A REVIEW OF LITERATURE

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## Abstract

Sound financial decisions rely on timely, accurate, and relevant information. Accounting theory provides the conceptual and methodological basis for producing such information, thereby influencing decisions on investment, management, credit, and regulation. This paper reviews conceptual, theoretical, and empirical studies to explore how accounting theory shapes these decisions, with emphasis on emerging-market contexts such as Nigeria. The findings indicate that the theoretical principles of accounting, through measurement bases and qualitative characteristics, strengthen accountability, transparency, and comparability, which in turn improve capital allocation and risk evaluation. Nonetheless, several limitations remain, including managerial opportunism, behavioural biases, inadequate enforcement, and reporting complexity. The paper therefore advocates integrating behavioural and contextual perspectives, enhancing institutional oversight, and upgrading accounting education to strengthen the relationship between theory and practice.

Keywords: Accounting Theory, Financial Decision-Making, Transparency, Emerging Economies, Regulatory Compliance

## 1. Introduction

Every financial decision, whether it concerns investment, lending, or internal management, depends on reliable and credible financial information. Yet users of financial statements frequently encounter challenges such as inconsistent valuation methods, incomplete disclosure, and earnings manipulation, all of which undermine confidence and distort resource allocation (Healy & Wahlen, 1999). In this regard, accounting theory plays a pivotal role by defining the principles and conceptual frameworks that transform raw economic data into meaningful, decision-useful information.

In this study, financial decision-making is treated as the dependent construct encompassing investment choices, resource allocation, credit assessment, and regulatory interventions. The main explanatory constructs are accounting information quality and the theoretical orientations, normative, positive, and descriptive, that guide recognition, measurement, and disclosure. Accounting theory serves as the medium through which economic events are converted into quantified financial representations, forming the informational base on which decision makers act.

Through its rules of recognition and measurement, accounting theory directly affects the dependability and relevance of reported data. These reported numbers influence firm

valuation, debt covenants, and managerial performance evaluations. A firm grasp of this connection is vital for policymakers, practitioners, and researchers seeking to enhance market efficiency and information credibility.

By synthesizing conceptual, theoretical, and empirical literature, this paper explains the pathways through which accounting theory contributes to improved decision quality and identifies the institutional factors that hinder its application. The discussion emphasizes emerging economies, where weak institutional infrastructure and enforcement often dilute the practical value of theoretically sound standards.

Advanced economies generally enjoy strong enforcement, developed capital markets, and mature regulatory environments that allow theoretical accounting principles to translate effectively into credible reports (IFRS Foundation, 2021; Deloitte, 2023). Conversely, in many developing nations, Nigeria inclusive, constraints such as limited auditor expertise, poor governance, and asymmetrical information inhibit consistent application of accounting standards. Addressing these contextual issues is therefore central to the current analysis.

The objectives of this paper are fourfold. First, it aims to trace the evolution of accounting theory and establish its relevance to financial decision-making processes. Second, it seeks to review the existing conceptual, theoretical, and empirical studies that link accounting theory to decision-making outcomes. Third, the paper examines how accounting theory operates in practice, particularly within the context of emerging markets where institutional and regulatory challenges often affect its application. Finally, it proposes policy recommendations aimed at bridging the persistent gap between accounting theory and practical financial decision-making, thereby enhancing the usefulness and credibility of financial information.

The remaining sections are arranged as follows: Section 2 reviews the literature (conceptual, theoretical, and empirical perspectives); Section 3 explains the qualitative methodology; Section 4 discusses the synthesized findings; and Section 5 concludes with key insights and practical implications.

## **2. Literature Review**

### **2.1 Conceptual Review: Accounting Theory and Decision-Usefulness**

Accounting theory forms the intellectual base that underlies modern financial reporting and disclosure practices. It establishes a structured system for recognizing, measuring, and presenting financial transactions in a way that enhances the usefulness of information to decision-makers. According to the International Accounting Standards Board (IASB, 2018), the key objective of financial reporting is to provide information that supports existing and potential investors, lenders, and creditors in allocating resources effectively. The decision-usefulness approach therefore lies at the heart of accounting theory, emphasizing fundamental qualitative characteristics such as relevance, faithful representation, comparability, verifiability, timeliness, and understandability.

Over time, accounting theory has evolved alongside economic and business developments. Its evolution, from stewardship and historical cost models to fair value, sustainability, and integrated reporting frameworks, illustrates the responsiveness of accounting principles to the needs of users and the realities of the marketplace. Beyond serving as a record-keeping tool, accounting theory provides interpretive models that help transform data into valuable insights for judgments under uncertainty. By doing so, it enables users to evaluate performance, assess risks, and make informed decisions.

### **2.1.1 Role of Accounting Theory in Financial Decision-Making**

Accounting theory supports a wide range of decision-making activities by ensuring that financial information is coherent, standardized, and dependable. Through the decision-usefulness objective, it transforms accounting data from mere historical records into meaningful guides for future-oriented decisions.

#### **Investor Decision-Making:**

For investors, accounting theory ensures that reported figures reflect profitability, liquidity, and value creation potential. Frameworks derived from accounting theory, such as fair value measurement and accrual accounting, enhance the predictive power of financial statements. The consistent application of conceptual frameworks reduces information asymmetry and promotes efficient markets (Damodaran, 2012; Abel et al., 2019). Transparent, theory-based reporting enhances investor confidence and facilitates accurate valuation of securities.

#### **Managerial Decision-Making:**

Managers depend on theoretical accounting models for planning, performance evaluation, and control. Frameworks like the Balanced Scorecard (Kaplan & Norton, 1992) integrate both financial and non-financial metrics, aligning short-term performance indicators with long-term strategic goals. Studies such as Joseph et al. (2024) reveal that theory-based accounting systems improve cost management, budgeting, and organizational alignment, contributing to superior operational outcomes.

#### **Credit and Lending Decisions:**

Lenders rely on ratios and performance indicators rooted in accounting theory to assess a borrower's financial health. Metrics such as liquidity, solvency, and profitability ratios, derived from theoretical constructs, aid credit risk assessment (Altman, 1968). Reliable financial information improves the quality of lending decisions and minimizes credit default risks (Osho & Adebambo, 2018).

#### **Regulatory and Policy Decisions:**

Regulators and standard-setting bodies base their frameworks on accounting theory to ensure uniformity and comparability across organizations. The IASB's conceptual framework and IFRS standards promote global consistency and transparency (IASB,

2018). In emerging markets, the faithful application of these theory-driven frameworks enhances investor confidence and stimulates cross-border capital flows (Deloitte, 2023).

### **Broader Economic Implications:**

At the macroeconomic level, accounting theory facilitates international investment and corporate accountability through harmonized standards and disclosures (IFRS Foundation, 2021). It also provides a foundation for non-financial reporting, such as environmental, social, and governance (ESG) disclosures, which have become integral to modern corporate strategy.

### **2.1.2 Contemporary Challenges and Adaptations of Accounting Theory**

Recent technological and societal developments, such as digitalization, artificial intelligence, blockchain, and sustainability reporting, have forced accounting theory to adapt to new realities. Traditional frameworks that focused mainly on tangible assets and periodic reporting are increasingly inadequate for capturing emerging concepts like digital assets, carbon credits, and continuous reporting (IFRS Foundation, 2021).

Furthermore, insights from behavioural accounting research have challenged the assumption of perfect rationality among users of financial reports. Studies show that investors and managers often interpret information through cognitive biases and heuristics. Integrating behavioural perspectives into accounting theory enhances its relevance by explaining how users actually process and respond to information. As the business environment evolves, accounting theory must continue to expand to include broader notions of value, accountability, and stakeholder engagement, ensuring its continued usefulness in decision-making.

## **2.2 Theoretical Review**

Theoretical perspectives in accounting help explain both the formation of accounting standards and the behaviour of users and preparers of financial information. Among the most influential frameworks are the Positive Accounting Theory, the Normative Accounting Theory, and the Descriptive/Behavioural Theories.

The Positive Accounting Theory (Watts & Zimmerman, 1986) seeks to predict and explain managerial behaviour under different accounting standards, highlighting how self-interest and contractual incentives influence reporting choices. In contrast, the Normative Accounting Theory prescribes what accounting should be, focusing on ideal standards of fairness, consistency, and decision-usefulness. Meanwhile, Descriptive and Behavioural Theories emphasize how individuals actually use and interpret financial data, incorporating psychological and contextual factors. Together, these theories underscore that accounting is not static; it evolves through the interaction of economic, institutional, and human factors.

## **2.3 Empirical Review**

Empirical research provides substantial evidence that accounting theory enhances the usefulness of financial reporting for decision-making, particularly in emerging markets such as Nigeria. Much of this evidence is linked to the implementation of International Financial Reporting Standards (IFRS), which operationalize theoretical accounting principles into practice.

Lateef, Rashid, Olowookere, and Ado (2021) evaluated the relevance and timeliness of financial reports before and after IFRS adoption in Nigeria. Their study of non-financial listed firms revealed that post-IFRS financial statements had higher predictive power for investors, confirming that standardized theoretical frameworks strengthen market confidence and transparency. Likewise, Ibrahim and Dabo (2021) found that EPS, BVPS, and cash flow per share significantly influenced stock prices of service firms, underscoring the importance of accounting theory in investors' evaluations.

Similarly, Ihenyen, Egede, and Pereowei (2023) also documented a significant link between IFRS-based accounting information and share prices of industrial firms in Nigeria between 2012 and 2022. Their findings validate the argument that theoretically grounded accounting enhances the credibility and decision-usefulness of financial data. Nwinkonzor and Odoemelam (2024) confirmed these results using data from 2006 to 2022, showing that IFRS adoption improved the association between accounting figures and market values among manufacturing firms.

Further evidence from Ibo and Olasupo (2024) demonstrated that normative accounting assumptions, such as fair value and accrual principles, directly influence investment decisions in consumer goods firms. Their results indicate that theoretical frameworks guide both the preparation and interpretation of financial statements, shaping rational investor behaviour. Odoemelam and Wobo (2025) examined IFRS as a driver of the value relevance of accounting earnings across industries in Nigeria. They found a stronger relationship between earnings per share (EPS), book value per share (BVPS), and market prices following IFRS adoption, demonstrating that theory-based reporting improves investor decision quality.

Comparable studies from Malaysia, Kenya, and Indonesia reinforce these conclusions, showing that IFRS adoption enhances transparency, reliability, and comparability of accounting information (Lateef et al., 2021; Ihenyen et al., 2023). Collectively, these empirical findings confirm that accounting theory, implemented through global reporting frameworks, plays a critical role in strengthening decision-making and improving financial market efficiency.

## **2.4 Critical Analysis of the Literature**

### **2.4.1 Strengths of Accounting Theory**

Accounting theory provides well-defined conceptual and procedural frameworks for measurement, recognition, and disclosure, ensuring that financial reporting remains consistent and comparable across entities (IASB, 2018; Abel et al., 2019). It contributes

to the reduction of information asymmetry and enhances decision quality among investors, managers, creditors, and regulators. The theory also underpins management control systems, helping organizations align operational performance with strategic objectives through frameworks such as the Balanced Scorecard (Kaplan & Norton, 1992). Furthermore, its adaptability allows it to evolve alongside changes in the business environment, including technological advances and sustainability reporting demands.

#### **2.4.2 Limitations and Gaps**

Despite its strengths, accounting theory faces practical and contextual limitations. Opportunistic reporting behaviours by managers may undermine the principle of faithful representation (Healy & Wahlen, 1999). Behavioural research indicates that psychological biases and limited financial literacy can distort how users interpret accounting information (Ram & Tarpria, 2019). In many emerging economies, enforcement mechanisms are weak, professional capacity is low, and compliance with international standards remains inconsistent (Deloitte, 2023). Additionally, excessive technical complexity in disclosures can obscure rather than clarify financial information (Brown & Tarca, 2013). These weaknesses highlight the need for reforms that bridge the gap between theoretical ideals and practical realities.

#### **2.4.3 Future Directions**

The ongoing evolution of accounting theory should embrace behavioural insights, ethical considerations, and greater flexibility for context-specific application without compromising global comparability. Simplifying disclosures, leveraging digital technologies for real-time financial reporting, and embedding sustainability principles are essential to maintaining relevance and decision-usefulness. Future research and policy efforts should also emphasize capacity building and institutional strengthening to ensure consistent implementation of theoretically sound accounting standards.

### **3. Methodology**

This paper employs a qualitative, literature-based methodology, relying entirely on secondary sources. The study population comprises scholarly publications, standard-setting documents, professional reports, and relevant case studies addressing the interface between accounting theory and financial decision-making.

A purposive and systematic selection process was employed in gathering the relevant literature for this study. The selection focused on materials that met three key criteria: first, they had to be directly relevant to accounting theory and its influence on financial decision outcomes; second, they were required to be published in peer-reviewed journals or professionally recognized outlets to ensure academic credibility; and third, they needed to demonstrate applicability to both developed and emerging economies, with particular emphasis on the Nigerian context.

Data were sourced from reputable databases such as Google Scholar, Scopus, and JSTOR using keywords including accounting theory, decision usefulness, financial reporting, and Nigeria. The interpretive synthesis approach was then applied to extract

major themes, reconcile inconsistencies, and highlight conceptual and empirical gaps. The reliance on secondary data is justified given the study's objective, to integrate and interpret existing theoretical and empirical knowledge rather than generate new primary evidence.

## **4. Results and Discussion**

### **4.1 Accounting Theory and Investor Decisions**

Accounting theory affects investment decisions by ensuring that financial information is comparable, transparent, and standardized. When recognition and measurement principles are consistently applied, they enhance investors' ability to forecast cash flows and assess firm performance. Empirical evidence demonstrates that firms operating under well-enforced theoretical frameworks exhibit lower earnings volatility and attract higher market valuations (Abel et al., 2019). In contrast, weak enforcement mechanisms and earnings management practices reduce investors' confidence and distort valuation accuracy (Osho & Adebambo, 2018).

### **4.2 Managerial Application of Theory-Based Information**

Theoretical principles form the backbone of management accounting systems such as budgeting, variance analysis, and balanced scorecards (Kaplan & Norton, 1992). By linking operational activities to strategic outcomes, theory-driven accounting systems promote better resource allocation and performance evaluation. Studies such as Nielsen (2015) and Joseph et al. (2024) show that organizations that internalize accounting theory into their control systems exhibit improved efficiency, accountability, and long-term competitiveness.

### **4.3 Accounting Theory and Credit Decisions**

Creditors rely heavily on accounting ratios and financial indicators, grounded in accounting theory, to evaluate solvency, profitability, and liquidity (Altman, 1968). High-quality reporting allows lenders to differentiate between viable and high-risk borrowers, thereby optimizing credit distribution. However, inconsistencies in recognition and disclosure practices or earnings manipulation (Healy & Wahlen, 1999) increase perceived risk and lead to higher borrowing costs. Thus, consistent application of theory-based standards contributes to financial system stability.

### **4.4 Regulatory Decisions and Market Integrity**

Regulatory authorities design policies and disclosure requirements based on conceptual accounting frameworks. Effective enforcement ensures that theoretical standards are translated into credible reporting practices. In many developing economies, challenges such as corruption, low institutional capacity, and inadequate audit oversight hinder this translation (Deloitte, 2023). Strengthening enforcement mechanisms, therefore, remains a priority for aligning accounting theory with real-world practice.

#### **4.5 Behavioural and Institutional Constraints**

Behavioural biases influence how users interpret accounting data. Heuristics and framing effects can lead to inconsistent judgments even when information is theoretically sound (Ram & Tarpria, 2019). Institutional constraints, such as weak auditing infrastructure, regulatory inefficiencies, and corruption, further reduce the practical impact of accounting theory in emerging markets (IFRS Foundation, 2021). Understanding these contextual barriers is essential to designing reforms that make accounting theory more effective in practice.

#### **4.6 Integrated Discussion and Implications**

The synthesis of reviewed literature indicates that accounting theory significantly enhances decision quality where institutions and enforcement mechanisms are strong. In developing countries, however, the focus should not be on rejecting international standards but on improving implementation capacity and contextual adaptation. Training auditors, building institutional credibility, and designing simplified disclosure models can help close the gap between theory and practice. This balanced approach ensures that financial information remains both globally comparable and locally relevant.

#### **5. Conclusion and Policy Implications**

Accounting theory provides the foundational framework for generating reliable and relevant financial information that supports investment, management, credit, and regulatory decisions. This review confirms that theoretical models, when properly implemented, enhance transparency, comparability, and market efficiency. Nevertheless, institutional and behavioural challenges continue to limit the full benefits of accounting theory, particularly in emerging economies.

To strengthen the practical application of accounting theory, this paper recommends three key policy priorities. First, there is a need to enhance enforcement mechanisms and audit capacity to ensure the consistent and effective application of accounting standards across organizations. Second, accounting education and professional training should be modernized to incorporate behavioural, ethical, and digital competencies that reflect the evolving demands of the profession. Finally, disclosure practices should be reformed to make financial reports both theoretically robust and user-friendly, thereby improving their relevance, transparency, and decision-usefulness for diverse stakeholders.

By pursuing these reforms, regulators and professional bodies can bridge the persistent gap between theory and practice, enhance decision-usefulness, and contribute to sustainable economic and financial development.

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