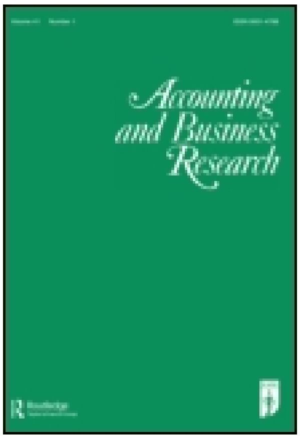

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Conceptual frameworks of accounting: Some brief reflections on theory and practice

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Conceptual frameworks of accounting: some brief reflections on theory and practice

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Two very different approaches to evaluating conceptual frameworks (CFs) for accounting are set out by Christensen (2010) and Boyle (2010).[1] Christensen reviews a body of research, primarily theoretical and based on 'information economics', which has explored the potential role and 'comparative advantage' of standardised, audited financial statements in a setting where shareholders and managers (formally characterised as 'principals' and 'agents') are making investment decisions and are implementing performance-based compensation contracts. To make the link to published reports as the primary focus of standard-setters' CFs and to stock exchange investors, Christensen explores these problems within a competitive market setting (formally characterised as 'efficient') where multiple information sources are utilised by multiple information intermediaries, such as analysts and financial journalists, as well as by investors themselves. The major insights from his review are that two distinct functions of accounting, namely, providing useful information for investment decisions and providing control information for monitoring and rewarding managers' performance, are demonstrated ideally to require different kinds of accounting measures (in particular with differing degrees of relevance and reliability). 'Moral hazard' results from managers having 'proprietary information' about the firm, i.e. knowing things that owners and other outsiders do not know unless the managers tell them, and therefore being able to hide the full story if they choose to act opportunistically in their own rather than owners' best interests. Even if separate accounting bases were employed for each of the distinct functions, the moral hazard means that inevitably the two kinds of reporting 'infect' each other. The outcome is that setting just one satisfactory body of accounting standards that has to cover both will be extremely problematic, given managers' own incentives. Moreover, setting rules that will be the same for all companies inevitably loses the particular balance of characteristics of information requirements that would be optimal for each individual firm, and there has to be a political decision as to who will benefit and who will lose.

Furthermore, by the time published, audited, accounting reports appear, it is likely that there will be little 'news' in them. That conclusion has been supported by empirical evidence since Ball & Brown's famous 1968 paper. However, this does not mean the accounting reports have no value. Managers know that after the end of the year they will have to release the audited accounts to their shareholders and other investors. This will itself constrain the information released during the year to be as consistent as possible. Their actions are also constrained by the information they know will eventually be reported. Hence accounting information plays a role in controlling agency costs.

Christensen therefore argues that the qualitative characteristics (QCs) that are a feature of all the frameworks to date (both national and international) are too crude to help in calibrating the actual trade-offs that need to be made. The same can be said of the high level definitions of 'elements of financial statements' and, one might add, the 'recognition criteria'. Moreover, from an information perspective, there is no inherent superiority in any one basis of measurement: choices should be made of 'horses for courses' in individual standards and therefore there is little value in including measurement in the CF. Christensen's conclusion, arguing as he has from 'the bottom up', is that this leaves only the highest level of the CF as potentially fulfilling a useful role, in setting out what he calls a 'Constitution'.[2] By this he means the broad objectives that the standard-setters will pursue, and

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[1] **Editor's note:** Boyle's commentary relates to the version of Christensen's paper presented at the ICAEW's Information for Better Markets Conference in December 2009. Christensen subsequently made amendments to his paper for publication in response to an academic reviewer's comments.

[2] **Editor's note:** This description should not be confused with the formal *Constitution* that governs the IASC Foundation and regulates the composition and conduct of the IASB.

principles they will observe, in writing rules for every major company around the world to follow.

Boyle, by contrast approaches the issue more from the 'top down' perspective of a regulator and finds it hard to relate the context of Christensen's 'bottom up' world of 'primitive' firms to his arena. Here the accounting rules of IASB and FASB are primarily for large, listed companies, with boards of directors and hierarchies of management reporting publicly to widely dispersed shareholders. Alongside the financial institutions there are passive, small investors for whose protection much of the regulation has been designed. The insights from 'agency' models seem difficult to scale up to such a multiperson world – but cf. ICAEW (2005). The 'efficiency' of unfettered markets in providing full information flows to all parties is questionable (as the global financial crisis of 2008 has reminded everyone), and regulation is needed because even non-speculative investors, who need to balance their investment portfolios, want to know that individual firms' risks are fully and fairly reflected in their market prices. If the public, through the government, are to give standard-setters, such as IASB, the power to set mandatory standards then they need to be assured of their independence, their balanced representativeness, and above all their intellectual credibility and technical competence. The constitutional relationships between the IASC Foundation and the IASB (and, in the EU, the requirement for endorsement prior to adoption of new standards) are designed to cover the first two of these concerns. It is in respect of the third that the CF has its own important role.

Arguments for and against regulation per se and over how costs and benefits of alternative accounting rules are to be assessed are covered in the papers by Bushman & Landsman (2010) and by Schipper (2010) presented in the conference to which Christensen contributed. Leuz (2010) explores the importance of the national and institutional contexts in shaping accepted and acceptable forms of accounting; and Moran (2010) reminds us that the delegation of powers to non-government bodies is itself a political decision, and the balance between the two may emerge differently at different times and in different political jurisdictions, so that international regulation introduces a yet higher level of complexity.

Here I will pursue Boyle's argument that the CF is needed to demonstrate the technical credentials of the IASB (or FASB). New IASB Board members have to sign up to the CF. Boyle appears to think that it is the current type of CF that is needed. Consequently, as he asserts, definitions of elements such as 'assets' are a required part of the CF to ensure as much consistency as possible across time (not least as Board members change). These arguments have had a long currency, ever since FASB began its CF project in 1974 (Macve, 1981).

However, we should note that in Boyle's 'real world', what is recognised in accounting as an asset (and correspondingly as a liability) and how it is measured frequently changes as standards change. Consider for example: the current proposals on leases; recent US recognition of 'in process research and development' at acquisition date as a continuing asset in its standard on business combinations; removal of 'acquisition costs' in business combinations and (proposed) in life insurance accounting; pension liabilities; and proposals to change IAS 37 in respect of what used to be called 'contingent liabilities'. Assets may be treated inconsistently within current standards, e.g. 'acquired' and 'internally developed' intangibles such as brands and goodwill; a new subsidiary's assets at the date of acquisition (including intangibles) identified and measured at 'fair value' while the holding company's equivalent assets remain unrecognised or valued at (depreciated) historical cost. Other changes in the reporting of income have not even resulted from recognising net asset changes. Consider for example the expensing of executive stock options (Bromwich et al., 2010) or the latest proposals on 'revenue recognition' (Macve, 2010). It has long been argued that seeking such higher-level definitions, and believing that the levels of the CF must form a deductive logical sequence concluding with clear, consistent 'high quality' standards, represents a serious failure to understand the insights of the modern philosophy of language (e.g. Kitchen, 1954; Macve, 1981; Sunder, 2007; Dennis 2006, 2008).

Christensen also analyses rigorously the role of QCs and demonstrates why it has long been argued that they are little more than common sense 'rules of thumb' and do not deserve the repeated reshufflings of their meanings and rankings that have occupied much space in successive versions of the CF (e.g. Chambers, 1964; Macve, 1981). CFs have also thus far stumbled over the crucial measurement stage. One honourable exception is the UK ASB's (1999) *Statement of Principles* which, while retaining advocacy of a 'mixed measurement model', argued that current values should be 'deprival values' (see, e.g. Lennard, 2010; Macve, 2010 and Whittington, 2010).

In comparing Christensen's and Boyle's approaches we may note that Christensen's literature citations largely reflect US sources. Here I reflect briefly on how far UK literature has supported his approach vis à vis Boyle's. The 'information economics' approach to analysing accounting problems and voluntary disclosure is clearly set out in leading textbooks such as Bromwich (1992), which also covers the economic arguments in favour of regulating the mandatory provision of accounting information (including problems of 'public goods' and cost structures of disclosure), and the conceptual difficulties in deriving an unambiguous, practical notion of 'income'.

A major feature of current CFs is their ultimate focus on measuring income (and potentially components of income such as 'earnings'), even though they argue this is to be achieved through the 'balance sheet' approach of focusing on the recognition and measurement of assets and liabilities and of changes in them. Christensen notes that it is well known that the measurement of 'income' in the economist's sense of the change in wealth, or of the 'permanent income', is not achievable except in conditions where the knowledge would be redundant, so settling the definitions and measurement bases cannot achieve that goal (for fuller recent expositions of the reasons for this see, e.g. Bromwich et al., 2010 and Whittington, 2010). As the FASB's original CF project (and its subsequent imitations by, e.g. ASB, IASC and now IASB) can indeed be viewed as the culmination of a 'search for accounting principles' imposed on the accounting profession in the US in the 1930s at the instigation of the Securities and Exchange Commission (SEC) (e.g. Macve, 1983; cf. Zeff, 1999), it has so far remained part and parcel of the search for the 'best' definition of profit/income to replace what is seen as the untidy and incoherent tangle of assorted, historically evolved, 'conventions' that appear to lack conceptual justification (e.g. Chambers, 1964; FASB/IASB, 2005).

Even in the 1930s there was a 'British' voice in the US. George O. May of Price Waterhouse argued that better disclosure of information and of accounting choices was what was needed, rather than the attempted specification of detailed uniform accounting rules (e.g. Macve, 1983: 178–179). Perhaps May's position was undermined by the almost complete lack of explanation of what accounting policies were being used by UK companies at that time. That situation lasted until the advent of UK accounting standards in the 1970s (Zeff, 2009) and in particular the UK standard SSAP 2 *Disclosure of Accounting Policies* (ASC, 1972).

There remains an urgent need for a fundamental rethink of what 'kind of thing' a CF for accounting should be (Power, 1992). It should probably follow Christensen's advice and stay at the 'top level'. It might focus, for example, on setting out the key factors and questions that the standard-setters would address and their approach to the trade-offs they would have to make (e.g. Macve, 1981). It could set out the need for 'practical reasoning' based on 'bottom up' investigation and understanding of current practices, evaluation of their continuing practical value (alongside their conceptual justification), and deliberation and consultation on potential for improvement. That could be more beneficial than attempting 'top down' logical deduction of 'correct' standards that the current kind of 'official' CF has conspicuously failed to deliver over the 35-plus years of its very expensive development (e.g. Dopuch and Sunder, 1980; Macve, 1997; Dennis, 2006, 2008). In a recent initiative, the members of the Financial Accounting Standards Committee of the American Accounting Association (Bloomfield et al., 2009) critique the extant frameworks and the IASB/FASB convergence of frameworks, offering instead a framework that meets their own preferred criteria. Their alternative adopts primarily an income statement approach rather than the FASB/IASB balance sheet approach.

We should not be surprised if such alternative kinds of CF lead to piecemeal, evolutionary improvements in accounting practice and disclosures rather than wholesale replacement by a new, much more logically consistent 'accounting model' (ICAEW, 2009). An interesting comparison is the standard QWERTY keyboard.[3] It is inefficient, but universal (outside specialist typing competitions). An efficient keyboard would, from the beginning, have been centred according to the relative frequency of the use of the individual letters in writing the English language. However, it is widely believed that because this would have caused the original 'hammer' typewriters to jam, they had to be 'slowed down' by spacing out the most frequent characters. To help the marketing of the new mechanical writing machine, Remington, so the widespread belief goes, designed the top row so that it contains all the letters of 'typewriter' (plus Q, U and O for camouflage), which is the word the sales force would use in demonstrating the machine's superior speed. The trade-off between speed and mechanical efficiency was historically contingent on conditions at that time. Now the QWERTY keyboard is so embedded that we are still using it for

[3] (http://home.earthlink.net/~dcrehr/myths.html [accessed 16 March 2010])

electronic machines, even though the most efficient layout to achieve maximum speed is now known for each language. QWERTY seems likely to remain until keyboards themselves are obsolete.

Does the same apply, e.g. to 'relevance' and 'reliability' of accounting numbers, given changing relative costs in different places at different times? The accounting model we have is the outcome of many such past trade-offs (Basu and Waymire, 2008). It is now so embedded in many spheres that it is not clear that, even if accounting theory could set out a CF for a 'best' model, we would find it worthwhile to adopt it, given the costs of transition. 'Fixing what's broke' may continue to be sufficient (e.g. ICAEW, 2009), especially if this is complemented by empowering users (e.g. through internet 'drilling down' to finer information levels) to tailor the accounting to their own needs so that they are not constrained by the straight jacket of the 'standard model' and can again become more like the freely-contracting actors in Christensen's scenario.

An alternative approach to retaining desirable flexibility, this time perhaps more to suit preparers' differing situations while providing a standard 'benchmark', is the option to 'comply or explain' familiar in the UK from the *Combined Code of Corporate Governance* (FRC, 2008: Preamble). Or again, relevant groups of preparers, e.g. large multinationals (a 'global players segment') as suggested by Leuz (2010), could be allowed to use models of a kind more suited to their own complexity (as they can, for example, in adopting the Global Reporting Initiative or other voluntary codes for sustainability management and reporting (Chen & Macve, 2010). Alternatively specialist industry groups might build their own supplementary models to supply more useful information than their IFRS accounts, as European insurers have done with 'Embedded Value' reporting for life insurance accounting (Horton et al., 2007).The advent in recent years of the opportunity for shareholders to vote on the Directors' Remuneration Report (e.g. in the UK and Australia)[4] also increases the interaction between the users, preparers and auditors of published accounts.

Some concluding reflections

Christensen's analysis sets out some of the formal demonstrations that researchers have worked on that bear out older, more intuitive arguments that there can be no ideal practical measure of income. Income measurement always involves estimation of the future (Edey, 1970). The demands of investor decision-making and control (and other contractual relationships) generally require different kinds of accounting (Edey, 1978). Accordingly, standard-setting is inevitably dealing with compromises and trade-offs, albeit in a world where little is known about the effects of these and their costs and benefits (Schipper, 2010; cf. Gwilliam et al*.,* 2005). Difficult judgments must be made.

However, in viewing the existence of audit as implying that accounting data are 'hard to manipulate', Christiansen's characterisation seems over simplified. Arguably, it is not in the routine verification of 'hard' data, but rather in 'guaranteeing' that investors and others can trust the relatively 'soft' estimates and judgments underlying the accounting (based on the auditors' wide knowledge and experience of many companies, coupled with their close contact with the audit client's management), that auditors can be seen as 'adding value' (Grout et al., 1994); while Power (1996) argues that much of what is 'verifiable' by audit is not 'given' as hard data but is socially constructed to be 'auditable'.

Accounting reporting and disclosure also have an important role beyond that of providing information for managers and individual investors in individual firms, or even when comparing firms. Standardised, audited accounts are part of a regime that defines the economic environment in a country, or across countries, and enables investors to have confidence in the system as a whole as one to which to entrust their money. This was the main justification given by Edwards (1938) in his call for a revolutionary reform of UK accounting practice. It seems as true today. In the view of the US SEC it is the overall regime of standards of corporate governance, accounting, auditing and enforcement in a country that lowers the cost of capital to firms in that economy and thereby stimulates investment and economic growth. This effect is probably greater than what any individual firm can achieve by improving its own accounting and disclosures (cf. Botosan, 2006).

In other words, the firms etc., in Section 2 of Christensen's analysis are 'given' (exogenous to the argument). But equally one can argue that firms are 'endogenous', i.e. partly created by the availability of good accounting and an appropriate regulatory regime. That is Boyle's concern, and has been the concern of UK Company Law, not only in the Company Law Review from 1999 to 2005, but ever

[4] e.g. http://www.companydirectors.com.au/NR/rdonlyres/8BC9DA27-DF5A-4955–9E95-EB6B4BC78E8A/0/ISSUEPAPERREMUNERATIONREPORT170305.PDF (accessed 17 March 2010).

since the 19th century invention of 'limited liability' (Edey & Panitpakdi, 1978). It is interesting that such endogeneity is not currently admitted by the IASB, which takes the view that the stability of the current financial system is not a matter on which the standard-setter should be concerned.

There are mutually reinforcing insights to be gained from both 'bottom up' and 'top down' approaches. There will always be a creative tension between rigorous, abstract theoretical research and the current imperatives of practical and policy concerns. It is ironic that Boyle concludes by disparaging the kind of work outlined by Christensen when he begins his response by quoting Keynes's famous dictum, made when he was defending his own 'wild' theories against the objections of the 'practical men' of his day.

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