

‘Old laudanum in new bottles? Financial Accounting Theory (FAT) and Business, Financial and Accounting History (BFAH)’

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A new bottle of laudanum....

(thank you Wikipedia)



Laudanum

- From *praiseworthy* pharmaceutical and literary-creative aid ('tincture of opium')-- since Ancient Greece and beyond through to 19th century Britain....
- To (now) Class A criminal drug dependency (with the 1840s Opium Wars against China along the way)....
- Surely can't be compared to accounting...?

FAT: rationality

- Two recent books stress the rationality of financial accounting (largely) as it is (vs. FASB/IASB CF redesign) (Penman, 2011: ‘fundamentalist’, Waymire & Basu, 2008: ‘evolutionary’).
- Both mainly US/UK focussed...
- NB Emphasis on ‘conservative’ earnings and ‘hard balance sheet’ (Chicago/MIT/Rochester school): now being extended from ‘contracting’ to ‘valuation anchor to challenge stock-market price’ (and maybe explain ‘B/P’ risk in Fama-French model?)

FAT: rationality and myth.....

- W&B believe that DEB is a crucial tool for capitalism, but recognise however that we cannot **wholly** explain FAT (either as it is or should be) as rationally designed (cf FASB/IASB CF) but rather as the outcome of a constellation of historical and institutional factors (Burchell *et al.* AOS 1980)--but with a 'survival of the fittest'. (cf. Fleischman, *TAR*, 2009)

FAT as ‘institutional rationalised myth’?

- ‘Powerful institutional rules which function as highly rationalised myths’ (Meyer & Rowan, 1991)
- Become ‘taken for granted’
- But how much is rational?
- And how much is myth?

FAT and BFAH

- Creative tension within ‘power-knowledge’ regimes like accounting
- Problems with accounting are intrinsic in the origins of its modern power (Ezz,H&McV *ABR* 1990)—‘genealogy’
- So I will explore some interrelationships between FAT and Business, Financial and Accounting and history (BFAH)

Outline

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- 1. FAT: 3 modern examples and their history
- 2. 'Economic rationalist' history
- 3. An alternative history
- 4. Implications for future FAT?
- 5. Some conclusions for research
- 6. Questions?

It's time for some accounting...(!)

- 3 modern FAT Examples:

1. ESOs

2. Liabilities and discount rate changes

3. Life insurance—and 'Embedded Values'

1. ESOs

- shows expense/cost but not intangible asset (if incentive works) (Landsman *et al.* RAST 2006)
- NB no overall change in net assets so does not fit ‘balance sheet approach.
- appears to be driven by ‘proper matching’, e.g. Warren Buffett: Mcv 1998; Bromwich *et al.* Abacus 2010)
- ‘second best’ solution?
- Voluntary adoption as ‘counter-signal’ after Enron etc. facilitated previously fiercely resisted standard? (Zeff 1997; cf W&B 2008)

2. Liabilities and discount rate changes

- IAS37 now ‘off the agenda’ (Morley, 2011)
- consider ‘credit risk’ paradox
- counter-intuitive ‘gain’ as rating worsens (due to omitting fall in assets/unrecorded goodwill)—‘second best’ again (cf. Barth *et al.*, *TAR*, 2008)
- Now acknowledged in October 2010 addition to IFRS9: element of FV change due to credit risk to go to OCI not P&L

Liabilities (cont.)

- FV symptomatic of ‘balance-sheet’ not ‘income’ focus (e.g. Horton & Mcv, *AAR*, 2000): does not work for financial instruments if non-traded (cf. Penman, 2011)
- current inconsistencies in liability accounting result from history of gradually coping with longer-term and more complex financing instruments, plus new highly uncertain liabilities such as pensions, environmental etc. (Barker & McGeachin, 2010)

3. Life insurance—and ‘Embedded Values’

- IASB’s ED (2010) has now abandoned ‘FV’ approach of 2007 DP (Horton *et al.* 2007) for more traditional ‘spreading premium received’ (albeit with different presentation and allowance for some elements of value updating)
- New evidence that information asymmetry is reduced by the voluntary production of supplementary ‘embedded value’ (EV) performance measurement (Serafeim, *JAR* 2011)

EVs

- based on ‘economic balance sheet’
(Dullaway, 2001; Foroughi *et al.* *BAJ* 2011)
- reports NPV as ‘profit on new business ’
- Strange? Does not comply with the ‘hard balance sheet’ model of ‘accounting useful for investors to anchor on’ promoted by Penman (2011)?
- Not reported in US---why?
- But investors elsewhere appear to value EV over IFRS GAAP information (Serafeim, *JAR* 2011; cf. Horton & Mcv, *JBFA*, 1998)

Life insurance accounting in US

- does long history of conditioning through GAAP standardization, coupled with inherent difficulties of understanding the business, explain apparent US lack of interest in reporting EVs?
- even though economically irrational?
- effect of hostile M&A, Europe vs. US? (Serafeim, *JAR* 2011)

Economically rational history?

- e.g. Johnson & Kaplan (1987) on early US management accounting (later ‘perverted’ by regulated financial accounting rules for inventory costing, depreciation etc.) cf. Ezz, H&McV, *ABR* 1990
- Fleischman & Parker (e.g. 1992) and Boyns & Edwards (e.g. 2007) on UK BIR cost accounting. Cf. H&McV *AHJ* 2000; Bryer (e.g. 2006)
- Watts (2003) on emergence of ‘conservatism’ (followed by W&B 2008 and Penman (2011))

Economically rational history? (cont.)

- ‘Evolution’ of this and other ‘fundamental accounting principles’ (Waymire and Basu 2008) **But**
- what is social evolutionary process for accounting principles? (cf. biological adaptation/random mutation/genes)
- W&B agree difficult to explain **individual** a/c policy choices for good management given low ‘signal to noise ratio’. Effect of ‘institutional isomorphism’? (DiMaggio & Powell, *ASR* 1983)

Economically rational history? ***But***

- e.g. Coase (1938) and Wells (1978) re historical costs and overheads **vs.** rational management decision making.
- Hicks (1979) re 19th-century mill-owner's income
- Yamey (1977) re variety of financial accounting principles for income and valuation before 19-20th century profession and regulation (and later, standards)
- Hoskin & Mcv (2000) (following Chandler 1977) re 'excessive' accounting/administration in new 19th century US 'big business'

Alternative history?

- ‘Genealogy’ of accounting and the ‘examination’ (Hoskin & Mcv *AHJ* 2000) as disciplinary ‘power-knowledge’ (Power, *ARS*, 2011)
- 13th C invention of DEB as precipitate of new textual orientations in new universities
- USMA West Point after 1817—new ‘grammatocentric’ ways of learning, examining and grading by elite engineers
- From examination marks to accounting \$
- Examinations as institutional rational myth

Alternative history? (cont.)

- 1830s Springfield Armory and ‘time and motion’ standards long before Taylorism
- 1850s US railroad organization and accounting
- *constructing* objective performance and ‘calculable persons’ (Miller & O’Leary, AOS, 1987; Miller, AS 1992), in new business organizations
- new ‘grammatocentric’ practices and discourses of norms, performance and accountability (e.g. Hoskin & Mcv *AHJ* 2000)

Alternative history? (cont.)

- internalized systems of control that ‘quietly order us about’ (Foucault, quoted by Megill, 1979).

New power of accounting then permeates:

- external financing and accountability
- ‘Accountancy’ as a new profession
- inexorably extended beyond ‘big businesses’ to networks of financial markets, regulation, and now international financial reporting standards

Alternative history? (cont.)

- Extended beyond listed companies, e.g. into Oxford colleges (Jones, *ABR*, 1992); Lloyd's (Gwilliam *et al.* 1992; *AH* 2000)
- beyond business sphere into NPM and WGA
- Has audited, DEB, accrual accounting become a 'taken for granted' institutional rational myth?
- which supplies an ever-increasing 'real-time' demand for (illusion of?) control of 'action at a distance' (Ezz, H&Mcv *ABR* 1990; Power, 1997)

Improving FAT?

- How much is myth and how much is rational? How much is power and how much is knowledge?
- Penman (2011) and 'back to a balance sheet that won't bite you + RI' to challenge stockmarket price!
- But needs 'good accounting': so.....

Improving FAT? (cont.)

- Penman's simple remedies: historical (or transaction) cost for operating not speculating; 'no intangibles'; and FV only for financial activities (= 0 NPV)
- but avoids e.g. leases, pensions, fixed asset revaluation, 'deferred tax'---goodwill?
- changes in discount rates?
- 'replacement cost' for forecasting 'sustainable margins'? And price regulation? And hedging?

Improving FAT? (cont.)

- Penman (2011) avoids accounting for business combinations (where GAAP includes intangibles at FV)
- suspicious of deferred revenues and ‘big baths’ (‘cookie-jar’ accounting)
- **but** revenue and profits must be ‘earned’
- Just another stirring of the accrual accounting pot? (McV 1983) cf. deprival/relief value? (Horton *et al.* 2011)

Improving FAT? (cont.)

- Has conventional accounting model really outlived its usefulness (cf. ICAEW 2009; Lambert *JAE* 2010)?
- Embedded institutional familiarity: so unknown consequences of change.....
- Even if optimal *were* known, still subject to QWERTY transition-cost problem...and to 'second best'at least for now (McV *ABR* 2010)

Improving FAT? (cont.)

- E.g. **are** intangibles more uncertain? (cf W&B 2008 re General Electric in 1907)
- Could capitalise impairment write-downs and spread into future earnings?!
(Ohlson/Penman in AAA, 2010)
- The Carron Company, then on the road to ruin, tried that in 1769! (Bryer, AOS 2006; cf. Fleischman & Mcv, 2011)
- Potential impact on ‘accrual anomalies’ and F-F ‘B/P’?

The future? 1. China?

- A/C histories have focussed on US/UK (e.g. W&B 2008) and (some) rest of Europe
- China now nearly at full 'Anglo-US' IFRS
- No previous Western accounting and management tradition before 1978 'Reforms & Openness' of Deng Xiao Ping..
- But indigenous mercantile and bank accounting (without **full** DEB) appears in 18th-19th centuries (Hoskin & Mcv 2011)
- Business culture (e.g. family and regional social networks; *guānxi* 关系)? Changing?

The future? China (cont.)

- Politics (national and international) of China becoming 'global'? Now IASB Board member.
- Cf. Russia and 'translation' of international auditing standards (Mennicken, AOS, 2008).
- What if 'Washington consensus', neo-liberal model does not extend to BRICs?
- How will that reshape accounting and finance?

The future? 2. CSR reporting?

- Within or beyond accounting? (ICAEW 1992; Mcv 1997; ICAEW 2004))
- ‘Integrated reporting?’ (e.g. Prince of Wales’s sustainability project)
- Real change vs. ‘greenwash’? (Hopwood AOS 2009; Mcv & Chen, AAAJ, 2010)
- Business sustainability and changes in politics and society (Giddens, 2009)

Some research **choices**?

- Fight for advantage of being British / European! (e.g. RAE 2008 *Ashton et al.* BAR 2009)
- New data can reveal new evidence (e.g. as in cosmology; cf. Fama-French)
- But low ‘signal to noise’ ratios in statistical data
- Questions and explanatory theories remain even more important (e.g. Penman 2011 re B/P)
- How does ‘information for better markets’ relate to business models and risk taking (Sapra y’day)?
- Accounting’s role? (ICAEW 2010; 2011; Pope BAR 2010)

Research choices? (cont.)

- Accounting is the conceptual vocabulary for economics and finance, which have moved ever further away from the real households and firms that practice it to abstract theorising (e.g. H&Mcv, 1993; Chiapello, 2007 / Sapra yesterday...)
- Cf. Coase LSE's *Beaver* interview 15/3/2011: 'What people do in the business is largely a result of administrative decision. It is thus critically important to understand how firms operate, how they make decisions, ...how they interact...'

Research choices? (cont.)

Coase, *JAE*, 1990: it is not just ‘transaction costs’ but ‘the cost of organizing activities’ that seems likely to determine the institutional structure of production: and the ‘cost of organizing’ depends to a large degree on the efficiency of the accounting system (p.11). ‘A theory of the accounting system is part of a theory of the firm’ (and economics would benefit from further development of it) (p.12).....

Research choices? (cont.)
I hope I have shown why I have
learned that understanding the
current and potential role of the
‘rational myth’ of accounting within
firms and in capital markets also
requires understanding
comparative international
accounting history.....

So FAT: new bottles...but same old laudanum?



‘DRINK ME’ (Alice’s Adventures in Wonderland)

(thank you Wikipedia)



Like the '**DRINK ME**' bottles, it may
not be poison, but FAT can still
have
unintended consequences...

'to be taken with caution'!

For more.....

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These slides have been updated for the conference presentation. The final version (and in due course the related paper) will be available to download from my LSE website:

<http://www.lse.ac.uk/collections/accounting/facultyAndStaff/profiles/macve.htm>

Questions...?