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The Conceptual Framework: Revisiting the Basics
A comment on Hicks and the concept of 'income' in the conceptual framework¹

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ABSTRACT

In seeking to replace accounting 'conventions' by 'concepts' in the pursuit of principles-based standards, the FASB/IASB joint project on the conceptual framework grounds its approach on the famous definition of 'income' by Hicks. But we argue that the Boards have misquoted, misunderstood, and misapplied Hicks's concept. We then explore some alternative approaches to 'income' that other writers have suggested and propose an alternative view to that of FASB/IASB of how accounting concepts and conventions should be related.

Keywords: Income, assets, interest, conceptual framework, conventions

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1. Introduction

The FASB and IASB are engaged in a joint project, over a long time-frame, to converge and improve their respective conceptual frameworks for financial accounting. In October 2004, the Boards decided to add the project to their agendas and they currently expect to reach the stage of issuing discussion papers on what are commonly regarded as the ‘core’ areas of ‘elements and recognition’ and ‘measurement’ during 2008.³ But the overall approach was outlined in an early paper *Revisiting the Concepts* in May 2005.⁴ Here we focus principally on what appears to be—and is predicted in that paper to continue to be—the bedrock of the Boards’ frameworks, namely the conceptual ‘primacy of assets’ (p.9) and especially the attempt to derive this from Professor Sir John Hicks’s (1946) definition of ‘income’ (p.7; p.18).⁵

2. The bedrock?

‘..a wise man, which built his house upon a rock.....a foolish man, which built his house upon the sand...and it fell; and great was the fall of it.’ *Matthew, 7: 24-27.*

Starting with the overriding objective of usefulness in making economic decisions, and thereby of usefulness in assessing cash flow prospects, the Boards’ frameworks focus on ‘enterprise resources, claims to those resources, and changes in them’ (p.3).⁶

³ http://www.fasb.org/project/conceptual_framework.shtml
<http://www.iasb.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm> (both accessed 8 Dec 2007).

⁴ This FASB/IASB ‘communications’ paper (dated May 2005) on ‘a new conceptual framework project’ was written by FASB and IASB staff members (Halsey G. Bullen and Kimberley Crook). Originally it did not carry the customary disclaimer as to the status of staff opinions. Although the disclaimer does now appear on p.16 and the FASB website now refers to it as a ‘staff authored article’, at the time of issue it could be taken as an authoritative statement of how the two Boards intended to undertake the convergence and improvement of their existing conceptual frameworks, based on and building on their existing frameworks, even though there had not been any prior exposure for public comment as to whether some more radical approach would be appropriate (cf. Bromwich, 2001; Dennis, 2006; Rayman, 2006).

⁵ Our analysis here is given within the perspective of the ‘value school’, where the accounting objective is seen to be that of reporting ‘wealth’ and ‘income’, as this is the objective embraced by FASB/IASB (2005). It is the conceptual issues arising therefrom that we explore here, and we do not directly consider the implications of adopting the alternative ‘information content school’ based on an objective measuring and disclosing informative events (cf. for example, Bromwich, 1992; Christiansen & Demski, 2003; Sundem, 2007).

⁶ As many commentators have observed, the more obvious primary focus for the stated purpose would be on forecasts of future cash flows. We do not pursue that argument further here; but do consider other purposes below (e.g. Black, 1993).

This leads to definitions of the elements of financial statements, beginning with assets, which are (in FASB's current version) characterized as 'probable future economic benefits obtained or controlled by a particular entity as the result of past transactions or other events'.⁷ It is argued that all other elements can be derived from the definition of assets, which gives assets 'conceptual primacy'⁸ and leads to the 'asset/liability' view of income measurement, 'in which income is a measure of the increase in the net resources of the enterprise during a period, defined primarily in terms of increases in assets and decreases in liabilities' (p.7).

At a joint FASB/IASB meeting in October 2007 it was tentatively decided for the new joint framework that, as a working definition, 'an *asset* of an entity is a present economic resource to which, through an enforceable right or other means, the entity has access or can limit the access of others' (IASB *UPDATE* October, 2007, p.5). This definition, which is in substance like the definitions in the existing individual FASB and IASB frameworks, stands in contrast with 'earlier efforts that included deferred debits among assets' (FASB/IASB 2005, p.6).

'Deferred debits' (Sprouse's 'what-you-may-call-its' (Storey, 2003, p.44)) are allegedly indefinable independently and are simply the result of the 'revenue and expense', or 'matching', approach to measuring income. But, at least in principle, the accusation that traditional accounting conventions allow into the balance sheet items that would not meet the FASB/IASB asset definition appears to be false. A traditional UK professional textbook such as Cropper (1930), for example, explains in relation to items of 'deferred revenue expenditure' that these 'must be carefully reviewed, and... may be "held up" as an asset legitimately, if written off over a reasonable period. It is assumed in such cases that benefits will accrue in succeeding years from the expenditure, and so these years should bear their proportion of the burden' (p.94). So 'deferred debits', as traditionally understood, must also represent 'probable future

⁷ FASB, 1980, para.19. The IASB's (1989) current definition is: 'a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity'.

⁸ For fundamental scepticism about the effectiveness of any such attempts at 'necessary and sufficient' definitions see, e.g., Kitchen, 1954; Dopuch & Sunder, 1980; Dennis, 2006; Sunder, 2007.

economic benefits’ (which the FASB/IASB 2005 paper—somewhat surprisingly—claims are ‘phenomena observable in the real world’ (p.6)).⁹

It is at this point that the framework purports to be ‘grounded in a theory prevalent in economics: that an entity’s income can be objectively determined from the change in its wealth plus what it consumed during a period’ and Hicks (1946, pp. 178-9) is cited. It is on this foundation that the ‘conceptual primacy’ of assets, and the superiority of the ‘asset/liability’ view over the ‘revenue and expense view’ in measuring a business’s income, are purportedly based (FASB/IASB 2005, p.7).

The Boards’ attempt to ground their converged framework of accounting theory and principles on a sound economics foundation is to be welcomed.¹⁰ Unfortunately, their foundation will not support the particular structure that the Boards wish to erect. Although Hicks was concerned here only with individuals’ income, his definition of ‘Income No.1’ can be translated for a company as equal to ‘the maximum amount that could be distributed to the equity shareholders in a period and leave intact the capital value of the company’s prospective receipts as at the beginning of the period’ (e.g. Solomons, 1961). *Ex ante* this will be based on what was expected about cash flows and interest rates at the beginning of the period, and *ex post* on what actually occurs during the period and on revised expectations about the future at the end of the period.^{11,12}

⁹ Bromwich (2007) analyses how far the Boards’ pursuit of ‘fair values’ can be expected to yield reliable external measures of ‘probable future economic benefits’ (such as future cash flows). See also Hitz (2007); and for some notorious adverse practical consequences, Gwilliam & Jackson, 2007.

¹⁰ While Hicks (1946) himself saw ‘income’ as a poor tool for economic analysis (although he moderated this view in Hicks (1965)), an income concept is important in National Income statistics and also in Friedman’s (1957) ‘Permanent Income Hypothesis’ for explaining consumer behaviour. The interrelated concept of ‘capital’ is an essential constituent of theories of economic development (e.g. Moe, 2007), as ‘wealth’ is of rational individual decision making. The concept of ‘profit’ is of course fundamental in microeconomic analysis of the market behaviour of firms.

¹¹ Adapting the notation in Bromwich (1992, chapters 3 & 4): cash flow for period 1 as estimated at the beginning of period 1 (‘at time 0’) = C_{1t_0} ; and as realised during period 1 and known at time 1 = C_{1t_1} . The value of prospective cash flows in periods 2 and following, as foreseen at time 0 = V_{1t_0} ; and as foreseen at time 1 in the light of new knowledge and revision of expectations during period 1 = V_{1t_1} . Given an unchanged discount rate r , the value of prospective cash flows in periods 1 and following, as foreseen at time 0 = $V_{0t_0} = (C_{1t_0} + V_{1t_0}) (1+r)^{-1}$; and as re-estimated with hindsight at time 1 in the light of new knowledge and revision of expectations during period 1 = $V_{0t_1} = (C_{1t_1} + V_{1t_1}) (1+r)^{-1}$. Income No.1 *ex ante* for period 1 = $(C_{1t_0} + V_{1t_0}) - V_{0t_0} = rV_{0t_0}$ and (Hicks’s) Income No.1 *ex post* for period 1 = $(C_{1t_1} + V_{1t_1}) - V_{0t_0}$. If the rate of interest r is expected to remain constant, and all and only income is distributed/consumed, future periods’ income *ex ante* will also remain constant (at rV_{0t_0}), i.e. it is ‘permanent income’ (e.g. Beaver, 1998).

Hicks observation that what he labels as ‘Income No. 1 *ex post*’ has ‘one supremely important property’ (i.e. objectivity) is quoted at p.18 of the FASB/IASB (2005) paper—but the quoted words are taken out of context and omit the clause we italicise here. The relevant full sentence reads (Hicks, 1946, p.178-9, our emphasis added): ‘*So long as we confine our attention to income from property, and leave out of account any increment or decrement in the value of prospects due to changes in people’s own earning power (accumulation or decumulation of “Human Capital”)*, Income No. 1 *ex post* is not a subjective affair, like other kinds of income; it is almost completely objective’.

What does the omitted, but vitally important, qualifying clause ‘*so long as... ..*’ imply? The concept of income as ‘current cash flow plus increase in the net present value of the entity’s expected future cash flows’ [excluding transactions with owners], or ‘cash flow plus actual capital accumulation’, has long been advanced in writing for practitioners by many leading academic accounting authors (e.g. by Edwards (1938) in the UK). However, as explained, e.g. by Beaver and Demski, 1979, this concept of income is only fully determinable and objective where there are ‘complete and perfect markets’—i.e. where every resource and claim on future cash flows has been ‘commoditized’ into fully exchangeable assets¹³ and where everyone faces the same prices (including interest—the ‘price’ of future versus current commodities). In this situation there is no doubt about the magnitude of wealth and therefore about the magnitude of changes in it (‘Income No.1’) both *ex ante* and *ex post*. So the *reporting* of income is redundant.

¹² As Kaldor (1955) explains, what Hicks calls income *ex post* is what American writers have generally called ‘*accrued income*—i.e. consumption plus *actual* capital accumulation’ (in our notation, $C_1t_1 + (V_1t_1 - V_0t_0)$). *Ex post* more normally refers to income calculated by reference to a revised estimate of what the opening capital *would have been* (in our notation V_0t_1), if the knowledge and changes in expectations becoming available during the period had been there at the beginning (i.e. income ‘with hindsight’ and ‘excluding windfalls’). This latter version (as expounded e.g. by Lindahl, 1933) is, in our notation, $(C_1t_1 + V_1t_1) - V_0t_1 = rV_0t_1$. Given constant r , ‘permanent income’ is revised to rV_0t_1 (and will doubtless be revised again at the end of each subsequent period, e.g. by, say, period 7 to rV_0t_7). It was taken up in Hicks (1979), and is more consistent as well both with Alexander’s ‘variable income’ (Solomons, 1961) and with the conceptual approach proposed by Solomons himself in his *Guidelines* (1989): cf. Macve, 1997.

¹³ This is what Hicks calls ‘property’ (referring presumably to land, stock-exchange investments and the like), where ‘the capital value of the individual’s property at the beginning of the week is an assessable figure; so is the capital value of his property at the end of the week; thus, if we assume we can measure his consumption, his income *ex post* can be directly calculated’ (1946, p.109).

In the real world, markets are neither complete nor perfect, so there will, in the case of business enterprises, be a large element of the value of their future cash flow prospects that is not captured in the value of their net assets, however good the markets in which the value of those assets and liabilities may be measured.¹⁴ This element of value depends *inter alia* on the skill with which management and the workforce can exploit an enterprise's resources and its markets, and its business, social and political opportunities—what Hicks labels 'Human Capital'.

In general therefore an 'objective' version of Hicks's 'No.1 *ex post*' concept of the business income of a listed enterprise is more likely to be found in the measure of its 'shareholder return' (dividend plus/minus change in share price), i.e. the change in its 'capital value' at the stockmarket level, than in the change in the enterprise's net assets.¹⁵ As discussed further in the next section, this view was later articulated by Hicks himself (1979). But if firms are merely to report their stockprice return (plus dividends) as their income, their accounts are again redundant, at least for valuation or investment decision purposes.

3. 'Firm' or 'net assets'?

In the real world of incomplete and imperfect markets, there is no justification for the FASB/IASB (2005) paper's rendering (at p.18) of Hicks's 'capital value' as 'in

¹⁴ The difference between net asset ('book') value and an enterprise's market value is its 'internal goodwill' which is not recognised in financial statements, except where an enterprise is taken over by another enterprise so that 'goodwill on acquisition' has to be recorded in respect of the subsidiary. Even then, the recognised goodwill may not equal what the previous management had estimated as 'internal goodwill', as the negotiated takeover price will reflect the interaction of the seller's and the purchaser's estimates and their relative bargaining power. (However, 'fresh start' accounting was due to be considered under Phase II of the FASB/IASB Business Combinations project and this could, at least in principle, extend to recognition of the goodwill of *both acquirer and acquiree*, e.g. Pendrill, 1976. In fact the newly issued statements SFAS141 and SFAS160 only extend the measurement of the acquiree's goodwill to include the share attributable to the minority (i.e. non-controlling) interests—<http://www.fasb.org/news/nr120407.shtml> [accessed 9 Dec 2007]; while the IASB's new requirements will leave this as only optional <http://www.iasb.org/Current+Projects/IASB+Projects/Business+Combinations/Business+Combinations+II.htm> [accessed 10 Dec 2007]).

¹⁵ The authors of FASB/IASB 2005 may have been misled by previous academic literature which has similarly claimed (*almost* complete) objectivity for Hicks's 'No.1 *ex post*' concept (e.g. Parker *et al.*, 1986, pp. 3, 8, 17—although this source is not in their references). Bryer's (2006) attempt to identify a capitalist calculation of the realised ROCE as the main driver of the British Industrial Revolution faces a similar difficulty: there was no way capitalists could know from their accounts what rate of return they had achieved—and in fact little if any evidence that they attempted to do so (Fleischman & Macve, 2007).

accounting terms, its assets and liabilities'.¹⁶ There is of course an extensive academic literature exploring how far concepts and measures of asset and liability value that are consistent with (while not generally capturing all of) Hicks's underlying model of 'capital value' may be developed (including the literature on 'deprival' value, e.g. Baxter, 1984; Edey, 1974, and more recently on 'fair value' e.g. Bromwich, 2007); and how changes in such net asset values may be related to Hicks's notion of 'Income No.1' (e.g. see 'Introduction to First Edition' in Parker *et al.*, 1986: a classic treatment is Edwards & Bell (1961)). Any such links require considerable further restrictive assumptions to handle *inter alia* what are identified in the FASB/IASB 2005 paper (pp. 15-16) as the 'cross-cutting issues' of 'uncertainty', 'unit of account' and 'management intentions'.

As we have said, in the work cited in FASB/IASB 2005, Hicks confines himself to the individual person who wishes to measure his or her income and he does not actually discuss firms there at all. However, he does in Hicks (1979). Here he revisits his earlier analysis and begins by commenting that an early nineteenth-century mill-owner, in trying to estimate the profitability of his business, would be seeking to ascertain 'the *maximum* that could be *safely* taken out of the business...without damaging the prospects of the business. But that, it is clear, would be a matter of judgement.' He argues that, with the advent of the income tax, and of the joint-stock corporation, there are other parties now interested in knowing the business's profitability and 'at this point the accountant enters'.

Hicks observes that the accountant's approach needs to be as objective as possible to minimise disagreements; so it cannot measure profit in the way the mill-owner himself would think of it. According to Hicks, the accountant's approach naturally draws on the 'mercantile' tradition with which accountancy is already familiar, whereby the problem of sales and costs and inventory for each item of trade overlapping accounting period-ends can be relatively simply solved by carrying forward the inventory at cost.¹⁷ This, however, requires adaptation for industrialisation, as one has also to deal with plant and machinery and measure periodic cost of use. To Hicks: 'It is just the same problem as the allocation of

¹⁶ Schipper & Vincent (2003, Introduction) and Barth (2007, p.10) make a similar identification.

¹⁷ albeit there are theoretically intractable problems in allocating common overheads.

overheads, and to that, as is well known, there is no firm *economic* solution. Neither has the accountant found a solution—only a name¹⁸ and a set of, essentially arbitrary, rules... There is thus no reason why there should be any simple rule which would cause the profits that are calculated by its use to have any correspondence with the income that would be assessed by the criterion with which we began—the *maximum* that can be *safely* taken out of the business’ (pp.4-5).

Hicks then turns to exploring what the depreciation for a period (e.g. period 1) would be following this criterion. He is only able to do so by postulating a purchase of the whole business at time 0 and a sale of the whole business at time 1, to obtain an objective measure of [using our notation] V_{0t_0} and V_{1t_1} .

He notes that: ‘There can, I think, be little doubt that an accountant, who was asked to do the accounts of a business with this peculiar history, would refuse to do them in terms of¹⁹ V_{0t_0} and V_{1t_1} ; he would insist in doing them in terms of...the values which “stand in the books”. The economist, however, would find V_{0t_0} and V_{1t_1} much more interesting...it would be these *market values* which he would want to take as representing the initial and final capital’ (p.6). So we can see that what Hicks here recognised as an objective *ex post* measure of a firm’s income does not provide the foundation for a measure based on the change in a firm’s net assets that is being looked for in FASB/IASB (2005).

Hicks’s (1979) argument and analysis finally lead him to regard as current profit that defined by Lindahl (1933)²⁰: i.e. $(C_{1t_1} + V_{1t_1}) - V_{0t_1} = rV_{0t_1}$. ‘This is effectively what Friedman would call the *permanent income* derived from the business’ (Hicks, 1979, p.11). And although Hicks has been ‘looking for a definition of current profit which, so far as possible, should register the performance of the business within the year, excluding what has happened before and what is to come after... V_{1t_1} ...would appear to have a large part, even, in many cases, the dominant part, in determining the

¹⁸ [i.e. ‘depreciation’]

¹⁹ We substitute our notation for Hicks’s here.

²⁰ See again fn.15 above.

current profit' (p.10).²¹ Moreover, it is the income of the proprietors, rather than of the business (p.11).

In short, Hicks does not find a satisfactory, practical way of defining a *business firm's* income, whether *ex ante* or *ex post*.

4. How useful is 'Income No.1 *ex post*'?

Whatever the relation between asset/liability measures in accounting statements and Hicks's 'capital value', and whether or not 'Income No. 1 *ex post*' can be 'objective', there is however an even greater problem with the FASB/IASB (2005) paper's reliance on Hicks's concept as the bedrock of its approach to the conceptual framework. In the next paragraph of the passage cited there from Hicks (1946), Hicks goes on to say about this concept: '*Ex post* calculations....have no significance for conduct..... On the general principle of "bygones are bygones", it can have no relevance to present decisions.' This, given the FASB's/IASB's 'overriding objective' of 'decision usefulness', undermines the whole structure that the paper attempts to build. That structure is being built on sand, as it is the overall wealth available at the end of each period, not the *ex post* income of the period, that is relevant for decision making, e.g. about future investment and consumption.

Hicks does concede some role for his 'Income No. 1 *ex post*': such calculations 'have their place in economic and statistical *history*'; they are a useful measuring rod for economic progress; but... they have no significance for conduct' (1946, p. 109).

However, it may be argued that one cannot expect to be able to predict the future and income *ex ante* without some knowledge based in past experience (e.g. as

²¹ A further rearrangement of the terms gives Hicks an expression which 'does look like a formulation which belongs to the current period, as rV_{0t_1} , which we have seen to be equivalent, apparently does not' (p.10). Professor W.T. Baxter wrote to Hicks on 8 June 1984 querying how an 'equivalent' reformulation could avoid 'infection by the future'. Hicks replied on 5 July that 'the passage on my p.10 was not well put' and explaining that what he had really intended was to put the 'focus on things that had happened during the period, including changes in expectation during the period, avoiding the emphasis on the capitalisation which looks so artificial. "Looks like" was meant to be taken literally; the avoidance is apparent. But I wish that I had put the point a bit differently.' Hicks went on to agree with Baxter 'that Permanent Income was what I was fishing for in Chapter XIV of Value and Capital'; and also pointed out that his negative conclusion there about the need for the concept of income for his purposes was overstated (referring to his Capital and Growth, 1965, Chapter VIII, especially the footnote on p. 86).

hypothesised in Friedman, 1957). Hicks discussed further the role of accounting here in a book review for the *Economic Journal* (Hicks, 1948). As explained by Brief (1982), with extensive quotations, Hicks here endorsed what he thought to be an important argument (buried in the compilation of miscellaneous articles, etc. constituting the book being reviewed), namely the importance of the underlying objectivity of the ‘statistics’ that the accounts record: hence the justification for historical cost and the dubious value of introducing subjective adjustments (e.g. to lower market value). So, for example, the bias introduced by historical cost in inflationary times is a matter for correction by *users* in their *interpretation* of the accounting numbers.

However, Hicks added his own observation that ‘bare’ statistics are never sufficient: so what is to be done for external shareholders?²² The accountant ‘has thus some public obligation to pack into his figures the maximum of information even if he can only do this, within the limits prescribed, by some sacrifice of objectivity. How ought this difficulty to be got over? Should it be laid down that companies must publish an audited report as well as audited accounts? *Or would this make the accountant, more than ever, master of the destinies of us all?*’ (1948, p.564 [emphasis added]).²³

So the main issue with Income *ex post* is ‘how much of the future is it useful to bring into accounts of the past if they are to be helpful in forming expectations about future Income *ex ante*? (cf. Barth, 2006). This must be primarily an empirical question, to which the answer may vary according to how far ‘permanent’ and ‘transitory’ elements can be distinguished, and according to different types of business activity (e.g. Penman, 2007); while also being subject to different users’ needs and trade-offs of ‘relevance’ and reliability’ (cf. Sundem, 2007). There is no necessary merit in simply tracking Hicks’s ‘Income No. 1 *ex post*’ (Sunder, 1997, p. 79; cf. Schipper & Vincent, 2003).

²² This book review was written long before the advent of UK standards, including ‘disclosure of accounting policies’ in the 1970s (Macve, 1997).

²³ Hicks’s respect for the influence of actual accounting practice is illustrated in his argument that the origins of the Fundist views of the English Classical economists lay in merchants’ business and accounting practice. ‘Even to this day, accountants are Fundists. It is not true, accountants will insist, that the plant and machinery of a firm are *capital*; they are not capital, they are assets. Capital, to the accountant, appears on the liabilities side of the balance sheet; plant and machinery appear on the assets side. Capital accordingly is a fund that is embodied in the assets’ (1974, p.310).

5. A role for 'Income *ex ante*' ?

Some authors (e.g. Black, 1993) have argued that the primary focus of accounts (not just of their users) should be on estimating 'standard stream income'. Given that stream and a (constant) discount rate one can directly derive the value of the firm by capitalisation (e.g. Whittington, 1983, p.33). The approach underlies the common practice of presenting of supplementary 'underlying' EPS numbers²⁴ and Black (1993) has been the most forceful recent exponent of it.

The FASB/IASB 2005 paper says (on p.7) that a concept of income founded ultimately on the definition of 'assets' is necessary because, among the proponents of the alternative (the 'revenue and expense') view, 'none could meet the challenge' of defining 'income directly, without reference to assets or liabilities or recourse to highly subjective terminology like *proper matching*'.²⁵

Hicks himself could 'meet the challenge'. Dissatisfied with his 'No. 1' version he had already offered 'Income No.2', defined as the amount that an entity can consume in a period and still expect to be able to consume the same amount in each ensuing period (1946, p.174).²⁶ In the case of a joint stock company this translates as 'the maximum dividend the company could pay this period to its current equity shareholders and expect to be able to be able to pay them the same dividend in all future periods',

²⁴ For example, in the interim statement of AstraZeneca for the half-year ended 30 June 2007, the 'business highlights' explain 'Core EPS' as: 'Management believes that investors' understanding of the Company's performance is enhanced by disclosure of Core EPS, as it provides an understanding of the underlying ability to generate returns to shareholders. The Core EPS measure is adjusted to exclude certain significant items, such as charges and provisions relating to restructuring and synergy programmes, amortisation of significant intangibles rising from corporate acquisitions and those related to our current and future exit arrangements with Merck in the US, and other specified items. Core EPS is not, and should not be viewed as, a substitute for EPS in accordance with IFRS' [p.17].

²⁵ IASB Board member James Leisenring has frequently made the same assertion in his presentations on the conceptual framework. We do not pursue here the argument that the challenge itself is rigged. (For example, unless and until the Boards can find unambiguous valuation bases (e.g., by reference to current market prices) that are acceptable for all assets and liabilities, the 'asset/liability' approach itself will in practice continue to require the use of accounting procedures, such as inventory flow accounting and depreciation of non-financial fixed assets, which themselves include conventions for 'proper matching of costs and revenues', in order to arrive at the measures of assets and liabilities needed for the construction of statements of financial position/balance sheets.)

²⁶ When there is inflation, the expectation needs to be 'in real terms' (Hicks's 'Income No.3' (1946, p.174)). A numerical illustration of 'No.1' vs. 'No.2' is given in Appendix XIII to Horton & Macve (1995). See also Rayman, 2007.

which is equivalent to what financial analysts call its ‘maintainable (or ‘permanent’) income’.²⁷

It was this ‘No.2’ concept of income that underlay the proposals in the UK’s Sandilands Report (1975) for ‘current cost accounting’. Sandilands (1975: p.47, para.166) said: ‘no accounting system can predict a company’s future prospects. However, an accounting system can at least ensure that the profit figure reported is such that, if the profit for the year were fully distributed, it would not prejudice the ability of the company to continue to generate the same profit in future years... ..’ Scott (1984, p.205) argues for the importance of assisting users to estimate ‘(real) standard stream income’ (alongside ‘gain’) and, while critical of much of the methodology proposed by Sandilands, suggests ways in which accounts can be best adapted under changing prices to achieve this, many of which must inevitably be subjective. Scott concludes (drawing on his own experience as an investment Trustee for a charity): ‘First,...there is a strong practical need for estimates of standard stream income and, second, ...useful estimates can be provided—but not, so far, or perhaps ever, by accountants *qua* accountants’ (p.240). This conclusion appears close to Hicks’s (1948) view that adjustment to the basic historical cost accounting records should be made, as far as possible, by those using and interpreting the accounts, rather than within the accounts themselves.

Given the ‘maintainable income’ one can, under further restrictive assumptions, also derive definitions and measures of ‘assets’ and ‘liabilities’ that would be consistent with this concept, but they are to be derived from it, not it from them. Thus, more recently, Ohlson (2006) argues that investors like to have a natural starting point in the income statement as they try to forecast subsequent periods’ sustainable earnings.²⁸ This concept of sustainable earnings is again consistent with Hicks’s (1946) ‘No. 2 Income’. Ohlson argues that reporting such maintainable earnings would require that assets and liabilities be derived from income and not *vice versa* (as in his formulation of an ‘accounting rule’ for deriving a period’s closing net operating

²⁷ That is, ‘Income No. 2’ is the sustainable perpetuity based on the existing information set. Recall that within Hicks’s framework of analysis, ‘Income No. 2’ is, as he notes (p.174), the same thing as ‘Income No. 1’ only when there is no expected (or actual) change in the rate of interest at which future cash flows are discounted to obtain the ‘capital value’ (see again fn. 14 above).

²⁸ We use here the terms sustainable, maintainable, and persistent interchangeably.

assets and its periodic operating expense). However, it remains unclear how far Ohlson's resulting balance sheet figures would be subject to any 'reality check' (as his proposed system would prohibit immediate write-downs: they would be accounted for 'prospectively').

Ohlson's approach also takes as non-problematic 'fair value' accounting for *financial* assets and liabilities (largely similar to Penman, 2007): but in fact the problem of changing interest rates (and risk) causes equal difficulty here, at least in a 'second best' world where not all values and changes in them can be captured in the accounts. So here too a 'Hicks No.2' rather than a 'Hicks No.1' approach may often be needed (e.g. Horton and Macve, 2000).

Finally we may note that, given the conceptual tension between 'Income No.1' (expressed in terms of capital value) and 'Income No.2' (expressed in terms of maintainable income), there are also conceptual grounds for believing that the most relevant income concept for users and their economic decisions will often vary with their individual circumstances and conditions (Paish, 1940). Thus someone facing a major expenditure (e.g. a family wedding or an unexpected, uninsured medical operation and hospitalization) would be concerned more about the effect of changes in the value of their wealth ('No.1'); while someone facing retirement might be more concerned with how much maintainable pension they are entitled to or can obtain from their investments ('No.2'). This insight can go a long way towards explaining why the underlying motivations of those who identify with the 'asset/liability' view and those who identify with the 'revenue/expense' (or 'matching') view are sometimes complementary, but are often seen as in opposition with regard to what is the most useful approach to measuring enterprise income in the context of individual accounting standards. Neither approach should therefore necessarily be preferred *in principle* over the other as the basis for accounting standard setting: in each case the relevant approach should be chosen on its merits in that context (consistent with the argument in Penman, 2007).

6. ‘Conventions’ vs ‘Conceptual principles’?

FASB/IASB (2005) sees the conceptual framework project as a crusade against *conventions*. ‘To be principles-based, standards cannot be a collection of conventions but rather must be rooted in fundamental concepts.’ Economists writing about accounting have generally been very respectful of accounting conventions. As noted above, Hicks argued that the accountant’s solution to ‘depreciation’ was a natural development from merchandise accounting. He also credited the accountant’s view of capital as a ‘fund’ with a profound influence on English Classical economists; and noted that Marshall seemed content with the accountants’ approach to depreciation (Hicks, 1974, p.313). While more recent inflationary pressures and tax policy changes have put the conventions under great strain (1974, p.312), as noted above Hicks appeared to believe that the necessary adjustments could best be made by those using and interpreting the accounts rather than by expecting reform of the accounts themselves. Indeed this could interfere with the underlying, objective statistical record (Hicks, 1948; Brief, 1982).

Kaldor too (1955, p.123) noted that ‘The accountant is rightly in search therefore of a concept of income *ex post* which is as near a counterpart as can be found to the investor’s income *ex ante*. In the light of the foregoing analysis it is not surprising that the accountant’s definition of income *ex post* is based, as it can only be based, on a series of admittedly arbitrary conventions whose value depends, to a large extent, on their status as time-honoured conventions—i.e. on their steady and consistent application.’²⁹

There may of course also be value in ‘sticking to agreed rules’ for purposes of contractual and other ‘settling up’ such as taxation, bonuses, partners’ profit shares, loan covenants, etc. , where Lindahl’s ‘restatement with hindsight’ would never allow closure. Similarly Solomons’ (1989) *Guidelines* do not deal with this difficulty.

²⁹ Kaldor adds a footnote (1955, pp.123-4): ‘The nature of these conventions cannot be discussed here, but their net result (in accordance with the general accounting principle that it is better to err on the conservative side) is to bring more of the gains and less of the losses into the windfall category than could properly be regarded as belonging there. Thus the conventions for writing *down* assets are far more liberal than for writing them *up*. Occasionally, however, the conventions have the opposite results—as for example, the depreciation of fixed assets on the basis of historical costs, in times of inflation.’

That is not to say accounting conventions cannot be improved: the economists had perhaps an overindulgent view of accounting's achievements which may not be surprising given that they were generally writing before the advent of UK standards and the wider understanding of just how inconsistent many accounting practices are.

But it is naïve of FASB/IASB to overlook the power of conventions, and their surrounding myths, in maintaining the ordinary fabric of social structure and interaction. The real question to be asked is 'does analysis of how they operate suggest that the time has come to modify them? and if so how? And will the benefits outweigh the cost?'³⁰

It is well known that in 1961 Solomons predicted the 'twilight' of income measurement within 25 years, but in 1989 was writing his *Guidelines* for the UK's Accounting Standards Board ('ASB') on how best to report it. Similarly Ohlson (1987), in his commentary on Beaver & Demski (1979), argued that the reporting of income is too embedded in accounting tradition to be abandoned, despite the inescapable conceptual limitations. So rather than pursue the FASB/IASB (2005) direction of seeking to *replace* 'conventions' with 'concepts' the focus should rather be on deepening understanding of how and why those conventions have emerged and thereby of how best to adapt them, where necessary, to new situations and purposes *in the light of* relevant conceptual considerations.

While much of the academic discussion reviewed here, as well as the FASB/IASB (2005) paper itself, appears to recycle arguments from more than 50 years ago, there have been interesting recent practical developments in alternative ways of setting out 'income' and 'value' in accounting reports, given dissatisfaction with existing conventions. The most conspicuous of these at the present time is the developments in supplementary reporting of life insurance profitability according to a '(Market

³⁰ Consider the QWERTY keyboard. It is easy to show a 'conceptually' better layout that would enable faster typing of English: but the convention that originated from the initial need to *slow-down* the hammers to avoid jamming—supplemented by Remington's desire to have their early salesmen able to demonstrate how quick and clear typing would be by typing 'typewriter' using only the keys on the top row—has now become so engrained through generations of learning of keyboard skills (learning which is still growing exponentially) that it seems ever more unlikely that a substitute 'efficient' keyboard layout will enter general use (cf. <http://home.earthlink.net/~dcrehr/myths.html> [accessed 4 Jan 2008]). Is 'historical cost accounting' similar (cf. Yamey, 1960; 1977)?

Consistent) Embedded Value' model which bears structural similarity to a 'Hicks No.1 *ex ante-ex post*' cycle. This emerging practice has been developed to overcome the severe limitations of the traditional approach in a new world, where there is extensive restructuring of financial institutions together with changes in both their market opportunities and in their regulation (Horton, Serafeim & Macve, 2007). But, as ASB has recognised, the new approach has potentially major implications for the conception of performance measurement and reporting in other industries. It is to such experiments and their consequences that standard setters should be looking to find a basis for improvement in their conceptual framework, rather than to further attempted refinement of concepts such as 'income' or 'assets'.

7 Conclusions

A variety of authors have seen merit in both the 'gain' ('No.1') and the 'standard stream' ('No.2') views of income as useful in helping triangulating the amount to be reported as a firm's earnings. As Paish (1940) pointed out, there are legitimate economic motivations underlying interest in both views. The 'new conceptual framework' project of FASB and IASB will not itself be able to eliminate either underlying economic motivation in favour of the other, so neither is it likely that it will be able to eliminate the 'revenue/expense' view in favour of the 'asset/liability' view. It is therefore truly important that the project 'revisits the concepts' in a much more fundamental way. Indeed, revisiting the concepts will help both the Boards and their constituents to understand why accounting practice *has* to be made up of conventions and how those conventions, despite there being no clear framework for identifying what is 'optimal' (e.g. Christensen & Demski, 2003), have become so powerful as calculations of 'performance', including business performance, in the modern world (Hoskin & Macve, 2000).³¹ To rewrite a key sentence from p.1 of the FASB/IASB (2005) paper: 'To be principles-based, standards have to be a collection of (socially) useful conventions, rooted in fundamental concepts.'

³¹ The paper refers to Storey & Storey (1998) as 'the definitive history of the FASB's conceptual framework project' (p.18). While no history can be 'definitive' it is at least important that it be independent and objective. Reed Storey was, as noted, himself a major player in the development of the project: stronger claimants for providing independent and more objective histories would be, e.g., Zeff (1999) and Macve (1997).

Hicks's (1946) analysis does not provide conceptual justification for the FASB/IASB's exclusive focus on a 'balance sheet' approach to the accounting framework, or for its seeking to avoid the difficult problems of addressing directly how best to measure and report business performance and to help users identify the drivers of value creation.

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