In Search of the Ideal GAAP: Stewardship & Decision-making……..Is there a way forward?

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A conference spat…

- At ICAEW's *IFBM* conference, December 2009, Boyle (retiring CEO of the Financial Reporting Council (FRC)) attacked Christensen's presentation and research on CF as an irrelevant waste of public (i.e. taxpayers') money…..
- I was asked to write a commentary on both and add some UK literature (Macve, *ABR* 2010 in your pack)
- Christensen (*ABR* 2010)----'bottom up' CF
- Boyle (*ABR* 2010)----'top down' CF

Christensen (2010): 'bottom up' CF

- 2 distinct functions of accounting by firms (amid multiple information sources and intermediaries in an efficient market):

a. Information for investment decisions

b. Control information for monitoring and rewarding managers' performance (≈ 'stewardship')

- But given managers' incentives and moral hazard they 'infect' each other

Christensen (2010) (cont…)

- So setting universal standards problematic
- And loses 'optimal' info for each firm → political choice of who benefits and who loses
- Even if no new info, confirmatory value of annual report constrains managers prior info releases and their actions → helps control agency costs.
- High level QCs, Definitions, Recognition Criteria too crude to choose 'standards'

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Boyle (2010): ‘top down’

- IASB/FASB rules needed for large listed, audited companies with managerial hierarchies and investors ranging from active institutional investors to passive ‘little old ladies in Idaho’ (the focus of the SEC’s protection)
- Can agency models be ‘scaled up’ here (Gwilliam et al *Ac Hist* 2000 (Lloyd’s); cf. ICAEW 2005; Armstrong *et al*. *JAE* 2010) ?
- GFC has undermined confidence in market efficiency and regulators need to ensure investors can understand risk/reward ratio

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Boyle (2010): cont….

- Standard setters have to demonstrate intellectual credibility and technical competence
- [note: New IASB Board Members (and FASB?) are required to sign up to the IASB CF (2010)]
- Boyle supports the current kind of CF: e.g. definition of ‘asset’ is needed to ensure consistency in standards as Board members change

Boyle vs Christensen

- ***Question***: To what extent do Christensen's atomistic investee firms only exist because of an enabling 'top down' regulatory regime? (e.g. Edwards 1938)
- But that gives little guidance on what either general CF or specific accounting standards should be….
- However, first order 'standard' rules could be supplemented in various ways to allow some informative diversity (Mcv *ABR* 2010)…..

CF issues…….

- IASB/FASB faced (unexpectedly) great controversy over 'information for decisions' (IFD) and 'stewardship' (ST) in the revision of their CF 'objectives' and related 'qualitative characteristics'.
- The rest of the revisions to the CF (including Elements and their Measurement) are now on the 'back burner' (IASB 2011a)

CF issues…(cont.)

- ***Bottom line***: does it matter what IASB/FASB decide about relative importance of IFD and ST?
- i.e. does it (or any of the CF) affect *actual* accounting *standards?* (Dopuch & Sunder, *TAR*, 1980; Mcv 1981)
- I'll look at some examples ('history') and then revisit the 'theory'

CF issues (cont)….

- This will lead to revisiting the role of the CF (and alternative 'academic' CFs [e.g. AAA 2010])
- And to thinking about 'is there a way forward?'
- And about relevant research…

(Ancient) history examples of varied uses of accounting

- Performance of slave bakers (against expected yield) found in Middle East in 3rd millennium BC
- Jesus's 'parable of the talents' in 1st century AD
- 'Accrual' for unpaid wages found in Roman Egypt in 3rd century AD. For financial control of subsidiary estates? And 'decision making'?
- Mediæval 'audits' by the UK Exchequer and manorial lords (against expected yields)—apparently failed to identify full deficits

[These and more examples in Mcv *EAR* 2002]

(More recent) history: some examples

- Pacioli (1494): 'value inventory at (target!) selling price'
- Yamey (1977) re variety of financial accounting principles for income and valuation before 19-20th century profession, stock exchanges and regulation (and then 'standards'—in UK only from 1973 [Zeff 2009])
- Hoskin & Mcv (2000) (following Chandler 1977) re 'excessive' accounting/administration in new 19th century US 'big business' (as often throughout history)
- 'Secret reserve' accounting for financial stability (banks, insurance, and shipping companies) even after 'Royal Mail' case and 1948 UK Companies Act [in Baxter & Davidson 1977]

History shows……

- Accounting varies both as to:

a. Objects accounted for (corn, money, debts, tangible business assets, liabilities, intangibles….etc.)

b. Accountability relationships (master and slave; subject and ruler; trading contracts; trustees and beneficiaries; owners and managers; managers and subordinates; within organisations and outwith…..etc.)

NB: increasing separation and information asymmetry: requires (illusion of?) control at a distance

History shows……

- ‘Bringing in the future’ (accruals; forecasts / budgets) is there from the beginning….Is HCA a myth?
- Hard to tell what accounting used for and how *just from the accounts*
- Variety consistent with Christensen’s (2010) ‘information’ approach
- But **comparative** performance measures also needed

(Recent) History: some examples

•Does not give much guidance on regulating the economic framework that is Boyle's (*ABR* 2010) concern.

•*Would FASB/IASB's (or AAA's) CF do better?*

•How did their CF help resolve:

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) or 'deferred contract revenue' (Horton et al. *ABR* 2011) [FASB and IASB (2011b) now to re-expose their revenue recognition proposals]
- 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' (with different presentation and allowance for some elements of value updating)
- ***BUT*** evidence that information asymmetry is reduced by voluntary production of supplementary 'embedded value' (EV ≈ FV) performance measurement (Serafeim, *JAR* 2011)

EVs

- based on 'economic balance sheet' (Horton *et al.* 2007; Mcv *BAJ* 2011a)
- 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 e.g. 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)

(Recent) history examples…

- Little evidence that ‘balance sheet’ CF helped resolve these issues
- Some evidence that more concerned with proper ‘matching’ for income measurement: but that approach to defining income has made little conceptual progress since 1930s beginnings of US ‘search for accounting principles’, driven by SEC [Mcv, 1983]
- Degree of ‘conservatism’ varies for both [Lambert, 2010]

(Recent) history: some examples (cont…)

- Not clear that ‘IFD’ vs ‘Stewardship’ would change outcome
- e.g. Life Insurance actuaries use EV not only for valuation but also for financial control and for sharing out bonuses to with-profits policies
- cf. Lloyd’s ‘reinsurance to close’ [Mcv & Gwilliam, 1993] for sharing out to Names. Traditional ‘three-year accounting’ a trade-off between certainty and impatience

Economically rational history? (e.g. W&B 2008)

•***BUT*** e.g. Coase (1938) and Wells (1978) re historical costs and 'arbitrary' overheads ***vs.*** rational management decision making.

•Hicks (1979) re 19th-century mill-owner's income (cf. FASB/IASB [Bromwich et al. *Abacus* 2010])

•Need an alternative history of how accounting practices and discourses around 'performance' have become embedded in a range of different institutions and activities

[e.g. Hoskin & Mcv *AHJ* 2000]

Theory…..

- Can this history shed any light on the theoretical debates over 'IFD' and 'ST'?
- Literature (e.g. Lambert, *JAE* 2010), distinguishes information for 'valuation' (i.e. investors' investment decisions) and for 'contracting' (which aims at control of managers and includes internal management control)
- Can accounting achieve ***either***? Or rather provides a 'rational institutional myth' that meets demand for (illusion of?) 'control at a distance' ? [Mcv 2011b]

Theory…(cont.)

- Rochester/MIT/Chicago school privileges contracting and deduces need for conservatism (e.g. Kothari *et al*. (2010)).
- But conservatism also generally supported by e.g. Waymire and Basu (2008) and by Penman (2011) who focuses on valuation
- A 'crusade' against Fair Value (and 'mark to market' income reporting) other than for liquid financial instruments
- Keep operating and financing separate…

Theory (cont…)

- Reflected in AAA's 'alternative' CF (2010) (authored by Ohlson and Penman) :
- 5 'principles':

1. Transactions based 'actual verifiable events' ***BUT incorrigible allocations in HCA*** (Thomas *TAR* 1978)***?***
2. Operating activities separate from financial activities ***BUT non-0 NPV financial activities? Interest implicit in prices? (cf. Islamic accounting)***

Theory (cont…)

3. (Permanent) operating earnings ***BUT this requires replacement costs (*****as AAA 2007*****)?***
4. Balance sheet conservatism (tangible assets <= FV and all assets <= FV of business as a whole). Deficit to be prospectively expensed…… ***BUT FV (until recent convolutions*** **(IASB 2011c)*****) is exit price and BS intended to be 'recoverable value' <u>not</u> liquidation value*** **(Solomons 1961; cf. Kothari et al 2010).** ***RC (or DV) more relevant*** **(AAA 2007; Horton *et al*. *ABR* 2011)*****?***

Theory (cont…)

4. (cont.) 'Timely loss recognition' does **not** capture loss of planned NPV [Edey, 1963; Lambert *JAE* 2010]
5. Owners' equity perspective ***OK! It's just presentation and classification (e.g. interest; tax)…..***

Underlying problem of separating performance of managers from performance of the business (Solomons *TAR* 1961)

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CF issues

- Debate between different objectives is longstanding (e.g. Edey, 1978; cf. Solomons, *TAR* 1961)
- As Lambert [*JAE* 2010] argues it's not necessarily 'valuation vs. stewardship'
- Nor 'conservatism' vs. FV
- Rather 'how much conservatism for each?
- Will vary from standard to standard…

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Improving accounting standards?

- Penman's (also AAA 2010) 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'? (cf. AAA 2007) And price regulation? And hedging?

Improving accounting standards? (cont…)

- Penman (2011) avoids accounting for business combinations (where GAAP includes intangibles at FV)
- **Cf. accountability for M&A goodwill** [Arnold *et al* 1992; Kothari *et al. JAE* 2010]
- 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? (Grady's 'scrub-brush' : Mcv 1983)
- HC vs 'FV' cf. deprival/relief value? (Horton *et al*. *ABR* 2011)

Improving Accounting Standards? (cont…)

- Has current mixed 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 for IFD or ST or both, still subject to QWERTY transition-cost problem…and to 'second best' ……at least for now (Mcv *ABR* 2010)

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Improving accounting standards?(cont…)

- E.g. ***are*** intangibles more uncertain? (cf W&B 2008 re General Electric in 1907: but wrote off PME too---to 'counter-signal'?)
- 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' (e.g. Penman 2011)?

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A way forward?

- How to do CF (and standards) in 'second best world' where current accounting practice embedded in multiple institutions and used for many purposes?
- 'Practical reasoning' based on reflexive recursion from current practice through evaluation to redesign [e.g. Dennis 2008]
- More like painting/maintaining/upgrading Forth Bridge than designing Millennium Bridge (cf. Sapra 2011)…
- QWERTY…?

Research?

- Ideal typewriter? cf. iPod!!! cf. Sterling
- Coase (*JAE*1980 /2011): crucial need to understand how decisions are made *within* firms and how accounting influences this
- Examine other eras and places…. comparative international history vs. FASB/IASB 'imperialism'
- Other futures? BRIC? Will markets rule?
- CSR: even if doesn't affect stockmarket now? (eg. Chen & Mcv *AAAJ* 2010)

Research choices? (cont.)

I hope I have shown why understanding the current and potential role of accounting within firms and in capital markets also requires understanding of comparative international accounting history…by both policy makers and academic researchers

For more……

If you would like to follow up any of the references please contact me at

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Q & A…?