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# CONTENTS

About the authors v
Preface xi
How to use this book xii
Acknowledgements xiv

## Part 1

### ACCOUNTING THEORY 1

1 Introduction 3
   - Overview of accounting theory 4
   - Content outline 14
   - Additional readings 16
   - Endnotes 17

2 Accounting theory construction 19
   - Pragmatic theories 20
   - Syntactic and semantic theories 21
   - Normative theories 24
   - Positive theories 28
   - Different perspectives 29
   - Scientific approach applied to accounting 37
   - Issues for auditing theory construction 39
   - Summary 42
   - Questions 43
   - Additional readings 45
   - Endnotes 51

3 Applying theory to accounting regulation 53
   - The theories of regulation relevant to accounting and auditing 54
   - How theories of regulation apply to accounting and auditing practice 60
   - The regulatory framework for financial reporting 69
   - The institutional structure for setting accounting and auditing standards 74
   - Summary 80
   - Questions 82
   - Additional readings 84
   - Websites 84
   - Endnotes 88

## Part 2

### THEORY AND ACCOUNTING PRACTICE 91

4 A conceptual framework 93
   - The role of a conceptual framework 94
   - Objectives of conceptual frameworks 97
   - Developing a conceptual framework 101
   - A critique of conceptual framework projects 111
   - Conceptual framework for auditing standards 119
   - Summary 122
   - Questions 123
   - Additional readings 125
   - Endnotes 130

5 Measurement theory 133
   - Importance of measurement 134
   - Scales 134
      - Permissible operations of scales 136
   - Types of measurement 138
      - Reliability and accuracy 140
   - Measurement in accounting 145
      - Measurement issues for auditors 150
   - Summary 152
   - Questions 153
   - Additional readings 154
   - Endnotes 159

6 Accounting measurement systems 161
   - Three main income and capital measurement systems 162
      - Historical cost accounting 162
      - Current cost accounting 171
      - Exit price accounting 183
   - Value in use versus value in exchange 190
      - A global perspective and International Financial Reporting Standards 191
      - Issues for auditors 201
   - Summary 203
   - Questions 206
   - Problems 207
   - Additional readings 210
   - Endnotes 215
<table>
<thead>
<tr>
<th>Part 3: Accounting and Research</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>11 Positive theory of accounting policy and disclosure</td>
<td>359</td>
</tr>
<tr>
<td>Background</td>
<td>360</td>
</tr>
<tr>
<td>Contracting theory</td>
<td>361</td>
</tr>
<tr>
<td>Agency theory</td>
<td>362</td>
</tr>
<tr>
<td>Price protection and shareholder/manager agency problems</td>
<td>365</td>
</tr>
<tr>
<td>Shareholder–debtholder agency problems</td>
<td>369</td>
</tr>
<tr>
<td>Ex post opportunism versus ex ante efficient contracting</td>
<td>374</td>
</tr>
<tr>
<td>Signalling theory</td>
<td>375</td>
</tr>
<tr>
<td>Political processes</td>
<td>377</td>
</tr>
<tr>
<td>Conservatism, accounting standards and agency costs</td>
<td>379</td>
</tr>
<tr>
<td>Additional empirical tests of the theory</td>
<td>381</td>
</tr>
<tr>
<td>Evaluating the theory</td>
<td>389</td>
</tr>
<tr>
<td>Issues for auditors</td>
<td>392</td>
</tr>
<tr>
<td>Summary</td>
<td>394</td>
</tr>
<tr>
<td>Questions</td>
<td>396</td>
</tr>
<tr>
<td>Additional readings</td>
<td>398</td>
</tr>
<tr>
<td>Endnotes</td>
<td>400</td>
</tr>
<tr>
<td>12 Capital market research</td>
<td>403</td>
</tr>
<tr>
<td>Philosophy of positive accounting theory</td>
<td>404</td>
</tr>
<tr>
<td>Strengths of positive theory</td>
<td>405</td>
</tr>
<tr>
<td>Scope of positive accounting theory</td>
<td>407</td>
</tr>
<tr>
<td>Capital market research and the efficient markets hypothesis</td>
<td>408</td>
</tr>
<tr>
<td>Impact of accounting profits announcements on share prices</td>
<td>412</td>
</tr>
<tr>
<td>Trading strategies</td>
<td>426</td>
</tr>
<tr>
<td>Issues for auditors</td>
<td>433</td>
</tr>
<tr>
<td>Summary</td>
<td>435</td>
</tr>
<tr>
<td>Questions</td>
<td>436</td>
</tr>
<tr>
<td>Additional readings</td>
<td>437</td>
</tr>
<tr>
<td>Endnotes</td>
<td>440</td>
</tr>
<tr>
<td>13 Behavioural research in accounting</td>
<td>445</td>
</tr>
<tr>
<td>Behavioural accounting research: definition and scope</td>
<td>446</td>
</tr>
<tr>
<td>Why is BAR important?</td>
<td>447</td>
</tr>
</tbody>
</table>
Representativeness: the evidence 462
Accounting and behaviour 464
Limitations of BAR 465
Issues for auditors 466
Summary 468
Questions 469
Additional readings 470
Endnotes 472

14 Emerging issues in accounting and auditing 477
   Current factors influencing accounting and auditing research, regulation and practice 478
   Issues surrounding the application of fair value accounting during the global financial crisis 481
   Possible directions in future international accounting standard setting arrangements 483
   Sustainability accounting, reporting and assurance 485
   Other non-financial accounting and reporting issues 493
   Summary 496
   Questions 497
   Endnotes 500

List of key terms 503
Index 513
During the period that the seventh edition of Accounting Theory was being prepared, the world financial system suffered its greatest crisis since the collapse of the US stock market in 1929. From mid-2007 financial markets experienced a number of economic shocks as borrowers in the United States began to default on home loans, and the ‘sub-prime’ crisis was born. An international liquidity crisis hit markets around October 2008 as banks in the United States, United Kingdom and elsewhere either failed or sought injections of capital from governments and other parties. As asset prices fell and market liquidity for investments disappeared, some commentators pointed to fair value accounting as the cause of the crisis. Political pressure on standard setters and regulators was intense as action to ameliorate the crisis was demanded and taken.

We must ask the question of where an accounting theory textbook fits in such an environment. Does the crisis mean that past material about accounting theory is no longer relevant? Our answer is no. We suggest that our existing knowledge can be used to understand current events and to equip us for future action. The primary strength of Accounting Theory is the balanced approach taken in explaining and discussing the alternative theories and perspectives of accounting and the rigour of the learning material presented. It will always be important for students to study accounting theory, and that relevant material is presented and discussed in an objective manner. In part one of the revised text, our objective is to help readers explore what is meant by theory and how theory relates to the practice of accounting. In this part, chapter 3 addresses the role of theory in regulation and provides material that helps us to evaluate an event such as the global financial crisis and the responses to it.

At the time the sixth edition was released in 2006, we noted a major change in the financial reporting environment, namely the adoption of International Financial Reporting Standards (IFRS). These standards are now used in more than 100 countries around the world, including Australia and New Zealand and the major European and Asian economies. The worldwide adoption of IFRS confirms our focus on these standards, their theoretical underpinnings and the process by which they are set. We include extensive material on IFRS, particularly in part 2, chapters 4 to 10. We do not aim to be a 'how-to' manual for IFRS but rather to explore the theory behind standards. We apply theories to practice and make extensive use of theory in action vignettes and case studies drawn from real-world examples.

One of the strengths of our book is that we provide a longer term perspective on issues; we relate theory to practice over time. Not only do we provide up-to-date materials about standards, regulation and practice to inform readers of the current situation, we also provide the background to critical developments. Our historical perspective is particularly important in understanding current events, such as fair value accounting. For example, the material about the development of current cost accounting from the 1960s onwards provides essential background for readers to understand today's fair value accounting. Thus, readers have a wealth of material to develop informed views about the issues faced in practice today. Differences in accounting practice are a function of differences in theoretical viewpoints on the part of those responsible for measuring and reporting accounting information. In order for students to argue for a particular approach and to apply a particular view, they must understand the principles and research that underlie their perspective.

What is “fair value accounting”? International GAAP uses historical cost as accounting convention. This convention embraces the “mixed-measurement” model. For example, “carrying values” may include amounts measured on the bank of historical cost net of accumulated depreciation, IAS 17 fair value measurement, current values (i.e. values e.g. IAS 2, not realisable values, IAS 16 current replacement cost, IFRS 5 fair value less cost to sell, historical cost (undiluted), etc."

This text answer can be seen as self-serving and even cowardly. To counter this charge and provide the useful insights which is the aim of the book it is suggested that the author consider the following recommendations:

1. Acknowledging the causes of the financial crisis from an accounting perspective (e.g. what part did “mark-to-market" play in precipitating or exacerbating the liquidity crisis?)
2. Give specific accounting and financial reporting reasons why government felt the need to intervene with mandatory effect.
3. Such an analytical and evidence-based approach will carry weight whereas the author’s unconsidered opinion will not.

Justify what constitutes balance? What are the constituents that must be included and combined?

This is actually a weakness: a mere chronicle of events without a coherent development of ideas.

A historical perspective is not essential to an understanding of fair value given that fair values deal with “exit values” - looking forward, not historical values.

Self-evidently true and reasonable but the history is not essential - just give us an outline of the growth of ideas. The fully formed ideas as currently established are what is of interest. The history leading up to it is secondary.

The part is not a reliable guide to dealing with today’s issues.

Why is this a strength? Accounting is concerned with the past and there is a “binding force of precedent" to require reflection on past deliberations in order to comply with its outcomes.

Background information may be interesting but not essential for an understanding of current IFRS. All that is required for competent application is a different study of IFRS requirements and guidance.

Differences in accounting practice are due to factors other than “theoretical viewpoints”. In any case, should theory (which informs standards setting) not be used to remove disagreements by providing a reference point for resolving misunderstandings and disagreements through a logical reasoning? What good is theory if it introduces unresolvable differences in accounting practices?

Legitimate differences in accounting practice are normally due to differences in the "business model" which has the strongest effect on an accounting policy (e.g. the fair value option under IFRS). Can be used to reflect the way in which the business manages a portfolio of assets. Further, the option results in the financial asset being classified as FVTPL whereas its natural classification would have been FVOI and measured at amortised cost.

Thus, the same asset can be classified differently by different entities depending on their business model regardless of theory. Any explanation that sound theory would support this because sound theory would promote management effectiveness driven in part by relevant information.
An important new feature of this edition is our introduction of material about auditing in each chapter. The crucial role of external auditing has long been recognised in capital markets. Thus, in the face of considerable external scrutiny of corporate financial reporting, we considered it was timely to introduce material that specifically addresses issues relating to auditors and the audit function. This innovation is consistent with our approach in which we aim to build on the solid foundation of detailed, well-researched discussion and analysis in earlier editions of the book, but also to bring in new material that is relevant to understanding how theory applies in practice. By extending our text into the auditing area, we meet our goal of revealing as well as integrating material students will find useful in understanding the accounting domain. We also provide an objective analysis of issues to help students to understand and scientifically debate issues. Without such an approach we are in danger of producing students who are technically capable, but unable to exercise appropriate judgement to provide and present information that serves users’ needs.

In part three, we include chapters on positive accounting theory, capital market and behavioural research. These chapters provide an overview of important theories and studies and are updated with new theory in action vignettes and case studies to provide current material illustrating topical issues. We conclude with a new chapter on emerging issues in accounting and auditing in which we refer again to IFRS and the global financial crisis as well as other topical issues.

We hope that all our readers find their exploration of the world of accounting theory through our book an informative and thought-provoking experience. We know that accounting theory often represents a major challenge to accounting students. We therefore thank instructors for their continued commitment to the text and to its approach to informed, rigorous debate. In this regard, we are always keen for feedback and encourage both academics and students to contact us with comments and suggestions for improvements or expansion of the issues covered.

Allan Hodgson thanks Brendan O’Dwyer at the University of Amsterdam for scholarly advice and support in mounting a course at Amsterdam Business School that draws heavily on this book. Ann Tarca thanks her students at the University of Western Australia, who provide lively discussions based on material in this book. She also acknowledges the contribution of her research colleagues, without whom developing an understanding of accounting theory and issues would not be possible. We also thank the professional editorial and management team at John Wiley & Sons for their hard work and persistence in updating and making the content relevant to students, and in their undoubted commitment to maintaining high academic standards in the accounting discipline. Finally, we thank our families for their continued support and understanding.

Jayne Godfrey
Allan Hodgson
Ann Tarca
Jane Hamilton
Scott Holmes
November 2009
Accounting Theory, 7th edition, has been designed with you — the student — in mind. The design is our attempt to provide you with a book that both communicates the subject matter and facilitates learning. We have accomplished these goals through the following elements.

**LEARNING OBJECTIVES** assist you to identify the essential elements of the chapter. They are clearly stated and linked to subsequent discussion in the chapter.

The **INTRODUCTION** outlines the key issues, topics, processes and procedures to be discussed in the chapter.

**THEORY IN ACTION** vignettes feature throughout the text, and profile industry experiences and professional events that reinforce the role of accounting theory in the profession. Questions are supplied with each, and the information that is included has been obtained from Australian and international newspapers and professional articles.

**APPLICATIONS TO AUDITING** — each chapter contains information on how accounting theory relates to auditing. Presenting an audit perspective, this information encourages students to appreciate how accounting theory underpins all aspects of what auditors and accountants do.
The **SUMMARY** restates each learning objective and the key issues explored in the chapter to reinforce the learning objectives of the chapter.

End-of-chapter **QUESTIONS** test your understanding of the material presented in the chapter, improving your analytical and interpretative skills.

**PROBLEMS** included in selected chapters present more challenging activities to test your knowledge of the issues developed in the chapter, ability to resolve the issues.

**CASE STUDIES** encourage detailed evaluation of the issues explored in the chapter. The case studies are drawn from Australian and international sources that are ideal for individual and group-based activities.

**KEY TERMS** are presented at the end of the book, and provide an invaluable resource for your learning.
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Figures

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Part 1

Accounting theory

1. Introduction 3
2. Accounting theory construction 19
3. Applying theory to accounting regulation 53
Introduction

LEARNING OBJECTIVES

After reading this chapter, you should have an appreciation of the following:
1. what is meant by ‘accounting theory’ and the purpose it has served over time
2. the structure of this book and how it logically sequences its discussion of accounting theory.

WHY DOES THE THEORY OF ACCOUNTING NOT ADDRESS THE LANGUAGE, GRAMMAR AND FORM OF ACCOUNTING AND FINANCIAL REPORTING?
1. What is the difference between measurement, estimation and valuation?
2. What is a concept, principle, policy, convention and assumption, and what is the relationship between them? Give us specific examples.
3. Why does the theory not address a priori “duality”, profits, income, equity and others?
4. Why does the theory not discuss reporting formats as part of the process of what accounting is about?

WHY DOES THE THEORY OF ACCOUNTING NOT TELL US HOW TO SET AN ACCOUNTING POLICY?
Provide guidelines using model businesses to demonstrate effects of various policy options depicting theoretical perspectives.
How does the theory deal with uncertainties and risks?

WHY DOES THE THEORY OF ACCOUNTING NOT ADDRESS ISSUES IN INTERPRETATION OF FINANCIAL INFORMATION?
1. Cross the cash and income divide
2. Choice of KPI as indicators of management bias?
3. Provide a framework for interpretation as part of decision-usefulness.

WHY DOES THE THEORY NOT EXPLAIN WHY INCONSISTENCIES OCCUR?
1. IFRS 13 fair value measurement based on “exit values” does not apply to inventories which is the item that is most ready to exit the entity?
2. A change from LIFO to FIFO is a change in measurement basis subject to retrospective adjustment (IAS8) but a change in measurement basis from cost to valuation under IAS 16 is accounted for prospectively.
3. The tension between relevance and verifiability - why does the theory not address this and provide clear and specific apriori reasoning as a framework for evaluating and exercising judgement.
4. How does the theory justify fair value option under IFRS9?
5. How does the theory justify “mixed-measurement” model? How can this model produce financial statements that warrant the auditor’s stamp of “true and fair view?”
This chapter traces the historical development of accounting theory and illustrates how the view of accounting has changed over time. It finishes by providing an overview of the chapters in this book.

**OVERVIEW OF ACCOUNTING THEORY**

Why do rockets need so much power to lift off? Why do humans walk on two legs? To answer these questions, we are likely to call upon the theories of gravity and evolution. These theories are generally held in high regard for their powers of explanation and prediction, but what is it that gives them their authority? In fact, what is a theory? Furthermore, what is the relevance of accounting theory to accounting?

In a perfect financial world there is no demand for published accounting reports and hence any accounting theory. We would simply look up freely available prices for the value of assets, revenues, or the costs of all inputs (including managerial costs). In such an Arrow-Debreu economy, all this information is available now and for all future time periods. But we do not live in such an economic world. Instead, there is a demand for financial information to fill gaps in our knowledge and to reduce uncertainties about current and future values. This demand comes from a wide range of stakeholders — both internal and external.

In accounting theory, a major issue is related to questions around measurement. In general, how should assets and liabilities be measured? By their historic cost, their selling price, updated by current costs to buy, or by the present value of future cash flows? Should we recognise all internally generated intangibles or only recognise them when they are evidenced by an external transaction, such as in a takeover price? Then again, what is the impact of implementing different measurement systems on the economy or market or on each individual stakeholder?

Theory can be described simply as the logical reasoning behind the statement of a belief. Whether the theory is accepted depends on:
- how well it explains and predicts reality
- how well it is constructed both theoretically and empirically
- how acceptable are the implications of the theory to a body of scientists, professionals and society as a whole.

It is important to understand that accounting theory is not simply an abstract process. It is not divorced from reality. In fact, its main objectives are to explain why and how current accounting practice evolved, to suggest improvements, and to provide the basis for developments in such practice.
Accounting theory is a modern concept when compared with, say, theories emanating from mathematics or physics. Accounting first developed as a set of tools to record activities or transactions. Even Pacioli’s treatise (see next page) on double-entry accounting was focused on documenting the processes involved and not about explaining the underlying basis for this method of recording. Chambers summarised a view that accounting has mainly developed in an improvised fashion rather than systematically from a structured theory:

Accounting has frequently been described as a body of practices which have been developed in response to practical needs rather than by deliberate and systematic thinking.

That is, many accounting prescriptions on how to account were developed to resolve problems as they arose. Hence, the theory underlying those prescriptions also developed in a largely unstructured manner. This has led to inconsistencies in practice. Examples of such inconsistencies include different methods of depreciation and inventory expensing even within the same industry; and measuring some assets at fair value whereas others are measured at cost. In other cases, some transactions are kept off the financial statements completely. For example, the move to regulate disclosures concerned with the capitalisation of certain lease commitments was a direct response to practices being adopted that failed to recognise the lease liability in company accounts. More recently, in response to increasing demand, an accounting standard was introduced requiring firms to report the cost of providing executive remuneration in the form of share options. These examples are consistent with and illustrate the historical development of accounting methods (the inconsistency problem). It is worth pointing out at this juncture that some theoretical accountants argue that, because business situations vary across industry (and countries), we need a variety of accounting methods that can be adapted to fit the changing, needs of business.

Accounting practices also have multiple demands from insiders, such as managers and employees, and outsiders such as investors, creditors, taxation, legislative authorities and society in general. This means that accounting theory is complex and one of the issues under intense debate is who should financial accounting reports serve? That is, who are the primary users of accounting information? We call this the 'objective problem' — the problem of determining the objective of financial information.

For many years, accounting standard setters have been trying to solve the objective and inconsistency problems by developing a conceptual (theoretical) framework that would lead to more consistent treatment of like items. However, conceptual framework projects have not resolved the inconsistencies in practice, and have often been used to justify or support such inconsistencies rather than resolve them. Because such frameworks seek to provide universal guidance, they have proved too general to provide a clear set of decision rules which lead to an obvious practical answer for the full range of choices required in preparing accounting reports.

Pre-theory

Before the double-entry system was formalised in the 1400s, very little was written about the theory underlying accounting practices. During the developmental period of the double-entry system, the main emphasis was on practice. It was not until 1494 that a Franciscan monk, Fra Pacioli, wrote the first book to document the double-entry accounting system as we know it. The title of his work was *Summa de Arithmetica Geometria Proportioni et Proportionalita* (Review of Arithmetic, Geometry and Proportions). For 300 years following Pacioli’s 1494 treatise, developments in
accounting concentrated on refining practice. This is referred to as the ‘pre-theory period’. Goldberg asserts:

No theory of accounting was devised from the time of Pacioli down to the opening of the nineteenth century. Suggestions of theory appear here and there, but not to the extent necessary to place accounting on a systematic basis.

Until the 1930s, developments in accounting theory were rather random and ill-defined, evolving as they were needed to justify particular practices. However, developments in the 1800s led to the formalisation of existing practices in textbooks and teaching methods. The rapid expansion in technology, accompanied by the large-scale separation of ownership from control of the means of production, increased the demand for both management and financial accounting information. In particular, growth of the business sector and the construction of railroad networks in the United States and the United Kingdom increased the demand for detailed accounting information, for improved techniques, and for accounting practices such as depreciation which addressed the long-term nature of assets. The introduction of taxation legislation and the ‘teething’ problems associated with the birth of the corporation led to increased government legislation regarding reporting requirements. Further, some government and corporate economic policy decisions were beginning to be based on accounting numbers. Also during this period, economic theory was progressing rapidly and was beginning to be linked to the demands for accounting information. These developments occurred mainly in the United Kingdom. They provided an impetus for the growth of theories explaining accounting practice to enable accountants to deal with new issues as they arose and to explain to students why certain procedures were adopted. After this, developments in accounting theory shifted from the United Kingdom to the United States.

**Pragmatic accounting**

The period 1800–1955 is often referred to as the ‘general scientific period’. The emphasis was on providing an overall framework to explain why accountants account as they do; that is, based upon observation of practice. Empirical analysis relies on real-world observations rather than basing practice on deductive logic that is critical of current practices. The major focus of accounting was on the use of historical cost transactions and the application of the conservatism principle. The scientific method was interpreted as being based on empirics.

However, while it has been labelled an empirical period in accounting development, there was a degree of logical debate about the merits of measurement procedures. This was especially the case after the Great Wall Street Crash in 1929. This led to the creation of the Securities and Exchange Commission (SEC) in the United States in the early 1930s. The SEC had a brief and legislative power to improve financial regulation and reporting, with many seeing the crash being caused by questionable accounting methods. Stephen Zeff reports that Healy and Kripke, two leading practitioners, were highly critical of the accounting write up practices in the United States in the 1920s. Such comments as ‘... write ups were used to create income or to relieve the income accounts of important charges’ and ‘... you can capitalize ... everything except the furnace ashes in the basement’ and ‘... illustrated what they saw as the flagrant write up of assets in the 1920s.’

The 1930s period also gave rise to several notable accounting publications and initiatives and saw the birth of professionally based conceptual theory. In 1936 the American Accounting Association (AAA) released A Tentative Statement of Accounting Principles Affecting Corporate Reports; in 1938 the American Institute of Certified Practising Accountants (AICPA) made an independent review of accounting principles and released
A Statement of Accounting Principles (authored by Sanders, Hatfield and Moore). In the same year, the AICPA established the Accounting Procedures Committee, which published a series of accounting research bulletins. The nature of these bulletins (and other accounting theory publications at the time) was summarised in the preface of Bulletin No. 43:

Forty-two bulletins were issued during the period 1939 to 1953. Eight of these were reports on terminology. The other 34 were the result of research by the committee on accounting procedures directed to those segments of accounting practice where problems were most demanding and with which business and the accounting profession were most concerned at the time.

As a result of this sporadic approach to the development of accounting principles, the AICPA established the Accounting Principles Board and appointed a director of accounting research in 1959. Overall, this period focused on the existing practical 'viewpoint' of accounting and, as research gained momentum over the period, the theories promulgated to explain practice became more detailed and complex.

Normative accounting

The period 1956–70 is labelled the 'normative period', because it was a period when accounting theorists attempted to establish 'norms' for 'best accounting practice'. During this period researchers, such as Edwards and Bell in 1961 and Chambers in 1966, were less concerned about what actually happened in practice and more concerned about developing theories that prescribed what should happen. In the years before 1956, several authors produced preliminary normative works which related mainly to issues surrounding the appropriate basis for the valuation of assets and owners' claims. These theories made adjustments for the impact of inflation and specific increases in asset prices.

The normative period was one of significant debate. It degenerated into a battle between competing viewpoints on the ideal approach to measuring and reporting accounting information. During this period, the debate was predominantly about measurement rather than the actual practice of recording and reporting information. However, the end result was no clear choice for changing practice to one ideal system of (inflation or price adjusted) accounting, leading to the continued use of the historical cost method. The accounting profession in Australia has been reluctant to reignite the debate about recommending on a specific and ideal measurement system and has failed to issue comprehensive measurement guidelines. Instead, in 2005 the profession adopted the measurement guidelines contained in the International Accounting Standards Board's (IASB) conceptual framework. The IASB has rather an unstructured approach, with the accounting standards allowing adoption of current value measurement concepts to be mixed with historical cost.

Normative theories are distinguished because they adopt an objective (ideal) stance and then specify the means of achieving the stated objective. They provide prescriptions for what should occur to achieve their stated objective. As mentioned, the major focus of the normative accounting theories during the period 1956–70 was the impact of changing prices on the value of assets and the calculation of profit (such theories were often seen as a consequence of the record levels of inflation experienced during this period).

Two groups dominated the normative period — the critics of historical cost accounting and the conceptual framework proponents. There was some overlap between these two groups, especially when historical cost critics tried to develop theories of accounting where asset measurement and profit determination depended on inflation and/or specific price movements.

During the normative period, the idea of a 'conceptual framework' gained increased popularity. A 'conceptual framework' is a structured theory of accounting. Such
frameworks are meant to encompass all components of financial reporting and are intended to guide practice.\textsuperscript{10} For example, in 1965 Goldberg was commissioned by the AAA to investigate the nature of accounting. The result was the publication of \textit{An Inquiry into the Nature of Accounting}, which aimed at developing a framework of accounting theory by providing a discussion of the nature and meaning of accounting.\textsuperscript{11} One year later, the AAA released \textit{A Statement of Basic Accounting Theory}, with the stated purpose of providing 'an integrated statement of basic accounting theory which will serve as a guide to educators, practitioners and others interested in accounting'. These frameworks had a common logical approach. They first stated the objective (purpose) of accounting and then worked downwards to derive accounting principles and rules that fulfilled that objective.

The normative period began drawing to an end in the early 1970s, and was replaced by the 'specific scientific theory' period, or the 'positive era' (1970–). The two main factors that prompted the demise of the normative period were:

- the unlikelihood of acceptance of any one particular normative theory
- the application of financial economic principles, increased supply of data and testing methods.

Because normative accounting theories prescribe how accounting should be practised, they are based on opinions of what the accounts should report, and the best way to do that. Opinions as to the appropriate goals and methods of accounting vary between individuals, and most of the dissatisfaction with the normative approach was that it provided no means of resolving these differences of opinion. Henderson, Peirson and Brown\textsuperscript{12} outline the two major criticisms of normative theories in the early 1970s:

- Normative theories do not necessarily involve empirical hypothesis testing.
- Normative theories are based on value judgements.

Further, the underlying assumptions of some normative theories were untested, and it was unclear whether the theories had strong foundations or assumptions about the purpose of accounting. Pragmatically, it was also difficult to obtain general acceptance of any particular normative accounting theory.

\begin{figure}
\centering
\includegraphics[width=\textwidth]{image}
\caption{Theory implementation and politics}
\end{figure}

\textbf{A depression scholar knows what it takes}

\textit{by Robert Samuelson}

It would have been insane for US president Barack Obama not to nominate Ben Bernanke to a second term as chairman of the Federal Reserve. The economics dictated it, as did the politics.

We will never know whether the world might have suffered a depression if Bernanke's Fed had not responded so aggressively.

Early this year, the Nobel Prize-winning economist and New York Times columnist Paul Krugman issued depression warnings.

Bernanke admitted similar fears in interviews with David Wessel, economics editor of \textit{The Wall Street Journal} and author of \textit{In Fed We Trust}. The fact that the global economy is no longer uncontrollably spiraling downward (for 2010, the Economist Intelligence Unit predicts growth of 2.7 per cent for the world and 1.8 per cent for the United States) was no foregone conclusion. Nor was it ordained that the panic gripping financial markets just six months ago would subside.

From recent lows in March, the US stockmarket is now up roughly 50 per cent.

It is not that Bernanke's performance was flawless. Far from it. He made two blunders. First, he didn't see the crisis coming. Even after the collapse of the investment bank Bear Stearns in March 2008, he didn't foresee a widespread financial panic or a savage recession.
In the summer of 2008, the economy was weakening but seemed — to Bernanke and most economists — to be suffering from inflationary overheating. Consumer prices were rising at a 5 per cent annual rate, oil was peaking at $147 a barrel.

Second, along with the then-treasury secretary Henry Paulson, Bernanke allowed Lehman Brothers to go bankrupt in September. Both have said they lacked the legal power to rescue Lehman and that no one wanted to buy it.

If Bernanke and Paulson had fully anticipated the consequences of Lehman's failure, they almost certainly would have found a way to save it. Once Lehman collapsed, the crisis got much worse. Banks retreated from lending to each other, investors wouldn't buy new bonds, banks, consumers and businesses hoarded cash. The economy contracted at an annual rate of 5 per cent to 6 per cent.

Here is where Bernanke distinguished himself. A student of the Great Depression, and especially of the disastrous effects of bank failures, he went well beyond the standard response of lowering interest rates (the overnight Fed funds rate dropped effectively to zero by December). The Fed created a dizzying array of liquidity facilities to substitute more than $US1 trillion of Fed credit for retreating private credit. It supported markets for mortgages, money market funds, commercial paper, auto loans and student loans. The strategy was, as Wessel says, to do whatever it took to avoid a complete loss of credit and confidence — a loss causing continuous drops in spending and asset prices (for stocks, bonds, homes) and ending in depression.

Although there were other actors, the Fed's interventions were decisive in halting the panic. It is an open question whether any other Fed chairman — someone without Bernanke's detailed knowledge of the Depression — would have been so bold in supporting credit markets. Moreover, Bernanke's approach inspired similar moves abroad. But this is also Bernanke's burden. If the Fed doesn't withdraw all that extra credit quickly enough, it may spawn inflation. If it withdraws it too quickly, it may subvert recovery.


Questions
1. The article describes how a particular theoretical approach has been replaced by another. Explain why one theory replaces another, and who, or what, determines whether an existing theory survives.
2. Does the reintroduction of a theory mean that it should not have been replaced in the first place?
3. Should a theory be discarded if it does not specify the means of achieving a stated objective? Explain your answer.

Positive accounting

The dissatisfaction with normative theories, combined with increased access to empirical data sets and an increasing recognition of economic arguments within the accounting literature, led to the shift to a 'new' form of empiricism which operates under the broad label of 'positive theory'. In effect, positive theory was hardly 'new', as it was based on the empirical approach, which formed the basis of the general scientific period. Positive theory sought to provide a framework for explaining the practices which were being observed; that is, whether what practising accountants produced had a decision-usefulness objective, whether it filled other roles, and whether it was inferior or superior to proposed alternatives.

The objective of positive accounting theory is to explain and predict accounting practice. An example of a positive accounting theory is the theory that leads to what is known as the 'bonus plan hypothesis'. This theory relies on managers being wealth-maximisers who would rather have more wealth than less, even at the expense of...
shareholders. If managers are remunerated partly with bonuses based on reported accounting profits, the managers have incentives to use accounting policies that maximise reported profits in periods when they are likely to receive bonuses. This theory leads to the prediction (hypothesis) that managers who are remunerated via bonus plans use profit-increasing accounting methods more than managers who are not remunerated via bonus plans. Such theories are important since they explain the economic, or wealth, effects of accounting and why accounting is important to various parties such as shareholders, lenders and managers — all of whose personal wealth is affected by accounting decisions. It is also important in assisting in the design of contracts based on accounting numbers that control such behaviour.

By explaining and predicting accounting practice, Watts and Zimmerman consider that positive theory has given order to the apparent confusion associated with the choice of accounting techniques. They argue that positive accounting theory helps predict the reactions of investors in the market (such as current shareholders) to the actions of management and to reported accounting information. One benefit of such research is that it enables regulators to assess the economic consequences of the various accounting practices they consider. The problem with this approach is that wealth maximisation became the answer to every question. Basically, whatever the observed practice, it could be construed as a means of maximising wealth (normally for the firm, but sometimes for management). To give the argument symmetry, the reverse argument could also be applied — namely, that the observed practice was to minimise the impact of costs or some external event on the value of the firm. The positive literature involves developing hypotheses about reality which are subsequently tested by observation of impact, usually based upon the assumption of wealth maximisation. The approach has attracted criticisms which are largely based on the seemingly narrow approach that concentrated on agency theory and assumptions about the efficiency of markets.

The potential role of positive accounting theories in explaining and predicting behaviour is illustrated in theory in action 1.2.

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**Out of control**

Fresh blow to banking as rogue trader costs Societe Generale US$7.1 billion

_by Sudip Kar-Cupta_

A "massive fraud" by a junior rogue trader has punched a US$7 billion hole in the finances of French bank Societe Generale, leaving its credibility in tatters and forcing it to get emergency cash.

France's central bank and government scrambled to shore up confidence in the banking system after Societe Generale, France's second-biggest bank, said it had been the victim of massive and "exceptional" fraud resulting in losses of 4.9 billion euros.

SocGen, one of France's oldest banks and a world leader in free-wheeling modern financial derivatives, blamed a young backroom trader whom it said had tried to cover up bad bets on the stock market. "It was an extremely sophisticated fraud in the way it was concealed", said Societe Generale chairman Daniel Bouton, who offered to resign but has been asked to stay on.

Shares in the bank fell more than 6% to 74 euros.

The Bank of France announced an enquiry by the Banking Commission. Governor Christian Noyer said SocGen had been able to overcome the crisis because it was "very solid".
If fraud is proved, the loss will be the biggest caused by a single trader, dwarfing the US$1.4 billion loss by trader Nick Leeson that brought down British bank Barings in the 1990s.

SocGen declined to name the trader, but said he had been suspended pending dismissal after confessing to his actions. It described him as a man in his thirties who had worked for SocGen since 2002 and earned less than 100,000 (US$146,500) euros a year. He now faces legal action from Societe Generale, which is in turn already being sued by a group of 100 angry shareholders.

The bank accused the trader of taking "massive fraudulent" positions in 2007 and 2008 on European equity market indexes, meaning he was gambling on broad movements in share prices. When the bank discovered the concealed trades, it decided to close the positions in the market as quickly as possible, but this coincided with a sharp market sell-off, and the bank's losses on the deals spiraled to 4.9 billion euros.

Like Leeson before him, the trader apparently benefited from knowledge of the bank's control systems after working in the back office of its trading rooms, according to SocGen.

It said he had used a "scheme of elaborate fictitious transactions" to try to cover up his mistakes, but did not accuse him of profiting personally from his actions.

The announcement sent a shiver through the world banking industry, which is suffering a credit crunch as high-risk U.S. mortgage borrowers default on their loans. Lehman Brothers chief executive and chairman Richard Fuld called it "everyone's worst nightmare" in a comment from the World Economic Forum in Davos, Switzerland.

"We get the feeling that the financial markets have become a big casino which has lost control. It seems incredible that the Societe Generale can lose 5 billion through one operator", said Alain Crouzet, a portfolio manager at Montsegur Finance.

Other said the crisis at SocGen, one of the top 10 banks in the eurozone by market value, could spell trouble elsewhere. "The most serious thing is that this puts into doubt the risk-management systems at some banks," said Fortis analyst Carlos Garcia. "You can't suddenly announce this from one day to the next a hit of $7 billion. In the light of this, what we've done is to downgrade banks that are very linked to trading income or whose capital base is weak."

Analysts said the episode would have a major impact on the reputation of SocGen, which was founded in 1864 and is one of France's most prestigious blue-chip companies. Several said the bank, which has for years been coveted by larger French rival BNP Paribas, could face a battle to remain independent. Shares in BNP rose 7%.

SocGen said it expected a 2007 net profit of between 600 and 800 million euros, well below its 2006 profit figure.


Questions
1. 'Rogue' is defined in the Oxford dictionary as 'that which lacks appropriate control; something which is irresponsible or undisciplined'. Given this definition, who is ultimately responsible for the rogue trading outlined in the Societe Generale scandal — the trader directly involved; management, who are responsible for the high-risk framework in which the trader operated; or a combination of both?
2. Discuss the role played in the SocGen case by each of the following three elements: personality, institutional framework, and opportunity.
3. How could Societe Generale have been unaware of the activity of its trader and of the environment that it had created for the trader to operate within?
4. Do you think that the actions of 'rogue' traders are predictable under particular theories (such as agency theory)? Explain your answer.
This seemingly narrow approach of the positive theorists resulted in a resurgence, especially in the 1980s, in behavioural research. Behavioural research is concerned with the broader sociological implications of accounting numbers and the associated actions of key participants such as managers, shareholders, creditors and the government as they react to accounting information. An example is a theory that predicts that loan managers cannot process all the financial information they receive, so they assess firms’ credit risk using the information that is most relevant to the background of the loan manager. If the loan manager had been involved with loans to firms that defaulted on their debt agreements because of poor cash flows, despite profitable activities, it is predicted that the manager will place more reliance on cash flow information than other information. On the other hand, if the loan manager had been involved with loans to firms that defaulted because of unprofitable operations, it is predicted that the manager will place more reliance on the reported profit or loss and earnings prospects of prospective borrowers. Behavioural accounting theory tends to focus on psychological and sociological influences on individuals in their use and/or preparation of accounting. Note that, although it had a resurgence in the 1980s and continues to be important, behavioural research in accounting emerged in the early 1950s and first appeared in the accounting literature in 1967.16

More recently, there has been a spate of very significant and dramatic corporate collapses or confessions of corporate wrongdoing. Many stakeholders (shareholders, government, and creditors) are concerned about the failure of accounting information to signal such financial catastrophes and the apparent manipulation of accounting information and of those meant to independently report on financial information (auditors). In fact, in some of these cases (such as Enron in 2001 and the collapses in the financial sector in 2008) it appears that the auditors colluded with management to mislead the external stakeholders. In one sense, this supports the positive view that at least one party was acting to maximise its wealth to the obvious detriment of others. This leads to an alternative view — if theory focused on the impact of accounting on behaviour rather than on explanations after the event of observed behaviour, the current corporate and reporting failures could well have been predicted. Instead, as occurred in the aftermath of the 1930s following the ‘Great Crash’ of the Wall Street exchange, the legislative reporting requirements have been increased significantly (e.g. the Sarbanes–Oxley Act (2002) in the United States), following the collapse of WorldCom and Enron.

One view is that it is impossible to develop a single theory of accounting, as human greed, opportunism, future uncertainty, and a degree of naivety on the part of some stakeholders can never be captured in a theory of accounting per se. Accounting standards and legislated reporting measures are the outcome of competing sets of interests and this may well be the place to begin developing a new theory of accounting behaviour. Either way, the current environment is one of increased disclosures and reporting requirements with legislated sanctions. But the key question is will this advance the development of theories relating to accounting measurements and disclosures?

**Recent developments**

Both academic and professional interests in theory development have tended to be aligned in the past. In recent times, however, academic and professional developments
in accounting theory have taken somewhat different approaches. Whereas the academic research emphasis remains in the area of capital market, agency theory, and behavioural impacts, the profession has pursued a more normative approach. In particular, the profession has sought normative theories to unify accounting practice and make it more homogeneous, whereas academic researchers have sought to better understand the role and impact of different forms of accounting information. These positive and normative approaches are not incompatible, since an understanding of the impact of accounting is a factor that accounting standard setters consider in developing prescriptions for practice.

In the mid to late 1980s, the Australian accounting profession was heavily involved in the conceptual framework debate in an attempt to provide a definitive statement of the nature and purpose of financial reporting and to provide appropriate criteria for deciding between alternative accounting practices. In December 1987, the Australian Accounting Research Foundation (AARF) released ED 42A–D 'Proposed Statements of Accounting Concepts', which outlined the objective, qualitative characteristics and rules for the definition and measurement of assets and liabilities. It also included a detailed outline of the 'tentative building blocks of a conceptual framework for regulation of financial reporting'. This was closely followed by ED 46A–B in March 1988, which outlined the concept of a reporting entity and provided definitions of the measurement and recognition of expenses. In 1990, the AARF formally applied the basis of the conceptual framework in Statement of Accounting Concepts (SAC) 1, 2 and 3, followed in 1392 by SAC 4. SAC 5, the controversial measurement statement, had not been released prior to the adoption of international financial reporting standards (IFRS) in 2005.

The transition to IFRS saw the replacement of SAC 3 and SAC 4 with the IASB’s conceptual framework, which together with SAC 1 and SAC 2 make up the conceptual framework in Australia. The IASB framework also forms the basis for the frameworks of other standard-setting nations such as the United Kingdom, Canada and New Zealand. The conceptual frameworks of the various countries are used in developing accounting standards and in attempting to reduce the inconsistencies arising from earlier fragmented theory and practice developments. The need for a single, consistent framework has gained widespread acceptance in recent years. The IASB, in a joint project with the US Financial Accounting Standards Board, embarked on a new conceptual framework project in 2005 to update and improve the conceptual framework for standard setters and preparers of financial statements to use.

The need for a single set of international accounting standards was acknowledged by the accounting profession in Australia with the adoption of IFRS in January 2005. International standards seek to harmonise practices across international reporting boundaries and to reduce the differences in reported information which are a direct consequence of different accounting choices. This approach aims to eliminate accounting disclosures and techniques specific to one or a small group of countries which subsequently affects the comparability or integration of information, particularly for multinational and listed corporations. The assumption is that the same theoretical issues apply whether the standards are specific to one country or designed for global application.

Figure 1.1, overleaf, summarises the main periods of theory development to the present.
Practice development

1450 to 1750: Pre-theory period
(continued development of practice)

1750 to 1920s:
Formalisation of practice

800s to 1955: General scientific period—
developments of practice and development of explanatory framework)

1970s: Normative period—
achievement of ideal practices and
building a framework to explain
and predict behaviour

2000 to present: Mixed development—
positive and normative regulatory theories

FIGURE 1.1 Accounting theory timeline

LO 2 CONTENT OUTLINE

This book provides a link between issues in accounting theory, research and practice. To reflect this, the book is divided into three parts:

Part 1: Accounting theory (chapters 1–3)

Part 2: Theory contributing to practice through accounting standards (chapters 4–10)

Part 3: Accounting and research (chapters 11–14)

Chapters 2 and 3 detail many different theory construction frameworks and then apply them to analyse examples from the accounting literature. The 'parts' of a theory are detailed, the means of testing theories are considered and the chronological development of accounting theory is traced. Understanding the components of theory development is important for accountants, not just those who will become academics, but also those who need to understand the choice of alternative accounting methods and explain this to clients and stakeholders. It is also important to distinguish between theory development as it relates to the natural versus human sciences. Accounting processes and information are the result of a complex set of human interactions and decisions which may not fit the traditional empirical (or scientific) process. When it comes to interpreting human behaviour, completely rational and systematic approaches may not apply. To be a complete professional accountant one needs to understand the mainstream approaches to theory development, in order to specifically consider theories of accounting, the behaviours accounting information demands, and the advice needed by clients. Thus, these chapters set down the fundamentals of taking a scientific perspective.

Chapter 4 describes how, over time, the different perspectives of the different users of financial statements have influenced the focus of accounting. It covers issues such as whether the focus of accounting is on reporting the ownership interest in the firm or the financial affairs of the firm as a separate operating entity. In addition, this
Constructivist epistemology of accounting analogous to the social sciences.

Chapter highlights a common view that accountants actually create their own ‘reality’, that is, accounting measures and reports are an outcome of the boundaries drawn by accountants to construct the reporting entity. Basically, a significant number of choices and decisions are made to ensure the accounting methods fit the reporting entity. It is important to appreciate that human decisions, preferences and objectives will affect the accounting viewpoint adopted, which in turn drives the accounting choices made in recording, measuring and reporting accounting information. This is an important chapter in the context that the IFRS has adopted a shareholder perspective rather than an entity perspective when determining the focus of accounting.

Since measurement is fundamental to accounting, chapter 5 provides an introduction to some important technical issues in relation to measurement and to how it applies to accounting theory and practice. We learn that in fundamental measurement numbers can be assigned by reference to natural laws, but in accounting there is considerable debate over the nature of fundamental value. We also learn that accounting is derived measurement that depends on the previous measurement of two or more other quantities. For example, we calculate income and expenses before profit is determined. Fiat measurements are those that relate numbers to properties of objects or events on the basis of arbitrary definitions.

Chapter 6 provides an overview of the accounting measurement systems from which the principles of fair value accounting can be said to be derived. The first section describes conventional historical cost accounting and the theoretical bases, criticisms and defence of the system. During the normative period, the historical cost system came under attack, and theories were developed to deal with the effects of changing prices on asset valuation and profit determination. These theories focused on either buying prices (current costs) or selling prices (exit prices). This part of the chapter outlines the development of current cost and exit price accounting theories and techniques, reviews the application of such techniques, and analyses the perceived impact of reporting current cost and exit price information. Thus, this chapter enables the student to place into perspective arguments about accounting measurement and the current debates about measurement in IFRS.

The definition and measurement of assets and liabilities are fundamental in determining the net value of the firm and, in many cases, the income and equity. Chapter 7 provides the definition of an asset and addresses measurement issues related to tangible, intangible and financial assets. The mixed measurement attribute model applied by IFRS is outlined as well as the concepts and methods behind different measurement methods. Chapter 8 is concerned with the credit side of the balance sheet — liabilities and equity. Liabilities are first defined and applications associated with applying the recognition and mixed measurement criteria to employee benefits, pension liabilities, provisions and contingencies are discussed. Issues are currently under intense debate as the IASB and FASB attempt to improve accounting standards in these areas. The chapter finishes with the definition of equity as the residual interest in assets, discusses the concept of capital, and outlines the difference between debt and equity.

The calculation of profit has been a key component in accounting measurement over many years and forms a fundamental component in many valuation models, capital market research, agency contracts, taxation issues, social issues and the behaviour of individuals. Chapters 9 and 10 provide overviews of the issues faced in the two main components used to derive income — revenue and expenses. Discussion is provided about recognition criterion — from cash transactions through to more recent concepts such as the acquisition of a customer valued at exit price. We show that there is
now less emphasis on the traditional notions of realisation and earned. We also discuss
the concept of the comprehensive income. Expenses are defined and concepts such as
economic benefits, expired costs and matching expenses and revenue are discussed in
chapter 10. One outcome of these two chapters is the ultimate consideration of the
nature of profit and the alternative measurement rules that can give rise to quite different
levels of reported profit.

Positive empirical accounting theory has been at the forefront of the academic
accounting research agenda for several decades. Chapters 11 and 12 focus on the
philosophy, scope and impact of positive theory on accounting theory development.
Chapter 11 details the development of theories of accounting policy choice and revenue
management. It focuses on contracting, agency and signalling theories, as a result of the
divergence between managers and shareholders (and debtors), that provide managers
with incentives to manage accounting numbers to maximise the wealth of themselves or
the firm. Chapter 12 describes and explains the development of theories about the role of
accounting information in the share market. It focuses on evidence of how share prices
respond to accounting information, and why the information should influence either
the price or amount of shares that are traded. The role and development of behavioural
accounting theory are described in chapter 13. This chapter explains how relaxing some
of the assumptions underlying positive accounting theory and focusing on individual
behaviour rather than on aggregate market behaviour influences an understanding of
the role of accounting reports and their significance, in various contexts, to various
parties. The final chapter, chapter 14, discusses some recent controversial issues in
accounting theory and regulation. Issues covered are the use of XBRL — a system that
enables users to extract accounting data at a micro (less aggregated) level, the impact of
Sarbanes–Oxley on the accounting and auditing professions, the role of fair values in
the global financial crisis of 2008–2009, the IASB and FASB convergence program, and
the impact of IFRS on auditors. Finally, the chapter ends by summarising a number
of issues in sustainability accounting. This research area is a growing extension to
the traditional focus of accounting theory on financial issues. It examines social and
environmental issues in an accounting context. Topics covered include the Global
Reporting Initiatives, climate change issues and accounting for carbon emissions rights,
assurance problems, and water accounting.

Overall, this book aims to assist students to develop the necessary skills to interpret,
discuss, evaluate and criticise competing theories and concepts, and to apply the elements
of these theories and concepts to current accounting issues. More specifically, it aims to
help students evaluate the current issues surrounding the introduction of IFRS on a
scientific basis, using logic and empirical perspectives.

Additional readings

Anthony, R, Hawkins, D, & Merchant, K 1999, Accounting: text and cases, 10th edn, New
Barry, P 2002, Rich kids: how the Murdochs and Packers lost $350 million in One.Tel, Sydney:
Random House.
Marshall, D, McManus, W, & Viele, D 2002, Accounting: what the numbers mean, 5th edn,
January, Rice University.
Endnotes

1. An Arrow–Debreu economy is when there are complete and perfect markets with all possible information available about current and future events.


6. Henderson, Peirson and Brown op. cit., p. 58.


10. A detailed analysis of the conceptual framework literature is provided in chapter 2 of this book.


13. Chapters 11 and 12 provide a detailed analysis of the positive accounting literature.

14. For further detail, see chapter 11.


After reading this chapter, you should have an appreciation of the following:

1. how pragmatic approaches to theory development apply to accounting
2. criticisms that have been levelled at historical cost accounting as a theoretical model
3. normative true income theories and the decision-usefulness approach to accounting theory
4. how positive theories are constructed
5. alternative naturalistic approaches and the importance of ontology
6. misconceptions associated with scientific approaches to accounting research, and why they are misconceptions

issues for auditing theory construction.
A useful way to study and assess accounting theories is to classify them according to the assumptions they rely on, how they were formulated, and their approaches to explaining and predicting actual events. Some of the classifications that have proven most useful are pragmatic, syntactic, semantic, normative, positive and naturalistic approaches. Pragmatic approaches are based on observing the behaviour of accountants or those who use the information generated by accountants. Syntactic approaches rely on logical argument, based on a set of premises, and semantic approaches concern how theories correspond to real-world events. Normative theories rely on both semantic and syntactic approaches. Positive approaches test hypotheses against actual events, and naturalistic approaches consider individual cases and do not try to generalise.

This chapter provides some insight into how accounting theories in each of these classifications were formulated. We also note some of the weaknesses and criticisms of various theories. Later chapters consider the different types of theory in detail in relation to particular accounting issues.

**PRAGMATIC THEORIES**

**Descriptive pragmatic approach**

The descriptive pragmatic approach to accounting theory construction is an inductive approach — it is based on continual observation of the behaviour of accountants in order to copy their accounting procedures and principles. Hence, a theory can be developed from observations of how accountants act in certain situations. The theory can be tested by observing whether accountants do, in fact, act in the way the theory suggests. Sterling called this method the ‘anthropological approach’:

... if the accounting anthropologist has observed that accounting man normally records a ‘conservative’ figure and generalises this as the ‘principle of conservatism’, then we can test this principle by observing whether or not accounting man does in fact record a conservative figure. If the accounting anthropologist sets forth the ‘principle of diversity’, then we can test this principle by observing whether or not accounting man does in fact record similar occurrences in different ways. And so forth.¹

The descriptive pragmatic approach is probably the oldest and most universally used method of accounting theory construction. Until quite recently, it was a popular way of learning accounting skills — future accountants were trained by being apprenticed or articled to a practising accountant.

However, there have been several criticisms of this approach to accounting theory construction:

- The descriptive pragmatic approach does not include an analytical judgement of the quality of an accountant's actions; there is no assessment of whether the accountant reports in the way he or she should.
- This approach does not provide for accounting techniques to be challenged, hence it does not allow for change. For example, we observe practising accountants' methods and techniques and teach those methods and techniques to students. Those students will become practising accountants whom we will observe in the future to learn what to teach, and so on.
- The descriptive pragmatic approach focuses attention on accountants' behaviour, not on measuring the attributes of the firm, such as assets, liabilities and profit. In taking a descriptive pragmatic approach, we are not concerning ourselves with the semantics of accounting phenomena.
Sterling comments:

... it is my value judgement that the theory of accounting ought to be concerned with accounting phenomena, not practising accountants, in the same way that theories of physics are concerned with physical phenomena, not practising physicists.

Sterling concludes that such a pragmatic approach is inappropriate for accounting theory construction. His conclusion is, of course, in relation to normative theories of how accounting should be conducted rather than pragmatic theories that describe real-world practices.

Psychological pragmatic approach

In contrast to descriptive pragmatic approaches where theorists observe accountants' behaviours, psychological pragmatic approaches require theorists to observe users' responses to the accountants' outputs (such as financial reports). A reaction by the user is taken as evidence that the financial statements are useful and contain relevant information. A problem with the psychological pragmatic approach is that some users may react in an illogical manner, some might have a preconditioned response, and others may not react when they should. This shortcoming is overcome by concentrating on decision theories and testing them on large samples of people, rather than concentrating on the responses of individuals.

SYNTACTIC AND SEMANTIC THEORIES

One theoretical interpretation of traditional historical cost accounting is that it is largely a syntactic theory. This interpretation may be described as follows: the semantic inputs of the system are the transactions and exchanges recorded in the vouchers, journals and ledgers of the business. These are then manipulated (partitioned and summed) on the basis of the premises and assumptions of historical cost accounting. For example, we assume that inflation is not to be recorded and market values of assets and liabilities are ignored. We then use double-entry accounting and the principles of historical cost accounting to calculate profit and loss and the financial position. The individual propositions are verified every time the statements are audited by checking the calculations and manipulations. However, the accounts are rarely audited specifically in terms of whether and how people will use them (a pragmatic test) or in terms of what they mean (a semantic test). In this way, historical cost accounting has been confirmed many times. If we assume a Lakatosian research program, the principles of historical cost accounting form the negative heuristic and, in a Kuhnian viewpoint, the dominant paradigm.

Some accounting theorists are critical of this approach. They argue that the theory has semantic content only on the basis of its inputs. There is no independent empirical operation to verify the calculated outputs, for example, 'profit' or 'total assets'. These figures are not observed; they are simple summations of account balances, and the auditing process is, in essence, simply a recalculation. The auditing process verifies the inputs by examining underlying documents and checks mathematical calculations. However, it does not verify the final outputs. This means that even if accounting reports are prepared using perfect syntax, they may have little, if any, value in practice.

Sterling comments:

The inadequacy of this procedure to confirm a theory is immediately apparent. If one were to attempt to confirm a theory of astronomy, as exemplified by a particular planetarium, then one might begin by checking on the accuracy of the observational inputs and one might also check for errors in computation. However, at some point the...
Outputs of the system would be verified. One would look at the sky to see if the stars were in fact in the position indicated by the planetarium. In the absence of this last step, several absurdities could result. First, the set of equations could describe any situation whatsoever, e.g., a rectangular orbit. If one restricted the 'verification' procedure to a check on the accuracy of the inputs and a recalculation, then one would certify that this planetarium presents fairly the position of the stars. The only way to discover that the orbit ought or ought not to be rectangular is to perform a separate operation and compare the results of that operation with the outputs of the system. If enough of these outputs were subjected to independent verification, the theory of rectangular orbits would be either confirmed or disconfirmed. Second, if there were two planetariums concerned with the same phenomena but with different sets of equations resulting in contradictory outputs, then the auditing procedure would require that both of them be certified as correct when at least one of them is necessarily wrong. Finally, the number of different sets of equations with different outputs is limitless.

The following article demonstrates the importance of ensuring that the syntax and semantics are not only correct, but also complete.

Do share prices rise when profit improves?

Bonuses soften wage freeze

by Sue Mitchell

Metcash has frozen employee salaries and non-executive directors' fees but has softened the blow for senior executives by offering $1 million long-term retention payments.

The ... retention offers are conditional on Metcash achieving a compound 8 per cent increase in earnings per share over the next five years while the previous offers, entered into in 2006 and 2007, were conditional on Metcash achieving compound earnings per share growth of 12.5 per cent and 10 per cent respectively.

The declining hurdle rate for retention bonuses reflects the slowing growth outlook for Metcash after its $900 million acquisition of Foodland's Australian operations in 2005 ... "Post that acquisition there was quite a lot of access to potential synergies ... to an extent most of that has flowed through," said Deutsche Bank analyst Kristan Walker.

Metcash increased earnings per share by 13.3 per cent in 2009 and is forecasting more growth this year, driving sales and earnings through a combination of organic growth and acquisitions.

Metcash shares rose 7c to close at $4.29 yesterday.


Questions

1. The article describes a market reaction to accounting news. This description provides an example of which approach to theory?
   (a) pragmatic
   (b) syntactic
   (c) semantic
   Explain your answer.

2. Consider the following syllogism:
   When a company reports better prospects than previously, investors force that company's share price to increase.
   • Metcash is a company that has reported better earnings per share than previously.
   • Investors forced Metcash share prices to increase.
   (a) Is there a flaw in the syntax or semantics within the syllogism that means its conclusion is not true? If so what is the flaw? (Hint: Consider whether the general premise at the start of the syllogism must always be true.)
   (b) What is the practical significance of this theory being invalid and its conclusion false?
Historical cost accounting has also been criticised on the basis of its syntactic element, for example with respect to the practice of summing several different money amounts assigned to specific assets:

The sum of two weights means nothing unless they are measured by the same rules . . . What, then, about the procedure of adding the amount of cash held by a company today to the amount of cash paid 20 years ago for a piece of freehold land which the company still holds today?⁴

Chambers adds further criticism:

The impression one gains from the internal inconsistency of many of the arguments upon which the justification of conventional accounting is made to rest is strongly reminiscent of the underlying philosophy of the rulers of Oceania in George Orwell’s Nineteen Eighty-Four. The distinctive feature of this philosophy is doublethink. Doublethink means the power of holding two contradictory beliefs in one’s mind simultaneously, and accepting both of them.⁵

Chambers goes on to give some examples of accounting doublethink:

Valuations are incorporated in balance sheets . . . but the balance sheet is not a valuation statement.

Fixed assets should be carried at cost . . . in historical accounts, unless such cost is no longer meaningful.⁶

Questions have been raised also about the imprecision of definitions in accounting. In terms of a Popperian approach to science, many of the propositions of conventional accounting are not falsifiable. Take, for example, the following criticism of a definition of depreciation:

Definitions are unacceptable which imply that depreciation for the year is a measurement, expressed in monetary terms, of the physical deterioration within the year, or the decline in monetary value within the year, or, indeed of anything that actually occurs within the year.⁷

Sterling takes this point further by stating that the problem lies in the way accountants have defined the determination of costs and profit as a choice among conventions, which are in turn defined so that a present magnitude depends on a future magnitude. For example, depreciation depends on allocation, which in turn depends on a future sale (disposal value) and the expected useful life of the asset. The same is true for profit. Under this logic, true profit cannot be determined until the firm has been liquidated.

Theories based on historical cost conventions lead to cautious hypotheses. The hypotheses therefore are unable to be tested and, as per the falsificationist approach (in which a hypothesis is not informative and does not add to scientific progress if it is not worded or proposed so that it is falsifiable), they are not useful for financial decision making except to verify accounting entries. Hence, they are uninformative and do not add to knowledge or progress in accounting. The above criticisms of historical cost are essentially criticisms about measuring current values and were the forerunner of the current move of International Financial Reporting Standards (IFRS) towards ‘fair value’ accounting.

In defence of the historical cost system, accountants argue that there is no requirement that accounting outputs should have any semantic content (correspondence with current real-world events, transactions, or values) or be subject to falsification rules. They counter by using the argument that the role of accounting is to allocate the historical cost of resource usage against revenue — the matching concept — to determine the surplus secured from economic activity. In this case, assets, liabilities and equity are
residuals from this process; they are not meant to measure or say anything about entity value or about the entity's financial state of affairs. If we adopt this allocation approach, the definition of depreciation is then in accordance with the matching concept. Although it may be syntactic, this cost allocation assumption can conflict with normative theories about how we should account to provide information that is useful for decision making. The assumption that accounting should be a measurement system, providing information useful for decision making, is a normative premise assumed by a large group of accounting theorists and regulators.

The criticism that there are many different and acceptable historical cost allocation systems can be explained within a 'positive accounting' framework which makes the assumption that accounting information is an economic good, subject to demand and supply forces.

Under positive approaches to accounting theory development, diversity of accounting techniques exists because diversity is required. This is because different accounting techniques are needed to account for different business situations. For example, where firms are regulated by agencies that allow them to charge prices only on a cost-recovery basis, historical cost could be useful for management accounting price setting and for informing outside users of financial statements about the firm's likely future profits, and also as a means of influencing price-regulation agencies regarding the appropriateness of their price-setting formula. The allocation of costs used for price setting might involve accelerated cost recognition, such as diminishing-balance depreciation over a short period of time because this gives high costs and leads to high prices being set for the firm's products. However, a slower cost allocation might better reflect to outside users the likely life and value of the assets. Agency theory suggests that the accounting technique required to minimise the costs of contracting will often differ from situation to situation. Moreover, different political and regulatory costs affect each firm. Since firms seek to minimise all costs, they will choose different accounting techniques and because historical cost allocation allows a substantial number of allocation techniques, then firms can simply choose the most efficient technique.

NORMATIVE THEORIES

The 1950s and 1960s saw what has been described as the 'golden age' of normative accounting research. During this period, accounting researchers became more concerned with policy recommendations and with what should be done, rather than with analysing and explaining the currently accepted practice. Normative theories in this period concentrated either on deriving the 'true income' (profit) for an accounting period or on discussing the type of accounting information which would be useful in making economic decisions.

True income: True income theorists concentrated on deriving a single measure for assets and a unique (and correct) profit figure. However, there was no agreement on what constituted a correct or true measure of value and profit. Much of the literature during this period consisted of academic debate about the merits and demerits of alternative measurement systems.

Decision-usefulness: The decision-usefulness approach assumes that the basic objective of accounting is to aid the decision-making process of certain 'users' of accounting reports by providing useful, or relevant, accounting data; for example, to help investors (current and potential) decide whether to buy, hold or sell shares. One test of usefulness already discussed is the psychological pragmatic reaction to data. Others do not identify a particular group but argue that all users have the same requirement for accounting data.
In most cases decision-usefulness theories of accounting are based on classical economics concepts of profit and wealth or rational decision making. They usually make adjustments to historical cost measures to account for inflation or the market values of assets. They are, in essence, measurement theories of accounting. They are normative in nature because they make the following assumptions:

- accounting should be a measurement system
- profit and value can be measured precisely
- financial accounting is useful for making economic decisions
- markets are inefficient or can be fooled by 'creative accountants'
- conventional accounting is inefficient (in an information sense)
- there is one unique profit measure.

These assumptions were rarely subjected to any empirical testing. Their proponents usually described their derived accounting system as the 'ideal'. They recommended it to replace historical cost and prescribed its use by all and sundry.

Normative researchers labelled their approach to theory formulation scientific and, in general, based their theory on both analytic (syntactic) and empirical (inductive) propositions. Conceptually, the normative theories of the 1950s and 1960s began with a statement of the domain (scope) and objectives of accounting, the assumptions underlying the system and definitions of all the key concepts. The domain of accounting was general. It was in relation to the entire income statement and balance sheet, not just specific accounting items such as accounting for doubtful debts only. Also, it was in relation to all users of financial statements and not confined to a specific user or user group.

The normative theorists also made assumptions about the nature of a firm's operations based on their observations. Detailed and precise accounting principles and rules and a logical explanation of the accounting outputs were outlined. The deductive framework was to be rigorous and consistent in its analytic concepts. Financial statements should mean what they say; they should have semantic connections with the real world. Although financial statements are abstractions and reductions of firms' economic affairs, since they summarise the stock and the movement of economic resources, they should be pragmatic only to the extent that they were surrogates for direct experience. The pragmatic tests were that, when observing financial statements, users should act as though they actually observed the events the financial statements represented.

Although this methodology has both syntactic and semantic features, it relies mainly on syntactic relations and therefore has been labelled 'hypothetico-deductive'.

An important question in this accounting research concerns the usefulness of accounting data. Are the quantitative data we derive from given sets of operations based on an overall theory of accounting useful to users of financial statements? To find the answer, what was usually done was to take the output data of specific accounting systems and determine whether this data helped decision makers make the right financial decisions. This is a direct approach to testing accounting theory. Figure 2.1 indicates the procedure. The arrows signify the output of each model. Decision makers use accounting data to make predictions about the company. Based on these predictions, they decide what to do, such as sell shares in the company or buy more.

![FIGURE 2.1 The decision process](image)
In science, this decision-usefulness approach is referred to as either financial instrumentalism or realism. The suggestion that alternative accounting systems should be assessed according to their predictive ability is an extension of logical positivism and is termed ‘instrumentalism’ — that is, a theory has no utility except as an instrument for prediction. According to Friedman, theories cannot be tested by the realism of their assumptions; they can be judged only by their predictive power. There are, however, some problems involved in applying this test. First, if the prediction is verified, it verifies the prediction model of the user, not the accounting system. There are, of course, other variables besides accounting data that affect a financial prediction. We do not know precisely how the accounting data were used. Second, if the decision turns out to be the right one, it verifies the decision model, not the accounting system. Therefore, it is difficult to interpret the validity of the accounting model based simply on decision making.

On the other hand, realism stresses the explanatory role of science; in essence, prediction in reverse. This methodological point of view stresses the feedback role of accounting. The 'realism' approach to accounting means that for an accounting theory to be valid it must be more than an instrument for forecasting; it must also hold as a description of the reality that underlies the accounting phenomena. Accounting, under this approach, gains predictive ability only because it gives relevant feedback or descriptive explanation of what has occurred. We can also question the logical validity of using prediction (forecasting) as a scientific test for an accounting theory in a dynamic environment where intervening variables cannot be controlled. Prediction in science is more valid when we can control variables such as air pressure, heat, weight and so on. When we cannot control variables in the economic environment, such as inflation and interest rates or consumer confidence, we have to assess predictions statistically, according to how probable it is that the evidence supporting the prediction is representative.

The following article is a comment on the way accounting theory has evolved, become accepted and then implemented.

**IFRS is a Big Four gravy train**

*by Richard Murphy*

It’s been announced that International Financial Reporting Standards are to be used by UK local authorities from 1 April 2010 for the preparation of their accounts.

Now, I'm not usually one of those who goes around suggesting the public sector is wasting money, largely because when all is said and done it seems to me no more prone to the frailty of human fallibility than the private sector, where I have witnessed waste on the most colossal scale. But on this occasion I'm going to, and I'm going to point a finger at those imposing the waste.

IFRS are completely and utterly inappropriate for use by local authorities. The reason is simply stated: IFRS are designed to produce what the IASB call 'decision useful information'. I question that, but for logical reason in this case.

The IASB defines decision useful information as that needed by an investor to decide whether to buy or sell shares in an entity. They do not consider there to be any other reason for financial reporting. That is why the entire focus of IFRS shifted from that in the previous UK GAAP, which was on reporting profit, to one of reporting changes in balance sheet value.

This is no minor issue: UK GAAP was accruals accounting and sought to match transactions in a period to provide a measure of what had happened in that time scale. Balance sheets are a residual measure in that process. So this GAAP was about stewardship, financial performance, delivery of value for money, and action over time.
IFRS on the other hand is about measuring value at a point of time and comparing that with value at another point of time. The difference is the result for the period.

So the balance sheet is predominant and the profit and loss account secondary because it is assumed that the investor in the entity will have a short time scale for involvement (usually less than a year — the UK stock exchange changes hands entirely well over once a year now, on average) and is therefore wholly uninterested in stewardship, performance over time or even delivery of results.

The IFRS belief is that the only issue of concern to the investors, who they believe to be the sole user of accounts, is in making a quick buck from dealing.

Now, let's get down to some basic facts here. No one invests in a local authority. They're not for sale. They do not provide an investment return. With rare exceptions (and I regret this) they do not even issue bonds to finance their capital projects.

So the user of the financial statements that IFRS assume to exist are not present in the case of local authorities. There are no investors. And the use for which the financial statements that IFRS assumes to exist, being the decision to buy and sell shares, does not exist in the case of local authorities. There is nothing to buy and sell.

This alone, at this most obvious and basic level, makes it abundantly obvious that IFRS is the wrong accounting system for local authorities (as it is for any unquoted company, incidentally, for much the same reason — an absence of any marketable security).

It's worse than that though: IFRS will not require accounting for stewardship of public funds entrusted, or for the supply of services, both of which are core to the management of local authorities. And we know that a failure to measure almost always means a failure to deliver in management terms. This means we have a potential disaster on our hands.

And whose fault is this? Well firstly, the IASB’s. They do not act in the public interest, after all. They are a private cartel designed by and promoted for, in no small part, the benefit of their biggest sponsors — who are the Big 4 firms of accountants. Second, those firms have much to answer for.

They have just made a fortune from the IFRS transition for first tier listed companies, now they're selling similar services to the secondary markets and after that there was a void. So they've persuaded the professional bodies (which they dominate) to move IASB into local authorities which will give their teams work for several more years. You can call that cynical if you like — but actually, it's just a statement of fact.

What I really hate is when people say the public sector is inefficient when the entire reason is that the public sector was sold a completely dud product by the private sector. That's true of most of the IT debacles, for example. It will be true here.

Someone needs to wake up, smell the coffee and realise that UK local authorities are being sold a dud reporting system designed from the outset to be unfit for their needs. This project must be cancelled now before it is too late! This is not just a waste of money. This is a straightforward con.

I am angry. And so should all local authority tax payers in the UK. We're going to be taken for a ride unless we protest now.


Questions
1. Murphy comments on the different theories of accounting under IFRS and UK GAAP. What are the differences and why is IFRS deemed inappropriate for local authorities?
2. Based upon the arguments by Murphy should we have different accounting systems? For local authorities? For different countries?
3. What approach is Murphy using when he addresses the question of accounting for local authorities?
4. Why do you think IFRS has been adopted for local authorities? Is it scientific or unscientific?
Normative theories of investment

Shares set for a pullback, not new lows

by Glenn Mumford

It's been a great run, but I'm starting to get very nervous. Australian equities are now about 40 per cent off bear-market lows. Ditto the Australian dollar. Commodity indices are at nine-month highs, while domestic interest rates are at 49-year lows.

I remain a bull — a true believer. My 2010 target on the S&P/ASX 200 Index is 5500. I'm still a supporter of the commodity super-cycle. And the little Aussie battler should test parity against an ailing greenback at some stage over the next 18 months.

So why in the world am I worried? I get the feeling we may be trading at interim highs on equities, the Australian dollar and commodities... I can't shake the feeling that investors have already factored in most of the market's medium-term positives. This inevitably leaves them prone to short-term negative surprises.

Commodities are a particular concern. I think Xstrata's Mick Davis caught the mood on Tuesday when he pointed to the "froth" that had accompanied the run-up in metal prices. "Sentiment has been driving prices, rather than fundamentals," he warned. I'm also expecting a more pragmatic reading of the domestic interest rate outlook to soften the local currency.

Equity investors appear to be searching for an excuse to take some profits. Many are still pinching themselves, as they come to terms with their recent good fortune. Selling pressure in the US would be the likeliest catalyst for this "judicious liquidation", though with reporting season about to get underway, some less-than-stellar 2008/9 profit outcomes could provide an added trigger.

So how should investors play this? As volatility returns, the market will inevitably wrong-foot many as it moves to find a new floor. Do you look to take advantage of gains that have accrued since the March lows and lock a little away? Or do you grit your teeth and ride out any short-term volatility, before the expected fourth-quarter resumption of the dominant market trend? Whatever path you take, view any correction as an added opportunity. just remember what we said back in March. Forget selling rallies — it's time to buy dips.


Questions

1. What is a bull market? What is a bear market?
2. Why would high commodity prices and low interest rates help to maintain share prices?
3. What is the theory underlying the advice to buy the 'dips'? Is this a normative theory?

   Explain your answer.

POSITIVE THEORIES

During the 1970s, accounting theory saw a move back to empirical methodology, which is often referred to as positive methodology. Positivism or empiricism means testing or relating accounting hypotheses or theories back to experiences or facts of the real world. Positive accounting research first focused on empirically testing some of the assumptions made by the normative accounting theorists. For example, by using questionnaires and other survey techniques, attitudes to the usefulness of different accounting techniques were determined. A typical approach was to survey the opinions of financial analysts, bank officers and accountants on the usefulness of different inflation accounting methods in their decision-making tasks (such as predicting bankruptcy or deciding whether to buy or sell shares). Another approach was to test...
the assumed importance of accounting outputs in the marketplace. Tests attempted to
determine whether inflation accounting increased the information efficiency of share
markets; whether profit is an important determinant in share valuation; whether the
cost of gathering 'finer' accounting data outweighed the benefits; or whether the use of
different accounting techniques affected value.

Today, the greater bulk of positive theory is concerned mainly with 'explaining'
the reasons for current practice and 'predicting' the role of accounting and associated
information in the economic decisions of individuals, firms and other parties that
contribute to the operation of the marketplace and the economy. This research
tests theories that assume that accounting information is an economic and political
commodity, and that people act in their own self-interest. Positive accounting theory
in particular covers questions such as: Do firms substitute alternative ways of financing
assets when the rules governing the accounting for leases change? Which firms are more
likely to use straight-line depreciation rather than diminishing-balance depreciation,
and why? The theory used to answer these questions generally revolves around
managers' incentives to maximise bonuses based on their companies' profits, their
incentives to avoid breaching accounting-based debt covenants and thereby reducing
the cost of debt, or their incentives to use accounting techniques to divert attention
from their high profits if those profits would attract public or government scrutiny, and
perhaps lead to higher taxes. In this book, chapters 11, 12 and 13 focus on different
types of positive accounting theories.

The main difference between normative and positive theories is that normative
theories are prescriptive, whereas positive theories are descriptive, explanatory or
predictive. Normative theories prescribe how people such as accountants should behave
to achieve an outcome that is judged to be right, moral, just, or otherwise a 'good'
outcome. Positive theories do not prescribe how people (e.g. accountants) should
behave to achieve an outcome that is judged to be 'good'. Rather, they avoid making
value-laden prescriptions. Instead, they describe how people do behave (regardless of
whether it is 'right'); they explain why people behave in a certain manner, for example
to achieve some objective such as maximising share values or their personal wealth
(regardless of whether that is 'right'); or they predict what people have done or will do
(again, regardless of whether that is 'right' or 'best behaviour').

Many positive theory researchers are largely dismissive of normative viewpoints.
Similarly, many normative theorists do not accept the value of positive accounting
research. In fact, the theories can coexist, and can complement each other. Positive
accounting theory can help provide an understanding of the role of accounting which,
in turn, can form the basis for developing normative theories to improve the practice
of accounting.

DIFFERENT PERSPECTIVES

To this point, we have focused on what may be considered to be a highly structured
approach to theory formulation — the scientific approach. We start with a theory based
on prior knowledge or accepted 'scientific' theory constructions. When we observe
real-world behaviour that does not concur with the theory, we treat that anomaly as a
research issue and express it as a research problem to be explained. We develop a theory
to explain the observed behaviour and use that theory to generate testable hypotheses
that will be corroborated only if the theory holds. We then follow precise and highly
structured or predetermined procedures for data collection and, after subjecting the data
(usually) to mathematical or statistical techniques, we validate or refute the hypotheses
This approach has an inherent assumption that the world to be researched is an objective reality capable of examination in terms of large-scale or average statistics. This type of research is carried out by incremental hypotheses which are then combined to provide greater understanding, or better predictions, of accounting. The implied assumption is that a good theory holds under circumstances that are constant across firms, industries and time.

This approach to research is generally described as the 'scientific' approach and is the approach currently used by most researchers in accounting, and the approach that is published in most major academic accounting journals. It is important to note that it is based on certain ontological assumptions (the way we view the world), which imply different epistemologies (the way we gather knowledge, or learn) and different research methods. This, in turn, influences the types of research problems posed and the hypotheses that are tested. It is important for accounting researchers to clearly recognise the assumptions underlying their research and to consider whether alternative research approaches are more appropriate. There is a body of literature, loosely labelled naturalistic research, which is critical of the highly structured approach adopted by 'scientific' researchers. We briefly review some of their criticisms in this section. Most researchers now accept that the most appropriate approach depends on the nature of the research question being considered.

The first criticism of the scientific method is that large-scale statistical research tends to lump everything together. Hypotheses based on the use of stock market prices or surveys render much of accounting research remote from the world of practitioners. Also, they are not commensurate with the concerns of many individual accountants in their roles as accountants. Some researchers advocate the naturalist research focus as being more appropriate for gaining a knowledge of accounting behaviour in its natural setting. The idea is that we undertake research as naturally as possible. This approach has two implications. First, we do not have any preconceived assumptions or theories. Second, we focus on firm-specific problems. This is done by taking a flexible research approach using close observations and placing less emphasis on mathematical analysis, modelling, statistical tests, surveys and laboratory tests. The usual way to undertake naturalistic research is to use individual case studies and more detailed fieldwork. This type of research is much more micro in its perspective because it is aimed at solving individual problems which may be firm-specific. Therefore, results may be more difficult to generalise.

The naturalistic approach can be compared with 'scientific' accounting research, which is more prone to aggregating the results from testing a number of hypotheses in order to form 'general theories of accounting'. Naturalistic research starts from specific real-world situations; the main intention is to answer the question 'What is going on here?', not to provide generalisable conditions for wide segments of society.

The case-study approach is seen by some researchers as best fulfilling the role of exploring or crystallising the research problem for naturalistic research. For example:

... where it is not feasible to develop theoretical models prior to empirical observation, the next best alternative (an exploratory approach) may be followed.\textsuperscript{10}

Tomkins and Groves disagree with this viewpoint. They see the naturalistic research approach as being more appropriate to different ontological assumptions.\textsuperscript{11} Differences in ontological assumptions imply different research styles and influence the research questions asked and investigated. For example, we may view accounting as a social construction. We may wish to understand what self-images people hold, what underlying assumptions sustain that view, or what part this perception plays in controlling the way they perform their everyday role. These are the types of questions that might be researched using a subjective ontology.
To further explain ontology and the different research styles which may be used, we consider the article by Tomkins and Groves and the Morgan and Smircich classification they used. First, they list a six-way classification of the nature of the social world (see Table 2.1).

Categories 1–6 are alternative ways of looking at the world. Category 1 is a strict objectivist viewpoint of the world, where behaviour will always conform to a set of behavioural rules, and outcomes of decisions and actions are highly predictable. In relation to category 1, for example, researchers assume that all managers aim to maximise their personal wealth and that they are aware of how they can use accounting techniques to do so (e.g. by increasing reported earnings, thereby increasing their bonuses that are tied to reported earnings). This enables researchers to predict what accounting methods managers will use if accounting choice is unregulated. Researchers will predict that all managers behave in the same manner because they have a shared view of the world and of the outcomes of their actions, and because they share preferences for particular outcomes. When researchers view the world as a concrete structure (category 1), this enables them to use the scientific approach and statistical methods to test their predictions. The scientific approach is appropriate where the behaviour investigated is predicted to occur systematically, according to a model of behaviour and events.

As we move down through the categories we are gradually relaxing our assumptions about the 'concreteness' of the world: category 1 assumes that the world is concrete and stable, category 6 views the world as unstable and human-specific. In category 6, humans are not expected to behave according to a set of behavioural rules that apply to everyone equally. Complex interrelationships and individualistic decision models are assumed. Individuals are not expected to think alike. Because individualism is expected in category 6, the scientific method and statistical tests are inappropriate because their assumptions are violated. Although individuals may behave rationally according to their personal understanding of the world and of the outcomes of particular actions, they do not share a common understanding of how the world works, and they have different preferred outcomes from their decisions. For example, some managers might prefer to maximise their personal wealth; others might prefer to maximise their subordinates’ job satisfaction; and others might prefer to minimise their personal work effort. Understanding decision making involves understanding individuals' perceptions and preferences.

For categories 1–3, it is more appropriate to use the scientific approach. By appropriate observation and measurement, it is assumed that one has readily available, stable and usually very simple functions relating to isolated and small subsets of the social world that can be used for accurate predictions.

For categories 4–6, Tomkins and Groves suggest that naturalistic or exploratory research is more appropriate. These three categories are generally labelled as 'symbolic

### Table 2.1 Six basic ontological assumption sets

<table>
<thead>
<tr>
<th>Category</th>
<th>Assumption</th>
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<tbody>
<tr>
<td>1.</td>
<td>Reality as a concrete structure</td>
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<tr>
<td>2.</td>
<td>Reality as a concrete process</td>
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<tr>
<td>3.</td>
<td>Reality as a contextual field of information</td>
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<td>4.</td>
<td>Reality as symbolic discourse</td>
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<tr>
<td>5.</td>
<td>Reality as social construction</td>
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<tr>
<td>6.</td>
<td>Reality as projection of human imagination</td>
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interactionist. Symbolic interactionists see their world as one in which people form their own separate impressions through a process of human interaction and negotiation. They believe that social action and interaction is possible only through exchange of shared interpretations of 'labels' attached to people, things and situations. Reality is not embodied in the rules of interpretation themselves, but only in the meanings that result from people's interpretation of the situations and events they experience. A 'scientific' approach to researching the interpretations people make might elucidate such rules through large-scale, statistical research in those areas where meanings held by individuals might be assumed to be stable. In contrast, the 'naturalist' would research the problem by placing emphasis on 'feeling one's way inside the experience of the actor' in order to gain an understanding of the problem. This process might identify many significant forms of social behaviour which cannot be related to a few well-specified variables with stable meanings, but which result from the nature of the interactions among a group of people.

As we have previously noted, the ontological assumption we make implies different epistemological approaches and certain research methods. This in turn influences the types of research problems asked and the hypotheses that are tested. To help you understand this, we present a comparison of the scientific and naturalistic approaches in table 2.2.

<table>
<thead>
<tr>
<th>Scientific research</th>
<th>Naturalistic research</th>
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<tbody>
<tr>
<td><strong>Ontological assumptions</strong></td>
<td>• Reality is objective and concrete.</td>
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<tr>
<td>• Accounting is objective reality.</td>
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<tr>
<td><strong>Epistemological approaches</strong></td>
<td>• Holistic</td>
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<tr>
<td>• Piecemeal advancement of knowledge</td>
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<td>• Reductionism</td>
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<td>• Testing of individual hypotheses</td>
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<td>• Laws capable of generalisation</td>
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<tr>
<td><strong>Methodology</strong></td>
<td>• Unstructured</td>
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<td>• Structured</td>
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<td>• Prior theoretical base</td>
<td></td>
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<tr>
<td>• Empirical validation or extension</td>
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<tr>
<td><strong>Methods</strong></td>
<td>• No prior theory</td>
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<tr>
<td>• Syntactic model formulation</td>
<td></td>
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<tr>
<td>• Empirical induction to form hypotheses</td>
<td></td>
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<td>• Appropriate statistical methods</td>
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<tr>
<td>• Case studies</td>
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<tr>
<td>• Exploration by flexibility</td>
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<td>• Experience of events</td>
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In the following article as a further illustration of different perspectives on accounting theory formation, extracts from 'Financial accounting: an epistemological research note' (Schiehll, Borba, Dal-Ri Murcia 2007) provide an overview of accounting theory development and the authors' view on the development of accounting theories.

**Financial accounting: an epistemological research note**

by Eduardo Schiehll, José Alonso Borba, and Fernando Dal-Ri Murcia

What is accounting? It is amazing how this simple, basic question has never been answered precisely (Kam, 1986). A simple and widely-held concept of accounting is the process of identifying, measuring, recording, and communicating economic information about an organization so that it may be used for sound decision-making. This concept was derived from Wells (1976), and like other concepts of accounting, it emphasizes the application
aspect of accounting knowledge. Viewing this definition from an epistemological perspective, one might argue that the object of study is not well defined, the methodology (truth criteria) is not identified, and the purpose of accounting research is poorly delimited. The aim of this document is not to criticize this specific definition, but to argue that one of the difficulties in understanding accounting as a scientific discipline resides in its definition as stated in the literature. Among others, the importance of viewing accounting as a scientific field is that fundamental or applied research is the only way to generate and improve knowledge in a scientific field. In other words, the relevance of, and incentives for, conducting research in a specific discipline like accounting depend on the extent to which specific methods may be applied to improve the discipline's body of knowledge.

Following this line of reasoning, we believe that in order to perceive and appreciate accounting as a scientific field, a first, essential step would be to understand the distinctions and associations between accounting theory and accounting practice. According to the framework proposed by Kuhn (1972), for example, we may conjecture that accounting theory is a body of statements or propositions connected by rules of inferential reasoning, (i.e. testable hypotheses or premises and conclusions) that form the general frame of reference for the development or explanation of accounting practices. The study by Hendriksen (1982) corroborates this argument, adding that accounting theory may be defined as logical reasoning in the form of a set of broad principles that:

1. provide a general frame of reference by which accounting practice can be evaluated, and
2. guide the development of new practices and procedures.

According to these principles, we argue that the next step in perceiving accounting as a scientific field would be to identify the accounting theories that are being developed and how they are verified. In this respect, Popper (1982) suggests that accounting knowledge is a body of normative and positive empirical theories built around inductive inferences.

"Normative" means that accounting theories contain imperative value judgments stemming from factual statements about the object of study, e.g., the market value of firm equity. Another justification is that normative conclusions are very often the origin of policy recommendations, which may or may not be adopted by practitioners in the field. According to Watts & Zimmermann (1986), normative theories are almost entirely devoted to the examination of questions of "what ought to be done." Thus, this theory attempts to prescribe what information ought to be communicated and how it ought to be presented. In other words, the normative theories attempt to explain what accounting "should be" rather than what accounting "is."

On the other hand, positive theories attempt to explain why accounting is what it is. They describe not only what accounting information should and how it should be communicated to its users, but also why accountants do what they do and the effects of all this on people and resource utilization (Christenson, 1983). However, as suggested by Schroeder and Clark (1995), ideally there should be no such distinction (normative versus positive) because a well-developed and complete theory encompasses both what should be and what it is.

The empirical and inductive attributes of accounting theory are easier to justify. In fact, according to Sterling (1970), only mathematics and logic can be classified as non-empirical sciences. Accounting theories in particular are fundamentally based on experience and observation. For example, the qualitative and quantitative variations of firm equity studied in Financial Accounting, or the dysfunctional behaviors of budgetary control investigated in Management Accounting.

However, accounting premises and conclusions are connected by inductive inference. Double-entry bookkeeping system can serve to illustrate this point. The double-entry system is based on noting changes in the wealth of a firm and an attempt to translate the qualitative and quantitative variations in the firm’s equity. The double-entry system, perhaps the first and most important paradigm of accounting science, was invented in the commercial city-states of medieval Italy in response to the emergence of trade and commerce. According to de Roover (1938) the double-entry was born when people came to see that you could not take something out of one pigeonhole without putting it into another. It has emerged as a natural outcome of the evolutionary process to the need of times (Kam, 1986). The first published...
accounting work was written in 1494 by the Venetian monk Luca Pacioli (1450–1520). It summarizes principles that have remained essentially unchanged to this day. Subsequent works written in the 16th century introduced the first formulations of the concepts of assets, liabilities, and income. In keeping with this theme, Lakatos (1978) suggests that a theory is constructed by a body of concepts. From this perspective, assets, liabilities, income, and other notions derived from these such as long and short term, revenue, costs, expenses, operational, no operational, etc., have a specific (or rather particular) meaning in the accounting field, and are fundamental elements for the building and understanding of accounting knowledge. In the same line of thinking, the study by Glaubier and Underdow (1994) suggests that the concepts of financial accounting are particularly significant to the development of accounting theory in two ways:

1) they are themselves part of an empirical process for developing rules of financial accounting, and

2) they reflect the influence of institutional forces which shape the philosophy of accounting in a given and social environment.

Much later, the Industrial Revolution drove the need for accounting practices that could handle mechanization, factory-manufacturing operations, and the mass production of goods and services. With the rise of large, publicly held business corporations owned by absentee stockholders and administrated by professional managers, the accounting role was further redefined. According to Schroeder, Clark and Cathey (2005) the Industrial Revolution brought the need for more formal accounting procedures and standards. In terms of epistemology, these two events may be interpreted as a crisis (Kuhn, 1972) in accounting science. Organizations were immersed in a new social and economic reality. New paradigms were imposed onto management activities, calling for new accounting theories to support the new accounting practices. From that point on, research in the accounting field split off into two directions: financial accounting and management accounting.

While the first focuses on the outside user of accounting information, the second focuses on the internal user and the decision making process. However, independently of this split, theorists continue their quest: explain accounting practice. In the next section we discuss the purposes, evolution and methods of financial accounting research.

The sociological and discursive perspectives of accounting
The studies by Latour (1989) and Whitley (1984) suggest that the sociological and discursive perspectives of a science are basically determined by the extent and intensity of its interaction with society. Like every other social science, accounting conducts its research based upon assumptions about the nature of social science and the nature of society (Belkaoui, 1997). As it happens, financial accounting may be analyzed from both the sociological and discursive perspectives. Thus, accounting may be viewed as a "socio-systemic" structure, with input, process, and output. The idea is that financial accounting knowledge does not affect only the accountants and accounting practices, but also (directly or indirectly) impacts the management context in all its ramifications. As Beaver (1998) suggests, the current financial report environment consists of various groups (investors, information intermediaries, regulators, managers, auditors, etc.) who are affected by and have a stake in financial reporting requirements. Hereafter, the sociological and discursive perspectives of accounting will be analyzed assisted by the strong interdependence between science and society (the science "players"). Our argument is that, as an applied science, the accounting discipline is no exception to the rule. In this sense, the process of constructing accounting theories has been analyzed, culminating in the conclusion that market pressure, tax laws (institutional influence), management decision needs, and macroeconomic factors such as inflation are the main inputs to a sociological accounting system. These inputs are the starting points for an accounting translation process. Thus, the discursive result is the creation or improvement of accounting practices, while the sociological contribution is the correct incorporation of these aspects into the accounting framework to address user needs and serve as interpretation models. Therefore, the accounting "socio-output" is represented by better assessments of a firm's financial health.
by investors and stakeholders and improved decision-making by managers. Thus, selection of a financial reporting system might be viewed as a social choice, where bargain power will determine whoever gets their desires fulfilled. In a number of countries, such as the United States, where financial reporting information is directed primarily toward the needs of investors and creditors, decision usefulness is the overriding criterion for judging its quality (Mueller, Gernon and Meek, 1994). However, in some other countries, such as some Latin American countries, financial accounting is designed primarily to ensure that the right amount of tax is collected. In this sense, accounting is shaped by the environmental forces in which it operates. At the same time, scientific research in accounting has also been influenced by social and environmental forces, which resulted in two different streams of research: the North-American and the European. According to Lopes and Martins (2005) research in accounting cannot be considered independently of the social environment in which it is inserted. The research itself is a product of the social environment. The North American stream of accounting research, which is known as the mainstream, has been based on the economic concepts and in a framework based on the positive method, which basically relies on:

(i) hypotheses development
(ii) economic theories to support the hypotheses
(iii) empirical tests using econometrics techniques
(iv) conclusions that wish to construct a theory in order to explain and predict particle

This line of research has been largely disseminated by the Elite Schools (Chicago, MIT, Rochester, Stanford, etc.) and their PhDs programs. This research has also been stimulated by premier scientific journals like The Accounting Review (TAR), Journal of Accounting Research (JAR), Journal of Accounting and Economics (JAE), Contemporary Research (CAR) and Review of Accounting Studies (RAS). However, an alternative stream of research has emerged with the foundation of the journal Accounting, Organization and Society, in England. Here, we call it the European or British stream, as most of the researchers were originally British like Antony Hopwood, Michael Power and Peter Miller. However, we might note the existence of British authors that are adopters of the "North-American approach" and vice-versa.

The theoretical approach used by the British stream of research has been based on disciplines like sociology, psychology, history and political economy. In this line of research, the accounting phenomenon cannot be viewed within the best possible option (normative) or a set of hypotheses to be tested (positive); instead the proposition is that forces that shape accounting should be elaborated within a set of social interactions that act in a debate arena (Lopes and Martins, 2005).

Final remarks
This brief epistemological overview of the history of financial accounting research demonstrates how it gained importance as a hands-on activity before the accounting theorists arrived on the scene. Consequently, accounting practices were shaped by accounting practitioners and the government authorities, which took a keen interest in the protection of capital markets and creditors. The capital market still wields a strong influence over the sociological and discursive branches of financial accounting science. Research programs have been supported by regulatory bodies such as AICPA (USA) and CICA (Canada) and professional accounting associations such as AAA (USA) and CAAA (Canada)**. Financial accounting research has also been impacted by the corporative influence. This influence has taken the form of standards designed to control financial accounting practices instead of fostering discussion on the anomalies between the reality and evaluation of firm equity. As a consequence, few paradigms or accounting theories have been put forward to guide research avenues in financial accounting. When Positive Accounting Theory brought to accounting a theory-testing approach, researchers embarked on an efficient capital market approach, which led to improved utilization of rigorous research methods and statistical analysis. These factors may have shielded financial accounting from criticism, and therefore creativity, compared to other management disciplines, where there was more incentive for qualitative and interpretative investigation. At the same time recent accounting scandals involving highly

CHAPTER 2 Accounting theory construction
known corporations have raised questions about financial reports’ reliability, which seem to [have] somehow shifted the focus back to regulation that could result in less information usefulness, in order to recover the integrity of accounting information. As such, researchers in financial accounting need to be aware of the many dimensions and realities that they are attempting to "account for" and represent. Numerical Accounting highlights aspects of organizational reality that are quantifiable and built into the accounting framework, but oftentimes ignore aspects of organizational reality that are not quantifiable in this way. That said such challenges are part and parcel of all scientific fields.

Both inductive and deductive inferences may generate positive or normative theories. Positive theories attempt to explain what and how accounting information is presented and how it should be communicated to users. Normative theories attempt to prescribe what data ought to be communicated and how they ought to be presented, that is, they attempt to explain what should be rather than what is. Watts & Zimmerman (1986).

**AICPA** is the acronym for American Institute of Certified Public Accountants; **CICA** is the acronym for Chartered Accountants of Canada; **AAA** is the acronym for American Accounting Association; and **CAA** is the acronym for Canadian Academic Accounting Association.

**References**


**Questions**

1. Outline at least two theories mentioned above and describe the ontological and epistemological assumptions made in each theory.
2. What do the authors mean when they say accounting theories contain 'imperative value judgements'?
3. Why are accounting theories about social choices? How does accounting affect society? How would you go about researching societal impact?

SCIENTIFIC APPROACH APPLIED TO ACCOUNTING

Misconceptions of purpose

A great deal of misunderstanding exists about the attempt to apply a scientific approach to accounting. Some believe that the attempt is to make scientists out of accounting practitioners. This view is not the aim of the approach. A scientist is one who uses the scientific method and, therefore, is mainly a researcher. The medical profession provides a good analogy of the difference between researcher and practitioner and the use and effect of the scientific method.

The medical researcher is a scientist, but the medical practitioner (the doctor) is not. The latter applies the tools of medicine. He or she is a professional person who is expected to use judgement to diagnose diseases and recommend treatments. The 'tools' the doctor applies consist mainly of knowledge gained through scientific research by medical investigators. But, as in many other fields, scientific research has not found all the answers to medical questions and some of the conclusions are not as persuasive as others. The conclusions of research are generalisations, but the practitioner is faced with specific cases that may not conform exactly with general conclusions.

For these reasons, the practitioner's judgement is always necessary in applying the 'tools' of his or her trade. What is significant is that the practitioner takes a scientific attitude in practice — that is, he or she takes seriously the view that evidence to support a diagnosis or treatment is important. Accountants who believe in a scientific approach want empirical evidence and logical explanation to support accounting practices so that practitioners can recommend the most appropriate methods for given situations based on this evidence. People find statements more convincing when substantiated by objective, empirical evidence than statements based only on debatable rationalisations.

Another common misunderstanding about the application of the scientific view in accounting is that 'absolute truth' is desired, which of course is not possible. Therefore, those who argue against the scientific approach to theory formulation contend that it is fruitless to seek that which is impossible. Such an argument is based on the misconception that science discovers absolute truth. The scientific method is not perfect. It is a human invention to help us ascertain whether a statement should be considered realistic or not. The structure of the process in which this determination is made is such that no one can claim absolute truth in science. Thus, scientific truth is provisional. A statement or theory gains the status of 'confirmation' only after scientists in the area from which the theory evolves decide that the evidence is sufficiently persuasive, for example, when statistical tests show that the results obtained have less than a 5 per cent probability of occurring by chance. The history of science discloses that substitutions, adjustments and modifications of theories are made in the light of new evidence.
Coles Myer chief executive John Fletcher previously set five-year annual profit growth targets in the company's initial revival plan, against the advice of his board.

'The downside risk of sharing that externally was that you get halfway through it and people can check you along the way and if you're not delivering, the pressure gets built up. And he's missing targets and all of a sudden he's out of a job,' Mr Fletcher said.

'The five years is getting close so as a team we'll be going through that ... we definitely won't be sharing any targets again ... I've done that once,' he said, 'I don't need that now. And the risk of doing that twice with the market I don't want to take.'

While Mr Fletcher's experience has been more bruising than most, rival chief executives are following his lead by pulling back on making specific projections about earnings.

Perpetual Trustees announced a 27 per cent rise in 2004-05 earnings but chief executive David Deverall deferred first-half guidance until the annual meeting in October.

By contrast at the same time last year, he said the company expected improvement in operating profit after tax in excess of 10 per cent, subject to market conditions.

'This time last year, we thought we would exceed a 10 per cent increase in operating profit after tax and we ended up delivering 27 per cent so in our view that wasn't very helpful guidance,' said Perpetual Trustees chief financial officer John Nesbitt.

'So this year our view was to wait a little while until things settle and give more appropriate guidance at the AGM. I think that's consistent with the perceived trend in the market not to give guidance because of the general uncertainty.'

Sankar Narayan, the CFO of John Fairfax Holdings — publisher of The Australian Financial Review — said the company's practice was to give general directional guidance followed by much more precise guidance later in the year when advertising demand was more visible.

Mr Narayan agreed that other companies had been 'fairly general' in their guidance this reporting period and speculated that 'it may be because of the economic environment'.

Pacific Brands' investor relations executive Katherine Cooper said the company had decided against providing specific guidance. 'The problem with guidance is the market is so susceptible to expectations that even if you exceed your own forecasts but the market thinks something different you can be marked down,' she said.

Other companies such as BHP Billiton, IAG and Rio Tinto continue to provide broad outlook statements but not specific profit forecasts.

'If you can tell us what the Australian dollar is going to be at the end of the year and a few other variables we'll tell you what we're going to make, I think it's as simple as that,' Rio spokesman Ian Head said.

IAG investor relations chief Anne O'Driscoll said the insurer never provided a profit forecast, in part as a large equity portfolio made the figure unpredictable.

'People aren't very good at predicting what the market will do,' she added.


Questions
1. What market backlash do businesspeople fear if they do not meet their forecast earnings or growth targets? Why?
2. Mr Fletcher describes how he has learned not to publicly disclose 5-year annual profit growth targets. Explain what is likely to have caused him to learn that lesson. In coming to the conclusion, what approach to theory construction has Mr Fletcher applied? Explain your answer.
3. Can the scientific approach to theory construction and testing be useful in relation to predicting when and how investors will react to earnings announcements? Why or why not?

4. What is the importance to society of developing a theory to explain the relationship between earnings forecasts, earnings announcements, and share price movements?

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**Alternative approaches to accounting theory construction**

**Telstra retains forecast for 2009 earnings to rise**

*by Andrea Tan*

Telstra Corp., Australia’s largest phone company, reaffirmed its forecast for earnings and sales to climb this year on growth from its mobile and internet units amid the global financial turmoil.

Earnings before interest, tax, depreciation, and amortization will probably rise as much as 7 percent in the 12 months ending June 30, Telstra said today in a statement to the Australian stock exchange. Sales this year may climb between 3 percent and 4 percent, the company said.

Telstra, based in Melbourne, stuck to its forecasts even as the credit crisis forces some companies to cut earnings estimates. The phone operator is three years into a five-year plan to raise profit by slashing its workforce by as much as 12,000 and has said it will invest more than A$10 billion ($6.8 billion) to upgrade the speed and geographic coverage of its networks to counter falling revenue from fixed-line operations.

“Unlike most companies at this time, Telstra is in an enviable position,” Chief Executive Officer Sol Trujillo told investors in Sydney today. “You can take it to the bank that we’re going to grow earnings.”

Mobile-phone unit sales rose by a “double-digit” percentage in the fiscal first quarter ended Sept. 30, he said.

Telstra, which has cut 9,584 jobs since it announced its five-year plan, expects to save between A$200 million and A$300 million in labor costs by June 2010, Chief Financial Officer John Stanhope said. The phone operator had 46,649 workers at the end of June 30, according to its annual report.

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**Questions**

1. What market backlash do businesspeople fear if they do not meet their forecast earnings or growth targets? Why?

2. Can the scientific approach to theory construction and testing be useful in relation to predicting when and how investors will react to earnings announcements? Why or why not?

3. What is the importance to society of developing a theory to explain the relationship between earnings forecasts, earnings announcements, and share price movements?

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**ISSUES FOR AUDITING THEORY CONSTRUCTION**

As discussed earlier, auditing is a verification process that is applied to the accounting inputs and processes. Auditors are not verifying outputs for conformance to one unique economic measure of profit, but provide an opinion on whether the financial statements are in accordance with the applicable reporting framework. In addition, depending on the jurisdiction, auditors provide an opinion on whether the statements present fairly, in all material respects, or give a true and fair view.14
In general, the construction of a theory of auditing has followed, with a lag, the development of accounting theory. The early literature on auditing focused on issues arising in the conduct of an audit, such as the emphasis on fraud detection, discovery of errors of principle and the nature of account verification. The pragmatic approach to auditing theory development is evident in early texts explaining the process and principles of auditing. For example, the concept of professional scepticism has its roots in principles laid down in nineteenth-century legal cases, such as Kingston Cotton Mill (in 1896) and London and General Bank (in 1895). The judgement of Lopes LJ in the Kingston Cotton Mill case defined the auditor's responsibilities with respect to the detection of fraud as the right to believe company representatives, provided reasonable care is taken. Further cases in various jurisdictions refined and developed the concept of professional scepticism, and the auditing standards have adapted and developed over time to incorporate this concept. Today's standards still refer to the auditor's right to accept records and documents as genuine, provided the auditor investigates further if any condition creates doubt about that presumption.

Mautz and Sharaf, in 1961, attempted to generalise the existing literature and provide a comprehensive theory of auditing. Their motivation to write the monograph was to counter the prevailing view that auditing was a practical exercise, not only without any theoretical underpinnings, but not requiring theoretical development. Mautz and Sharaf argued that practical issues could be resolved only by development and use of theory. They provided eight postulates as a foundation for the theory of auditing and developed the basic concepts of such a theory. These concepts were identified as evidence, due audit care, fair presentation, independence and ethical conduct. However, although these concepts are now embedded in the auditing standards and regulations, the development of an auditing theory progressed slowly in the years following Mautz and Sharaf's publication.

The normative era of accounting theory and research also coincided with a normative approach to auditing theory. In the early 1970s the American Accounting Association (AAA) established the Committee on Basic Auditing Concepts to investigate the role and function of auditing, to make recommendations for research projects, examine the problems of evidence, and issue a position paper on the scope of auditing by accountants. The report provides a normative statement on auditing with an emphasis on concepts that should be studied by students, and suggestions for research which may 'lead to better fulfilment of the role of auditing in society'. The resulting Statement of Basic Auditing Concepts (ASOBAC) emphasised the essence of auditing as the collecting and evaluating of evidence without fully developing the theory of how evidentiary material is used in the reasoning process to support the auditor's opinion.

The growth of positive theories of accounting in the 1970s was accompanied by a change in direction of auditing research. Two major streams of research developed, both of which relied on empirical data and were designed in a positive or scientific framework. Experimentalists focused on a micro-level understanding of the audit testing/judgement process (known as JDM, or judgement/decision making research). This research sought to explain how auditors make judgements and decisions so that they could predict how auditors would behave when placed in certain situations. The early research in this field provided somewhat disturbing evidence of differing judgements by auditors when presented with the same information, although these effects appeared at least partly due to the problem of creating realistic audit tasks in an experimental setting.

The other major stream of empirical auditing research that developed in this era examined questions of auditor choice by companies and the factors affecting the level
of fees paid by companies to their auditors. This research was particularly interested in whether the quality of audits performed by different auditors in different circumstances differed. DeAngelo\textsuperscript{30} argued that audit quality is positively related to audit firm size because larger auditors have 'more to lose' by failing to report a discovered breach in a particular client's records. That is, large audit firms have more clients to lose than small audit firms from compromising their independence on an audit in order to please the client. This theory helps explain why large audit firms dominate the audit services market. Simunic\textsuperscript{31} developed a theory to explain that audit fees are based on client characteristics and reflected the forces of demand and supply. This literature is based on economic concepts of efficient markets and the role of the auditor in resolving agency conflicts between shareholders, managers and lenders. These theories are discussed further in later chapters.
A review of accounting theory construction reveals that there are many different approaches to theory formulation in accounting. This chapter classifies and explains some of these approaches. Whereas the previous chapter focuses on theory in general, this chapter extends that discussion to focus on theory construction in relation to accounting.

How pragmatic approaches to theory development apply to accounting
Accounting was dominated by descriptive pragmatic approaches to theory development or syntactic explanations of pragmatic relationships before the late 1950s. Pragmatic approaches are inductive approaches designed to learn from what accountants do (descriptive pragmatic approach) or how users respond to accounting information (psychological pragmatic approach), in order to replicate accounting procedures and principles.

Criticisms that have been levelled at historical cost accounting as a theoretical model
Historical cost accounting has been criticised for a number of reasons, some of which are explored in later chapters. In this chapter we explored why traditional historical cost has been criticised for poor syntax, whereby different types of monetary measures are added, and for semantic deficiencies since there is no independent empirically observable correspondent to concepts such as 'profit' or 'asset'. In later chapters we explore whether alternative accounting theories compensate for these deficiencies.

Normative true income theories and the decision-usefulness approach to accounting theory
The 1950s and 1960s saw accounting theory formulated using a normative approach to prescribe how accountants should report either to derive the 'true income' for an organisation or to generate information that is useful for decision making. 'True income' theorists concentrated on deriving a single, correct measure of income. However, 'true income' is a concept that was never defined to the satisfaction of all parties. Decision-usefulness approaches focused on developing theories to ensure that accounting reports would provide the information most useful for making the decisions that the theorists believed to be most important. This period saw accounting theory develop mostly in relation to measurement theories of value and adjustments to take into account how inflation affected values. Normative theorists relied mostly on syntactic logic in deriving theories, and concentrated on measurement.
How positive theories are constructed

From the early 1970s, accounting theory became more involved in empirical or positive theory development and testing. Positive accounting theorists concentrate on understanding the assumptions that normative theorists take for granted. Unlike normative theories, which prescribe particular courses of action, positive theories describe, explain, or predict observable phenomena, such as why accountants do what they do and what is the impact of historical cost accounting on capital markets. Positive theories start when anomalies to existing theory are observed, and researchers develop theories to explain those anomalies and then test them, generally using the scientific inductive approach to theory construction and evaluation.

Alternative naturalistic approaches and the importance of ontology

In contrast to the normative and inductive approaches to theory formulation and testing, the naturalistic approach is more an exploratory approach that does not attempt to draw large-scale inferences, but rather tries to explain complex and potentially unique situations using an unstructured approach. The naturalistic approach regards accounting as constructed reality rather than objective reality, and naturalistic research is more likely to use case studies and individual experiences of events than the scientific approach of syntactic model formulation and empirical induction to develop hypotheses, followed by statistical testing of the hypotheses.

Misconceptions associated with scientific approaches to accounting research, and why they are misconceptions

Some have contended that the scientific approach to theory construction in accounting is inappropriate because it tries to make scientists out of accounting practitioners or because the scientific method assumes that there is an 'absolute truth' that accounting should achieve. Both of these views are incorrect. Although an accounting researcher may apply the scientific method to theory construction, practitioners do not act as scientists; rather, they use the empirical evidence and logical explanations from the approach to support their practices. The scientific method does not claim to provide 'truth'. Instead, it attempts to provide persuasive evidence which, on the balance of probability, may provide as good a description, explanation, or prediction as theory can provide.

Issues for auditing theory construction

The development of a theory of auditing has followed, with a lag, approaches in accounting theory. Early writers attempted to document the process of auditing and the duties expected of auditors. Attempts to develop a general theory of auditing began in the 1960s and described and prescribed best auditing practice. More recently, experimental research has studied how auditors make decisions in an attempt to predict auditor behaviour, and positive theories explain demand for auditing and audit fees using economic models.

Questions

1. 'A theory that is purely syntactic is sterile.' Is this true? How can this statement relate to accounting?

2. One type of theory construction involves observing the practices and techniques of working accountants and then teaching those practices and techniques to successive accountants.
   (a) What type of theory construction is this?
   (b) What are the advantages of this approach compared with a decision-usefulness approach to theory construction?
3. Describe the semantic approach to theory construction.
   (a) Should the outputs of accounting systems be verified?
   (b) If so, how can this be achieved? If not, why not?
4. In the 1970s there was much debate about how to account for inflation.
   (a) Did this debate involve positive theory or normative theory?
   (b) Is it important to account for the effects of inflation? Why or why not?
5. Researchers who develop positive theories and researchers who develop normative theories often do not share the same views about the roles of their respective approaches to theory construction.
   (a) How do positive and normative theories differ?
   (b) Can positive theories assist normative theories, or vice versa? If yes, give an example. If not, why not?
6. Can accounting theory be constructed as a purely syntactical exercise? Why or why not?
7. Classify the following hypotheses according to whether they are the conclusions of positive or normative theories. Explain your answers.
   (a) Historical cost accounting should be replaced by a market value system.
   (b) Historical cost accounting provides information used by creditors.
   (c) Historical cost accounting is used by many managers to allocate costs in determining divisional performance.
8. Give an example of the types of issues that might be resolved by accounting theories developed using the following methods of theory construction.
   (a) psychological pragmatic approach
   (b) scientific approach
   (c) naturalistic approach
   (d) normative approach
   (e) positive approach
9. Explain the naturalistic and syntactical approaches to theory construction. Are these approaches mutually exclusive? Why or why not?
10. The decision-usefulness approach to theory development can be used to develop theories of accounting.
    (a) Explain what is meant by the decision-usefulness approach to theory development.
    (b) How can the decision-usefulness approach relate to accounting theory formulation?
    (c) Give two examples of decisions that require data obtained from accounting reports.
11. What type of a theory is historical cost? How has it been derived? Do you have any criticisms of historical cost accounting?
12. Explain the psychological pragmatic approach to accounting theory. Give an example of how it can be applied.
13. Give an example of an accounting convention usually adopted in historical cost accounting. Conventions govern the way accounting is practised, and conventions are, by definition, known from practice.
    (a) What theoretical approach is used to derive conventions?
    (b) What does your answer to (a) imply about the potential for accounting theories based on conventions to be innovative in providing useful information?
14. How do you think the massive amounts of data now available from information technologies will affect
   (a) the development of accounting theories?
   (b) the testing of accounting theories?
15. What are some common criticisms of a scientific approach to professions such as accounting and law? Are they valid? Why or why not?
16. Early auditing theories were constructed by observing the practices of auditors.
   What type of theory construction is this? What are the advantages and disadvantages of this approach?
17. How would you design an experiment to provide evidence on how auditors make judgements? What competing issues would arise?

Additional readings


New accounting rules 'don't add up'

by Barney Jopson

Britain's biggest companies, once enthusiastic advocates of international accounting standards, have turned sour on the new rules, complaining that they are making accounts more opaque and less useful.

Jon Symonds, chairman of the influential Hundred Group of finance directors, said companies were being forced to present numbers to investors that almost defied
explanation. ‘I don’t want a technical and theoretical approach (to accounting) to undermine communication between business and owners,’ he told The Financial Times.

International Financial Reporting Standards have changed the face of accounts since their introduction in the European Union this year, requiring listed companies to dig out previously unreported figures and disclose much other information in a different way. The unhappiness of British companies is an ominous development for rule-makers at the International Accounting Standards Board (IASB) in London, which has generally found its British constituents more supportive than those in Europe.

Mr Symonds, chief financial officer of AstraZeneca, said he supported the goal of a single set of global reporting standards to make accounts clearer and more comparable.

But IFRS were developing in the wrong direction and he expressed reservations about the standards’ conceptual foundations, the use of ‘fair value’ accounting, and growing US influence over their form. The new standards are more complex than existing British accounting rules and require greater technical disclosure of a range of items from derivatives and employee stock options to pension fund deficits and off-balance-sheet finance. The introduction of ‘fair value’ accounting, requiring asset and liability revaluations to be passed through the income statement, has already sparked ire elsewhere in the EU. Some companies say it introduces volatility into reported profits, distracting attention from underlying performance.

Tom Jones, vice-chairman of the IASB, rejected the criticism of fair value accounting but admitted that standard-setters were having little success in placating disgruntled companies. ‘It’s not our objective to get away from economic reality ... There is nothing more real than the value of an asset today,’ he said.

Mr Symonds also voiced worries about an agreement between the IASB and the US Financial Accounting Standards Board to close differences between their accounting rules and thus reduce corporate compliance costs. ‘There is some concern that the strength of the relationship between the IASB and FASB means we are heading down a US path without adequate debate.’

The Hundred Group is working on a more detailed list of desired changes to present to the IASB. Under pressure from the EU, standard-setters have tried in recent months to respond to the concerns of at least some constituents.


Questions
1. What are international financial reporting standards (IFRS)?
2. Many arguments are expressed in this article. List three factors that you think are causing British businesspeople to be upset about the prospect of adopting the IFRS.
3. Consider each of the three factors you mentioned in response to question 2.
   (a) Is there empirical evidence to support the factor?
   (b) Is the analysis leading from the factor to the complaints about adopting the IFRS scientific or naturalistic in its approach? Explain your answer.
4. How could researchers evaluate the decision usefulness of adopting the IFRS?
5. What role can positive theory play in resolving the issue(s) described in the article?
6. What role can normative theory play in resolving the issue(s) described in the article?
Although Lend Lease's 13.5% rise in underlying profit for 2004-05 and guidance of double-digit growth for 2006 were reasonable enough, the market was not impressed.

Against the 52-week high of $14.24, the price is now $12.91. The problem is lack of excitement, compared with its history as a glamour stock. Lend Lease has done well to produce a growth business after its disastrous plunge into United States property funds management, but what remains is largely a retail and residential development and construction group, with a property investment portfolio thrown in.

It is an international business, with substantial activities in the United States and Britain as well as Australia. It has undertaken prominent projects, including cleaning up the World Trade Center site after the September 11, 2001 terrorist attacks. But no one is getting excited about largely cyclical industries. Lend Lease has not entered the glamour infrastructure areas such as toll roads and tunnels, and has no plans to do so.

In private, competitors snigger at those behind Lend Lease naively selling its MLC funds management business just as the Australian superannuation boom was about to get going, to dive into the unknown world of US property.

Of course, that all happened before present chief executive Greg Clarke was hired. His job was to knock what remained into shape and he is generally seen as having done a good job. But there are questions about why Lend Lease's bid for General Property Trust failed and whether Clarke should have moved faster and more aggressively and put his foot on a sizeable unit-holding.

GPT was effectively Lend Lease's captive institution. The relationship had been mutually beneficial. Lend Lease made substantial fees as GPT's manager and this annuity income provided a balance to Lend Lease's more cyclical businesses.

There is still a substantial amount of investment income flowing from top-class investment properties such as the Bluewater shopping centre in Britain and the King of Prussia mall in the US. Investment income amounted to 22% of 2004-05 earnings and the long-term aim is to lift this to 30–35%. One benefit of this would be a strengthening of Lend Lease's credit rating, but Clarke concedes that this annuity income goal will take some years to achieve.

At $12.91, Lend Lease shares yield 4.4%, based on the 2004-05 dividend of 57¢. The payment is partly franked and the outlook is for more of the same. Chief financial officer Roger Burrows says that with about a third of earnings coming from Australia, the franking credits should be enough to provided 40–50% dividend franking on a 60–80% profit payout.

This means investors need a higher yield than would be required from a comparable company paying fully franked dividends. The present price reflects this. As a result, the return looks reasonable, certainly if double-digit earnings and dividend growth can be sustained.

Source: BRW, 1–7 September 2005, p. 79.

Questions

1. Lend Lease reported a 13.5 per cent increase in profit for 2004-05. Why was the share market unimpressed?
2. In trying to explain shareholders' subdued reaction to Lend Lease reported earnings, explain whether and/or how you could use the following approaches to accounting theory construction.
   (a) pragmatic
   (b) decision usefulness
   (c) positive accounting theory
   (d) normative theory
   (e) scientific approach
   (f) naturalistic approach

3. Which of the approaches described in answer to question (2) do you believe is most useful? Why?

4. Are the approaches you described in answer to question (2) mutually exclusive, or can they be used to complement each other? Explain.

The following article provides an example of alternative approaches to the construction and evaluation of accounting theory and policy.

**Intergovernmental working group of experts on international standards of accounting and reporting**

As this Group of Experts has underscored on many occasions, principles-based, high quality financial reporting standards are critical for the coherence and efficient functioning of the international financial architecture. A rapidly globalizing world economy needs global accounting, reporting and auditing standards. In a world economy that has been growing increasingly interdependent, resource mobilization and allocation has been taking place across borders. In the second half of this decade, we have witnessed the transformation of the financial reporting landscape. An unprecedented number of enterprises adopted International Financial Reporting Standards as the basis for the preparation of their financial statements.

The centrality of reliable and comparable information for financial stability and investors' ability to assess risk and allocate resources to different investment opportunities has been painfully demonstrated by recent events. The global financial crisis has shown how — in a world of unprecedented financial interdependence — intransparent financial market products and financial accounts can wreak havoc not only with investors' profits, but — more importantly — with the development prospects of innocent bystanders, including some of the most vulnerable populations.

At the heart of this crisis are problems with opacity and complexity, while financial institutions may have been reporting a lot of information, the question was whether or not those reports provided any meaningful insight or useful understanding of the companies' inherent risks. With hindsight, the answer is clearly no. It is now evident that even the boards of leading banks and their own accountants and internal auditors did not fully understand the risks of their own products.

Ultimately, regaining investor confidence will once again require full transparency, better accounting, reporting and auditing standards and practices. The current crisis has prompted a re-examination of several accounting, reporting and auditing requirements -- including consolidatton of off-balance sheet entities, fair value or mark-to-market valuation of financial instruments and related uncertainties.

I understand that in light of the current crisis, standard setters have taken action to amend relevant standards . . .

Questions
1. What are international financial reporting standards (IFRS)?
2. Many concerns are expressed in this article. List three factors that you think are causing concern about the impact of adoption of IFRS.
3. Consider each of the three factors you mentioned in response to question 2. Is there empirical evidence to support the factor?
4. Is the analysis leading from the factor to the concerns about adoption of IFRS scientific or naturalistic in its approach? Explain your answer.
5. What role can normative theory play in resolving the issue(s) described in the article?

Numerous approaches can be taken to construct a theory of how and why investors use accounting numbers in making their investment decisions. The following case is an example of how more than one approach might be possible or even appropriate.

Tabcorp costs trouble market
by Fleur teyden
Tabcorp's full year profit may be back in the black but the gaming giant's shares were pounded almost 5 per cent yesterday, with investors worried about mounting licence fees and taxes and an extra $100 million to be spent upgrading Star City casino.

The fresh outlay of funds will take the cost of the Sydney casino refurbishment to $575 million in an environment Tabcorp chief executive Elmer Funke Kupper said remained challenging.

"I think we'll still have a soft patch in the economy over the next 12 months and, while we're all very encouraged by the housing market recovery and equity markets... I think that uncertainty is still there," he said.

Tabcorp unveiled a $521.7 million net profit for the year to June 30, a sharp turnaround from the previous year's $164.6 million loss, which had been weighed down by writedowns associated with the Victoria Government's decision to end the gambling duopoly between Tabcorp and Tatts in 2012.

Normalised profit for the past year, including the effect of one-off items and fluctuations in Tabcorp's theoretical win rate against high-rolling gamblers, rose 1.2 per cent to $496.2 million. Revenue rose 5 per cent to $4.2 billion.

However, investors dismissed the profit result — which was slightly ahead of expectations — with the scrip closing 35c weaker at $7.03 in a stronger overall share market. Analysts said investors were spooked by the company's grim outlook and the admission that licence fees to racing clubs could rise to $65 million — more than double the $30 million it had previously flagged. The company also will have to absorb higher taxes in Queensland.

"The outlook commentary was a bit underwhelming," said Austock analyst Rohan Sundram.

"Wagering will probably achieve low growth due to the full-year impact of race field charges, but casinos is where the biggest downside is — there will be a $30 million tax hit on the Queensland casino pokies and then a $20 million EBIT impact from refurb disruptions at Star City. It's going to be tough."

Mr Funke Kupper said the board gave the green light to the extra spend on Star City earlier this month. He said about a third of the extra $100 million would go towards beefing up gaming, a third towards food and beverage outlets and "nightlife", and the rest to electrical upgrades.
April, when they averaged below US$1400 a tonne. Prices had since rebounded to trade above US$2000 a tonne.

Shares in Alumina yesterday ended up 16c, or 9.79 per cent, at $1.795 - the stock's highest close since last November 10, when it ended at $1.945. "The market is liking the result, which is combined with the fact that aluminium was up 4 per cent overnight," said IG Markets research analyst Ben Potter.

The company did not declare a dividend, after previously paying a 12c a share interim dividend. It said it would continue to review the dividend issue every six months.

Questions

1. Alumina reported an 86.3 per cent fall in first half-year profit, and suspended its final dividend. Why did its share price rise by 9.79 per cent on the announcement date?

2. In trying to explain the positive response to Alumina’s reported earnings, explain whether and/or how you could use the following approaches to accounting theory construction.
   (a) decision usefulness
   (b) normative
   (c) scientific

3. Which of the approaches described in answer to question (2) do you believe is most useful? Why?

4. Explain the importance to investors of developing a theory to explain the relationship between earnings announcements and share price movements.

Endnotes

2. ibid.
3. ibid.
6. ibid.
12. ibid.
13. ibid., p. 367.
14. ISA 700, Forming an opinion and reporting on financial statements, September 2008. The meaning of the phrase ‘present fairly’ has been debated extensively, specifically whether it has any implications for the quality of the financial statements beyond their compliance with the relevant accounting standards; see for example, Y Toba, 'A semantic meaning analysis of the ultimate proposition to be verified by independent auditors', The Accounting Review, vol. 55 no. 4, October 1980, pp. 604–619.
15. For example, WA Staub, 'Mode of conducting an audit', The Accounting Review, vol. 18, no. 2 April 1943, pp. 91–98.
16. Kingston Cotton Mill Co. (No. 2) (1896) 2 Ch. 279, Lopes LJ: It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest, and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom but, in the absence of anything of that kind, he is only bound to be reasonably cautious and careful.
17. London and General Bank (No. 2) (1895) 2 Ch. 673.
18. For example, Pacific Acceptance Corporation Ltd v. Forsyth (1370) 92 WN (NSW) 29; Thomas Gerrard & Son Ltd (1967) 2 All ER 525.


After reading this chapter, you should have an appreciation of the following:

1. the theories of regulation that are relevant to accounting and auditing
2. how theories of regulation apply to accounting and auditing practice
3. the regulatory framework for financial reporting
4. the institutional structure for setting accounting and auditing standards.
At the end of each quarter, half-year and financial year firms are busy preparing their accounts and (at least at year-end) having them audited by an independent auditor. Firms lodge their accounts with government agencies and listed firms provide reports and other information for their stock exchange. Firms issue press releases for investors and advisers. To what extent can theory help us to understand why these activities occur? Can theory explain why private sector bodies and governments and their agencies take an active role in the financial reporting process? This chapter addresses these questions.

First, we consider a number of theories that are relevant to the practice of accounting and auditing. We discuss the theory of efficient markets and agency theory to understand the setting in which financial reporting occurs. We consider three specific theories of regulation, which have been proposed to explain regulation in capital markets. The theories are public interest, regulatory capture and private interest theory. In the next section, we consider how the three theories apply in practice. Consider the case where a government changes financial reporting requirements or introduces more oversight of auditors following a major corporate collapse (e.g. as occurred in the United States with the Sarbanes-Oxley Act in 2002). Can public interest theory explain this intervention in the market place, or is private interest theory more applicable? If a major industry group is able to ensure production of an accounting standard which aligns with its preferences for accounting measurement and disclosure, has the group captured the standard setter? We consider the extent to which each of the three theories is helpful in understanding these and similar events.

In this chapter we identify many different parties that are involved in the preparation and regulation of financial reporting. In the third section we present a description of the regulatory framework and discuss the elements which are likely to comprise a 'proforma' (or example) framework. The elements considered are: statutory requirements; corporate governance; auditors and oversight; and independent enforcement bodies. We explore how these elements influence the output of the financial reporting process, that is, the financial statements.

Finally, we describe the international standard setting process. Accounting standards can be viewed as a key part of the regulatory framework as they influence the behaviour of preparers and auditors and thus the information provided for users of financial reports. Since accounting standards involve wealth transfers, many parties are concerned about their content and have become involved in their formulation. In recent years, standard setting has moved to the international arena, with the standards developed by the London-based International Accounting Standards Board (IASB) used in more than 100 countries. The goal of harmonisation of financial reporting has led the IASB to work closely with the United States's Financial Accounting Standards Board (FASB) on a number of joint projects. We also describe the development of auditing standards, which has become increasingly international.

**THE THEORIES OF REGULATION RELEVANT TO ACCOUNTING AND AUDITING**

Capital market theorists suggest that managers have many incentives to voluntarily provide accounting information to parties external to the firm, and to have that information verified by independent auditors. So why do we observe regulation of financial reporting through company law and accounting standards? Why do most countries have legal requirements to produce audited financial statements? There are several theories which are relevant to understanding the regulation of financial
reporting (i.e. the preparing, auditing and supply of accounting information about an entity). They include:

- theory of efficient markets
- agency theory
- theories of regulation — public interest, regulatory capture and private interest.

**Theory of efficient markets**

Free market economists would argue that markets function best without government intervention, and that maximum efficiency is achieved by allowing forces of supply and demand to dictate market behaviour. In the world's increasingly international capital markets, forces of demand and supply have a large influence on the flows of information and capital. However, governments also actively intervene in these markets, regulating not only how markets are conducted but also the provision of information which has been described as the 'lifeblood' of capital markets. At best, government intervention aims to assist market development and promote economic growth. Equitable and transparent markets, where there is a balance of wealth-enhancing opportunities and investor protection, are considered vital to attract participants. Nevertheless, optimal market regulation is an art rather than a science.

Accounting can be seen as an information industry; that is, the business of accounting is to produce information. Advocates of the free-market approach argue that, as with any other product, demand and supply forces should operate. There is a demand for accounting information by users and a supply of such information from companies in the form of financial statements. An equilibrium price therefore can theoretically be found for accounting information.

Suppose a new type of financial information is demanded by users and a supplier is willing to provide it for a price. The price will finally adjust to one where the supplier still finds it advantageous to furnish the information and users believe the cost is equal to or less than the benefits of the information. If not, then the information will not be provided. In other words, free-market forces can determine what type of accounting data to provide and the necessary standards that underlie them.

It is highly unlikely that authoritative, regulatory bodies will relinquish their present power in accounting. Because of that, critics of the free-market approach say the theory is unrealistic. Furthermore, they argue that the theory is unworkable because the market mechanisms will not be able to achieve a socially ideal equilibrium price for accounting information for the following reasons.

Accounting information cannot be considered in the same way as other products, because it is a 'public' good. Once the information is released by a company, it is available to everyone. Although the information may be sold to certain people only, others who did not pay for it cannot be easily excluded from using the information. This phenomenon is referred to as the 'free-rider' problem, outlined overleaf. In the accounting setting, examples of free riders include financial analysts and potential investors. Because not all users can be charged for the cost of producing the accounting information, suppliers will have minimal incentive to produce it. Only regulatory intervention can persuade companies to produce the information necessary to meet real demand and to ensure an efficient capital market.

A company has a monopoly on the supply of information about itself and, therefore, the tendency will be for the company to underproduce and sell at a high price. From society's point of view, mandatory reporting will result in more information at a lower cost.
Even if a free market existed for accounting information, a regulatory board would still be needed because users are unable to agree on what they want and accountants will not agree on the procedures to derive the desired information. Further, the value of information provided by companies to users is greatly enhanced if it can be compared with information from other companies.

**Agency theory**

The demand for financial information can be categorised as being either for stewardship or for decision-making purposes. Atkinson and Feltham state that agency theory considers mainly the stewardship demand for information. The theory concentrates on the relationships in which the welfare of one person (e.g. the owner) is entrusted to another, the agent (e.g. a manager). Atkinson and Feltham explain that the demand for stewardship information relates to the desire to:

- motivate the agent
- distribute risk efficiently.

The demand for information for decision-making purposes relates to the role of information in statistical decision theory. Information is valuable if it improves the allocation of resources and risks in the economy. It does this by reducing uncertainty.

Uncertainty in agency theory can be classified as ex ante or ex post. Ex ante (before the event) uncertainty exists at the time a decision is to be made, such as uncertainty about controllable events that will affect production or uncertainty about the skill of the manager. Ex post (after the event) uncertainty exists after the decision has been made and the results realised. This uncertainty is the same as ex ante uncertainty except that it can be reduced by ex post reports on what actually happened. Agency theory focuses on the impact of alternative ex post reports that affect ex post uncertainty.

Atkinson and Feltham see the role of standard setting as one of identifying situations where welfare improvements will be obtained from a given policy on financial reporting. Welfare improvements relate to Pareto comparisons. Policy A would be preferred to policy B if under the former every person is at least as well off as under the latter and at least one person is better off. Policy A would also be preferred to policy B if it resulted in a more efficient allocation of resources and risk. Thus, under this view, it appears that perceived economic consequences of accounting standards play an important role.

Agency theory gives us a framework in which to study contracts between principals and agents and to predict the economic consequences of standards. For example, it is often logical that managers' compensation be tied to reported profits or they may have less incentive to achieve profits. In this situation, one type of contractual relationship is between users of accounting data and the company. Contracts for financial data can be alternatives to public reporting. If accounting were 'deregulated', the market mechanism could generate sufficient information and reach a socially ideal equilibrium point where the cost of providing the information equals the benefits. Supporters of this view argue that mandatory disclosures are therefore unnecessary and undesirable because market forces can be depended on to generate any desired information. Further, companies have incentives to disclose information voluntarily, as evidenced by the significant level of voluntary disclosures by listed companies. The possibility of over-legislat ing reporting requirements also relates to the 'free-rider' effect. Basically, where the marginal cost of information is perceived to be less than the possible (marginal) benefits, users will demand increased levels of disclosure. However, interested parties who bear little or none of the costs of disclosure have greater incentives to demand increased levels of disclosure, hence the term 'free rider'.
Moreover, advocates argue, required reporting tends to create overproduction of information. Since the cost of producing information is not borne by users, they will demand more and more information. An authoritative body, such as the IASB, may be misled by this exaggerated demand and, consequently, prescribe more disclosure of information than necessary. This may create a 'standards overload', about which many companies and accountants have complained.

**Theories of regulation**

**Public interest theory**

The central economic reason for the origins of government intervention in the operations of various markets in the 'public interest' is that of market failure. Within this theoretical framework, regulation is intended by legislatures to 'protect consumer interests by securing improved economic performance... compared with an unregulated situation'.

A potential market failure occurs when there is a failure of one of the conditions necessary for the best operation of a competitive market. Examples of potential failures include:

- lack of competition (monopoly, oligopoly)
- barriers to entry
- imperfect information gaps (information asymmetry) between buyers and sellers or certain market signals (e.g., seller reputation)
- the 'public-good' nature of some products (e.g., financial information), where the provision of the product to a single individual makes it equally and costlessly available to other individuals. Market failure occurs here because since other individuals can receive the product free of charge — the normal pricing system in the market cannot function.

Public interest theory is based on the assumption that economic markets are subject to a series of market imperfections or transaction failures, which, if left uncorrected, will result in both inefficient and inequitable outcomes. It is also based on three further assumptions that:

- the interest of consumers is translated into legislative action through the operation of the internal marketplace. Within this market, votes are seen as a form of currency. The policies, or at least the images, presented by the competing candidates for the office are the commodities being bought.
- there are agents (entrepreneurial politicians and public interest groups) who will seek regulation on behalf of the 'public interest'. These agents may satisfy their self-interest instrumentally through pursuit of public interest objectives... but the theory requires that at least some preferences for the public interest be genuine and terminal.
- the government has no independent role to play in the development of regulations. Rather, government officials are simply neutral arbiters who intervene costlessly in markets at the request of 'public interest' agents.

**Regulatory capture theory**

A second theory proposed to understand regulation of financial reporting is capture theory. This theory maintains that although the 'purpose in fact' or origin of regulation is to protect the public interest as discussed above, this purpose is not achieved because, in the process of regulation, the regulatee comes to control or dominate the regulator. That is, the capture view singles out regulated entities as 'prevailing in the struggle to influence legislation... [It] predicts a regular sequence, in which the original purposes of a regulatory program are later thwarted through the efforts of the interest group.'
Capture theory assumes, firstly, that all members of society are economically rational; therefore, each person will pursue his or her self-interest to the point where the private marginal benefit from lobbying regulators just equals the private marginal cost. Regulation has the potential to redistribute wealth. Therefore, people lobby for regulations that increase their wealth, or they lobby to ensure that regulations are ineffective in decreasing their wealth. Second, the capture view assumes, as with public interest theory, that the government has no independent role to play in the regulatory process, and that interest groups battle for control of the government’s coercive powers to achieve their desired wealth distribution.

Capture is said to occur in any one of four situations, namely, if the regulated entities:

- control the regulation and the regulatory agency
- succeed in coordinating the regulatory body's activities with their activities, so that their private interest is satisfied
- neutralise or ensure non-performance (or mediocre performance) by the regulating body
- in a subtle process of interaction with the regulators, succeed in co-opting the regulators into a mutually shared perspective, thus giving them the regulation they seek.\[10\]

Regulatory agency capture involves capture of the administration, implementation and, to a large degree, evaluation of the effects of the policy process within any regulated area. It has been found to be especially pronounced where the following preconditions apply:

- There is a small number of client entities.
- Individuals within the regulatory agency have regular contact with a common set of individuals within the regulated entities and have either a regulated industry background or a potential for future employment opportunities in the regulated industry.
- The regulated industry controls the information needed for regulation.
- There is complexity of information and product.
- The regulatory agency has minimal resources in comparison to the industry it is regulating.

The main reason for the capture view centres on the fact that regulatory decisions usually have major effects on the interests of regulated industries. For example, the permission to operate a business or to provide a particular product or service may be granted or denied by regulatory agencies, and the level and structure of prices charged for an industry's output may be determined by statute. In turn, regulated industries perceive that their overall financial position can be significantly affected by regulatory decisions. Therefore, they generate intense activity aimed at influencing the regulatory agency.\[11\]

In contrast, non-industry groups such as the general public and consumers find themselves in a different situation with 'each person's individual stake in a regulatory decision [being] very small, perhaps imperceptible ... Moreover, even when they do become concerned about a regulatory issue, general interests lack pre-existing organisations through which their concerns can easily be channelled'.\[12\]

The regulatory capture theory would suggest that professional accounting bodies or the corporate sector will seek as much control as possible over the setting of accounting standards governing the reporting by their members. This involves either formal control over standard setting, representation on the relevant standard setting bodies, or significant influence/control over the decisions made by the relevant standard setting bodies.
Private interest theory

A third theory has emerged in response to dissatisfaction with explanations provided by both the public interest and the capture theories. The assumptions of these theories, that regulation comes into existence as a result of government response to public demands to rectify inefficient or inequitable practices by individuals and organisations, was strongly challenged in 1971 by George Stigler.13 The basic theme of Stigler's challenge is that governments have one basic resource which 'is not shared even with the mightiest of its citizens: the power to coerce'.14 This 'power to coerce' is a potential resource or threat to every business firm in that with its power to prohibit or compel and/or to provide or withdraw taxes and subsidies, the government can and does selectively help or hurt many businesses.

Stigler argues that regulatory activity reflects the relative political power of interest groups. Their interaction is with politicians who are not neutral arbiters (as in the public interest and capture theories) but, rather, are like business executives or consumers, and are thus rationally self-interested. The politicians seek to maximise their chances of future electoral success. Government officials will 'sell' aspects of their right to coerce others in the form of supplying regulatory programs and legislation, which will act to enhance their ability to win votes and raise money to finance election campaigns.

The essential commodity transacted in this political market is a transfer of wealth, with constituents on the demand side and their political representatives on the supply side. 'Viewed in this way, the market here, as elsewhere, will distribute more of the good to those whose effective demand is the highest. For Stigler, the question of which group will have the highest effective demand translated very quickly into a question of numbers.'15

Private interest theorists believe that there is a market for regulation with similar supply and demand forces operating as in the capital market. Within this political market there are many bidders. However, only one group will be successful, and that is the group that makes the highest bid. In this view, producer groups are most often the highest bidders and are thus able to use the power of the government to their own advantage for two reasons. First, the firms in any given industry are fewer in number than the persons outside the industry that may bear the costs of the regulation sought, such as restrictions on entry. Therefore, the firms seeking political protection find it easier to become an organised interest group capable of wielding political influence. Since the per capita gains to them are likely to be high, they have an incentive to combine their efforts to achieve mutually beneficial ends.

In contrast, much larger but more diffuse groups, such as consumer and public interest groups, are limited in their ability to make an effective bid, due to two major cost factors:

- the costs of organisation (e.g., the costs involved with mobilising their votes and contributing resources to the support of the appropriate political party)
- information costs (e.g., costs associated with obtaining information about government actions).

The basic assertion of private interest theory is that there is a law of diminishing returns in the relationship between group size and the costs of using the political process. Given this assertion, theorists believe that regulation does not arise as a result of a government's response to public demands. Instead, regulation is sought by the 'producer' private interest group and is designed and operated mainly for its benefit.

But even if a group has a strong incentive to organise, there must still be a mechanism by which the group acquires and uses its influence. Stigler's second assumption is that government officials, like business executives or consumers, are rationally self-interested.
They seek to maximise their votes (if they are elected officials) or their wealth (if they are appointed officials), or both. Producer private interest groups can supply these resources by providing campaign contributions and political advertising to elected officials and lucrative opportunities for post-government employment.

Thus, regulation can simply be seen as a device for transferring profits to well-organised groups in the form of subsidies, price-fixing, control of entry of political competitors, and suppression of the production of substitutes if the groups will return the favour with votes and contributions to politicians. The theory [therefore] predicts that regulators will use their power to transfer income from those with less political power to those with more.16

We will now apply these theories to practice.

**HOW THEORIES OF REGULATION APPLY TO ACCOUNTING AND AUDITING PRACTICE**

In the previous section, we explored a number of theories of regulation, which have been proposed to explain the regulation of accounting and auditing. We now consider the application of the public interest, capture and private interest theories in practice. We ask to what extent these theories explain and predict the regulation of accounting and auditing as observed in capital markets.

**Application of public interest theory**

Under public interest theory, governments intervene in the regulation of financial reporting in response to market failure and 'in the public interest'. The basic argument is that market mechanisms have failed and government action is necessary for the greater good. The introduction of the Sarbanes-Oxley Act in the United States in 2002 following the collapse of the Enron Corporation and the audit firm Arthur Andersen can be viewed through the lens of 'the public interest'. New financial reporting and corporate governance requirements were introduced and new standards and oversight structures for auditors were created.17 Canada, Kuhn and Sutton argue that the Sarbanes-Oxley Act created, in the public interest, one of the greatest protections in financial markets and related corporate behaviour in history.18 Case study 3.1 at the end of this chapter provides an opportunity to consider the costs and benefits of the Sarbanes-Oxley Act.

An earlier example is the Australian government establishing the Accounting Standards Review Board (ASRB) in 1984. The government's intervention in the accounting standard setting process is seen as justified by failures in the market for accounting information, evidenced by the significant number of corporate collapses even after auditors had certified accounts as 'true and fair'. Similarly, calls for stricter accounting standards or for changes in standard setting processes following major corporate collapses in the late 1990s and early 2000s (Enron and Worldcom in the United States; HIH and One.Tel in Australia) are seen as justified under the public interest theory.

Corporate collapses are deemed to indicate that there were serious violations of competitive conditions. The violations stemmed from information asymmetries between the suppliers (corporate management and accounting professionals) and external financial statement users (investors) who do not know what accounting information they need and/or are unable to determine the value of the accounting information they receive. Furthermore, financial information can be seen as a 'public good' which has led to a divergence between the marginal costs and benefits to (a) the users of financial
information and (b) information producers (corporate management). Before government intervention (e.g. the establishment of the ASRB), standards were not legislatively backed and public interest theorists argue that it was not surprising to find that the amount of the information produced by corporate entities fell short of 'the quality necessary for informed investment decisions and optimal resource allocation in the economy'.

Thus, the public interest theory framework suggests the government intervention in the accounting standard setting process is to rectify failures in the market for accounting information. In turn, public interest was served by a return of confidence in the capital markets by investors.

By concentrating on the necessity of government intervention in the marketplace to protect consumers, public interest theory generally ignores the findings of many research studies which indicate that the managers of business entities have strong incentives to 'correct' market failure perceptions about their business activities. This correction is achieved through the release of extensive voluntary disclosures of information which protects the users of financial information. For example, market forces will exert pressure on firms to reduce uncertainty about the quality of the firm's product, the future viability of the firm, and the ability of current management to ensure appropriate returns to investors. It is claimed that failure to reduce this uncertainty leads to the firm being viewed as a 'lemon'. This, in turn, can result in additional costs to the firm in the form of, for example, higher interest charges, increased security requirements for loans and an increased threat of takeover from competitors. Thus, we find examples where we can apply public interest theory, but it is not clear that the theory is the only explanation for the observed behaviours.

Application of capture theory

Walker argues that although the Australian government originally introduced the ASRB to ensure the protection of the 'public interest, he believes capture theory is more applicable in explaining the events. He argues that the board was successfully captured by the accounting profession, the regulated industry. The ultimate signals of capture, according to Walker, centred on events such as the fact that the 'due process' provisions were abandoned in favour of 'fast-track' approval of standards submitted by the Australian Accounting Research Foundation (AARF). Furthermore, a number of disputes between the ASRB and the AARF were settled in the latter's favour and the AARF (funded by the profession) merged with the ASRB (funded by the government). The ASRB formally had power to consider standards submitted to it from any source. This was an attempt to broaden political acceptability of approved standards; however, only one out of 23 approved standards came from a source outside the profession. Thus, as with ordinary standards, it could be argued that the 'due process' mechanism within the ASRB failed to achieve its purpose.

Basically, Walker's argument is that the accounting profession needed to legitimise accounting standards (that is, ensure compliance with the standards) which could be achieved only by standards that had the 'force of law' by ensuring that accounting standards were backed by legislation. However, the accounting profession had an economic interest in retaining the standard setting process, which it did not want to relinquish to the government. In turn, therefore, the only way the profession could both legitimise accounting standards and maintain its economic interests was to 'capture' the ASRB, the body that had the power to make accounting standards mandatory for corporate entities. Under the capture view, regulatory intervention in the accounting standard setting process was designed, as with the public interest theory framework, to protect the public interest. However, Walker's study portrays the accounting profession...
as an elite group that, in effect, was not accountable to the public interest, which sought and achieved control of the standard setting process for its own gain, and which was constrained only by the fear of state intervention.\textsuperscript{24}

The international harmonisation of accounting has raised new questions in relation to the applicability of capture theory. While there was widespread support in Australia for the harmonisation of accounting standards, the adoption of international standards strongly reflect the interests and preferences of large companies, the Australian Securities Exchange (ASX) and sections of the accounting profession.\textsuperscript{25} CLERP 1 directed standard setters to have a commercial focus and to be responsive to business needs, reflecting a response by government to lobbying against Australian Accounting Standards Board (AASB) standards by the corporate sector. The ASX was a strong supporter of early adoption of international standards, presumably because it saw benefits for the ASX and listed companies flowing from the use of international standards. In one sense, the interests of all these parties have been overtaken by international events. Having exercised their influence and achieved their preference for adoption of international standards, they are now in the position of having given up influence over the process of the development of those standards. It is unlikely that these parties (large companies, the accounting profession and the ASX) can influence future Australian accounting standards in the same way as they have in the past. None of them is in the position to control or 'capture' the standard setting process post-2005.

With Australia's and Europe's decisions to adopt international standards, and the IASB's mission to have its standards adopted in all countries throughout the world, the focus of regulatory capture has shifted to the IASB. Zeff notes that the IASB is under a 'steady flow of insistent views' from trade associations, major companies and banks in European countries.\textsuperscript{26} He explains that there are many groups vitally concerned with the IASB output, so we can conclude that capture by any one group would be unlikely. However, the idea that the IASB has been 'captured' by the FASB has been flagged. The issue of IASB standards which are close to US Generally Accepted Accounting Principles (GAAP) does raise the question of the influence of US GAAP on IASB standards. Zeff reports that the dissent in Europe over IFRS 8, which closely follows a FASB standard, has raised afresh the question of whether convergence between the IASB and FASB is good for Europe.\textsuperscript{27}

**Application of private interest theory**

Private interest theory provides another approach to understanding behaviour of parties with an incentive to influence the regulation of financial reporting. Rahman\textsuperscript{28} sought to apply the private interest theory of Stigler, Posner and Peltzman to the establishment of the ASRB. Rahman's conclusion was that there were several limitations in Walker's study. He asserted that a systematic review of the Board's organisation and functions indicated that the Board was dependent on and susceptible to influence from several interest groups. Thus, while Rahman confirmed the influence of the accounting profession on the preparation and review of standards, he also found that other parties secured important roles that enabled them to constantly scrutinise and influence the Board's activities. These parties included the Ministerial Council which provided the Board with its basic authority. The Board had to operate with the notion that all its approved accounting standards were subject to political approval. This implied that the political consequences of its standards had to be minimal.

Rahman found that the Board also depended on the National Companies and Securities Commission (NCSC) for the enforcement of standards. The presence or absence of any standard which impeded the efficient administration of company law was thus liable to receive the attention of the NCSC (now the Australian Securities
and Investments Commission or ASIC). Furthermore, Rahman argued that Walker failed to mention the presence of a number of company executives on the ASRB Board. This is particularly important, given that it was mainly the corporate managers and directors that were required to comply with mandatory accounting standards on the introduction of the ASRB. Thus, it was this sector which was, in reality, the 'regulated industry'. Auditors or the accounting profession as a whole were ultimately affected only because they were actively involved in the preparation and authentication of company financial statements. The considerable representation of company executives on the board was devised, presumably, to help secure the interests of that group of regulated parties.\(^{2g}\)

From this perspective, the accounting profession did not 'capture' the standard setting process in Australia. Rather, it could be argued that the producer group, which is well organised and capable of wielding significant political influence compared with either the accounting profession or the much larger but more diffuse 'user' group, became extensively involved in, and ultimately controlled, the debate on the regulation of the standard setting process in the 1980s. Arguably, it did so in order to achieve a particular form of regulatory intervention which 'secures them from over-deregulation'.\(^{30}\) Other evidence of the lobbying power of the corporate preparers group (the managers/directors of the G100 public companies) can be seen in the pressure this group brought to bear on the accounting profession to effectively withdraw Statement of Accounting Concepts (SAC) 4 Definition and Recognition of the Elements of Financial Statements during the early 1990s.\(^{31}\) Further examples of influence by parties from the corporate sector are seen in the government's CLERP 1 proposals to restructure standard setting processes and the subsequent 2005 adoption of international accounting standards.

A limitation of these theories of regulation is that they are not mutually exclusive, that is, events explained by one theory may be explained equally well by another theory. It is not clear that a single explanation can be defended. For example, in relation to the Sarbanes-Oxley Act it can be argued that the US government was obliged to take action following the collapse of Enron, to show that it was responding to serious levels of concern about the adequacy of corporate governance, financial reporting supervision and auditing. Thus, the private interest theory may apply equally well to explaining observed events. Private interest theory has many supporters as it recognises the fundamental self-interest of parties involved in regulation. It also fits well with the view that standard setting is a political process. We consider the influence of politics on standard setting in the next section.

**Standard setting as a political process**

Standard setting is viewed as a political process because of its potential to significantly affect the wellbeing of a wide variety of interest groups. Therefore these groups attempt to influence the introduction of regulation. This model of political behaviour is a summary of the 'public choice' theory of regulation. It was used by Watts and Zimmerman to argue that the political process is simply a means of pursuing individual or group self-interest.\(^{32}\) Different groups are affected differently by accounting regulations. For example, a standard banning recognition of doubtful debts expense might be welcomed by firms that borrow heavily and are close to their borrowing agreement leverage constraints. On the other hand, large banks with high public profiles may be averse to the standard because it causes their profits to increase, understates their risk, and increases their apparent exploitation of their customers. In the presence of diverse and often conflicting interests, a decision-making body — a regulatory group — must strike a balance between them by making political choices.\(^{33}\) For those decisions to be
accepted by the people affected, the regulatory agency needs a mandate to make social choices; that is, it needs political legitimacy. Gerboth reinforces this view:

... a politicisation of accounting rule-making [is] not only inevitable, but just. In a society committed to democratic legitimisation of authority, only politically responsible institutions have the right to command others to obey rules.34

In response to dissatisfaction with standard setting by professional accounting bodies, governments in many countries have set up independent standard setters in an attempt to produce high quality standards which meet decision making needs of financial statement users. The standard setting 'due process' should allow stakeholders to contribute to standard setting, but also prevent any one party, such as the accounting profession, from dominating the process. Conceptual frameworks, previously developed in the United States, United Kingdom, Canada and Australia, sought to provide standard setting bodies with a framework within which to develop accounting standards. Independent national standard setters have had mixed success in producing conceptually sound accounting standards that achieved the decision-usefulness objective. New standards that have extended the traditional boundaries of financial reporting include those incorporating fair value measurement methods. However, there are notable examples where progress toward a conceptually preferred position has been slow or where political lobbying has 'derailed' an accounting standard. An example of the former is leasing. A C4+1 study in 1996 recommended capitalising property rights inherent in all leases.35 Standard setters have expressed a preference for recognising leases on the balance sheet, but have thus far been unable to secure a standard which satisfactorily achieves this objective. The IASB/FASB have a current joint project on lease accounting, which involves comprehensive reconsideration of all aspects of lease accounting and is expected to lead to fundamental changes in accounting for leases. The aim of the project is to develop a new common approach to lease accounting that would ensure that all assets and liabilities arising under lease contracts are recognised in the balance sheet. A discussion paper on the topic was issued in 2009.36 Issues relevant to understanding standards for lease accounting are explored in theory in action 3.1.

Companies should come clean on the value of leases on their books

by Paul Kerin

Investors should be very wary of the results reported by companies that rely heavily on leases.

Silly accounting rules can mean that the majority of many companies' assets and liabilities don't show up on their balance sheets. As a result, even terrific companies like Woolworths report grossly inflated returns on investment and provide financial risk measures that bear no relation to reality.

Following a spate of corporate crises such as Enron's collapse, the US Securities and Exchange Commission investigated off-balance-sheet arrangements. Its mid–2005 report made sobering reading. It estimated that US-listed companies had committed themselves to lease payments totalling $US1.25 trillion ($1.4 trillion) that did not appear on balance sheets. About 90 per cent of Australian leases are off balance sheet and most companies have some. This smoke and mirrors trick is particularly rife in the retailing and airline sectors. David Tweedle, chairman of the International Accounting Standards Board, recently told a US congressional hearing of his ambition to "actually fly in an aircraft that's on an airline's balance sheet before I die".

He should fly Qantas - to its credit, some (though not all) of its aircraft leases are on balance sheet. Last year, Business Week valued the off-balance-sheet lease liabilities of two large US retailers, CVS and Walgreen, at $US11.1 billion and $US15.2 billion respectively.
If these were on the balance sheet, the companies' respective total liabilities would be 260 per cent and 366 per cent of their reported levels.

In reality, companies committing themselves to leases effectively buy assets (right to use things) funded by debt. Obligations to make regular lease payments are just like obligations to make regular interest repayments. Good analysts, bankers and equity investors adjust reported financial statements to reflect this fact.

Accountants distinguish between "capital" and "operating" leases. Capital leases must go on balance sheet but operating leases don't. While the Australian standard says that lease classification should be based on a lease's "substance", its guidance criteria on capital leases (such as the lease term covering the "major part" of an asset's economic life) leave much wriggle room.

The US standard provides harder criteria, such as the present value of minimum lease payments exceeding 90 per cent of asset value. But such criteria have created a huge financial engineering industry and provided a "how to" guide for structuring lease deals to keep them off balance sheet.

Retailers can commit themselves to multi-decade leases involving huge lease payments, yet keep them off balance sheet. Fund manager JF Capital Partners estimates the capitalised values of Woolworths' and Coles' off-balance-sheet leases to be $11.8 billion and $10.8 billion respectively. Adjusting for this off balance sheeting makes a huge difference to their recently reported 2006-07 results.

Woolies reported that net debt fell $1.3 billion, to $2.4 billion, in 2006-07. But adjusted for off-balance-sheet leases (which rose $1.3 billion in value), it really remained unchanged at $14.1 billion. Coles' adjusted net debt is really $11.8 billion, versus the $900 million reported. That is, 83 per cent and 92 per cent of these companies' real net debt, respectively, is off balance sheet. Likewise, reported invested capital (debt plus equity) numbers grossly underestimate reality. Woolies' 71.9 per cent adjusted debt/capital ratio is more than double the 30.7 per cent reported, while Coles' is almost quadruple (75.1 per cent versus 19.4 per cent). While off balance sheeting doesn't distort returns on equity, its impact on debt ratios falsely downplays risk — which may cause shareholders to make poor risk/return trade-offs.

In fairness, off balance sheeting also reduces reported earnings before interest and tax (EBIT), because it causes the entire lease charge to be expensed. If lease assets and liabilities were on balance sheet, the expense would be split between depreciation and interest; the former affects EBIT, the latter doesn't. Nevertheless, off balance sheeting inflates reported returns on invested capital (ROI), as it reduces the invested capital denominator by much more than the EBIT numerator. Using JFCP's lease value and depreciation/interest splits, Woolies' lease-adjusted ROI is 15.2 per cent — while very healthy, it is little more than half the 27.1 per cent reported. Coles' 13 per cent adjusted ROI is less than half the 27.3 per cent reported.

Off balance sheeting can also make ROI trends misleading. For example, Coles often claims that its ROI has more than doubled since 2001-02. It has — from 12.7 per cent to 27.3 per cent — because reported EBIT has doubled while reported invested capital has grown only 21 per cent, kept in check mainly through sorely needed working capital reductions. But as working capital is small relative to off-balance-sheet lease value, which grew 24 per cent, the adjusted ROI has only risen from 9.7 per cent to 13 per cent.

Given the market's views on Woolies (great) and Coles (poor), you may wonder why Woolies' reported ROI looks slightly worse than Coles'. The main driver is Woolies' $5 billion of intangible assets (such as goodwill from acquisitions) versus Coles' $1.7 billion. If intangibles are excluded to provide a better measure of real operating performance, Woolies' ROI before lease adjustments becomes 95 per cent — more than double Coles' 43.1 per cent. After lease adjustments, it is 21 per cent, much higher than Coles' 14.5 per cent.

The Woolies/Coles comparison shows that off balance sheeting can make inter-company comparisons of reported returns very misleading.

As companies differ in the mix of assets under direct ownership, capital leases and operating leases, the only way to make like-for-like comparisons is to put all leases on balance sheet.

Off balance sheeting can also distort comparisons across business units. Reported ROIs of Target (65 per cent) and Food & Liquor (24 per cent) do partly reflect genuine performance...
differences. But they also reflect the fact that off-balance sheeting boosts ROI relatively less for units with higher earnings per square metre (as meterage drives lease charges, hence off-balance sheet lease values). Despite its current underperformance, Food & Liquor's $413 million EBIT is 24 per cent above Target's. On balance sheeting would narrow its apparent ROI gap.

Following the SEC's call, the International Accounting Standards Board plans to review lease accounting (with Australian participation). Unfortunately, a new standard won't emerge until at least 2009 — and it won't necessarily require full on balance sheeting. As current standards have fostered a huge industry and allowed companies to financially engineer rosy financial reports, big changes will meet heavy resistance.

Rather than wait for new standards to force on balance sheeting, companies that really care about shareholders should take the initiative to do it now.

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Source The Australian, 2 October 2007.

Questions
1. Describe current accounting practices for leases as outlined in this article.
2. Why does the author call leasing standards 'silly accounting rules'?
4. What are the advantages of capitalising leases? Given that most companies usually reporting operating leases, will they oppose new leasing rules?

There are many examples where political lobbying has interfered with the standard setting process and with the standards eventually issued by boards. Zeff tracks the rising importance of financial accounting standards in different sectors of the United States economy and describes the special-interest lobbying which has occurred to obtain standards compatible with parties' desired outcomes. Notable examples include the treatment of foreign currency translation gains and losses; unrealised holding gains and losses on current marketable equity securities; 'successful efforts' and 'full cost' policy choice for the oil and gas industry; as well as leasing, stock options, pensions, consolidated accounting and financial instruments. The US situation is not unique — Zeff describes lobbying of national standard setters in Canada, Sweden and the United Kingdom on a range of similar issues. He also notes significant lobbying of the IASB, in relation to the elimination of last in, first out (LIFO), share-based payment and financial instruments. We describe below the case in relation to financial instruments and then conclude this section with a description of the political processes surrounding the adoption of IAS 38 Intangible Assets in Australia.

**Financial instruments**

Few accounting standards have been as controversial as those for financial instruments. Consequently, the adoption of IAS 39 Financial Instruments — Recognition and Measurement in the European Union (EU) has been a highly politicised process. Forming standards to account for financial instruments has challenged standard setters for several years. Early developments occurred in the United States, where there has been considerable demand for the use of fair value measurement (i.e., mark-to-market or use of an estimation model to record fair value at balance date) to more accurately reflect the risks and rewards of holding financial instruments. Standard setters have viewed fair value measurement as useful for providing relevant information for decision making by users of financial information. The International Organization of Securities
Commissions (IOSCO) considered guidance for accounting for financial instruments essential and requested the International Accounting Standards Commission (IASC) to include a financial instruments standard among the core standards being prepared in expectation of endorsement by IOSCO for use by companies in cross-border listings. The IASB created IAS 39 based on the FASB standards relating to financial instruments (FAS 114, 115, 133 and 140) as an interim standard, noting that further development of IAS 39 would be required.

Following the announcement in 2002 that international accounting standards (IAS) would be adopted in Europe, much greater attention was focused on the content of international standards. EU-listed companies, which had previously followed national GAAP, would now be required to follow IAS at least for consolidated accounts. In the area of financial instruments, the accounting change was potentially dramatic. Generally, companies used historical cost accounting for financial instruments, showing them at cost or amortised cost, and including gains in the income statement only when they were realised. In relation to financial assets and liabilities, companies had considerable discretion about when gains and losses were recorded in income. IAS 39 would require companies to include unrealised gains and losses on certain financial instruments in income when they occurred (not when they were realised), thus restricting companies' choices about the timing of recognition of gains and losses on some instruments.

The reaction to IAS 39 among some European companies was extremely negative. The idea of including unrealised gains and losses in income was not popular in some countries, such as France and Germany, where accounting practice was essentially conservative, use of the historical cost principle the norm and upward revaluation of assets or liabilities not widely practised. Companies objected to possible subjectivity introduced into accounting measurement and expected volatility in reported earnings, as well as the costs incurred in meeting the requirements. Further, bank representatives argued that they would be forced to follow accounting rules (such as those proposed for hedge accounting) which did not reflect the underlying reality of their business, making accounting information less, rather than more, useful for decision making.

The IASB gave careful consideration to the issues raised by stakeholders. In December 2003 it amended the 2002 exposure draft after an extensive due process which included numerous board meetings, discussion of the exposure draft with constituent groups in nine roundtable meetings, receiving and evaluating more than 270 comment letters and discussing the topic with advisory committees and national standard setters from around the world. At the same time, financial statement preparers, notably the large French and German banks, were lobbying hard through all possible means to avoid the adoption of IAS 39. Lobbying efforts directed at the IASB were made by companies, individuals and their representative bodies such as professional associations, industry representative groups, national standard setters and European representative bodies including EFRAG. The ultimate lobbying activity was observed: a letter from the French president, Jacques Chirac, to the European Commission (EC) president which objected to measurement of derivatives at fair value and claimed that the IASB standard would have 'nefarious consequences for financial stability'.

The IASB responded as best it could to these concerns, but was committed to a standard based on the principle of recognition and measurement of financial instruments at fair value. Thus, IAS 39 was included in the standards submitted to the Accounting Regulatory Committee (ARC) for endorsement prior to adoption by the EC. The ARC endorsed all the IASB standards, but excluded certain provisions contained in IAS 39. These related to the use of fair value measurement and to hedging. Companies were not required to comply with these sections of IAS 39 when...
preparing accounts in accordance with IAS/IFRS from 2005. Thus, the lobbying activities of economically powerful and politically well-connected groups succeeded in dictating the content of an accounting standard. One of the issues of the 'carve out' has been resolved, while the other remains.  

The ARC’s decision was criticised by parties who saw the creation of ‘European IAS’ as a backward step, away from the goal of harmonised financial reporting. The UK standard setters did not agree with the ARC decision, and encouraged UK companies to comply with the full hedging requirements of IAS 39. The political controversy in relation to IAS 39 has not decreased with the passage of time. The financial crisis, which began in 2007-08 resulted in the IASB amending IAS 39 (and IFRS 7 Financial Instruments: Disclosures) to allow companies the choice of reclassifying some financial instruments from categories where fair value measurement applies to categories where items are measured based on amortised cost. The board defended the changes, which were made without due process consultation, in the light of requests from EU leaders and finance ministers and that the fact that the accounting choice was available under US GAAP. Both theory in action 3.2 and case study 3.2 address issues relating to regulation and accounting standards. They allow further exploration of the role of fair value accounting in the global financial crisis.

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**Accountants draw the line at regulating**

*by Patrick Durkin*

The global accounting standards setter has defended its role in the financial crisis and blamed prudential regulators for lax rules that enabled banks to make risky bets, dole out excessive bonuses and pay too much in dividends.

Members of the International Accounting Standards Board, visiting Sydney yesterday, also defended fair-value accounting, which banks have criticised for exacerbating the crisis by forcing them to record massive write-downs in asset values.

"We are not set up to be focused on financial stability," board member Stephen Cooper said. "There are other [prudential regulators] who are already set up to do that, but they don't want to do it.

"It seems crazy to me that people are asking us to do something we are patently not equipped to do."

The IASB will present its views to the G-20 meeting of world leaders in London next month and will urge leaders to put the onus for oversight of banks on prudential regulators.

"The regulator should be focused on not allowing banks to pay dividends and do share buybacks if that is going to put the bank in danger, rather than trying to change the profit that is reported," Mr Cooper said.

The IASB said the problems with fair-value accounting — the method of valuing assets at market value rather than historical cost — arose because it was not adopted widely enough and should be applied to all financial instruments.

The major investment banks apply the method to only 60 per cent to 80 per cent of financial instruments on their balance sheets, and the major retail banks apply it to as little as 10 per cent to 20 per cent.

"People are asking us to take a haircut to fair value or other measurements when times are good and increase the fair value when times are bad," Mr Cooper said.

"But to decide by how much you haircut and by how much you increase, you have to be close to the banks and the markets. The banking regulator has that closeness."

IASB member Warren MacGregor said the banking industry should keep an additional capital buffer to protect against catastrophes, as insurers did.

He also said Australian companies should report quarterly, as in the US, rather than twice a year, to ensure the timely disclosure of asset prices "if the need for timely information is clearly there."
The IASB will lobby the C-20 to ensure the US continues towards adopting international accounting standards. If the US fails to adopt the standards, there will be an increased risk of regulatory arbitrage: companies looking for gaps to determine the best jurisdiction for them to report in.


Questions
1. The article refers to a view circulating at the time, that fair value accounting contributed to the 'global financial crisis' (from October 2008, the near collapse of many banks caused capital flows to dry up and share prices to fall dramatically). How could fair value accounting exacerbate the financial crisis?
2. Why does the IASB member refuse to accept responsibility for the financial crisis?
3. The IASB considers adoption of IASB standards in the USA to be essential. Explain why it holds this view. To what extent does the IASB’s position reflect self-interest?

Intangible assets
The adoption of IAS 38 Intangible Assets in Australia also illustrates the role of politics in the standards setting process. The AASB had not issued a specific standard on accounting for intangibles, having withdrawn its exposure draft in 1992 due to lack of consensus on the subject. Many methods for valuing intangibles assets had developed and Australian companies used a variety of methods. IAS 38 (issued by the IASB in 1998 and revised in March 2004) required methods of accounting that were significantly different from those adopted by some Australian companies. For example, internally generated intangibles cannot be recognised and intangible assets without an active market cannot be revalued. Australian companies with substantial intangible assets in either of these categories lobbied the IASB, the AASB and the federal government for relief from the IAS 38 requirements based on the impact that they would have on companies' financial statements. The AASB requested that Australian companies be permitted to carry forward existing intangible asset values from 1 January 2005. However, the IASB declined their request. The AASB was unable to negotiate with the IASB to achieve an outcome that was considered important by some Australian companies. The result shows the relative power of the AASB and IASB and highlights the limited ability of the AASB to influence the IASB. It also illustrates the IASB’s need to be seen to be a strong independent standard setter. The Australian government chose not to intervene in the process of adopting IAS 38, despite company requests for it to do so. Transferring a fundamental aspect of standard setting offshore (to the IASB in London) allows the government to refer to global market forces demanding international comparability and gives it a justification to stay out of the standard setting process. It also highlights the loss of influence of the corporate sector over the standard setting process.

THE REGULATORY FRAMEWORK FOR FINANCIAL REPORTING
In the preceding discussion, we have referred to many parties with an active role within the financial reporting environment. They include the preparers of the financial reports (company directors and their executives and managers) and a company’s external auditors as well as the rule-makers, such as private sector groups, stock exchanges and governments and their agencies. The activities of these parties will be influenced by the environment in which financial reporting takes place; that is, its legal, economic
political and social setting. The specific environmental features of the financial reporting environment make up what can be called the regulatory framework of financial reporting. While regulatory frameworks vary between countries, they often have common elements. We outline these elements below to provide an overview of the regulatory framework for financial reporting (that is, a pro forma regulatory framework) and to demonstrate how the elements of the regulatory framework influence the output of the financial reporting process — the financial statements. The elements of the regulatory framework which we discuss are:

- statutory requirements
- corporate governance
- auditors and oversight
- independent enforcement bodies.

Statutory requirements

The key participants in the production of financial reports are corporate directors (and their executives and managers) and independent auditors. Elsewhere in this book, we have explained that there are many motivations for managers to voluntarily provide financial information and to have that information independently verified through the audit process. Now we turn to the role of statutory requirements as an incentive to produce financial statements and have them audited. In many countries company law mandates that directors provide audited accounts. Thus a primary influence on directors and auditors is the need to fulfil statutory reporting requirements, as contained in company law. On the one hand, company law will likely mandate basic requirements relating to which reports are to be prepared and their frequency of preparation. But it may also include particular requirements relating to the information to be included; for example, in Australia companies must disclose information about their environmental performance. In some jurisdictions, notably the United States, reporting requirements are derived predominantly from securities market law rather than company law. Additional financial reporting requirements are derived from specific accounting standards and in many jurisdictions these standards have the force of law. For example, listed companies in the European Union that prepare consolidated financial statements are required by law to use IASB standards adopted by the EU. In Australia, company law requires all reporting entities to follow legally endorsed IASB-based accounting standards. Taxation law is another statutory influence on financial accounting in many countries, notably those following a French or German accounting tradition. In these countries, for single entity reporting, the financial accounting rules are the same as tax rules. Company law, in turn, forms part of a wider legal system, which is likely to include ways of monitoring compliance with statutory requirements. For example, the OECD reports that many European countries have a body responsible for checking lodgement of accounts. In addition, the judicial system provides sanctions and penalties that promote compliance with company law.

Corporate governance

Another important element within a country's regulatory framework is the system of corporate governance. Davis takes a broad view of corporate governance and states that it refers to 'the structures, processes and institutions within and around organizations that allocate power and resource control among participants'. Some corporate governance practices are derived from laws which require directors to carry out specific actions in relation to the management for their companies. For example, requirements
to hold meetings with shareholders and to disclose matters of interest such as directors' remuneration and related party transactions are basic corporate governance matters which may be covered by company law.58

However, a regulatory framework may contain additional corporate governance guidance and rules, arising from both private sector voluntary recommendations and stock exchange listing rules. Corporate governance guidance may take the form of voluntary best practice recommendations, which encourage directors to adopt appropriate governance mechanisms, to best suit the situation of their individual company. Both supranational and national bodies have produced corporate governance recommendations. The International Federation of Accountants (IFAC) guidelines are an example of the former and corporate governance codes issued in the United Kingdom and Australia are examples of the latter.59 Governance requirements relating to financial reporting can be enforced by the stock exchanges or the government body responsible for enforcement of financial reporting requirements. For example, in the United Kingdom and Australia, the respective stock exchanges recommend compliance with the corporate governance codes and require companies not in compliance to provide explanations of the reasons for non-compliance, the so-called 'if not, why not' rule. EU directives on corporate governance can be enforced through member states' legal systems.

**Auditors and oversight**

In many countries auditors perform a vitally important function in providing assurance about the quality of information provided by companies in their financial statements.60 It is common for the auditing profession to be regulated in some way. The most basic form of regulation of the profession is limiting of membership to persons with particular qualifications and experience and requiring registration to practise. Other forms of regulation involve requiring membership of a professional body and commitment to an ethical code of conduct. Professional bodies may also sanction members in breach of their rules.61

Many of these forms of regulation are self-imposed because a profession may agree to follow a body of rules to maintain its privileged position and to protect its right to practise as a profession. For example, private sector self-regulation of the accounting profession is an early form of auditor oversight. In the past, professional bodies have taken their role of oversight of the profession seriously, devoting considerable resources to developing standards for professional conduct at a national and international level. Many national bodies representing auditors have voluntarily adopted international standards of auditing (ISA) as an indication of their commitment to providing a high-quality service and demonstrating behaviour appropriate to members of a profession.

Self-regulation of the auditing profession has been widely observed, but there are some notable examples where regulation was from early times the responsibility of state authorities. For example, in France and Italy regulation of auditors was the responsibility of their respective independent enforcement bodies (the securities market regulators, Autorité des Marches Financiers or AMF in France and Commissione Nazionale per le Società e la Borsa or Consob in Italy). In the case of the AMF and its predecessor organisation Commission des Operations de Bourse (COB), the regulator works closely with the Compagnie Nationale des Commissaires aux Comptes or CNCC, the body representing the auditing profession in the process of carrying out oversight of auditors’ activities.

The location of responsibility for auditor oversight with a statutory body, rather than allowing self-regulation, provides (at least in theory) for more independent regulation. The choice of a statutory regulator rather than self-regulation may reflect economic or
political differences in approaches to management of capital markets. For example, until 2005 the United Kingdom had a longstanding tradition of self-regulation of auditors, consistent with a cultural position of minimising intervention in the operation of the capital market. Statutory regulation of auditors is consistent with a more centralised, interventionist approach to regulation of business observed in France and Italy. In recent years, many countries have introduced statutory bodies responsible for auditor oversight, as discussed in the final section of this chapter.

Independent enforcement bodies

A study by the FEE includes an independent enforcement body as part of the overall system for enforcement of financial reporting requirements. The role of such a body in the regulation of financial reporting is to promote compliance with the regulations governing the production of financial statements, which are contained in law, and accounting standards. An independent enforcement body is an extension of lodgement supervision, a basic part of the regulatory framework. While many countries have a body responsible for lodgement supervision, setting up an independent enforcement body is a more recent event, linked to the adoption of IFRS in 2005. Because of the importance of comprehensive and consistent application of IFRS in achieving the goals of IFRS adoption, each EU member state was required to set up an independent enforcement body. The Committee of European Securities Regulators (CESR) reported that by 2006, 20 of the 27 EU member states had set up an enforcement mechanism that met, at least in part, the requirements laid down by CESR standards for enforcement.

A securities market regulator is the most commonly observed form for an independent enforcement body. Examples include the AMF in France, the Consob in Italy, the Autoriteit Financiële Markten (or AFM, Financial Market Authority) in the Netherlands, the Securities Exchange Commission in the United States and ASIC in Australia. Independent enforcement bodies may have extensive duties and powers in relation to the regulation of securities markets, which extend far beyond the monitoring of financial reporting. Nevertheless, such bodies can be very active in enforcing financial reporting requirements contained in law and accounting standards. The SEC is a notable example of an active market regulator, which is involved in setting accounting requirements (either directly or through a delegated committee, FASB), providing interpretation advice and taking legal action against firms for non-compliance. Theory in action 3.3 explores the role of both the FASB and the SEC in relation to the issue of backdating of stock options in the United States. We consider the extent to which FASB and/or the SEC can be considered responsible when there is non-compliance with an accounting standard.

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PART 1 Accounting theory

3.3 THEORY IN ACTION

Executive in U.S. convicted for backdating share options

by Eric Dash and Matt Richtel

New York: U.S. prosecutors scored a guilty verdict in the first options backdating case to go to trial, securing a conviction that is expected to embolden them to pursue similar cases.

Jurors in U.S. District Court in San Francisco on Tuesday convicted a former chief executive of Brocade Communications Systems, Gregory Reyes, 44, on 10 counts of conspiracy and fraud.

The verdict ended a five-week trial in which Reyes was accused of intentionally changing grant dates for hundreds of stock option awards without disclosing the move to investors.

Sentencing is scheduled for Nov. 21. Under U.S. sentencing guidelines, Reyes could face up to 20 years in prison for the most serious charges as well as pay millions of dollars in fines.
The verdict sent shock waves through Silicon Valley and law offices around the country that are representing dozens of companies and executives entangled in the widespread scandal.

In the wake of intense media attention, regulators cracked down on more than 100 companies over the unlikely coincidence of stock options being granted again and again to executives and employees on dates when the share price was low — a tactic that guaranteed the maximum profit when the options were later turned into cash.

Backdating is illegal if the company does not properly account for the discounted grants as an expense.

The U.S. Securities and Exchange Commission eventually investigated about 140 companies in connection with the practice, and prosecutors filed charges against at least five executives.

Yet lawyers have long argued that these cases were more winnable as civil rather than criminal courts where the burden of proof is much greater.

Most of the backdating cases, including the one against Reyes, hinged on proving that the defendants knowingly manipulated an option grant date to defraud investors.

But that claim can be obscured by the complexity of accounting issues. While lawyers on both sides acknowledge that these cases are difficult to win, the Brocade decision indicates that a guilty verdict is possible.

"It emboldens them in bringing other cases, but I don't think it means they will bring bushels of these cases," Sean O'Shea, a criminal defense lawyer in New York, said of prosecutors. "They will bring the strongest of those where they can show evil intent in trying to conceal information from shareholders."

Mark Zauderer, a trial lawyer in New York, said: "Defense lawyers are going to be keenly aware that where there is evidence of misleading documents, it will be difficult to rely on the defense that nobody knew it was illegal.

"Better to report something truthfully that is perhaps questionable than to risk misrepresenting the facts," he said.

In the Brocade case, prosecutors presented evidence that Reyes intentionally misled shareholders with a "systemic practice of cherry-picking stock prices" to build in gains for employees.

During the trial, a former human resources employee testified that Reyes told her that the practice was "not illegal if you don't get caught."

Prosecutors also said that Reyes denied backdating stock options when he was questioned by investigators about the pattern of favorable grant dates.

The lawyer for Reyes, Richard Marmaro, portrayed his client as a hard-working technology company executive who did not traffic in the accounting arcana of stock option grants.

Brocade, the defense argued, offered the low-priced grants as a way of attracting employees as the dot-com boom created an intense battle to hire talent.

Source: International Herald Tribune, the New York Times Company, Wednesday, 8 August 2007

Questions

Accounting standards require that, in certain circumstances, companies record an expense for stock options granted to employees.

1. Do you consider that the company Brocade Communications complied with the requirement to record an expense for stock options?

2. Who benefits from the 'backdating' of stock options? Who is harmed?

3. If options can be backdated, has the standard setting board (in the United States, the FASB) been effective in the role of promulgating accounting regulations?

4. What is the role of the SEC in relation to the regulation of accounting practice?
review panel, such as the United Kingdom’s Financial Reporting Review Panel (FRRP). The FRRP was formed in 1991 with power to investigate matters relating to financial reporting brought to its attention. The FRRP was set up as a private sector trust and comprises members of the business community. Thus, it is a structure that involves the private sector in regulation, which is viewed by many as an effective alternative approach to regulation. Another approach was taken by Germany following adoption of IFRS. They set up a two-tier enforcement system, comprising a review panel (Deutsche Prüfstelle für Rechnungslegung, i.e. the Financial Reporting Enforcement Panel or FREP), which reports to a government department (Bundesanstalt für Finanzdienstleistungsaufsicht or BaFin, i.e. the Federal Institute for the Oversight of Financial Services).

Another part of the regulatory framework which arises because of widespread adoption of IFRS is a system to coordinate enforcement. A supranational organisation, the International Organization of Securities Commissions (IOSCO) established a system for participating IOSCO members and other independent enforcement organisations to share information and consult in order to improve coordination and convergence. Each national regulator retains the ability to deal with an issue in its own right but the system aims to facilitate consistency and provide a reference point for future regulatory decisions. At a regional level, CESR has set up a coordination mechanism (European enforcers’ coordination sessions or EECS) to maintain a database of enforcement decisions. The EECS focuses on decisions taken or to be taken by local enforcers and gives input and feedback on specific cases in order to achieve consistency among European enforcers.

THE INSTITUTIONAL STRUCTURE FOR SETTING ACCOUNTING AND AUDITING STANDARDS

In our discussion of the regulatory framework for financial reporting, we saw that financial reporting requirements are commonly derived from statute law and accounting standards. In this section, we consider the development of an international standard setting body and the process of setting international accounting and auditing standards.

Background

The development of international accounting standards began formally with the formation of the International Accounting Standards Committee (IASC) in London in 1973. The committee comprised representatives of professional accounting bodies from nine countries (Australia, Canada, France, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, the United States and West Germany). Its aim was to develop accounting standards for the private sector suitable for use in countries throughout the world. Prior to 2005, International Accounting Standards (IAS) were influential in the following ways. They were adopted for use in countries without a national standard setting structure; for example in Papua New Guinea and Indonesia. In other cases, they were used in the development of national standards, such as in Singapore and Hong Kong. IAS were also used voluntarily from the early 1990s in the consolidated accounts of companies from countries such as Switzerland and Germany. In these countries, national accounting reflected a stakeholder orientation arising from their code law legal framework and tax-based accounting systems. Companies used IAS to provide additional information for capital market participants in a more transparent and comparable format.
The members of the IASC hailed from countries with a range of accounting practices and different approaches to setting accounting standards. Early IASC standards often allowed a choice of accounting policy to include the preferences of various member nations. During the late 1380s the IASC began work on the Improvements Project, to improve the quality of IAS and remove many optional treatments. The IOSCO, a body representing securities regulators throughout the world, sought a set of standards which its members could use in cross-border listings. The revised standards were endorsed by IOSCO in 2000, albeit with the proviso that member countries could add further requirements. The latter provision reflected the position of the market regulator in the United States, the SEC. It did not intend to remove the US GAAP reconciliation requirements (the so-called Form 20-F) for companies using IASC standards and listing on the more-regulated United States exchanges (such as the NYSE, NASDAQ and AMEX).

Although use of IAS throughout the world was increasing, further acceptance was limited by the fact the IASC was not an independent standard setting board. Consequently, it was restructured in 2001 to create the International Accounting Standards Board (IASB), an independent board based on the structure of the Financial Accounting Standards Board (FASB) in the United States. The board comprised fourteen full-time members, chosen for their expertise and experience in professional accounting and standard setting. It was supported by dedicated technical staff, located in London. The IASC Foundation became the oversight body of the IASB and an interpretations committee was formed. The formation of the IASB saw the disbanding of the G4+1 (a body comprising independent standard setters from Australia, Canada, New Zealand, the United Kingdom, the United States and the IASC), which was becoming influential in developing international standards. The IASB has responsibility for updating existing IAS (which still carry the IAS label) and producing International Financial Reporting Standards (IFRS).

The importance of the activities of the IASB increased dramatically with the decision in 2002 by the European Commission (EC) to adopt IASB standards in 2005. The EC announced that all listed companies in European Union (EU) member countries would prepare consolidated accounts based on IASB standards. This fundamental change was an important step promoting the production of more transparent and comparable financial information by listed European companies. It was prompted by the goal of developing a single, unified capital market in Europe. The decision prompted a flurry of activity at the IASB and in EU member countries. First, the IASB was required to produce a 'stable platform' of standards by 1 March 2004, to be reviewed by the EC's Accounting Regulatory Committee (ARC). The committee would recommend to the EC whether the standards should be endorsed for use in EU countries. Thus, the IASB had a heavy workload and tight timetable as it sought to finalise standards, including demanding and controversial projects such as accounting for financial instruments. Second, each EU member country had to prepare for adoption of international standards by considering how IFRS reporting would integrate with national reporting. For example, would parent company and private company accounts also use international standards or continue to use national GAAP? The setting up of independent national enforcement bodies, to promote compliance with international standards, was also required. Third, the accounting profession (including external auditors and public accountants) had to prepare for IFRS adoption. This involved technical training to acquaint themselves with standards, which in some cases were markedly different to existing national GAAP. Companies also faced many challenges. Personnel had to become technically proficient in the standards and companies had to revise accounting systems to record...
information required by the new regime. In addition, they had to communicate with stakeholders such as investors and financiers about how IFRS adoption would impact on their financial statements.

**The IASB and FASB convergence program**

The work program of the IASB was further complicated by the announcement of the IASB/FASB convergence program, called the Norwalk Agreement, in 2002. The FASB was formed in 1973 and is highly regarded throughout the world as a leading standard setter. The FASB has power delegated by the SEC to develop standards for financial reporting for listed companies. It has produced several accounting concept statements and a series of financial reporting standards focusing on providing high quality financial information which is useful for decision making. The use of international standards in the United States has been discussed at length. While some groups, such as the stock exchanges, mounted arguments in favour of acceptance of IAS based financial statements, the SEC until 2007 maintained that reconciliation to US GAAP was necessary to ensure a 'level playing field'. The SEC issued a concept release in 2000 which outlined its views about desirable attributes of the financial reporting framework. They include high-quality standards developed by an independent standard setting board, and compliance promoted by independent enforcement bodies. With the adoption of IAS in 2005 by many companies, pressure to allow the use of IAS without reconciliation (e.g. from EU companies cross-listed in the United States) increased. In 2007, the SEC agreed to permit foreign registrants to file IFRS accounts with the SEC without the Form 20-F reconciliation. The SEC then began the process of considering whether domestic registrants be permitted to use IFRS instead of US GAAP. While there are some supporters for use of IFRS in the United States, de Lange and Howieson argue that political realities mean the US is unlikely to give up sovereignty over the setting of accounting standards.

In the meantime, the IASB/FASB convergence program has generated considerable work for both Boards. It complicated the process of producing the 'stable platform' of standard for 2005 as the IASB was working to this aim while at the same time considering the extent to which standards could be revised to converge with US GAAP. The convergence program requires the FASB and IASB to identify differences between their respective standards, to review available solutions and to adopt the better treatment. In practice, convergence is a complicated process. Some of the differences arise because of underlying differences between the two sets of standards. US GAAP have been described as rule-based standards while IAS aim to be principles-based. The greater involvement of the United States means that international standard setting (and, in turn, national standard setting) is now dominated by the FASB and IASB. The convergence process can only be a two-way dialogue between the FASB and IASB because of its inherent difficulties, which would increase if more parties were involved. However, the IASB has a policy of working with national standard setters on projects where they are able to contribute to the standard setting process. The current liaison standard setters are national standard setting bodies from Australia, France, Germany, Japan, New Zealand, the United Kingdom and the United States. They participate in the IASB’s work through research projects, project teams and joint projects. The IASB is dependent on the contribution of national standard setters, yet it is unclear the extent to which these bodies will influence the final decisions of the IASB. Since 2005 bodies from the EU (such as national standard setting boards and EFRAG) have become more vocal in the process of developing accounting standards. The IASB may see itself as the global standard setter, but for the EU it is their 'local neighbourhood standard setter'. Given that standards have economic consequences, there is vigorous debate...
in Europe about the content of IASB standards and the direction of standard setting, as discussed previously in this chapter in relation to financial instruments. Case study 3.3 provides an opportunity to consider a number of important developments relating to the adoption of international standards, which bring out key issues arising from use of common standards.

**Accounting standards for the public sector**

As noted above, the IASB sets standards for the private sector. Different standards could apply to the public sector, given that public sector entities may have different goals and objectives and different stakeholders compared with private sector entities. Individual countries must decide the extent to which IASB standards will be followed by public sector entities. In Australia and New Zealand, the approach to date has been to pursue one set of accounting standards, suitable for both public and private sector entities. Such standards are described as 'sector neutral standards'.

In Australia the AASB has a number of functions, as described below by the then chairman, Professor David Boymal:

- produce accounting standards to be followed by reporting entities
- produce accounting standards for the public and not-for-profit sectors
- actively participate in development of international standards
- provide interpretation of accounting standards to ensure comparability of financial reporting by Australian reporting entities
- provide technical support to Australian representatives on international committees such as the IPSASB and SACs
- produce standards for private sector and not-for-profit entities are a key board function. In addition, the Board notes that it supports the work of the International Public Sector Accounting Standards Board (IPSASB), a committee of the International Federation of Accountants (IFAC). In 2009, IPSASB was involved in developing a conceptual framework for public sector accounting.

**International auditing standards**

Finally in this chapter, we consider the regulation of auditing practice and the development of international auditing standards. Historically, auditing was self-regulated. Several professional accounting societies were founded in the nineteenth century to promote the profession and to provide training for members. The formation of these societies occurred during a time when Companies Acts were being passed in the United Kingdom requiring audits and thus generating a significant source of revenue for accountants. As Watts and Zimmerman have documented, there is evidence of audits in the early history of corporations and the development of professional auditing reflected the development of capital markets. The authors conclude that audits were demanded to meet the needs of financial statement users and contracting parties and that legislation requiring audits merely codified the best existing practice.

As discussed in chapter 2, early auditing theory development documented the process of auditing and the duties expected of auditors. More general theoretical development followed which described and prescribed best auditing practice. These practices became enshrined in auditing standards issued by the profession. In the United States, the American Institute of Accountants was responsible for the first auditing standards in 1939. In Australia, auditing standards were issued by the professional accounting bodies through the AARF. The profession was responsible for maintaining ethical standards, including disciplining members who did not follow accounting and
auditing standards. However, this form of regulation was weakened if there was no legal requirement for accountants to be members of professional bodies. The American Institute of CPAs (AICPA) began a system of peer reviews in the 1960s, although it was voluntary until 1989.92

As noted previously, the accounting scandals at Enron and other companies in the early 2000s can be regarded as market failures and appear to have been used as justification for government intervention in auditing standard setting in the United States and Australia. Since the passage of the Sarbanes-Oxley Act (2002), reviews of audit firms in the US have been conducted by a government body, the Public Company Accounting and Oversight Board (PCAOB). The PCAOB is also responsible for setting auditing standards for the audit of public companies. In Australia, auditing standards have had legal backing through the Corporations Act 2001 since 1 July 2006 following passage of CLERP 9.

Even though auditing standards are now set by government bodies, the early focus has been more on rewriting standards to enable them to be incorporated into legislation than on changing their content. International Standards on Auditing (ISA) are developed by the International Auditing and Assurance Standards Board (IAASB). In Australia, the Auditing and Assurance Standards Board (AUASB) rewrote the previous set of professional standards and is directed to use ISA as a base from which to develop new Australian standards, with any necessary amendment.93

The IAASB operates under the auspices of the IFAC. The IFAC’s members are accounting organisations and most members of the IAASB have been practising auditors. This situation has led some commentators to suggest that the IAASB is ‘captured’ by the auditing profession in the same way that professional accounting bodies had ‘captured’ the national auditing standard setting process before the Sarbanes-Oxley Act in the US and CLERP 9 in Australia. Even though governments appear to have taken control of auditing standards, their reliance on the IAASB potentially undermines government authority.94

The IAASB appears to be aware of the threat to its credibility and power by its reliance on professional accountants for funding and expertise. The IFAC established the Public Interest Oversight Board (PIOB) in 2005 with the objective of increasing confidence in the standards issued by the IAASB and other IFAC bodies.95 Its aim is to ensure that standards are set in a transparent manner that reflects the public interest, with input by the public and regulators, and to facilitate audit regulation. As discussed further in chapter 14, the future success of the IAASB relies on successful enforcement of the auditing standards and retaining the trust of the various stakeholders.

Governments appear to believe that accounting and auditing standards matter, and they have some support from research for their view. There is evidence that the strength of accounting and auditing standards and the effectiveness of their enforcement are factors in the successful development of financial markets around the world. Francis, Khurana and Pereira gathered evidence on the quality of auditing, the strength of auditing enforcement, and the quality of accounting standards and found that high-quality accounting and auditing are more likely to exist in corporate governance with strong investor protection.96 However, although higher quality accounting and auditing are also positively associated with financial market development in these countries, the evidence does not support the contention that they are sufficient to encourage the development of financial markets without strong investor protection. One example of how the actions of auditors can impact on individual companies and on the broader market is addressed in theory in action 3.4. The article presented considers the market impact of auditors giving an ‘emphasis of matter’ opinion, which may be necessary for some companies following the 2007-08 financial crisis.
Many small caps to flash orange

by Damon Kitney and Patrick Durkin

Hundreds of small Australian Securities Exchange-listed companies will have their half-yearly accounts flagged by auditors over the next fortnight because of concerns they may fail to stay in business over the next 12 months.

The ongoing impact of the credit crisis means directors of many small companies will be unable to guarantee that their company will continue as a going concern, especially where they face rolling over their debt.

The warning by directors and accountants follows a crackdown by the Australian Securities and Investments Commission on insolvent trading and comes as the half-year reporting season draws to an end over the next two weeks — when many cash strapped companies tend to report.

In December, ASIC said directors should focus on whether companies will remain solvent given their ability to refinance debt, raise funds and comply with lending covenants.

"Managing banking covenants in an environment where asset values are dropping can be a very difficult thing, said Jeff Lucy, chairman of the Financial Reporting Council — the oversight body for accounting and auditing standards in Australia.

"For a small mining company, for instance, a drop in commodity prices leads you to look at the carrying value of mines. This reduces asset values, which then affects banking covenants." When signing off on accounts, auditors are also required to provide an assurance that companies will remain solvent over the next 12 months. Where there is uncertainty about whether a company can continue as a going concern, auditors are required to flag the accounts with "an emphasis of matter".

The technical accounting warning is one step below a "qualification", which is the most serious warning about potential irregularities in company accounts.

KPMG's national managing partner, risk and regulation, Michael Coleman, said he expected to see more accounts flagged with an "emphasis of matter" in the current environment because of uncertainty about their debt profile. But the high number of flagged accounts has created alarm among accountants and regulators amid concerns that investors may misinterpret the findings.

"In this environment, a simple event has a chain reaction," Mr Lucy said. "In putting the truth on the table, it can have a snowball effect. There needs to be a mature judgement applied. Does it mean that wheels are about to fall off? No. But rather than a qualification, which is a red flashing light, an emphasis of matter is really an orange glow."

The matter was discussed at a meeting of the Financial Reporting Council in Melbourne last week attended by Mr Lucy, Corporate Law Minister Nick Sherry and the new chairman of the Australian Accounting Standards Board, Bruce Porter.

"It is emphasising to the readers this particular point, it is saying go and have a look at this, go and have a read so you fully understand the accounts because of this uncertainty," Mr Porter said. "It is saying there is a lack of evidence to say 100 per cent [that this company will survive," he said.


Questions
1. What does the headline of the article mean by 'small cap' and 'flash orange'?
2. Explain the argument that merely by placing an 'emphasis of matter' section in an audit report you could start a chain reaction.
3. The article discusses bank covenants — explain the impact of asset values on bank covenants and the potential repercussions for a company.
The theories of regulation which are relevant to accounting and auditing

The aim of theory is to explain and predict real world phenomena. In this chapter we reviewed theories proposed to explain the practice of financial reporting and auditing. Theories from economics including the theory of efficient markets and agency theory are relevant to understanding the environment in which financial reporting occurs. Both these theories help us to understand the role of financial information and the incentives for its production. Specific theories of regulation also provide insights about how and why we observe the regulation of financial reporting.

Public interest theory proposes that governments or their agents introduce regulation to compensate for market failure. Regulation is intended to protect the interest of individuals and society as a whole; with regulation society is better off than otherwise. In relation to financial reporting, the assumption is that regulation will improve information flows thus improving capital market efficiency. In this theory the government is an independent party. Its agents respond to requests from 'entrepreneurial politicians' and public interest groups to intervene in the market. While it could be argued that these parties are acting in part with self-interest, the regulatory intervention is claimed to have some overall genuine public interest.

Regulation is not costless. It involves wealth transfers and therefore has economic consequences for the parties being regulated. Capture theory proposed that parties subject to regulation seek to control the government or its agents who are responsible for issuing the regulation. The theory assumes that individuals are economic rationalists and they will pursue their own self-interest. Thus, they act to increase and protect their wealth by seeking control of the regulating body. For example, they secure control by dictating the body's activities and agenda or by neutralising it (i.e. ensuring that its performance is ineffective).

A third theory takes a somewhat different perspective. Private interest theory proposes that, in contrast to the two prior theories, the government is not independent. It has the 'power to coerce' and will exercise this power in the way which best suits government objectives. Thus politicians are not neutral arbiters, but exercise their power to maximise their future electoral success. The government does not regulate in the public interest but rather in response to the private interest group with the most voting power. In capital markets the group with the most incentive and resources to lobby for their preferred regulation is often from the listed company or corporate sector.
How theories of regulation apply to accounting and auditing practice

In this section, we explored the extent to which public interest, capture and private interest theories can be applied in practice. We observed that governments in many countries have intervened in the process of setting accounting and auditing standards. Although standards were initially under the control of the private sector, a succession of events led to government control in many countries. For example, in Australia accounting standards were developed by the accounting profession. The government intervened in the accounting standard setting process from the 1980s by setting up bodies with the responsibility for promulgating accounting standards. We discussed the extent to which such bodies were 'captured' by the parties for whom they were creating regulations. We also considered the role of private interest groups in obtaining regulation favourable to their own interests.

The final part of this section expanded on the theme of the political nature of standard setting and regulation. Noted US academic Stephen Zeff has described standard setting as an inescapably political process. This view applies not just to the United States, but equally in other countries as well. We observed that the adoption of IASB standards in the European Union has taken the politicisation of accounting standard setting to a new level. Zeff explains that there are a range of parties involved, with different objectives and cultural preferences, which has resulted in a lengthy endorsement process subsequent to the IASB’s standard setting process (already a highly political process). We reviewed the adoption of IAS 39 in Europe to illustrate some of the issues involved.

The regulatory framework for financial reporting

Financial reporting does not occur in a vacuum. There are many factors which influence the process of producing financial information. In this section we described a number of key elements which may be observed in a number of countries' financial reporting framework. Our aim was to provide a 'proforma' of the regulatory framework and to show how the elements affect the production of financial reports. First, we discussed statutory requirements, that is, the laws which require preparation and auditing of financial reports. Such laws may be contained in company, securities market and taxation law. Common requirements which affect preparation of financial reports are the duty to prepare accounts (in accordance with accounting standards and other legal requirements), to have them audited by an external auditor and to lodge them with a government body. Next we referred to corporate governance. Some corporate governance practices follow requirements of law, while others reflect 'best practice' recommendations developed by the private sector. Examples of the former include the EU directives on corporate governance and examples of the latter are the governance codes which have been adopted in the United Kingdom and Australia.

Compliance with financial reporting requirements is promoted by external auditors and independent enforcement bodies. We observed that in many countries auditors have traditionally been the most important parties for promoting compliance with accounting standards. As a result of adoption of IASB standards in 2005 many countries have set up independent enforcement bodies. While some people consider such bodies a waste of resources (they have been described as 'checking the checkers'), many commentators point to the necessity of consistent enforcement across countries to ensure comparable application of IFRS. It is argued that without coordinated enforcement the benefits of adoption of international standards will not be achieved. We described the types of body which have been set up and the enforcement coordination mechanisms which have been put in place. An evaluation of the role and effectiveness of these bodies will occur in the future.
The institutional structure for setting accounting and auditing standards

In the final section of this chapter we provided an overview of the development of international bodies that provide accounting and auditing standards. We discussed the background to the current processes for developing international accounting standards, beginning with the formation of the IASC in 1973 and then the IASB in 2001. Key issues discussed were: IOSCO’s support for a set of core standards; the EU’s decision to adopt IASB standards from 2005; and the greater involvement of the United States in international standard setting, resulting from the IASB/FASB convergence project, which commenced in 2002.

We also discussed the setting of auditing standards. The professional accounting bodies have a long history of involvement with standard setting, which parallels the history of legal requirements for audits. Regulation of auditing occurred despite evidence that audits are demanded in the absence of regulation. Professional accounting bodies wrote the first auditing standards but governments have used market failures to justify regulating auditing standards in the United States and Australia. However, the Australian auditing standards are based on the international standards which are written by a body controlled largely by practising auditors. An oversight body has been established to ensure the standards reflect the public interest and have due regard to the views of regulators. Empirical research supports the role of accounting and auditing standards and their effective enforcement in the development of financial markets around the world.

Questions

1. General acceptance of accounting standards is important to the accounting profession. By whom does the profession require general acceptance of the standards, and why is it important to the profession?

2. The standard setting process is highly political. Describe an accounting regulation that would be politically controversial, and the types of political pressures that could be brought to bear in the standard setting process.

3. The text describes a theory of regulatory capture.
   (a) What is regulatory capture?
   (b) How can standard setting bodies such as the AASB avoid regulatory capture?
   (c) If a standard setting body is 'captured' by the profession, are there any steps that the government can take to make the body independent? If so, should the government take those steps? Justify your answer.
   (d) Do you believe that the current international accounting standard setting arrangements, based around the IASB, are at risk of regulatory capture? Why or why not?

4. In under 500 words, provide an argument for the regulatory approach to standard setting. Then, in under 500 words, provide an argument for the free-market approach to standard setting. Finally, analyse the arguments and conclude in favour of one approach rather than the other (which approach you favour is up to you, but you must decide which approach is better, at least under a set of assumed circumstances).

5. If the IASB concludes that the economic consequences of a standard it is about to approve will disadvantage a powerful lobby group, what should the IASB do about the situation?
6. How do you think accounting standards should be set? Is that the approach currently taken by the IASB?

7. ‘We should disband national standard setters. They are of no use following the adoption of international accounting standards’. Explain whether you agree or disagree with this statement.

8. What are ‘free-riders’? How can a system ensure that those who benefit most from an accounting standard requiring certain disclosures also bear the greatest costs of it?

9. The setting of accounting standards requires some assessment of economic and other benefits and costs. What are the ethical issues involved? Is it possible to avoid ethical issues in developing accounting standards?

10. You have been appointed as chief accountant of a firm that will be adversely affected by the method of accounting that is proposed in an exposure draft for an accounting standard on leasing. Write a report of 500 words or less explaining to your Board of Directors how you could lobby the AASB and the IASB to adopt an accounting practice other than the one proposed in the exposure draft. Also comment on the costs and benefits of lobbying for the company.

11. In 2001 and 2002 there were several high-profile corporate collapses in the United States associated with misleading financial statements and accounting practices. Following these collapses, new laws were introduced to improve the quality of financial reporting.
   (a) In your opinion, will further regulation prevent deliberately misleading reporting? Explain.
   (b) Are additional laws likely to prevent corporate collapses? Why or why not?
   (c) How important is the enforcement of financial reporting requirements in promoting high quality reporting?

12. Each of the three theories of regulation discussed in this chapter has its strengths and limitations in describing accounting standard setting, either past or present. What do you believe are those strengths and weaknesses? Provide an example where you believe each of the theories has applied, or is likely to apply.

13. From 1 January 2005 Australia adopted IASB standards.
   (a) Do you agree with this change? Why or why not?
   (b) Who stands to gain from Australia's adoption of IASB standards? Explain.
   (c) Who stands to lose from Australia's adoption of IASB standards? Explain.

14. What is the role of the Financial Reporting Council? Do you think that all members of the Financial Reporting Council should be qualified accountants? Why or why not?

15. The IASB and FASB began a convergence project in 2002.
   (a) What are the expected benefits of the convergence project?
   (b) What factors make convergence difficult?
   (c) How is the future of the IASB tied to convergence?

16. Should the SEC allow the use of IASB standards for US domestic listed companies? Discuss reasons for and against the use of IFRS by US companies.

17. Why has IFAC established a Public Interest Oversight Board?

18. Why would the quality of accounting and auditing standards affect the development of financial markets? Why is the strength of enforcement of the standards and investor protection important in this relationship?
Additional readings


Websites

Australian Accounting Standards Board (AASB) www.aasb.com.au
Australian Securities and Investments Commission (ASIC) www.asic.gov.au
CPA Australia www.cpaaustralia.com.au
Deloitte IASPlus www.iasplus.com
Ernst & Young www.ey.com.au
European Financial Reporting Action Group (EFRAG) www.efrag.com
Fédération des Experts Comptables Européens (FEE) www.fee.be
Financial Accounting Standards Board (FASB) www.fasb.org
Financial Reporting Council (FRC) www.asb.org.uk
Financial Reporting Council (FRC) www.frc.gov.au
Google scholar www.scholar.google.com
Institute of Chartered Accountants in Australia (ICAA) www.icaa.org.au
International Accounting Standards Board (IASB) www.iasb.org
KPMG www.kpmg.com.au
PricewaterhouseCoopers www.pwc.com.au

Balancing the costs and benefits of regulatory intervention

US’s Snow urges balance in Sarbanes-Oxley rules

US Treasury Secretary John Snow on Wednesday warned against using Sarbanes-Oxley financial reporting rules in ways that might dampen economic growth, and he sympathized with the plight of corporate executives who are under regulatory scrutiny.
'We need to maintain balance in our enforcement,' Snow said in prepared remarks to the New York University Center for Law and Business. 'We need to make sure the
emphasis is on substance and not form. We need to make sure that innocent mistakes are not criminal,' he said. Congress passed Sarbanes-Oxley in 2002 in response to a series of high-profile corporate scandals that felled Enron, WorldCom and the accounting firm Arthur Andersen. The law, named for Ohio Republican Rep. Michael Oxley and Maryland Democratic Sen. Paul Sarbanes, calls for strict financial reporting standards and accountability. Snow's comments come amid widespread complaints by businesses that Section 404 of the law, which requires managers to explain publicly how they look after corporate finances, is too costly and time-consuming. In a question and answer session with the audience, he said that he was sympathetic with the 'world' in which corporate executives and lawyers are living where they are 'under siege' from regulators. 'We've overdone this. We have got to find a way to rationalize this whole corporate governance regulatory process,' Snow said.

The treasury secretary warned that while Sarbanes-Oxley was essential in restoring public confidence in businesses after the scandals, it runs the risk of being a drag on US corporate effectiveness and willingness to invest in growing capital. 'This whole climate we find ourselves in, which Sarbanes-Oxley is only a part, may have altered the appetite for risk taking and may have engendered a risk-averse attitude,' Snow said in response to a question from the audience. He added that the ratio of capital spending to cash flows and corporate profit is lower than one would expect due perhaps to a reluctance among US companies to take risks. However, Snow maintained that passing Sarbanes-Oxley was necessary due to the acts of a few corporate miscreants and that modifying the law at this point would be ill-advised. 'Even though we all know there are ways that you could tweak (Sarbanes-Oxley) this way or that, the consequences of trying to amend it to deal with those issues this early in the process would have a political backlash that would be unfortunate and counterproductive,' he said.


Questions

2. Why are some parties now opposed to the Act? Why has their view changed from when the law was first introduced?
3. According to John Snow, what criteria should be considered in determining financial reporting rules?
4. Would you recommend a repeal of the Act? Why or why not?

Are bean counters to blame?

by Andrew Ross Sorkin

Some blame the rapacious lenders. Others point to the deadbeat borrowers. But Stephen A. Schwarzman sees another set of culprits behind all the pain in the financial industry: the accountants.

That's right, the bean counters.

A new accounting rule — "an accounting rule!" — partly explains why the American financial system looks so wobbly these days, he says.

Mr. Schwarzman, the co-founder of the private equity giant Blackstone Group, has been espousing this view for weeks over lunches and at cocktail parties around the globe. It's a controversial hypothesis, which others have put forward before, and it has sparked plenty of debate within the industry. But Mr. Schwarzman is convinced that the rule — known as FAS 157 — is forcing bookkeepers to overstate the problems at the nation's largest banks.
"From the C.E.O.'s I talk with," Mr. Schwarzman said during an interview on Monday morning, "the rule is accentuating-and amplifying potential losses. It's a significant contributing factor."

Some of his bigwig pals in finance believe that Wall Street is in much better shape than the balance sheets suggest, Mr. Schwarzman said. The president of Blackstone, Hamilton E. James, goes even further. FAS 157, he said, is not just misleading: "It's dangerous."

Huh? So the Citigroups and Merrill Lynches of the world are writing off billions of dollars — but they haven't actually lost the money?

Sort of. If Mr. Schwarzman is to be believed — and there's some evidence he might be right, at least partly — it all goes back to FAS 157, which went into effect Nov. 15, just as the credit hurricane tore through Wall Street. Remember, that was about the time Citigroup ousted Charles O. Prince III after the bank shocked investors by writing down $5.9 billion and Merrill Lynch showed E. Stanley O'Neal the door after it was forced to write down $8.4 billion. (The pain didn't end there, for either of those companies or the rest of the financial industry.)

FAS 157 represents the so-called fair value rule put into effect by the Financial Accounting Standards Board, the bookkeeping rule makers. It requires that certain assets held by financial companies, including tricky investments linked to mortgages and other kinds of debt, be marked to market. In other words, you have to value the assets at the price you could get for them if you sold them right now on the open market.

The idea seems noble enough. The rule forces banks to mark to market, rather to some theoretical price calculated by a computer — a system often derided as "mark to make-believe." (Occasionally, for certain types of assets, the rule allows for using a model — and yes, the potential for manipulation too.)

But here's the problem: Sometimes, there is no market — not for toxic investments like collateralized debt obligations, or C.D.O.'s, filled with subprime mortgages. No one will touch this stuff. And if there is no market, FAS 157 says, a bank must mark the investment's value down, possibly all the way to zero.

That partly explains why big banks had to write down countless billions in C.D.O. exposure. The losses are, at least in part, theoretical. Nonetheless, the banks, in response, are bringing down their leverage levels and running to the desert to raise additional capital, often at shareholders' expense.

Mr. Schwarzman and others say FAS 157 is forcing underserved write-offs and wreaking havoc on the financial system. There is even a campaign afoot in Washington to change the rule.

Some analysts, even insiders, say banks like Citigroup and Lehman Brothers marked down some of their C.D.O. exposure by more than 50 percent when the underlying mortgages wrapped inside the C.D.O.'s may have only fallen 15 percent.

Bob Traficanti, head of accounting policy and deputy comptroller at Citigroup, said at a conference last month that the bank had "securities with little or no credit deterioration, and we're being forced to mark these down to values that we think are unrealistically low."

As a result, Citigroup went hat in hand to Abu Dhabi, selling a significant stake and diluting existing shareholders in the process. According to the Securities and Exchange Commission, FAS 157 requires an institution "to consider actual market prices, or observable inputs, even when the market is less liquid than historical market volumes, unless those prices are the result of a forced liquidation or distress sale."

As a result, Christopher Hayward, finance director and head of holding company supervision initiatives at Merrill Lynch said: "There is a bit of this pressure, a bit of this atmosphere that says, 'Let's just mark it down, no one is going to question it if we mark it down.'"

Of course, Mr. Schwarzman's theory only holds up if the underlying assets are really worth much more than anyone currently expects. And if they are so mispriced, why isn't some vulture investor — or Mr. Schwarzman — buying up C.D.O.'s en masse?
For Mr. Schwartzman’s part, he says that the banks haven’t been willing to unload the investments at the distressed prices. Besides, the diligence required for most buyers is almost too complicated.

It is not clear that Mr. Schwarzman’s view is correct. The folks at the University of Chicago — those the-market-is-always-right guys — take umbrage at the mere suggestion that marking-to-market is not always appropriate.

FAS 157 proponents say that if Mr. Schwarzman and his crowd get their way, financial companies might end up valuing investments based on market prices when it suits them, and just look the other way when it doesn’t.

"He's entitled to his view, but I don't agree" said Daniel Alpert, managing director at the investment bank Westwood Capital. "I don't believe that people are taking write-downs that forces them to dilute their shareholders." If anything, Mr. Alpert says, "There is still a lot of sludge out there."

Mr. Schwarzman is suggesting that the market is somehow wrong, or wildly inefficient. (Of course, Mr. Schwarzman is a private equity guy, so the day-to-day swings in the market in his mind are always wrong.)

But some say Goldman Sachs proved why FAS 157 works: Goldman has been marking its books to market for years, and as a result, its risk officers were able to hold back its go-go traders from making bad bets when everyone else was throwing down their chips last year into the subprime game.

Of course, the purpose of FAS 157 was to make the market more transparent and efficient, which Mr. Schwarzman doesn’t take issue with.

"The concept of fair value accounting is correct and useful, but the application during periods of crisis is problematic," he said. "It's another one of those unintended consequences of making a rule that's supposed to be good that turns out the other way."

Let's hope he's right.

This article has been revised to reflect the following correction: The DealBook column on Tuesday, about an accounting rule that a private equity executive says is causing bank write-downs to be exaggerated, misstated the name of the organization that establishes accounting standards. It is the Financial Accounting Standards Board, not the Federal Accounting Standards Board.


Questions
1. List possible factors contributing to the banking crisis (the problem of bad debts relating to collateralised debt obligations, i.e. the so-called sub-prime crisis, which began in mid-2007 and became a more general global financial crisis in October 2008).
2. Has the market benefited from the regulation requiring the use of fair value accounting for financial instruments?
3. According to people quoted in the article, did the US capital market efficiently price the collateralised debt obligations (CDOs)?

The following five events represent significant developments in relation to the adoption and use of international accounting standards.

1. **June 2002** — The European Commission announces plans to adopt international accounting standards (IAS) for consolidated financial statements of all listed companies in European Union (EU) member states from 1 January 2005.
2. **October 2004** — The European Commission endorses IAS for use in the EU, with the exception of certain provisions of IAS 39 relating to hedge accounting and fair value measurement of financial instruments. When complying with IASB standards from 2005, companies will not be required to follow the excluded provision of IAS 39.
3. April 2005 — The European Commission seeks rule changes to make it easier for EU companies cross-listed in the United States to de-list from US stock exchanges. The Commission is seeking agreement from the United States securities market regulator, the SEC, to change the current requirement that companies show they have fewer than 300 shareholders before they are permitted to cease registration in the United States.

4. November 2007 — The SEC announces that from 2007, companies cross-listed on US stock exchanges which prepare accounts based on IAS are permitted to file financial reports with the SEC without reconciling the reports in accordance with US GAAP.

5. October 2008 — The IASB announces amendments to IAS 39 which permit companies to choose to reclassify items out of categories requiring fair value measurement into categories where amortised cost is used. The amendments were announced in response to the 2007–2008 financial crisis and were made without following the IASB’s due process.

Question
After considering the material presented in this chapter, what would be possible explanations for each of these five events?

Endnotes


8. For example, governments can provide subsidies to corporate entities; create and enforce barriers to entry within industries; and allow corporate directors to avoid detailed disclosures on bonuses and benefits received. In turn, these 'regulated' benefits have the potential to transfer monies from other parties such as, respectively, taxpayers, consumers within the 'closed' industry, and shareholders and other investors to the management of the 'favoured entities'.


12. Ibid.


G Whittred, 'The derived demand for consolidated financial reporting', Journal of Accounting and Economics, December 1987; D Skinner, 'Why firms voluntarily disclose bad news'.

88 PART 1 Accounting theory


23. The Australian Accounting Research Foundation was funded by the professional accounting bodies (ICAA and CPAA) to carry out research and participate in setting accounting and auditing standards for the public and private sector during the period 1966–2000.

24. This finding by Walker is consistent with that of Willmott op. cit., p. 63, who investigated the setting of accounting standards in the United Kingdom and the role of the accounting bodies in that process.


29. ibid., p. 2.


31. For example, refer to M Dobbie, 'SAC 4: the great debate', *Financial Forum*, vol. 2, no. 4, May 1993, pp. 1, 3, 5; and D Soh, 'G100 pulls the rug on SAC 4', *New Accountant*, vol. 6, no. 7, 15 April 1993, pp. 1, 9.


43. Jones and Venuti, op. cit.


46. Orsini, op. cit.


48. Orsini, op. cit.

49. While cases have been taken against members, self-regulation is always limited by the disciplinary bodies’ willingness to pursue cases against their peers.


52. The Committee of European Securities Regulators (CESR) CESR’s review of the implementation of
73. New York Stock Exchange; National Association of Securities Dealers Automated Quotations; American Stock Exchange.
74. IASB ‘About us’, www.iiasb.org/about/index.asp.
77. See chapter 4.
82. P De Lange and B Howieson, ‘On a slow boat to convergence: the relationship between the USA and International Accounting Standards’, working paper, University of South Australia, 2004.
83. See chapter 4.
84. IASB, ‘How do national standard setters fit into the IASB’s activities?’, www.iiasb.org.
85. A term used by Zeff; see Zeff 2008, AAR, p. 279.
88. CPA Australia was formed as the Australian Society of Accountants in 1952 from a merger of several professional accounting societies, the oldest of which, the Incorporated Institute of Accountants, was formed in 1886, www.cpaaustralia.com.au.
89. A Companies Act termed the ‘accountants friend’ is passed in 1862. The Act establishes the role of Official Liquidator, a person responsible for proceedings in the liquidation of public companies, the act creates a large source of revenue for accountants. Another Companies Act is passed in 1867, www.icaew.com.
92. ibid.