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Working Papers Series

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Regulation: Standardising Accounting Practice

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This is the practical extension of a previous paper (Gaffikin, 2005) in which the actual attempts to regulate accounting are described and discussed. A most important element of this is the attempts to establish a conceptual framework by the professional bodies. In Australia much of the thrust for regulation has been captured by the law – CLERP. To date there has been an attempt to integrate professional and legal regulation of the discipline with considerable cooperation between those involved.

There was, in the United States in the 1920s, in keeping with the spirit of the times, tremendous optimism leading to the widespread purchasing of shares (stock) in companies. Shares were purchased like many other commodities rather than as a result of careful investment planning. As a result, in the Stock Market Crash that precipitated the “Great Economic Depression” of the 1930s, many people lost great sums of money and consequently suffered extreme economic hardship; some, to the extent that it led to their suicide. Part of the reason for the massive corporate collapses was that the accounting for these companies was more directed to satisfying management whim than attempting to portray any perceived underlying economic reality. Often the motives of the management were the sale of the shares rather than the long term survival of the company through prudent planning and careful administration.

Principles for Practice

One consequence of the Stock Market Crash was a strong call for the discipline of accounting to produce financial information on which interested parties could rely – information that bore some correspondence to economic reality and with uniformity of practice by practitioners. These calls were manifested in at least two quarters. First, the New York Stock Exchange (NYSE) called on the accounting profession to develop a list of accepted accounting standards. Secondly, was the government creation of the Securities Exchange Commission (SEC) in 1934. It was important for the NYSE to restore public confidence in investing in corporations. In response to the call from the NYSE, the American Institute of Accountants (now the AIPCA) produced a list of five principles, viz

1. Unrealized profit should not be credited to net income. Profit is realized when a sale is completed.
2. Additional paid-in capital should not be charged with items that are more appropriately charged to net income.
3. Retains earning of a subsidiary should not be added to consolidated earnings.
4. In rare circumstances, treasury stock may be considered an asset of the firm, but dividends on such shares should not be considered as revenue.

5. Officers', 'affiliates', and employees' notes receivable should be separately disclosed.

The listing of these principles marked the beginning of the attempts by the profession to regulate the practice of accounting. It was the start of moves by the profession to establish a regime of self-regulation. Serious self-regulation was seen as necessary to prevent the intervention by the state in enforcing regulation on accounting practitioners. Thus, it was seen as necessary to maintain the integrity of the profession of accounting as the capacity to effectively self regulate was viewed as one of the hallmarks of a profession. The accounting profession, therefore, remained very private enterprise in keeping with the ideology of capitalism.

But, the state did intervene in creating the SEC as one of its functions was the oversight of the published accounting information of publicly listed corporations. However, after much debate between the SEC and the profession it was decided that the SEC would leave the profession to develop principles of accounting practice which would eventually become generally acceptable as a standard of professional performance. As indicated in the previous chapter, there have been varying interpretations placed on the reason for the state's intervention in creating the SEC and why the SEC delegated its accounting responsibility to the profession. Taken together, both the creation of the SEC and the profession's serious attempts at effective self-regulation would tend to suggest that they were necessary to preserve capitalism from the public disenchantment that marked the great depression.

These developments in the 1930s greatly affected processes of accounting regulation in the United States. Questions surrounding the issues involved continued for many years. Another period of major change in attitudes and the practices of accounting regulation started forty years later.

“New” Accounting

There were many changes in perceptions of accounting in the decade of the 1970s. As indicated in previous chapters there was a major shift in the approach to accounting research – the era of neo-empirical research began. There was also a major change in the approach to accounting regulation in the USA. There was significant dissatisfaction with the operation of the Accounting Principles Board (APB) which had been set up in 1959 to replace the Committee on Accounting Procedures which had been seen as failing to develop any theoretical foundations for accounting. The profession (AICPA) established two committees in the early 1970s. One was The Study Group on the Objectives of Financial Statements (Trueblood Committee) and the other The Study Group on the Establishment of Accounting Principles (Wheat Committee), both referred to by the names of the chairmen.

The Trueblood Committee issued its report towards the end of 1973 listing twelve objectives of financial reporting. A central theme of these objectives indicates a major (stated) shift in the perceptions of the use of accounting (financial statements). This was a greater recognition of the importance of accounting to decisions making, especially

investment decisions. This seems to reflect a general perception in the community and is certainly consistent with the conclusions of the American Accounting Association's ASOBAT and the thrust of neo-empirical accounting research. Consequently, the conclusions were not seen as not being a dramatically new development.

On the other hand, the conclusions of the Wheat Committee did signal a major change. This was in respect of the manner by which accounting self-regulation was to be maintained. The most radical development was the creation of a body independent of the AICPA, charged with the responsibility for regulating accounting practice: the Financial Accounting Standards Board (FASB). Actually the Wheat Committee established three bodies. There is first, the Financial Accounting Foundation (FAF) which has sixteen trustees. The other two bodies are the FASB and the Financial Accounting Standards Advisory Council. The FAF funds the other two bodies, appoints their members and oversees the operations of the FASB. It is the FASB that is responsible for the issuance of accounting standards. Unlike the other bodies FASB's seven members, not all of whom are practising accountants, are full time serving a maximum of two five year terms. It also employs staff to work on its projects.

The FASB issues several types of publications which include **Statements of Financial Accounting Standards** (which form GAAP) and Interpretations which explain, clarify and elaborate on GAAP. It also has undertaken a major project to establish a theoretical foundation for accounting known as a **Conceptual Framework**. This is an ongoing project and the FASB, from time to time, issues *Statements of Financial Accounting Concepts* (SFAC) as elements of the overall conceptual framework. There is a due process for issuing accounting standards which has not always been followed and this has been a major criticism levelled at the FASB. The issuing of SFACs has been a more painful and protracted process for the FASB and the project seems to have stalled. Reactions to these pronouncements were similar to those that followed the Accounting Research Bulletins by the Accounting Research Division of the APB – debate, controversy and inaction.

Regulation of Accounting Outside the United States

The brief outline above of the attempts to develop principles, and then a conceptual basis for accounting, has centred on developments in the United States. The major reason for this is that the United States has undoubtedly led such developments. However, similar attempts were being made outside the United States but often these were replicating much of what had gone on there. Not only does this suggest the United States was leading accounting thought but it is interesting to speculate on why this was so. Most people would agree that the political, economic and social environment in the United States was much more conducive to the development of accounting. Accounting was more readily accepted into university education in the United States than elsewhere¹. In Great Britain there were social barriers to the acceptance of accounting. It was necessary for those wishing to pursue a career in accounting to start as an articled clerk. This was a form of

¹ The first university accounting course was offered by the Wharton School of Finance and Economics, University of Pennsylvania in 1883.

apprenticeship and usually the clerk would pay for the position rather than be paid. Thus, only those who could afford to pay became accountants. Completion of the period of clerkship and passing professional examinations entitled a person (usually male) to apply for membership of the Institute of Chartered Accountants of England and Wales (ICAEW) – for those residing in England and Wales. Similar arrangements existed for those in Scotland and membership of the Institute of Chartered Accountants in Scotland. A university education played no (necessary) part in achieving professional accounting association membership. However, by the middle of the twentieth century there was much greater “democratisation” and more professional bodies were recognised. These bodies had different entry requirements although they still maintained the passing of professional examinations as a prerequisite of membership. However, despite the “recognition” of these “other” bodies there was very little professional interaction and perceived “class distinctions” persisted. Even relations between the two main institutes of chartered accountants were not that cordial!² It is important to be aware of this because it has had direct implications on the processes of accounting self-regulation. In the USA professional organisation was more ordered and the different accounting bodies represented different functions undertaken by accountants – financial reporting and auditing, management accounting financial analysis and so on. This was initially also true in the UK but there was considerable subsequent broadening of the membership base of many of the organisations so that often the different accounting bodies were in competition for membership. The development of accounting principles, therefore, tended to be much slower in Great Britain. (cf Zeff, 1971)

It is also important to note the British environment because it impacted on the development of the profession in the countries that had been subject to British colonisation – the previous colonies, dominions or members of the Commonwealth of Nations³. In both Canada and Australia there are more than one professional body representing accountants. Any move to develop accounting principles has necessitated cooperation. In New Zealand there has generally only been one professional accounting body but it is arguably the country that has followed Britain more closely than the others. In Great Britain and in these other countries there was for many years a much greater reliance on statute, especially the companies (corporations) laws, than in the USA. In most of these countries the push for accounting principles started in earnest around the middle of the twentieth century.

² The title chartered derives from the granting of a royal charter which has some social implications! By 1887 there were five chartered accounting bodies – Edinburgh, Glasgow, Aberdeen, England and Wales and Ireland. The first three later combined to form the Chartered Accountants in Scotland. Although a predecessor body was founded in 1919, the (now) Chartered Institute of Management Accountants (CIMA) only received its Royal Charter in 1975. CIMA, as its name suggests, has concentrated on promoting management accounting. The Association of Certified and Corporate Accountants (ACCA) was for many years seen as a body of “lesser professional status” than the ICAEW and only received its Royal Charter later in the twentieth century. Early attempts at developing accounting regulation in the UK did not include these two bodies although other non-accounting bodies (for example the London Stock Exchange, the City Panel on Take-overs and Mergers etc) were consulted!

³ This is not only true of ex-British colonies but those of other countries as well, for example France. This proposition is supported by Nobes (1998, p 170)

Accounting was regarded very differently in most of the continental European countries. Recognition of accountants as independent professionals was much slower coming. In France the first accounting regulation was contained in the Code Savary of 1673. However, accounting was seen as a technical practice whether it be preparing financial reports (financial accounting), auditing or management accounting and was regarded as part of overall governance of business. Accounting in France, along with many other aspects of life, was affected by the Second World War and additional laws were drafted. After the war (1947) an accounting plan was devised that would apply to every sector of the economy. The plan – Plan Comptable Général- included a chart of accounts to which all accounting in businesses was to comply. With developments in the second half of the twentieth century the Plan gradually lost its relevance. This developments included the growth of different forms business transactions, information technology and establishment of the European Union (EU), with the last mentioned increasingly directing the course of accounting regulation.

In Italy, the Collegio dei Raxonati of Venice was the first professional society of accountants, founded in 1581. This body closely regulated the activity of those offering accounting services so probably can be seen as the first (Western) accounting regulator. There were many developments in accounting thought, from the teaching of accounting to the practice of it, in Italy over the centuries. Many “theories” were suggested. Fabio Besta published a three volume treatise around the turn of the twentieth century which included the definition of accounting as “the science of economic control”. Thus, as in France, in Italy accounting was viewed as part of the overall business control environment. Also like France, accounting regulation was, towards the end of the twentieth century gradually subsumed by EU directives. German accounting was influenced by developments in Italian accounting thought. Similar attitudes to accounting existed there with obvious local differences.⁴

The Netherlands stands alone in experimenting with an accounting court in which disputes about the most appropriate accounting practices were settled “legalistically”. Thus, accounting in the non-English speaking world, until very recently, seems to have been perceived very differently to that in the English speaking countries.

In respect to the process of economic regulation, as indicated in the previous chapter there were, for many years, different ideologies in Europe and in the United States. Accounting practices were seen as part of the broader business environment. However, as many of the attempts to regulate business in Europe were perceived as failing there was a switch to emulating that which was seen as succeeding – that in the United States. Ironically, any analysis of developments in the United States will show that such attempts were also “failing”. Nevertheless, the economic success and strength of the US economy seemed to indicate otherwise. This was despite the spectacular economic successes of other countries in the second half of the twentieth century, notably, Japan and Germany (prior to the 1990s reunification). Both these economies had significantly different

⁴ The period in Germany after the First World War was dramatically affected by the extreme inflation and German accountants and economists had to tackle the problem of how to produce financial statements that bore any semblance to economic reality.

approaches to regulating business than the United States! Perhaps it was also because of the enormous political power wielded by the United States together with its demonstrated economic strength, that many felt it desirable to follow US practice. This was evident in the Indonesian accounting profession adopting the US principles enunciated by Paul Grady in ARS7 as its principles. Similarly in Australia where John Kenley was commissioned by the accounting professional bodies to adapt Grady's work to Australia (Kenley, 1970) and this was followed by an adaptation of APB Statement No 4 (Kenley and Staubus, 1972).

Internationally, there are three broad types of accounting regulatory regimes, two which are private and one which is government controlled. First, there are those countries where the professional accounting body (bodies) assume (assumes) responsibility for developing accounting standards (for example, Canada, Hong Kong, New Zealand and Taiwan). Secondly, there are independent bodies established to develop accounting standards with the accounting professional bodies bring one contributor (for example, UK and USA). Many of the countries with this type regulatory arrangement "evolved from the first form as the discussion of regulation in the United States has indicated. The third form is where the government assumes responsibility for accounting regulation including accounting standards (for example Australia, China, France and Malaysia). Some of these countries have "evolved from the first type as, for example, in Australia. The expression self-regulation is used in respect of the first two types. In the third type regulation is invariably developed through government legislation.

The Development of Standard Setting in Australia

Early attempts in Australia to issue accounting principles merely mimicked those previously issued by the ICAEW. They were recommended accounting principles and issued by the Institute of Chartered Accountants in Australia (ICAA) in 1946. They had little impact on accounting practice and there was a high degree of non-compliance. This attempt illustrates the two points made above, first, the influence of Great Britain and, secondly, the lack of a single professional body and the lack of cooperation of the many bodies that did exist. Two main accounting professional bodies dominated accounting in the second half of the twentieth century. The first was the ICAA, incorporated by Royal Charter in 1928 and the second CPA Australia, formed in the early 1950s with the amalgamation of some accounting bodies. CPA Australia was initially known as the Australian Society of Accountants (ASA) then changed its name to the Australian Society of Certified Practising Accountants (ASCPA) and finally, in 2000, changing its name to CPA Australia. Over the years several attempts have been made to rationalise this situation and amalgamate the two bodies but all have failed. As a consequence there has been a waste of resources and, at times, a lack of united professional body action on issues that have emerged. Unlike the United States, where the various bodies are generally distinguished by the function their members fulfil, in Australia both bodies cover the same ground – members occupy positions as public, private or government accountants (and other senior management positions).

However, like in the United States, crisis led to change. In the 1960s there were many company failures that prompted public concern, media pressure and even the threat of government intervention resulting in far greater cooperation between the two accounting bodies in respect of setting accounting standards. They jointly formed and sponsored the **Australian Accounting Research Foundation** (AARF). The primary function of this body was to carry out and sponsor research and then issue, through the medium of its **Accounting Standards Board** (AcSB), proposed accounting standards which would be confirmed by the councils of both bodies and which would require compliance with them by members. The process of accounting standard setting was essentially first identifying a problem area, undertaking research leading to the publication of an **exposure draft**, inviting public comment and debate after which the standard could be issued. The topic could have been identified from a number of sources from observing inappropriate practices, research by individual researchers or the AARF, noting problems identified by overseas professional bodies or from changes in the law. The above description is a simplification of the process but highlights the major steps involved.

Despite the good intentions of the professional bodies in creating the AARF there were constant problems with enforcing accounting standards. Inappropriate accounting practices persisted and were involved with many corporate scandals in the 1970s. And, although the professional bodies desired a continuation of self-regulation, the government created, in 1984 through Ministerial Council (that is not statute), the **Accounting Standards Review Board** (ASRB) whose responsibilities included reviewing and approving accounting standards. The ASRB had legislative support yet worked very closely with the AcSB and in September 1988 the two bodies merged with the AcSB ceasing to exist on the basis of the AARF having greater representation on the ASRB. This, Walker (1987) claims can be interpreted as a case of regulatory capture – the profession (the regulated/interested party) “taking control” of the regulator.⁵

The life of the ASRB was short lived and it was soon replaced by the Australian Accounting Standards Board (AASB). This body was established by the Australian Securities Commission Act of 1989 and section 226(1) set out the powers and functions of the new body, basically full responsibility for setting and reviewing accounting standards in Australia.

In the early stages of developing accounting standards a large part of the problem was their enforcement. This is always likely to be a problem where there is self-regulation. Statutory backing was seen by some people as desirable if accounting regulation was to be successful. The most logical place for such backing would be in the corporations legislation. However, in Australia each state was responsible for its own company law. This was a possible barrier to proper enforcement of accounting regulation as, although the state laws were similar, it would have been possible to avoid the jurisdiction of one state’s laws by moving interstate. Anyway a considerable part of business activity was national rather than within one state. In the last quarter of the twentieth century several successful moves were made by the various levels of government to unify company law

⁵ Walker’s article is an excellent presentation of the circumstance surrounding the attempts at that time to regulate accounting in Australia.

culminating in a national uniform code coming into effect on 1 January 1991. One consequence was that the decade of the 1990s saw the government undertake a major reform of company law, initially with the intention of simplifying it and then (from 1997) a more radical reform through the procedures known as the **Corporate Law Economic Reform Program (CLERP)**. A major item of the CLERP agenda was accounting standards. These moves virtually put an end to the accounting profession's self-regulation.

In the broader picture, accounting regulation is an integral part of the overall issue of **corporate governance**. Recall that the dubious business and accounting practices in the USA in the 1920s and the subsequent depression led to the call for improved and more uniform accounting practices. Similar circumstances in Australia in the late 1950s and 1960s, the late 1970s and 1980s and the late 1990s also led to calls for greater control over corporate management, including the financial statements they published. Movements towards greater and different accounting regulation can be observed as one response to these calls. However, it would be wrong to suggest this was the only reason for the change in the accounting regulation process – there were many. For example, in the second half of the 1990s there was pressure by business interests (such as the Australian Stock Exchange) to more greatly align Australian accounting reporting practices with international practices – a consequence of greater economic globalisation. This was necessary, it was claimed, in order to gain greater access to global financial markets.

Two pieces of legislation are significant to the establishment of a “new” AASB. These are, first, the Corporate Law Economic Reform Program Act 1999 and, secondly, the Australian Securities and Investments Commission Act 2001 (ASIC Act) (especially, section 236B). Under previous legislation the government had created the Financial Reporting Council with responsibility for oversight of corporate governance matters. This meant that it was responsible for both the AASB and the Australian Securities and Investments Commission (ASIC). On its web page it indicates that:

The Financial Reporting Council (FRC) is a statutory body under the *Australian Securities and Investments Commission Act 2001 (ASIC Act)*, as amended by the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004*. The FRC is responsible for providing broad oversight of the process for setting accounting and auditing standards as well as monitoring the effectiveness of auditor independence requirements in Australia and giving the Minister reports and advice on these matters.
(<http://www.frc.gov.au/about/> accessed 11 Feb 2006)

ASIC is an independent government body set up to enforce and administer Australian Corporations Law. It is not responsible for the issuing of accounting standards but can lobby for (or against) standards and has, from time to time, issued practice notes which in effect are its interpretations of accounting standards. As all Australian companies must comply with accounting standards, ASIC is definitely involved in the regulation of financial information provided by corporations.

Following the example of the EU, on 3 July 2002 the AASB issued a statement that Australia would adopt international accounting standards to be applied to financial statements issued on or after 1 January 2005. The EU had earlier decided to follow this path and this probably influenced the Australian decision. Thus, Australian accounting standards are now determined by the **International Accounting Standards Board (IASB)**.

Australian Accounting Regulation

The discussion above has briefly detailed how attempts to regulate the accounting information provided by companies – in financial statements - has changed from tentative steps by individual professional bodies to having the full force of statutory backing. It has been a complicated path that has seen professional self-regulation replaced by statutory regulation. This clearly demonstrates that accounting is seen as a very important part of the overall economic framework of the country and has become heavily politicised. Various governments have chosen not to let the development of accounting standards be part of a regime of professional self-regulation and market forces. Governments have been heavily influenced by various lobby groups such as business groups and the stock exchange. The efficient operation of financial and investment markets is an important feature of late capitalist economies and effective regulation (including its enforcement) has been seen as crucial to this. In addition, there are other important factors such as economic globalisation, the development of information technology and the growth of new financial instruments which have all contributed to the increased complexity of contemporary business practices. The reliability and timeliness of financial information are essential to facilitate contemporary business and this has been a major factor in the changes in the process of accounting standard formulation. The irony is that in order to facilitate the efficient operation of markets accounting regulation has become increasingly technical and at times highly complicated.

Evidence of this is the creation in late 1994 of the **Urgent Issues Group (UIG)** by AARF. The intention was to enable public discussion of accounting issues which confronted practitioners from time to time. As its name implies an objective was to quickly resolve accounting difficulties that arose usually from differing interpretations of accounting standards. Therefore, the UIG was not involved in the development of accounting standards but they were central to its work. Initially it issued *Abstracts* of consensus views. Thus, it assisted the AASB by dealing with “minor” problems that arose from accounting standards.

Consistent with the practice of international harmonisation of Australian accounting standards recent CLERP legislation has made the UIG a subcommittee of the “new” AASB which now issues *Interpretations* (not *Abstracts*). The predecessor of the IASB, the International Accounting Standards Committee (IASC) had a Standing Interpretations Committee (SIC) which issued SICs. With the restructure of the ISAC and the creation of the IASB this committee is now known as the **International Financial Reporting Interpretations Committee (IFRIC)**, which, as could be expected, issues IFRIC

Interpretations. The Australian UIG Interpretations are required to be consistent with IFRIC Interpretations (and the previous SICs)⁶. Accounting regulation is clearly quite complicated: the regulations are subject to official interpretations! Maybe the process of regulation is flawed in that it produces regulations that have to have official interpretations⁷. Whatever, it clearly demonstrates that there is a need for a greater theoretical foundation for accounting which would obviate the need for additional explanation. This, in fact was one of the original charges of the AARF.

A Conceptual Framework

One of the initial tasks of the FASB, as indicated above, was the development of a conceptual framework. In one its first statements on this project the FASB defined a conceptual framework as

. . . . a coherent system of interrelated objectives and fundamentals that is expected to lead to a consistent standards and that prescribe the nature, function and limits of financial accounting and reporting. (FASB, 1978, SFAC 1, p 1)

The development of a conceptual framework was an item on the first agenda of the FASB in 1973. Therefore it signalled the (US) accounting profession's continued concern with developing a theoretical basis on which accounting principles could be based (and this is clear from the above quotation). The project was to take a building block approach, starting with "fundamentals" and then building up from there. In this sense it was similar to what Chambers had advocated and the theory construction process described in Figure 2.1 in chapter 2.

The conceptual framework project proceeded through the FASB issuing Statements of Financial Accounting Concepts (SFACs). To date seven of these have been issued. Viz

1. Objectives of Financial Reporting by Business Enterprises (1978)
2. Qualitative Characteristics of Accounting Information (1980)
3. Elements of Financial Statements of Business Enterprises (1980; but superseded by SFAC 6)
4. Objectives of Financial Reporting by Nonbusiness Enterprises (1980)
5. Recognition and Measurement in Financial Statements of Business Enterprises (1984)
6. Elements of Financial Statements (1985) and

⁶ "All Australian Interpretations have the same authoritative status and those that are equivalent to the IASB Interpretations must be applied to achieve compliance with the International Financial Reporting Standards (IFRSs) of the IASB", *AASB 1048*, Preface)

⁷ Some standards deal with difficult issues and end up being quite complicated, for example, the US standard on accounting for derivatives "SFAS 133 is the most difficult and confusing standard ever issued by the FASB. It is the only standard to be followed by a FASB standard implementation group that addresses the many implementation concerns of companies. That group known as the Derivatives Implementation Group (DIG) publishes issues and conclusions at <http://www.rutgers.edu/Accounting/raw/fasb/map/index.html>. SFAS 133 is also the only standard for which a CD-ROM study guide was prepared by the FASB. See <http://www.rutgers.edu/Accounting/raw/fasb/CDROM133.html>." (Hubbard and Jensen)

7. Using Cash Flow Information and Present Value in Accounting Measurement (2000).

These statements (SFAC) are not accounting standards but statements of concepts which can be used as the basis for developing accounting standards.

The idea of a conceptual framework was adopted in several other countries such as the United Kingdom, Canada, Australia and New Zealand. In addition, the (then) International Accounting Standards Committee (now IASB) also started work on a type of conceptual framework project. While the titles of these efforts vary slightly they essentially have the same objective but none of the projects have made spectacular success. In the United Kingdom a document entitled *The Corporate Report* was commissioned and published (1976) by the ICAEW. One of the major authors to that report (Professor Edward Stamp) was commissioned by Canada to produce *Corporate Reporting: Its Future Evolution* (1980). (known as the *Stamp Report*). The IASC's document is entitled *Framework for the Preparation and Presentation of Financial Statements*

Australia followed the USA more closely⁸ and in 1979 AARF set about developing an Australian conceptual framework. In so doing the AARF commissioned a series of *Accounting Theory Monographs* on which Statements of Accounting Concepts (SAC), after initial publication in exposure draft form, could be based. To date four SACs have been published, viz

- SAC 1 "Definition of the Reporting Entity",
- SAC 2 "Objectives of General Purpose Financial Reporting",
- SAC 3 "Qualitative Characteristics of Financial Information", and
- SAC 4 "Definition and Recognition of the Elements of Financial Statements".

The first three were published in 1990 and, after controversy resulting in withdrawal then reissue, the fourth was published in May 1995. However, now that Australia has adopted IASB statements SAC 3 and SAC 4 have been abandoned in favour of the IASB's *Framework for the Preparation and Presentation of Financial Statements*. SAC 1 has been retained because it is fundamental to determining which Australian entities need to apply accounting standards and the IASB has no equivalent and SAC 2 is also essential to the application of Australian accounting standards.

It is important to be aware of the conceptual frameworks because they are designed to be the basis of accounting regulation, namely accounting standards. As Stevenson indicated, "The Standards will be concerned with the application aspects of the concepts" (1986, p 5). Refer back to Figure 2.1 in chapter 2 and note that the statements that form part of the conceptual framework would be placed on the left hand side. That is, it is from *concepts* that theories would develop. Therefore, despite being called theory monographs, the

⁸ Stevenson, then Director of AARF and the person in charge of the project, in speaking of the development of the Australian conceptual framework, has said, "we would maximise our use of FASB thinking" (1986, p 4).

works so labelled would form part of the initial explanations of the “everyday world” in order to derive the concepts. The regulators involved with developing conceptual frameworks have consciously elected to follow a particular process in theory construction. This has led to such projects attracting considerable criticism. Much of this has come from the fundamentalist position adopted by neo-empiricist researchers who seem to believe the outcome should be specific, incontestable rules for practice. Criticism has also come from “non-theory” communities – practitioners who, history has shown, are likely to challenge any procedure that restricts the freedom with which they have been accustomed to operating. However, this is not to suggest the projects should not be criticised but theory development depends on professional goodwill where possible. One of the strongest arguments in favour of conceptual framework projects is that it forces accountants to consider what they are doing and how they can go about it. For example, it may well be that accountants are attempting to produce and communicate financial information that is useful to decision makers, or those who rely on the information in making everyday decisions. These matters are obviously open to wide interpretation, for example, who are the users and what information do they “need”? Conceptual frameworks *may* be able to reduce the uncertainty – that is the main aim in developing them.

Conceptual Framework Construction

In 1995 the (then) AASB issued (the then) Policy statement which included a diagram showing what it referred to as the building blocks of a conceptual framework. It comprised seven levels which would lead to the development of accounting standards and a further level addressing monitoring compliance with the accounting standards. The approach depicted a top down process starting (at the top) with the definition of (general purpose) financial reporting followed (below) by the definition of the reporting entity and then the objectives (in financial reporting). The four issued SACs (above) related directly to the “building block” detailed in the diagram. However, the AARF and AASB had considerable difficulty in issuing a fifth SAC on measurement as it was impossible to obtain a consensus or acceptable viewpoint. And now subsequent events have overtaken the need for any further SACs as convergence with the IASB’s *Framework for the Preparation and Presentation of Financial Statements* has rendered them unnecessary. SACs 1 and 2 have been deemed to be necessary elements of Australian general purpose financial reporting but SACs 4 and 5 have been abandoned in favour of the *Framework* (now referred to as the AASB’s *Framework*). What is interesting is that AARF made a clear statement as to what it believed to be the process of theory construction. As stated above, this process is similar to that described in Figure 2.1. It is also consistent with the work of some of the individual theorists discussed in chapter 2; notably Chambers (as evident in his *Accounting, Evaluation and Economic Behavior*) and Moonitz (ARS 1 and 3) but probably many more. The Australian version differs from that of the FASB in that its first two building blocks were concerned with definitional issues and it is interesting that the two SFACs devoted to them have been retained as pertinent to Australian financial reporting. Once these were established the next stage was to determine the objectives of financial reporting from which the qualitative characteristics and the elements could be deduced.

Reporting entities

Traditionally financial reporting has generally been in the context of annual reports of public companies. However, SAC 1 recognises that there are many instance where decision makers need to rely on financial statements. Therefore it has defined a reporting entity as

. . . all entities (including economic entities) in respect of which it is reasonable to expect the existence of users dependent on general financial reports for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources. (SAC 1 para 40)

Therefore reporting entities would include public sector and not-for-profit entities.

Users of general purpose financial reports

SAC 2 states that the objective of financial reporting is “to provide information to users that is useful for making and evaluating decisions about the allocation of scarce resources” (SAC 2, para 26). Obviously, in order to satisfy this it is necessary to know who the users are. However, determining who the users are has been a persistent and prolonged problem for those involved with the discipline. In response to this question posed by Professor Edward Stamp, the then Director of Research of the FASB, Jim Leisenring, responded that they were “investors, creditors, potential investors and potential creditors” (Stamp, 1984, p S/3). In response to a similar question financial analyst and professor of accounting at New York University, Lee Seidler said

I know the Board (FASB) members are honest men of integrity. I think the problem is that they don't really know how financial statements are used. And in the past the only work we've had on it has been – unfortunately - academics setting questionnaire to analysts which are garbage in garbage out type research. (Stamp, 1984, p S/11)

In Australia the question is addressed in SAC 2 (paras 16-20) which claims there are three categories of user groups and the lists four, viz, resource providers, recipients of goods and services, parties performing a review or oversight function and management and governing bodies.

Determining who the users of financial statement are has been the subject of a great number of research studies over the last 80 years. Is it really necessary to know who users are? Many argue that users have to be identified in order to develop standards that would lead to the satisfaction of their needs. The logic of this is questionable as the resulting standards may very well privilege certain groups (of users). The consequences of this were discussed in the last chapter!

The AASB's *Framework* recognises that there will be a wide range of users. Financial statements will not meet all the needs of all users but should meet the “common needs of most users” (para 13) so they can especially assess the stewardship and management of management.

Qualitative Characteristics of Financial Reports

SAC 3 was designed to define the qualitative characteristics of financial reports. Similar sentiments are contained in the *Framework*. These characteristics are the attributes that make information useful to users and there are four of them, viz, understandability, relevance, reliability and comparability.

Understandability

Obviously if information is to be provided to interested parties it is important they understand it. However, this does not mean that complex but relevant information should not be disclosed. Rather it is beholden on the preparers to make this information as understandable as possible. This implies that investor (and other users) who do not have training in accounting should be able to understand the financial statements included in a company's annual report.

Relevance

Financial reports should disclose all relevant information. However, there is again circular logic here; even if users were known how could all their needs be met. This is similar to the problem of induction that Popper resolved to overcome. Seidler's critique went even further when he claimed that

Only someone who had never taken a logic course at university would attempt to develop a conceptual framework. (Stamp, 1984, p S/12)

The question of relevance is further complicated by the idea of *materiality*. "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial report" (*Framework*, para 30). The issue of relevance has been behind the value relevance (and other) research discussed in chapter 3. Determining materiality is a highly subjective decision and will impact on the issue of relevance.

Reliability

Intuitively, reliability would seem to be the most important qualitative characteristic of information in financial statements. It has generally been a hallmark of all professions – dependability and expertise in special forms of knowledge (knowledge "provides the basis for professional practice" Macdonald, 1995, p161). However, when it comes to specifying just what it means difficulties arise. In the *Framework* it is defined as information that is

. . . free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent. (para 31)

The Framework states that there are several "sub-components" of reliable information: faithful representation, substance over form, neutrality, prudence and completeness. The first, whilst being difficult to pin down the exact meaning, is in accordance with its title. The second states that the information should represent the economic reality rather than merely be included just because of some legal or regulatory requirement. Neutrality refers to a standard of objectivity to which preparers of financial information should comply. The selection and presentation of information should not influence the making of a

decision in order to meet a predetermined outcome. Unfortunately, numerous violations of these criteria have led to corporate scandals and frauds.

Prudence is similar to what used to be called conservatism. Here too, over zealous accountants have used this to perpetrate dubious accounting practices. The exclusion of items may lead to the wrong impression therefore completeness requires that all information within the bounds of materiality and cost be disclosed.

Comparability

Users of financial statements are often interested in comparing a reporting entity's performance over time. Therefore, it is important that the basis for accounting for items included in the financial statements remain consistent from year to year. However, this does not mean that an entity not change its accounting policies when better and improved (more relevant and reliable) methods arise. In situations where policies have changed this fact should be disclosed. Of course the law requires corporations to include two years' statements so it is important that proper comparison of these be possible. Prospective investors and analysts would usually be interested in more than the two years.

The Conceptual Framework as a Theory of Accounting

Regulation is a substitute for theory. In an ideal world theories will exist that explain and lead practice. However, often some direction for practitioners is necessary where no acceptable theory exists. This has been the story of accounting. Despite the efforts of theorists and researchers no acceptable theory of accounting exists. Therefore, in order to overcome inappropriate and even deviant behaviour of accountants in practice it has been necessary to make statements of considered *best practice*, that is, accounting standards with which accountants should comply. Accounting regulators such as the FASB, AARF, ISAB and others have recognised that the standards they issue should be based on sound theoretical considerations. The conceptual framework and other similar projects are attempts to provide this theoretical basis. However, after a promising start, most of these projects have slowed or even stopped. Various reasons - political, economic, sociological, methodological, epistemological or other - have been provided in the accounting literature why this has occurred. To some the attempts to produce a conceptual framework are means of maintaining a regime of professional self-regulation and avoiding government intervention. Self-regulation, as discussed above, is often seen as a signifier of professional status. If this is true there is nothing "sinister" in this motive as it seems quite natural to want the profession to want to self regulate. However, a less charitable interpretation is that the regulators are concerned with self preservation – maintaining their prestigious positions and the power and other associated benefits.

Others have argued that there have been epistemological and methodological deficiencies in the process of developing the frameworks. There are also ontological considerations. Positive theorists have suggested the procedures have been normative and not enough attention has been paid to extant practices. At one level this criticism is simply not true and there have even been those who have suggested that the conceptual frameworks are mainly descriptions of existing practices (similar to Grady's *Inventory of GAAP* in ARS 7

discussed earlier). However, it would be more accurate to say that positive theorists' criticism of the conceptual frameworks is that they conflict with the fundamental assumption of positive theory of market efficiency. This, of course, is true of all regulation as it can be seen as an externally imposed constraint on free market activity and the question is fundamental to the arguments about the need for regulation discussed in the last chapter.

Regulators have made (and continue to make) epistemological and methodological assumptions because of their realist ontological presuppositions. These are apparent in the claimed qualitative characteristics of financial information, for example, faithful representation, neutrality, and to a lesser extent, relevance and reliability and true and fair view. The epistemology is positivist and the methodology supposedly hypothetico-deductive (described in chapter 2). The problems with this methodology (and positive theorising) have been described above. In constructing a theory it is necessary to start with basic assumptions such as the context, the need for the theory and the behavioural implications of the theory. These assumptions are always subject to interpretation so invariably it is difficult to get agreement from those affected by the theory. This is true in respect of financial statements, for example, what use will be made of them, who will use them and other questions? The designers of the conceptual frameworks (including the *Framework*) have consciously adopted a user emphasis, a decision making perspective. In so doing they have had to make assumptions and these are contestable.

There are other methodological problems in the approach adopted in the conceptual framework projects. An excellent example of the use of hypothetico-deductivism in accounting is found in Chambers's *Accounting, Evaluation and Economic Behavior* in which he develops his theory of continuously contemporary accounting (CoCoA). Chambers sets up conditions and every subsequent statement follows from those stated conditions. This is not always the case in the conceptual framework projects the stated purpose of which is to lay the theoretical foundations from which accounting standards can be developed. In fact, in the Australian Framework the statement is made that it does not define standards and sometimes there may be a conflict (paras 3 & 4). Further, in CoCoA the technical features follow consistently from the initial conditions. The main reason for the slow progress in the conceptual framework projects is the non acceptance by and disagreement with practitioners as to the technical aspects, most especially over the recognition and the type of measurements to be used, yet these should be the deduced consequences of the prior theorising.

There are very few who would argue that the conceptual framework projects are example of successful theorising. There are probably many who would argue that the projects serve a useful purpose. With the *Framework* being the basis on which accounting standards are devised there will be more consistency in accounting standards. Previously accounting standards were developed individually and were often ad hoc and at times there were contradictions between standards. Now, the *Framework* defines the elements of financial statements so it will be easier to relate requirements of one standard to other standards. With more countries adopting IFRS and consequently *the Framework for the Preparation of Financial Statements* there will be greater international uniformity.

Cynical commentators have argued that frameworks are devices for establishing professional and personal legitimacy and therefore creating power relations. This may well be so but, if it is, developments this century have been detrimental to such aims. In Australia, there is no longer professional self-regulation. In the United States the spectacular corporate collapses and frauds have resulted in the creation of the greater government regulation such, for example the establishment of PCAOB (Public Company Accounting Oversight Board) and the Sarbanes Oxley legislation.

One thing is clear from the very unsatisfactory story of accounting so far and that is there has a complete lack of success in all the attempts to create a theoretical foundation for accounting. Individual theorists, committees, and regulators have all failed to develop an acceptable theory of accounting. In the absence of any theory the various regulations imposed on the discipline can be viewed as policies substituting for rigorous theory. One problem may be that people have an incorrect view of what a theory is and what theory can provide. The issue has been complicated by the growing globalisation of most aspects of contemporary life, especially economics and business. The implications of internationalisation and globalisation are discussed in a forthcoming paper.

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