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**Accounting and Neoliberalism: A critical reading of
IASB/FASB's *Conceptual Framework for Financial
Reporting 2010***

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Abstract

This paper explores the influence of neoliberal free market ideology on the accounting standard setting by using IASB/FASB's *Conceptual Framework for Financial Reporting 2010* as an example. By positioning the analysis in broader literature of neoliberalism and financialisation, this paper reveals the bias underlying the conceptual framework that promotes the interest of neoliberal financiers and its potential social impacts. This paper argues that the changes that take place in the joint project serve to strengthen the beliefs in the neoliberal markets and favours a very small group of users over the 'public interest' consideration of financial reporting. As unfolded through the effects of reporting Comprehensive Income and Fair Value Accounting saturated into financial statements, not only is accounting insufficiently alert to the speculative characteristics of financial markets, but it also seems to legitimise more 'estimations' into the system pushing further risk taking behaviour within the neoliberal markets. By exposing these biases and the possible damages, this paper provides some fundamental thinking on the neoliberal financialisation and its implications on this joint effort of globalising accounting regulations, namely, the IFRS and the US GAAP. It aims to enable more critical awareness about possible damages of applying neoliberal theory and rhetoric within an accounting context. It is shown that the arguments for a free market present actually wonderful sounding words to hide grim realities of the shift in the role financial capital plays in human societies.

Keywords: Conceptual Framework 2010; Neoliberalism; Financialisation; Shareholder Value.

1. Introduction

On 28 September 2010, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) released their Conceptual Framework for Financial Reporting 2010 (hereinafter called *Framework 2010*). This is planned as the first phase of their joint project to develop an improved Conceptual Framework (CF) for the International Financial Reporting Standards (IFRS) and the US generally accepted accounting practices (GAAP). The ultimate goal of this joint effort is to converge the IFRS and the US GAAP in June 2011 (FASB 2008). Given the distinct influences of these two organisations, this convergence project has drawn significant interest from accounting practitioners, academics, and broader communities, as reflected through the numerous responses to the Discussion Papers and Exposure Drafts released by IASB/FASB¹ and abundant research papers (e.g. Goldberg et al. 2006; Cauwenberge and Beelde 2007; Dick and Walton 2007; McGregor and Street 2007; Rayman 2007; Bradbury 2008; Whittington 2008; Wagenhofer 2009) over the recent years. To a large extent, nevertheless, existing discussion focuses mainly on the technical aspects of the new CF and the accounting standards that follow. Very little research has been documented in accounting literature regarding the ideological motivations underlying these convergence projects.

Instead of defining the technical problems, this paper challenges this convergence project with special reference given to its deeper ideological underpinnings. It draws upon theories of neoliberalism to show how the progress of the IASB/FASB's joint work has been heavily laden with neoliberal free-market ideology. It is shown to be part of a global process of neoliberalisation and financialisation of political and economic systems. Because the creation of neoliberal system has entailed much destruction on human societies over the past four decades (Ong 2006; Harvey 2007; Klein 2007), the real effect of these changes of accounting standard setting that favour the interests of neoliberal financiers is indeed suspicious.

This investigation is contextualised within the newly released *Framework 2010* that covers the Objective and Qualitative characteristics of financial reporting information. This is considered to be an important document because the conceptual framework would basically become the theoretical foundation of all the other specific accounting standards of the IFRS which every respective national that has adopted the IFRS must follow. It also provides a strong focus for this paper so that the very broad research topic can be reflected upon and evaluated.

This paper is structured as follows. Section 2 provides an overview of neoliberalism, financialisation and their influences on the global economy. Section 3 explores the Chapter 1 Objective of general purpose financial reporting of *Framework 2010*. Section 4 examines the Chapter 3 Qualitative characteristics of *Framework 2010*. Section 5 summaries the paper and draws conclusions.

2. Neoliberalism, Financialisation and Crisis

The reorganisation of the level of interaction between state and economy over the last 40 years has seen policies of privatisation, marketisation and deregulation promoted globally,

¹ IASB has published all the response letters on its website, available from: <http://www.ifrs.org/Current+Projects/IASB+Projects/IASB+Work+Plan.htm>.

changing the nature of the public and private sector as well as lifting restrictions on the way businesses conduct themselves nationally and internationally. These phenomena have often been described as neoliberal transformations – or neoliberalism (Harvey 2005; Cahill 2010; Cooper et al. 2010). In theory, neoliberalism proposes that “[h]uman well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets, and free trade” (Harvey 2005, p. 2). Proponents of neoliberalism argue that the best rules and conditions for markets to flourish include: deregulation of financial markets, privatisation, weakening of institutions of social protection, weakening of labour unions and labour market protections, shrinking of government, cutting of top tier tax rates, opening up of international goods and capital markets, and abandonment of full employment under the guise of the natural rate (Friedman and Friedman 1980; Munck 2005; Palley 2005; Gamble 2006). For many opponents, however, the ‘deregulation’ advocated by neoliberalism in theory may not reflect the nature of state-economic relations in practice. In fact, the “[m]aking of markets” (Munck 2005, p. 61), is a contested political process and not a natural state as much neoliberal theory would have us believe. In line with this, MacEwan (2005, p. 172) cautioned that:

[n]eoliberalism requires a strong state that can ensure the primacy of private property, preserve the dominance of markets over social control, and thus limit the operation of democratic power. Also, neoliberalism often requires a strong state, sometimes a dictatorial state, for its implementation.

In the context of contemporary economic globalisation, the establishment of the global market has required a whole set of international rules and institutions to regulate the growing volume of international trade (some examples include contract law, patents and arbitration procedures and the IMF, World Bank and the WTO). Whilst advancing policies of ‘deregulation’ (removal of state regulatory systems that intervene in markets), it is suggested that neoliberalism reconfigures regulation with market-oriented rules and policies to facilitate the development of a new form of capitalism. A new form of capitalism in which there are clear winners and losers (Harvey 2010) and one in which global accounting regulations lubricate and legitimise this process (Boyer 2007; Newberry and Robb 2008; Hopwood 2009; McSweeney 2009; Roberts and Jones 2009). Instead of generating social optima, ample research demonstrates that in many neoliberal countries social inequalities and concentrations of wealth and power have emerged (e.g. Harvey 2005; Johnston 2005; Shaikh 2005; Phillion 2007).

The most profound paradigm shift happened during the neoliberal period, was the rising financialisation in global economies due to the deregulation of the global financial sector (Palma 2009). In a general sense, financialisation is understood as the increasing dominance of financial markets, financial motives, and financial institutions in the operation of domestic and international economies (e.g. Epstein 2005; Froud et al. 2006; Dore 2008). This shift has brought about an overriding effect of financial interests over real economy with the proliferation of complex financial instruments and derivatives (BIS 2007; Dore 2008). To quote some empirical indices, for example, in the US, share market capitalisation as a

percent of GDP rose from its long-term average of about 50 percent to 185 percent in 1999 (Crotty 2005, p. 85). The outstanding amounts of the derivatives market are 19 times the size of the US economy, while trading volume on exchange was over 79 times the US GDP in 2003 (Dodd 2005, p. 150). At the global level, according to the Bank for International Settlements (Palma 2009, p. 834), the amounts outstanding of over-the-counter derivative contracts have jumped from US\$92 trillion to US\$683 trillion (7.5 times), or from 2.4 to 11 times the size of global output.

It is believed that what behinds this massive financialisation process is a systematic attempt to convert all value (tangible or intangible, present or future) into exchangeable financial instruments, such as the securitisation of government debts, off-balance sheet financing, tradable corporate bonds, the packaging of mortgages, consumer credit into securities, options and many other financial derivatives. Those financial innovations, together with creative accounting, have been able to transform any type of fixed asset into a liquidated financial instrument which is immediately exchangeable, as well as turn liabilities into assets/equities by expanding the scope of projection further into the future, and so forth. All these newly 'advanced' techniques have been extremely sophisticated and thus incomprehensible to most people, which propose great fundamental risks to the world economy.

A critical issue raised within the political economy field is that the comprehensive financialisation process has infiltrated financial frangibility into the whole economic system, which leads inevitably to macroeconomic instability (Dore 2008; Bryan et al. 2009). This lies fundamentally in the nature of the financial markets, as it focuses on immediate financial results that seek higher returns and riskier investments (Keynes 1936; Parenteau 2005). As Boogle and Sullivan (2009, p.22) warn that "[a]ny system whose revenue depends upon persuading investors to trade actively is, by definition, going to focus on short-term speculation". This is evidenced by the massive speculation that banks and other financial institutions are undertaking. Fitch Ratings (2007) reported that 58 percent of banks that buy and sell credit derivatives acknowledged that 'trading' or gambling is their 'dominant' motivation for operating in financial markets. Eric Dinallo, the insurance superintendent for New York State, said that 80 percent of the estimated \$62 trillion in CDSs outstanding in 2008 were speculative (New York Times 2009).

At the micro-level, financialisation has enormous influences on managerial behaviours in non-financial companies (NFC). There has been a major shift from viewing large NFCs as integrated, coherent combinations of relatively illiquid real assets assembled to pursue long-term growth and innovation, to a 'financial' conception in which the NFC is seen as a 'portfolio' of liquid sub-units that must be continually restructured to maximise the share price at every point in time (Crotty 2005). It is believed (see, e.g. Crotty 2005; Coles et al. 2006; Boogle and Sullivan 2009) that this approach has brought about fundamental changes into NFC management from valuing long-term success to exploiting short-term windows that undermines general economic performance. The inherent nature of capital, if referring to Marx (1894) that perpetuates higher return and its dominance over production, has driven

the NFC to focus on raising their return on equity, or in other words, pursuing 'shareholder value'.

On the other hand and as seen in the spreading use of share options, the shift in the incentive structures of top decision makers has aligned management interest with that of institutional investors. Referring to Crotty (2005)'s research, the average proportion of the earnings of the top 100 CEO's that came in the form of exercised share options was 22 percent in 1979, which rose substantially to about 50 percent in the late 1980s; in the financial boom years of 1995 through 1999, this average rose to 63 percent. Meanwhile, top CEO average pay in all forms rose from \$1.26 million in 1970, to \$37.5 million in 1999 (Piketty and Saez 2001, Table B4). According to the *Wall Street Journal* (June 6, 2002; A1):

[T]he incentives to do almost anything to increase the stock price were huge. And the incentives weren't to increase profit and share prices over a decade or two, but rather to increase profits – never mind if they have to be restated later – just long enough for executives to cash out.

Managers are also disciplined by the prospect of takeover and ousted if they fail to maximise profits (Palley 2007). Financial innovations such as leveraged buyouts and private equity investing financed by junk commercial papers are regarded as market efficiency improvements, which, according to many economists (see e.g. Morin and Jarrell 2001; Palley 2005; van Treeck 2009), not only contribute suspicious value to real income flows and physical investment at the macroeconomic level, but also largely compel managers to satisfy the interests of shareholders. This is in other words, the owners of capital.

As a result, the huge liquidity that was provided by the easy money policies and deregulations of capital markets during the neoliberal era, instead of fuelling a boom in productive capital investment, were mostly used for speculative financial investment (Crotty 2009). Much of the business of finance in the contemporary world turns out to be about speculative gains and nothing else. For instance, Panitch and Gindin (2005) estimated that in 2001 whilst an \$800 billion annual turnover would be required to support international trade and productive investment flows, the annual turnover of financial transactions in international markets stood at \$40 trillion. The perpetuation of fictitious wealth created by 'churning'² contributes suspicious values to real production.

The complexity of the networks linking financial markets together created immense fragility in the whole economic system: "[c]omplexity adds to the danger that any one part of the hyper-financial system can bring down the whole" (Financial Times 2008). What has been well presented through the current (2007-2010) financial crisis is exactly the overriding effect of the financialisation with damages inflicted by defaults in a very small fraction (subprime mortgage) of the financial sector, which would be inconceivable if it happened before the neoliberal era. The implication of this neoliberal transformation on the

² Since brokers get a commission for each transaction, they can maximise their incomes by frequent trading on their accounts no matter whether the trades add value to the account or not.

accounting discipline, however, has not yet been addressed adequately within accounting literature. For instance, a search on the Science Direct database (on 19 August 2010) with key words “neoliberalism and accounting” shows only seven articles (Andrew 2007; Cronin 2008; Andersson et al. 2010; Andrew et al. 2010; Cooper et al. 2010; Haslam 2010; Mennicken 2010) that examine the influence of neoliberalism on accounting but none that concerns this financialisation process. In this regard, this paper contributes to the current knowledge by revealing the functional role that accounting plays during this neoliberal financialisation.

3. Objective of general purpose financial reporting

At broader level, the global project of the IFRS convergence can be seen as part of the global neoliberal architecture. International accounting standard setters have the express goal of supporting global capital flow through a robust, reliable and relevant accounting system (IASB 2005). The unhindered flow of capital is critical to a global neoliberal economy and as has been pointed out:

[t]he free mobility of capital between sectors, regions, and countries is crucial which hence requires a removal of all barriers (such as tariffs, punitive taxation arrangements, planning and environmental controls, or other locational impediments) to unhindered capital flow (Harvey 2005, p. 66).

The globalisation of accounting standards, from this perspective, is part of the broader neoliberal project to free the global capital markets of ‘local impediments’ in order to optimise the conditions for corporations and capital. As has been argued, however, the ‘making’ of an ideal institutional setting for neoliberal projects embodies remarkable hegemonic relations and undesirable social impacts that have not been transparent in contemporary societies. Harvey (2005, p. 19), whilst positioning an argument in favour of the latter, has said:

[w]e can...interpret neoliberalization either as a *utopian* project to realize a theoretical design for the reorganization of international capitalism or as *political* project to re-establish the consideration or capital accumulation and to restore the power of economic elites.

Those critical of neoliberalism, as it has been ‘theorised’, have also argued that markets will never work in a textbook manner (Clarke 2005; Munck 2005; Shaikh 2005; Harrison 2006; Robinson 2006). As explained by Gamble (2006, p. 28), “[s]ince all power corrupts, even the most selfless neoliberal government will soon find itself taking decisions which benefit the interests of the state or of corporate interests rather than those of the wider public.” By striking the dynamism of the free market, as this paper wants to point out, neoliberalism brings our societies to the judgement and morality of financial capital in every direction. Instead of providing more ‘sober’ and risk-avoiding information that meets the public interest function of accounting (Sikka 2001), the current move of the IASB/FASB, as reflected through the recent changes they made in their Conceptual Framework and accounting standards, shows that the standard-setting bodies have been working in alignment with this

neoliberal assumption and deliberating policies that would facilitate the interest of neoliberal financiers.

3.1 The primary users of financial reporting

In the new Conceptual Framework released in September 2010, the Board established an objective of financial reporting and not just of financial statements as defined by the previous Conceptual Framework (hereinafter called *Framework (1989)*). This has been consistent with the scope of FASB Concepts Statement No. 1 *Objectives of Financial Reporting by Business Enterprises*. Apparently financial statements are a central part of financial reporting; nevertheless, the change reflects the Board's intention to apply the Framework in broader scope.

The most notable difference in the objective of financial reporting in the *Framework 2010* was that the primary users of general purpose financial reporting has been changed from “[p]resent and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public” (para. 9 of *Framework 1989*) to “[e]xisting and potential investors, lenders and other creditors” (para. OB2 of *Framework 2010*). The Board has narrowed down the scope of target users of financial reporting. Referring to the other stakeholders, the Board assumed that:

[o]ther parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups. (para. OB10 of *Framework 2010*)

In explaining the decision to include only “investors, lenders and other creditors” as the primary users, the Board noted that they “[h]ave the most critical and immediate need for the information in financial reports and many cannot require the entity to provide the information to them directly” (para. BC1.16 of *Framework 2010*). Further, the Board emphasised that:

[T]he Board's and the FASB's responsibilities require them to focus on the needs of participants in capital markets, which include not only existing investors but also potential investors and existing and potential lenders and other creditors.

Information that meets the needs of the specified primary users is likely to meet the needs of users both in jurisdictions with a corporate governance model defined in the context of shareholders and those with a corporate governance model defined in the context of all types of stakeholders. (para. BC1.16 of *Framework 2010*)

Although throughout history, the committees (IASB/FASB) have covertly applied a much narrowed focus of ‘shareholder’ as the primary users of financial reporting in their standard setting practices (Cooper and Sherer 1984), they have never stipulated this as overtly as they did in *Framework (2010)*. An issue that has been brought into hot debates within the comment letters to the IASB/FASB's Discussion Paper and Exposure Draft (ED) (available from http://www.fasb.org/project/cf_phase-a.shtml) was *stewardship*. The ED discussed the *Objective of Financial Reporting* and *Decision-usefulness* in separate sections (para. OB2 and

para. OB12 of the ED May 2008, accessed 15 December 2010, available from <http://www.ifrs.org/Current+Projects/IASB+Projects/Conceptual+Framework/EDMay08/EDMay08.htm>). It acknowledged the role financial statements can have in supporting decisions related to the stewardship of an entity's resources, but noted that its reporting requirements could be embraced by providing information relevant to future cash flows "[b]ecause management's performance in discharging its stewardship responsibilities usually affects an entity's ability to generate net cash inflows, management's performance is also of interest to potential capital providers who are interested in providing capital to the entity." (para. OB12 of the ED May 2008). As a result, in the *Framework 2010* the Board combined those two sections in Chapter 1 "[r]esulted in eliminating the separate subsections on usefulness in assessing cash flow prospects and usefulness in assessing stewardship." (para. BC1.27 of *Framework 2010*) Further, "[t]he Board decided not to use the term stewardship in the chapter because there would be difficulties in translating it into other languages" (para. BC1.28 of *Framework 2010*).

This sidelining of the objective of stewardship was obviously unacceptable to many (e.g. see Whittington 2008; Wagenhofer 2009). As such, "[a]ccountability entails more than the prediction of future cash flows" (Whittington 2008, p. 144). Wagenhofer (2009, p. 68) warns "[t]he growth strategies adopted by the IASB are risky" as it fails to take into account the diverse objectives of financial reporting. Its stewardship dimension is concerned with monitoring the past as well as predicting the future and, from the perspective of public interest, is often tied with the integrity of management as with its economic decision and performance (Puxty 1986; Whittington 2008). The Board's declaration, however, that its basic mission "[i]s to serve the information needs of participants in capital markets" (para. BC1.23 of *Framework 2010*) is a remarkable statement, as for an organisation that coordinates the financial reporting practices of the majority sectors across the world it bears such a narrowed vision of its responsibility. Positioning it in the broad context of the neoliberal economy, as this paper has presented, it is critical to recognise that this kind of policy deliberation has the capacity to highlight agendas in line with the interest of neoliberals with inadequate attention given to the over-riding effect of financial capital and its crisis created in the macro-economy. The Board dismissed some constituents' concern that maintaining financial stability in capital markets (the stability of a country's or region's economy or financial systems) should be an objective of financial reporting:

[T]he board acknowledged that the interests of investors, lenders and other creditors often overlap with those of regulators. However, expanding the objective of financial reporting to include maintaining financial stability could at times create conflicts between the objects that the Board is not well-equipped to resolve.

The Board noted that providing relevant and faithfully represented financial information can improve users' (investors, lenders and other creditors, or in other words, the providers of capital) confidence in the information, and thus contribute to promoting financial stability (para. BC1.23 of *Framework 2011*). This appears to be a very ignorant assumption, as given the problems that have been structurally saturated within the financialised neoliberal economy, the committees run the risk of being benign enablers to this kind of capitalism

through technical pronouncements. The target users (investors, lenders and other creditors) demand certain information which might differ from other groups of users of financial reporting. Prioritising their demand in the CF will influence other standards proposed by the IASB/FASB's convergence project. A critical change worth mentioning is the committees' current proposal on the *Presentation of Items of Other Comprehensive Income*.

3.2 Other Comprehensive Income

At present, entities have an option in IAS 1 to either present one statement of comprehensive income or two separate statements; one of profit or loss and another of comprehensive income. This would be changed according to the ED of IASB issued in May 2010 that requires entities to present a single statement with profit or loss as a subtotal and total comprehensive income as the bottom line number. Opponents are afraid that this approach enables the comprehensive income, possibly based largely on fair value measurement, to become the central figure for performance evaluation (Whittington 2008). This move reflects, nevertheless, a fundamental shift that the committee is fostering in defining the concept of income³. In theory, income is often understood to be two mutually exclusive concepts: 1) income as a measure of performance of an enterprise and its management; 2) or income as an enhancement of investor wealth (Sprouse and Moonitz 1962; Storey and Storey 1998; Hoed 2003; Newberry 2003). Newberry (2003) adds a detailed explanation of these two concepts: the measure of performance concept regards income as arising only from purposeful activities, particularly the recurring usage of physical non-current (or fixed) capital, while other gains or losses apparently unrelated to the purposeful activities are excluded; differently, the enhancement of wealth concept of income focuses on income from the investor's perspective. Income is the monetary difference between the amount invested and the amount subsequently distributed or available for distribution. The amount invested is equity (or net assets) therefore income, regardless of how it arises, accrues to investors in proportion to their stockholding. Because the focus is on increases in investors' wealth this concept of income implies that valuation is important and that matching costs with revenues is irrelevant. Therefore, it favours the use of realisable values (more fair value orientated) for all assets and liabilities.

The current move of the IASB/FASB towards reporting comprehensive income in financial statements implies that accounting standard-setters have started a change to adopt the enhancement of wealth concept of income. Some respondents to the ED (May 2010) disagreeing with the proposal for a single statement expressed that "[p]resenting total comprehensive income as the last number in the statement would confuse users...[and] requiring all items of income and expense to be presented in a single statement was the first step by the boards to eliminate the notion of profit or loss" (para. BC11 of the ED May 2010).

³ This will be finalised as part of the performance statement in Phase E of the Framework revision, Presentation and Disclosure according to IASB's working agenda (IASB Conceptual Framework project, <http://www.ifrs.org/Current+Projects/IASB+Projects/Conceptual+Framework/Conceptual+Framework.htm>).

From the perspective of creditors and investors, this change is crucial in the 'contemporary business environment' in which finance dominates other production sectors (Bryan et al. 2009). When the macro-economy is structurally saturated by speculative and highly mobile financial flows, a financial reporting system built upon historical cost measurement fails to satisfy the needs of 'users', this is because what users desire is the most updated information so that they would not miss out on the 'timely' opportunities for short selling in 'freed' and highly fluctuating markets. In nature the financial speculators care little on the 'real' productions but rather on short-term fluctuations arising from the volatility of financial markets. The statement of comprehensive income which emphasises on the value changes of capital provides more updated information to the users than the traditional income statement.

Under the circumstances, investors are explicitly defined as the targeted user of accounting information and the performance concept of income is undermined. These implicit preferences that are favourable to capital markets and 'financialisation' processes are contestable within some financial research on Wall Street as having seriously compromised financial reporting (e.g. Bradshaw and Sloan 2002; Levitt 2002; Newberry 2003). For instance, the standard identifies two components of comprehensive income: net income and other comprehensive income where Newberry (2003) argues that preparers of financial reports have promoted their own sub-components within net income in an attempt to direct user attention upward and away from both the comprehensive income total and the net income sub-total. More specifically:

[t]hese sub-components, often referred to by preparers as 'pro forma' figures, and which have become known as a 'Street' measure of earnings because of Wall Street analysts' acceptance of those figures, have gradually excluded an increasing number of items, mostly expenses. The expenses excluded may consist of major expenses such as restructuring costs and even marketing costs that, it is argued, are non-recurring. Expenses have also been chiselled out of an older measure of performance idea of earnings which reported earnings before interest and tax (EBIT) on the basis that the expenses excluded were irrelevant to performance evaluation." (Newberry 2003, p. 330)

As a result, the old idea that income measurement should be clearly attached to real production by tying income with real operating performance of firms, has been sidelined in the current discourses. Instead the focus has been placed on the concept of 'comprehensive income' in which 'cash flows' become the major focus. If accounting is to provide information for users to make economic decisions (AICPA 1971), the selection of what to report and what not to has reflected implicitly what the 'users' are under the circumstance. According to this logic, 'real' operating performance does not matter any longer to 'users' of financial reports (at least the standard setting bodies believe so as reflected through their decisions). What is prevailed nowadays is the value change of the 'wealth', which, on consideration of the neoliberal context in which accounting operates, largely represents interests of powerful and highly mobilised financial capital. Because they are oriented towards the short-term and they fluctuate, it becomes essential that accounting – the

language of business (Bloomfield 2008) be devised in a way that accounts for that neoliberal transformation.

The disruptive effect of comprehensive income was another concern raised within much empirical research. Campbell et al. (1999) examined the 1997 financial statements of 73 companies that adopted *Statement of Financial Accounting Standards (SFAS) No. 130* early and found that the average impact of other comprehensive income on net income is material and positive. Comprehensive income is substantially higher than net income which will, they caution, reduce the prominence of net income as the principle measure of a company's performance and may cause confusion among some financial statement users about true earnings. Jordan and Clark (2002) expanded the study into 100 firms for 1998 and reached a similar conclusion. McCoy et al. (2009) collected data from the Fortune 500 which shows that items of other comprehensive income can be volatile and its impact increased from a -1.9% of net income in 1999 to -30.9% of net income in 2001⁴. It is of concern that the disclosure of comprehensive income creates an additional performance measure that has been proven to be more volatile than net income (McCoy et al. 2009). This has the potential to confuse users, which is also a point raised by Hirst (2006). Given the current popularity of this approach, it is important to ask why this accounting method is more popular when it may actually undermine the quality of accounting information.

4. Qualitative characteristics of useful financial information

4.1 From Reliability to Faithful Representation

Substantial changes are also identified in the Chapter 3 Qualitative Characteristics of Financial Reporting of *Framework 2010*. Firstly, the Board used the term Faithful Representation to replace the term Reliability. Second. Substance over form, prudence (conservatism) and verifiability, which were aspects of reliability in *Framework (1989)*, are not considered aspects of faithful representation. Substance over form and prudence were removed, and Verifiability is now described as an enhancing qualitative characteristic rather than as part of this fundamental qualitative characteristic (para. BC3.19 of *Framework 2010*). Referring to the replacement of the term reliability, the Board argued

[T]he comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on

⁴ King (2006, p. 58) offers an explanation of this: values change fairly quickly, and small percentage changes in asset values will necessarily be a much larger percentage change of earnings. If a company has an 8% pre-tax margin on annual sales of \$100 million, it would be reporting \$2 million (\$8 million/4) each quarter. If it had a similar \$100 million of assets that went down 1% in the quarter, which is not at all unlikely in many markets, then quarterly earnings would be cut in half (the \$2 million profits minus \$1 million value change). Similarly, a 1% increase in asset value would increase quarterly earnings by 50%, which would make the next quarter hard to beat from operations alone.

faithful representation, perhaps combined with neutrality. Some apparently think that reliability refers primarily to precision. (para. BC3.23 of *Framework 2010*)

In order to explain what reliability was intended to mean, the Board considered the term *faithful representation*, the faithful depiction in financial reports of economic phenomena, encompasses the main characteristics that the previous frameworks included as aspects of reliability.

This replacement, however, has been considered by some (e.g. see Bradbury 2008; Whittington 2008) as an important change to eliminate the possibility of a trade-off between relevance and reliability. According to Whittington (2008, p. 148) “[t]his trade-off is frequently invoked as a reason for not using fair value measurements, which are perceived as often being relevant but unreliable.”

Along a similar line, the paragraph QC15 of Framework 2010 suggested that:

[f]ree from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

It is suggested that these changes align well with the committees’ working agenda to incorporate Fair Value Accounting (FVA) in the IFRS. To a large extent, the FVA has been firmly entrenched with the belief of a free market mechanism. In many ways, this is obvious, but this kind of recognition is significant as to avoid assuming these underpinnings as natural and incontestable. The ‘fair’ value, according to the definition, is a price that could be concluded between market participants but not others such as the value-in-use calculated by discounted future cash flows.

Theoretically, the assumption underlying FVA is that prices derived from arm’s length market transactions reflect an effective analysis of the necessary information required to calculate the correct values (McSweeney 2009). Markets are deemed to be self-optimising and are presumed to accurately value assets. This is embedded within a view of the market power that has been reiterated in the promotion of neoliberal ideology (Harvey 2005; Ong 2006; Klein 2007).

From a technical perspective, there are substantial concerns over the ‘reliability’ of these kinds of market valuations that contain substantive amount of expectations about hypothetical future events under the current financialised macro-economy. The mark-to-market valuations of many financial assets, such as ‘securitised’ assets, swaps, collateralised debt obligations, are often readily available in active markets⁵ and thereby used in practice (Plantin et al. 2008). However, much research (e.g. see Ackermann 2009; Christensen and Nikolaev 2009) has indicated that financial assets were often overstated by market

⁵ These assets are primarily traded through over-the-counter markets.

valuations, which ultimately must fall. For those infrequently traded or non-traded assets, there is considerable management discretion in determining the amount and timing of asset valuation and/or revaluation (McSweeney 2009). The conspicuous uncertainty involved in the pricing process, however, has been oddly neglected in much of the FVA debate. Many textbooks and academic journal articles present theories and examples that predict the future with such certainty that future circumstance including cash flows, interest rates, and so forth are knowable (Williams 1938; Allen 1994; McKinsey et al. 2000; McSweeney 2009).

In the previous historical cost accounting system, share market prices and estimations based on those hypothetical models were not taken into account of value measurement in the accounting system. Hence the volatility of the share market was virtually isolated having very limited effect on measuring values in other economic sectors. In this sense, FVA, together with the practice of reporting Comprehensive Income, allows this erratic market valuation to be transmitted into the internal evaluation produced by the firm which would significantly influence any economic decisions made upon this valuation information. In the contemporary financialised economic environment this technical feature would distort the price discovery process in the business activities facilitating the volatility of financial markets to permeate the broader economic system.

4.2 Mispricing the 'risk'

The neoliberal movement has witnessed, borrowing Crotty's (2009, p. 565) term, "[a] powerful incentive to pursue high-risk, high-leverage strategies" in the capitalist system. As such:

In 1981 household debt was 48% of GDP, while in 2007 it was 100%. Private sector debt was 123% of GDP in 1981 and 290% by late 2008. The financial sector has been in a leveraging frenzy: its debt rose from 22% of GDP in 1981 to 117% in late 2008 (Crotty 2009, p. 575).

This is a shift fundamentally justified and fuelled by efficient financial market theory. The perception that has been created is that complex financial innovations (mostly derivatives) would allow the risk associated with securities to be divided into its component parts, such as interest rate and counter-party risk, because investors could only purchase those risk segments when they felt comfortable to hold (Crotty 2009). The tightly integrated global financial system expands this kind of 'hedging' benefits even further with risks being lightly sprinkled all across the globe, like Crotty (2009, p. 572) illustrates: "[s]ince markets price risk correctly, no one would be fooled into holding excessive risk, so systemic risk would be minimised."

The sheer size of financial assets in the world economy leads to significant pressures on accounting measurement. For example, at the end of 2007 about 11,000 essentially unregulated, mainly unaudited, and largely off-shore domiciled hedge funds worldwide controlled about \$2,250 billion in assets; the largest 3% of hedge funds accounted for four-fifths of total industry assets in 2007 (International Financial Services London 2008). It is

critical that the appropriate accounting measurements and calculations for these dominant financial capitals be correct.

Under the circumstances, instead of providing risk-avoiding information in measuring financial assets, FVA reinforces the false belief that the market prices the value correctly despite the complex nature of those financial products that are inherently non-transparent. Take Collateralised Debt Obligations (CDO) for example. At a very general sense, a mortgage-backed CDO converts the cash flows from the mortgages in its domain into tranches that have different risk characteristics (Sumerlin and Katzovitz 2007). Several thousand mortgages may go into a single Mortgage-Backed Security (MBS) and as many as 150 MBSs can be packaged into a single CDO which is extremely difficult to value (Chacko et al. 2006). More specifically, considering the price determination:

Even with a mathematical approach to handling correlation, the complexity of calculating the expected default payment, which is what is needed to arrive at a CDO price, grows exponentially with an increasing number of reference assets [the original mortgages]. . . . As it turns out, it is hard to derive a generalized model or formula that handles this complex calculation while still being practical to use. (Chacko et al. 2006, p. 226)

Investment banks and rating agencies that create these commercial papers use extremely complicated simulation models⁶ to price them. These models are understood as “unreliable and easily manipulated statistical black boxes” and “market insiders refer to the process through which CDOs are priced as marking to ‘magic’ or to ‘myth’” (Crotty 2009, p. 567). The inevitable uncertainty involved in the pricing process, however, has been oddly neglected in much of the FVA debate and let alone the IASB’s CF project. Discussions around the level of uncertainty involved and its manifestation in the emerging neoliberal context have been largely absent. What is more detrimental, as this paper considers, is that the instability of the financial market is introduced into the valuation process of the firm through the market pricing mechanism which does not necessarily reflect the implied systemic risks. This certainly enables key financial actors to transfer risks further onto other actors who are less alerted by the pricing signals.

4.3 An accounting ‘gearing’

There is a lot of research pointing out a ‘pro-cyclical’ pattern that is at the root of most financial crises (e.g. Bernanke et al. 1999; Pritchett 2000; Karolyi 2002; Graciela et al. 2004; Boyer 2007). The argument centres on the accelerating effect of financial leverage. During speculative periods, an exogenous productivity rise generates better profits allowing a decrease of risk premium that extends the firm’s ability to borrow from a bank or other financial institutions. This also increases the net value of the firm and hence the firm can take on more debt and increase capital formation. Consequently, the credit mechanism of financial markets amplifies the effect of booms and busts. In this regard, FVA and the

⁶ They are derived from financial theories with Efficient Market Hypothesis embedded.

reporting of comprehensive income can be viewed as other 'gearing' tools reinforcing these forms of financial acceleration (Boyer 2007). For instance, in good times, the appreciation of capital will reduce the need for building reserves in banks to comply with prudential ratios. However, in bad times it will be much greater with an extra credit squeeze.

This undesirable effect has never been more obvious than during the global financial and economic meltdown triggered by the US sub-prime crisis in the late 2007. During the financial crisis, banks and financial institutions have had to revalue assets at unrealistically low 'current market prices' which have declined severely with the collapse of credit markets as mortgage defaults escalated, rather than the higher values the institutions believe the assets should be worth in an orderly market. The decrements of FV wipe off sharply the value of assets on the balance sheet and hence the bottom line numbers, which forced many institutions to become unviable due only to paper losses. This included the biggest financial institutions⁷ in the U.S. The failure has put enormous pressure on the markets and undermined investors' confidence. The practice of these accounting rules, hence, can have a significant negative effect on financial markets. Some of the examples are accounting-based regulatory capital requirements for banks⁸ (Allen and Carletti 2008) and rating agencies using accounting information and issuing ratings that are used in debt contracts or capital requirements (Plantin et al. 2008).

5. Conclusion

Over the decades, neoliberal theory and rhetoric have reshaped human societies to engage in mass privatisation, intensive cuts to social welfare spending and deregulation in the various markets. While much research of neoliberalism and its destructive effects are now available, what has been absent is the political-economic story of how neoliberalism is proliferated within the accounting discipline. In this sense, this paper fills the gap contributing a different perspective to accounting literature. It extends the technical analysis of the IASB/FASB's conceptual framework project and provides some fundamental thinking on the neoliberal transformation and its implications in accounting standard setting. Through a critical reading of the IASB/FASB's *Framework 2010*, this paper reveals how the progress of this joint project has been engaged implicitly with value systems related to neoliberal free-market fundamentalism.

⁷ Lehman Brothers Holdings Inc which declared bankruptcy in 2008.

⁸ A stated requirement of liquid reserves placed upon banks and institutions that deal in risky ventures. These requirements exist for the protection of investors who hold an interest in these types of businesses. Governing bodies place reserve requirements upon these institutions based on the premise that stakeholders will still receive limited payment should insolvency occur.

More specifically, the working relation is confined to the narrow definition of 'users' in financial reporting and to the discursive partiality in replacing the controversial term 'reliability' with 'faithful representation'. As such, the interest of the owners of capital is prevailed as exemplified through the committees' working agenda to promote the notion of comprehensive income that sidelines the 'real' operating performance. In defining the qualitative characteristics of useful financial information, the controversial issue of how to provide 'reliable' information hangs over the shifting process, as this term is replaced by a more neutral, but still elusive, discursive label namely Faithful Representation. As a result, this leaves the opposition of the increasing use of FVA bereft of theoretical grounds. As criticism centres on the 'unreliable' implementation of fair value based accounting measurement given the significant amount of subjective 'professional' judgement involved, it will become difficult to criticise FVA based on the notion of 'reliability' because the word 'reliability' is no longer part of the language that is endorsed by the committees for communicating the qualitative characteristics of useful financial information. Considering the effects of financialisation and the 'uncertainty' inherited within the financial market, 'reliability' is a significant attribute and the relegation of this notion involved in the conceptual framework has real potential to obscure the relevance of this issue within 'general' discussion, and hence the actions thereafter. By redefining the language, like labelling the 'mark-to-market' price as 'fair value', the committees are discursively creating a boundary for 'faithful representation' paralleling the 'estimation' and the possible errors. These changes identified are effective in distorting the traditional price discovery process and gearing further 'risks' saturated with the financial system. Instead of producing failure-avoiding information within a world "[w]here almost all asset classes could swing wildly in value" (Tett 2008, accessed 9 Feb 2011, available from: http://us.ft.com/ftgateway/superpage.ft?news_id=fto102720081232148560&page=2), the conceptual framework accords itself with the preconceived ideas of the neoliberal market, which works, implicitly and yet so full of possibility, with the neoliberal financiers to create a fictional world that is utterly compelling.

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