Conceptual Issues in Financial Reporting

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Abstract
Standard setters have sought a conceptual framework to guide development of a consistent set of accounting standards. However, the framework has two key weaknesses. First, it is very broad, lacks a measurement framework, and can be used ex post to justify a wide range of actual accounting standards. Second, all accounting issues are viewed as being conceptual issues. In many cases, we may need a good enough (even arbitrary) standard that coordinates our reporting choices, while at the same time trying to develop some systematic way of choosing measurement methods based on the cost and reliability of those measures.

We examine four key conceptual issues related to consistency that are at the heart of many financial reporting dilemmas: stocks and flows, ex-ante and ex post, conventions and economic substance, and evolution and design by standard setting bodies. Associated with each conceptual issue is an accounting duality; in some cases one side (e.g., stocks) is easier to measure in a reliable manner, while the other side (e.g., flows) is easier to measure in other instances. We suggest that financial reporting would benefit from a willingness to pay attention to both sides, and balance the reliability of measurement in specific issues (a local approach) with broad principles applied across many issues when possible (consistency).

Keywords: Conceptual Framework, Consistency, Verifiability, Conventions
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Introduction

Since 1972, financial reporting standards in the U.S. have been developed by a private standard setting organization called the Financial Accounting Standards Board (FASB), subject to oversight and approval of the Securities and Exchange Commission (SEC). For the sake of global logical consistency across standards, the FASB justifies its standards as being derived from a conceptual framework. The conceptual framework proposes qualitative characteristics such as relevance, faithful representation, comparability, and verifiability as criteria for selection of standards (see FASB Concept No. 8, 2010). Consistency is pursued by constructing a set of definitions (e.g., for assets and liabilities) and the adoption of a “fair value” perspective on financial reporting (see FASB/IASB 2005, 2006, and discussion in Bromwich et al. 2010). Exposure drafts on these proposals, especially those related to “fair value”, have attracted widespread interest and participation (e.g., AAA 2007; AAA 2010a and 2010b).

The principle of consistency has been thought of as a unitary concept in accounting debates. However, accounting creates an elaborate system of classification that can be examined at many levels of abstraction. All transactions have some features in common with other transactions, and also some differences. Classification activity requires treating transactions which have some features in common as being part of the same category, while ignoring certain differences. The lack of a well-articulated measurement framework (common set of core transaction features) makes it difficult to impose one uniform classification standard across all transactions and events that occur in the economy. Consistency can be examined with respect to many different dimensions: (1) ex ante vs. ex post, (2) choice between arbitrary conventions and procedures or attempting to capture the economic substance of business transactions, and (3)
level of detail at which a principle or rule is applied, because what is consistent at one level of detail (e.g., expense all research and development outlays) appears inconsistent at a finer level (e.g., expense the R&D outlays irrespective of whether or not they generate future benefits).

Arguably, unless consistency describes a striving towards conveying a true and fair view of the economic phenomena it purports to represent (faithful representation), it is easily reduced to an empty slogan. A survey by Collins et al., (2002) indicates that users perceive an accounting report to be of high quality when it reflects economic reality, rather than just achieving consistency. At the same time, O’Brien (2009) and others have argued that the FASB’s recent overhaul of the conceptual framework appears to be designed (by eliminating reliability and de-emphasizing verifiability) to justify fair value as the particular measurement focus rather than to serve as a more meaningful basis for evaluating tradeoffs. Historical cost also depicts an economic reality of the firm—one focused on the measurement of performance vs. fair value’s focus on measuring volatility. Trading off relevance with verifiability, or Ijiri’s (1975) broader concept of “hardness”, is an alternative starting point from which we could decide which economic picture is the most useful to present in particular situations.¹

We have a poor track record of using a conceptual framework and broad principles as the foundation (or even guide) in developing consistent accounting standards. In many cases, it is difficult to claim that particular accounting standards that seem to exhibit an evolutionary stability (and general acceptance) are consistent with each other, let alone any conceptual

¹ Ijiri (1975) defines hardness as having three ingredients: (1) “begin with verifiable facts”, (2) use a well-specified measurement process “to enable the parties to judge which measurement rules for transforming facts into figures are justifiable and which are not”, and (3) “the number of justifiable measurement rules should be restricted”. Ijiri (1975) contrasts hardness with Ijiri and Jaedicke’s (1966) objectivity (essentially the FASB’s verifiability): “after having obtained a distribution of the measure by a group of neutral measurers, the measurers are divided into two groups; one group is given an incentive to push the measure as low as possible and the other group is given incentive to push the measure as high as possible.” The less dispersion in the initial neutral measurements, the more objective is the measure. The less dispersion in the second competitive measurement, the harder is the measure.
framework. As Hatfield remarked in 1939, “[i]t will indeed be fortunate … if one can really recognize a principle when one comes face to face with it in the jungles of accounting literature.” As Paton (1922) observed, even when accounting has tried to adhere to “fundamental propositions”, many have been “largely assumptions of expediency”. Since the days of Hatfield and Paton, much effort has been devoted to developing a conceptual framework, yet much remains the same. Perhaps, accounting practice is inherently better served by a mix of concepts and expedient conventions and design and evolution (see Dopuch and Sunder 1980).

We use four basic facets of financial reporting to guide our exploration of the role of consistency vis-à-vis other qualitative considerations and the difficulty in representing the economic condition of an organization in a unique and defensible manner: (1) stocks and flows, (2) ex ante and ex post, (3) convention and economic substance, and (4) design and evolution. These dimensions underlie many of the financial reporting issues debated over the past century. It is useful to reflect on these foundational issues in isolation from the debates on specific standards and financial reporting practices. We raise the question of whether these issues should be thought of locally, rather than seeking some grand logical global consistency across their accounting applications. Perhaps the Financial Accounting Standards Committee of the AAA can help stimulate further reflection and discussion on these issues by sharing its thoughts and analysis. The following sections are written in that spirit.

**Stocks and Flows**

Stock and flow magnitudes are related by a simple law of conservation: ending stock equals the beginning stock plus the net flow over the interval of time between the two instants when the stocks are measured. This identity forms the basis of double-entry bookkeeping and the

If magnitudes of all resources of interest in financial reporting were observable and measurable, or at least were equally so, many of the controversies of financial reporting would not arise. However, resources vary in how well we can observe and measure their magnitudes; even the stocks and flows of the same resource are not susceptible to measurement with the same degree of precision (i.e., objectivity and reliability). Further, the measurability may change over time. These variations give rise to many of the familiar challenges in financial reporting.

Consider a building as an example. At the time of its construction or acquisition in an arms-length transaction, the stock of this resource is measurable with reasonable objectivity. But the rate of flow of services deriving from it is more subjective, even at the outset. With the passage of a few years, even the stock of the remaining services becomes more subjective if such buildings are not traded in a relatively perfect market. On the other hand, a patent that earns periodic royalties presents a case in which periodic flows are measurable with a high degree of objectivity but given the uncertainty about the quantity and duration of future royalties—the stock magnitude associated with the patent—is more subjective, unless of course, its value is determinable in a relatively perfect market, which is often not the case.

Other than cash, virtually all resources share this problem of heterogeneity of measurability of stocks and flows in varying degrees. Attempting to articulate the balance sheet to income/cash flow statements calls for either (1) including unacceptably subjective magnitudes in one statement, that correspond to not-so-subjective magnitudes in the other; or (2) excluding the not-so-subjective magnitudes from one statement because the corresponding magnitudes in the other are too subjective to justify their inclusion (e.g., fair value measurements on the balance
sheet that will have nothing to do with actual cash flows if a debt security is held to maturity). It is difficult to give up articulation on one hand, just as it is difficult to accept either of the two combinations on the other.

This problem of financial reporting has generated a variety of proposals. FASB/IASB (2005) joint manifesto on conceptual framework declared in favor of stocks (the so-called asset-liability) view of accounting on grounds that it corresponds to the Hicksian (1946) definition of income. However, conceptual consistency could be achieved just as well by taking an approach in favor of flows (see for example the FASB/IASB [2008] customer consideration model). Finally, there is the possibility that we abandon neither stocks nor flows, and continue to muddle along using accounting conventions that evolved in a world of ubiquitous measurement heterogeneity (discussed in a later section on accounting conventions).

As a practical matter and in spite of their strenuous protestations to the contrary, all rule-makers end up taking this “muddling through” route, as evidenced in the distances between their professed conceptual frameworks and actual pronouncements. In their lease accounting exposure draft, the FASB/IASB (2010) find it difficult to ensure that accounting for leases and executory contracts for services is done in a mutually consistent fashion by the lessee and the lessor (AAA, December 2010c). Yet, standard setters find it attractive to claim that they are pursuing global logical consistency of which FASB/IASB’s asset/liability approach is an example (Barth 2008).

**Ex ante and Ex post Consistency**

Accounting stands at the present, on the knife edge boundary between the past and the future. Inevitably, it struggles to define itself relative to the events of the past (what Hicks, 1946

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2 See Bromwich et al. (2010) for arguments as to why the FASB/IASB claim that their proposal is based on Hicksian analysis is not justified.
refers to as statistical record) and anticipation of future events that have not yet occurred, may never occur, and possibly remain to be conceived of in their details.

Looking back into the past, financial reports can be seen as consequences of decisions, commitments, and events that have already taken place. This statistical record is essential to establish accountability for creating and operating organizations as Ijiri (1975) has shown. In addition, to the extent we live in a world that retains some continuity persistence through time (i.e., does not continually and totally reinvent itself), this record helps form useful expectations about the behavior and events of the future, and thus serves as a common knowledge basis for formation of reputation. Absent historical record, accounting will not serve its function of communicating and implementing the social contracts that constitute organizations, or provide a validated database, and state variables that might serve to help make better decisions for the future, and at the very least, reduce repetition of mistakes of the past (see, e.g., Sunder, 1997). This is the conceptual justification for historical cost accounting based on actual transactions (Ijiri 1975), though even this form of accounting has to rely on subjective estimates about future events to some extent.

Looking into the future, decision-making (including negotiation and design of contracts) calls for estimates of anticipated consequences of alternative courses of action. Again, current values of the relevant state variables, and any anticipated changes in their value over time, are valuable knowledge. To the extent financial reports can fulfill this role, they become more important. However, with the exception of the few resources whose stocks or flows may be traded in relatively deep, perfect, and efficient markets, most future magnitudes call for use of subjective judgment aggravating problems of verification and moral hazard in our imperfect world. Besides imperfection of markets that do exist, many important resources are not actively
traded. This imperfection and incompleteness of markets raises difficult challenges for measurement of income (see Beaver and Demski, 1974, and Christensen and Demski, 2003).

Hicks (1946), whose analysis of income has the distinction of often being cited in accounting literature to support a variety of (frequently contradictory) positions, considered both stocks- as well as flows-based versions of ex ante and ex post concepts of income (along with others), and came to no clear conclusion about the dominance of any one over the rest (see, e.g., Bromwich et al. 2010).

In some cases accounting practices seek consistency ex post. For example, revenue is recorded at time of sale and a receivable is set up. At a later date, a bad debt allowance is calculated by aging a set of receivables and then using payment history (and arrears) as a guide to determine the amount of allowance needed. This practice creates ex post consistency in the recording of revenues, receivables and allowance for bad debts. It is also possible to set up the accounting for these amounts ex ante. At the time of sale, revenue recorded could be discounted based on an expected loss from sales to clients of different quality of credit worthiness (an option pursued in the 2010 FASB/IASB revenue recognition discussion paper). In some countries (e.g., Canada), bank regulators require all banks to charge a general loan loss provision based on the creditworthiness of classes of customers. A bank would thus book an allowance before any specific loan has gone into arrears. This practice could be construed as setting up ex ante consistency in the way that loan loss provisions are being set up. At present, in Canada, manufacturing companies set up bad debt allowances ex post, whereas banks set up loan loss provisions ex ante. Both these practices could be considered to be consistent, and there is no conceptual framework of accounting that can specify whether ex ante consistency dominates the ex post approach.
**Conventions and Economics**

Accounting standard setters desire a set of standards that can be applied consistently over time and across companies. There are two ways of identifying standards that have long run stability, namely, arbitrary conventions that act as co-ordinating devices, and measurement methods which reflect the long run economic substance of transactions. The standard setting consequences of these two approaches are quite different, and the accounting literature has not focused much attention on these differences.

**Conventions**

Accountants differ in their use and interpretations of the terms conventions, postulates, principles, and doctrines. Most accounting textbooks and standards enumerate accounting conventions in a variety of ways. Statements of fact, conclusions from argument, assumptions, opinions, and wish lists all seem to find space under the umbrella of accounting conventions. Chambers (1964) provides an illuminating analysis of this and other problems associated with accounting conventions.

The Accounting Principles Board (1970) took a narrow view of conventions. It listed items that are frequently cited as conventions by other writers (e.g., accounting entity, going concern, time period, monetary unit, and exchange price) out of a larger set, called “basic features of financial accounting” and labeled all generally accepted accounting principles as conventions because “they become generally accepted by agreement (often tacit agreement) rather than formal derivation from a set of postulates or basic concepts. The principles have developed on the basis of experience, reason, custom, usage, and to a significant extent, practical necessity.” (Paragraph 139). They essentially defined all accounting practice as conventional. However, in the list of “pervasive accounting principles,” they included six “measurement
principles” and three “modifying conventions”: conservatism, emphasis on income, and application of judgment by the profession as a whole. This interpretation of accounting convention is consistent with the idea of social norms (Sunder 2005). The large volume of accounting literature on conventions takes many diverse approaches to interpretation.

An early statement on accounting conventions is also one of the best: Gilman (1939) identified two characteristics of accounting propositions that constitute a convention: (1) they are based on general agreement and (2) they are more or less arbitrarily established. Among all generally accepted propositions, only those that are arbitrarily determined qualify. The definition and some of the examples given in Kohler’s Dictionary (Cooper and Ijiri 1983) have a similar flavor: “The adoption of a particular convention may be a historical accident, but once adopted, a convention acquires value as a means of communication and cooperation.” The idea that convention is an arbitrary social choice—whose value lies in the mere fact of its general acceptance rather than in the particular choice made—captures its essence. In other words, while some features of accounting may be valued directly for the specific choices made according to how well they reflect the long run economic substance of transactions, others may be valued indirectly for their coordination benefits that even arbitrary choices yield through their social acceptance and wide use.

As an example, Hardin (1982) analyzes contracts by convention using a simple game between two persons. When coordination by direct communication is difficult, costly, or impossible, it may be socially advantageous to coordinate through such a convention.

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<tr>
<th>Payoff Table</th>
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<tr>
<td>(In each cell, first number is row player’s and the second is column player’s payoff)</td>
<td>Column Player</td>
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<td>Left</td>
<td>Right</td>
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Each player must choose one out of the two possible moves. If the row player chooses top, the best thing for the column player is to choose left; if the column player chooses left, the best thing for the row player is to choose top. The same is true if the order in which the players chose their moves were reversed. Since the choice of top row and left column are the best responses to each other, this cell constitutes a Nash equilibrium of this game. By similar argument, bottom right is also a Nash equilibrium; the top right and bottom left are not.

No player can improve his or her payoff by moving out of the Nash equilibrium cells if the opponent is playing that cell. However, in the absence of some implicit or explicit coordination between the players, there can be no assurance that they will achieve the high payoffs associated with the Nash equilibria. Both players would be better off if they adopted some convention to coordinate their moves.

Certain conditions must be satisfied for a pattern of behavior to be a convention. First, it must apply to recurrent situations and not to one-of-a-kind events. Second, a convention has to be common knowledge. Not only does everyone behave in a certain way, but everyone also expects and knows that others will behave in that manner. Third, it is in everyone’s interest for one more person to conform to the convention. Finally, for a convention to be meaningful there must be an alternative pattern of behavior that is preferred by everyone, on the condition that everyone else conforms to that alternative.³ Thus, driving on the right (or left) side of the road

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³ For a formal definition of a convention, see Lewis (1969, p. 78): “A regularity R in the behavior of members of a population P when they are agents in a recurrent situation S is a convention if and only if it is true that, and it is common knowledge in P that, in almost any instance of S among members of P, (1) almost everyone conforms to R; (2) almost everyone expects almost everyone else to conform to R; (3) almost everyone has approximately the same
could be regarded as a convention. The social or economic value of the convention arises not from the particular choice (e.g., driving on the left or right), but from the fewer collisions that coordination—everyone driving on the same side of the road—yields in this example.

An accounting convention survives by familiarity from current use, and the costs of search and adjustment imposed by its abandonment. Once a change in convention has been made, and adjustment completed, no one is better or worse off than if the change had not been made, except for the cost of the adjustment itself. Therefore, agents have a stake in maintaining the status quo on conventions as long as the environment does not change much.

The current state of accounting measurement makes it very difficult to measure certain items. The standard setters choose between ignoring certain items (e.g., environmental liabilities that may occur in the distant future) or imposing an arbitrary measurement method, that is, follow a convention. Once an accounting issue has been identified to be subject to a convention, the standard setter can proceed expeditiously to support the status quo practice (or practices such as multiple ways of computing depreciation); and if no practice exists, select one so as to minimize the cost of adjustment. The bookkeeping practice of writing debits on the left and credits on the right-hand side of a sheet of paper is a convention in this sense. The same is true of listing of assets and liabilities in order of decreasing liquidity.

More substantive accounting policy choices that could be considered to be conventions include depreciation methods (e.g., straight line), goodwill amortization periods (which have historically ranged from 0 to 40 years), using one year as a cut-off for separating current from preferences regarding all possible combinations of actions; (4) almost everyone prefers that any one more (person) conform to R, on the condition that almost everyone conform to R; (5) almost everyone would prefer that any one more (person) conform to R’, on condition that almost everyone conform to R’, where R’ is some possible regularity in the behavior of members of P in S, such that almost no one in almost any instance of S among members of P could conform both to R’ and to R.”
non-current assets and liabilities, netting versus grossing income statement items such as revenues and returns, and classification of many instruments as debt versus equity. Some items may not conceptually be arbitrary but their implementation may be so subjective as to effectively make them seem arbitrary. Classification of items as unusual/extraordinary, recording dividends as operating or financing activity, determining what entities need to be consolidated, and measurement of intangibles/ goodwill may be constructively arbitrary in practice.

It is possible that a change in measurement methodology may alter how an item is measured and make some of these items easier to measure and hence less arbitrary. However, the crucial test is that there should be both a conceptual change and improved ability to measure the item reliably. For example, the change of goodwill accounting from amortization over an arbitrarily chosen fixed period to imposing an impairment test could move goodwill out of the category of accounting conventions. However, if management has too much discretion in making the impairment decision (see, for example, Hilton and O’Brien 2009), then the impairment decision is still essentially arbitrary.

In absence of a convention the economic benefits of general agreement would be lost, and agents would incur additional costs of auditing, reading, and interpreting financial statements and accounting books. The key implication of our argument for standard setting (and education of future accountants) is that elements of accounting that are classified as being conventions (e.g., amortization period of goodwill, methods of depreciation) need not be on the standard setting board’s agenda. Once these conventions have been adopted, and acknowledged to be arbitrary, they should be left alone unless there is some drastic change in the economy that renders the convention substantively inefficient as a general practice.
Note that it is easy to compile specific examples of inefficient consequences of even the best of social conventions; even the driving-on-the-right convention, enforced by law, merely reduces but does not eliminate all head on collisions. It is important however, that certain accounting practices (e.g., straight line depreciation) be commonly understood (and taught) as arbitrary, albeit useful, conventions, and not be justified by developing a forced economic logic of being uniquely optimal. It is also important for standard setting boards not to spend their time and research resources on endless projects to refine accounting conventions such as goodwill and depreciation.

**Attempts to Measure Economic Substance**

For many aspects of accounting that are sometimes referred to as conventions, standard setting boards sort through competing accounting treatments which reflect different economic perspectives. Conservatism, entity, going concern, period, accrual, matching, unit of account, and various valuation methods for revenue recognition, leasing and financial instruments are not conventions in the sense described above because the specific choices made in practice are not arbitrary but reflect a different picture of the economics of the firm. The FASB’s conceptual framework is supposed to provide guidance for developing related standards. Previous research has shown that the conceptual framework with its broad categories of relevance, faithful representation, verifiability cannot be used ex ante to reliably choose between accounting alternatives. Consider for example, which is more relevant: successful efforts or full cost accounting for oil and gas exploration? Most standard setters and users of accounting do not agree on such judgments (Joyce, Libby and Sunder 1982). Lack of sufficient precision in measurement criteria means that decisions about the appropriate underlying economic substance

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4 Depreciation is an example of the matching concept. However, we classified depreciation as an accounting convention because the accounting methodology for computing depreciation is arbitrary.
of transactions often have to be made based on the professional judgment of the members of standard setting boards, and then justified ex post using broad conceptual categories from the conceptual framework. Indeed, one of the critiques of the FASB/IASB’s conceptual framework is that the Boards may already have a predetermined outcome they wish to reach (e.g., use of the so-called “fair value” measures), and the conceptual framework is designed to provide the cover of ex post justification for these pre-determined outcomes (O’Brien 2009).

Stability of conventions as well as of economic features of accounting depends on stability of the environment of financial reporting. The long-run stability of some features of accounting arises when the forces that bring these features into usage are relatively stable, and so is the equilibrium solution. Longer term stability of an accounting practice—double entry, for example—should not be mistaken for a convention. Under causal interpretation (Ijiri, 1967) the “double” part of double-entry accounting arises from simultaneous consideration given to the causes and effects of economic events and actions, and match with our two-valued system of logic. It is possible that one day we may discover more causal links or switch our system of logic, in which case triple- or even quadruple-entry systems may become more appropriate (Ijiri, 1982).

When new, more complex, and poorly understood economic practices arise (e.g., derivatives), we need to resolve whether they should be subject to an accounting convention or to a substantive standard. If there is no adequate accounting methodology for addressing the issue, it is deemed to be a convention, and an arbitrary rule can expeditiously be adopted, perhaps through a separate and simpler process. If the new practice is deemed to be amenable to a reliable measurement and is intended to measure economic substance, then it could be a candidate to enter the normal standard setting process. The Board can then decide if they have
enough information, and experience from practice, to choose a preferred accounting treatment. This triage would enable the standard setting board to respond more quickly to conventions, and focus its research and decision making resources on the few issues where the current methodology of accounting makes it feasible to construct effective standards that focus on economic substance.

**Design and Evolution**

One conceptual issue in financial reporting that has received little attention in the accounting literature is the extent of standardization, and the choice of institutions to achieve the desired level—and no more—through appropriate standards. Financial reporting existed for a long period with little role for written standards. Indeed, a good understanding of this process is reflected in the Accounting Principles Board’s Statement (1970, paragraph 139) cited above. A fundamental conceptual issue is what kind of institutions can help us achieve an efficient type and extent of standardization. Extent of standardization calls for judgment because it is difficult for corporate bodies set up with the exclusive task of writing rules to exercise self-restraint and say no to requests for clarification of their rules; there is no rule for which further clarification cannot be sought. Even after this difficult judgment has been made in favor of standardization (i.e., issuing a written rule) more difficult judgments are required to choose among multiple candidate rules.

In accounting, as in law, many practices, language and their meaning evolve over long intervals of time as social mores and norms (see Baxter, 1953 and 1979; Kitchen, 1954; and Sunder, 2005a and b). Even then, the meaning of words must have an element of ambiguity for words to have the generality and applicability to more than one object or incidence. The extent and the manner of improving upon this slow evolutionary process through deliberate design by
an authoritative body is a basic conceptual issue in financial reporting. There are significant arguments in favor of both bottom-up evolution as well as top-down design (Sunder 2007).

Rule makers face a difficult problem in identifying better rules (Sunder 2010). One can appreciate this challenge by asking a simple question: what is a good rule for determining pass interference in the game of American football? Rules affect different members of society (and players in a game) in diverse ways. The direct effect of the rules on people depends on their individual circumstances, of which the rule maker can have only limited knowledge at best (see Hayek, 1945). Rules are designed in the hope that they will change or constrain the behavior of at least some people; however, changes in individual behavior interact in complex ways, generating aggregate consequences that are difficult for the rule-makers to anticipate and analyze.

The rule makers try to ameliorate this inherent informational disadvantage by soliciting information from the parties potentially affected by their actions. These parties may or may not have the incentive to report truthfully. Their strategic responses can muddy the waters, create a gaming problem and often force the rule maker to deal with unintended consequences of the rules. Whether evolved norms (since they emerge over longer intervals of time through trial-and-error) or designed rules (since they arise from careful deliberations) incorporate more and better information remains an open question.

Corporate bodies created to set standards face choices of structure, people and resources. Legislative structures emphasize representativeness; judicial structures emphasize impartiality, while bureaucratic structures value rules of procedure. It is difficult to attain representativeness, impartiality, and consistency of procedure all at once in a single institutional structure (Sunder, 1988). Finding people to operate the rule-making organizations raises parallel problems. The best experts may not be representative or impartial, and they may be inclined to use their judgment instead of following pre-defined procedures. Representative bodies may lack expertise in the
substance of the technical matters of accounting. Furthermore, some board members may not place impartiality high on their agenda. Those who pay the cost of developing written standards understandably may also seek to further their own agenda through their influence over the finances of the standard-setting entity.

Dependence on social norms does not provide a clearly superior route either. Norms take a long time to develop, and cannot be expected to develop expeditiously in response to urgent new developments. Societies can also get stuck in inefficient norms for long periods of time (e.g., slavery), and it takes concerted action to break from the shackles of self-fulfilling expectations that sustain social norms.

Given the limitations and weaknesses of designed standards and evolved norms, it is perhaps inevitable that accounting and business practices combine the two elements. The conceptual challenge before accounting is to develop a coherent method of combining the two along the lines achieved by statutory and common law. For example, the FASB/IASB are currently in the process of developing a new lease standard that is supposed to be principles-based (right-of-use model) and requires all leases to be reported on the balance sheet at the present value of the cash flows involved in the lease (FASB/IASB 2009). The proposed new lease standard maintains current definitions of a lease (excluding executory contracts), scope paragraph, definitions and measurement rules (renewal options are not counted), but removes the four bright line tests that currently separate leases into operating and capital leases. A recent experiment by Jamal and Tan (2010) indicates that for these new rules to make a difference in reporting behavior, the auditor must be able to exercise substantial discretion, which implies a subtle shift in the norm that governs auditor-management negotiation (Jamal and Tan 2010). Note that even when FASB/IASB use the so-called “fair value” reporting and attempt to bring leasing standards into compliance with underlying principles (a lease is a financing transaction),

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the proposed standard change is for a “local” adjustment (existing scope, definition, measurement rules and their associated loopholes remain in the standard), rather than a global adjustment where leasing rules are brought into conformity with all other rules especially those covering executory contracts, revenue recognition, consolidation and financial statement presentation. This attests to the practical difficulty of changing standards to make them globally consistent with all other standards.

As a response to calls for comment on structure of standard setting bodies, the AAA’s financial accounting standards committee has previously advocated a mix of reliance on public funding and charging users of standards a fee for use of standards (AAA 2010b). While it is comforting to stress independence of standard setters as their key attribute, it is also important to focus on competence and responsiveness to the complexities of actual business operations. In many areas of the economy, private standard setters provide a joint product consisting of standards and certification and charge the users of the standards a fee (see Jamal et al., 2003, 2005 for examples in e-commerce). This revenue model forces the standard setter to attend to the complexities of the business environment in which companies operate, instead of ignoring important features of the environment in imposing a uniform set of rules.

**Concluding Remarks**

Development and refinement of a conceptual framework of accounting is high on the agenda of standard setting boards. Often the development of standards is guided by subsidiary definitions (e.g., of assets and liabilities) and various measurement preferences (e.g., in favor of fair value) whereas justification of standards is made by reference to qualitative considerations in the conceptual framework (e.g., relevance, faithful representation) and a broader concern for consistency across standards. The use of consistency as a key justification is problematic both because it is used in an ex post way to justify decisions and because there are many different
meanings of consistency, depending on time, level of analysis, and in some cases, even arbitrary conventions can lead to long run consistency in accounting standards (and contracting behavior). Lack of a well-defined measurement model means that we have to depend on the professional judgment of standard setters to tradeoff consistency, cost and reliability of various measurement metrics.

Four dichotomies—stocks and flows, ex ante and ex post consistency, convention and economics, and evolution and design—capture a good part of the dilemmas that face accountants in virtually every aspect of financial reporting. We highlight these dichotomies in the hope of stimulating further reflection, discussion, and debate to deepen our understanding and enlighten the practice of accounting. We also raise the question about whether it is possible to ever achieve accounting global coherence and consistency across all transactions (and time), as opposed to more local muddling through the issues. We do not think that it is wise to choose one side of the dichotomy over the other (e.g., stocks over flows) and highlight that consistency has many possible definitions and sources. An explicit recognition that consistency and reliability of measurement have to be traded off may provide a better understanding of the current standard setting process and make it easier for standard setters to exercise and justify their professional judgment.
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