Non-ideal Accounting

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Abstract: Accounting conceptual frameworks make assumptions about the roles of corporations, the impact of accounting information on the economy and society, and the level of analysis for evaluating the framework. This paper argues that current thinking is based on a conception of an ideal world which does not exist and to provide more useful information accounting development needs to experiment with new approaches more in line with the complex, multidimensional and untidy reality in which accounting is practiced.

Field of Research: Financial Reporting

1 Introduction

The conceptual frameworks which accountants use make a number of assumptions many of which are influenced by finance theory and/or neoclassical economics. However recent events have raised questions about the role of accounting in the misallocation of resources and their responsibility for increasing the severity of business cycles. In such circumstances it might be expected that there would be a major re-evaluation of the underlying theory of financial reporting. In contrast current efforts to revise and harmonise the conceptual frameworks can be described as refinements of earlier approaches without questioning the fundamentals of the whole approach to external financial reporting. In these circumstances it appears that there is considerable opportunity for accounting research which explores alternative assumptions and broadens the consideration of the impact of the accounting on the operation of the economy and society. This would involve development of alternative economic and sociological foundations for accounting models followed by empirical testing to see whether or not the alternative models achieve better allocations of resources and avoidance of externalities than existing models. This paper will not undertake such investigations but will have a more limited objective of creating awareness of some of the assumptions of existing conceptual frameworks with a view to stimulating thoughts as to what alternative assumptions could be fruitfully explored. The next section will examine the literature from a range of disciplines regarding the assumptions of accounting conceptual frameworks.

2 Literature Review

2.1 Economic Assumptions

The accounting conceptual framework adopts a neo-classical approach which assumes that the role of accounting is to contribute as far as possible to a laissez faire economic system. It assumes that markets efficiently allocate resources (Christensen & Demski, 2003) and that accounting contributes to these allocations and that the stock market is a major source of new finance.

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Comments by Rodrik (2009, 62) on the current public perception of economics is relevant here:

> "The fault lies not with economics, but with economists. The problem is that economists (and those who listen to them) became overly confident in their preferred models of the moment: markets are efficient, financial innovation transfers risk to those best able to bear it; self regulation works best; and government intervention is ineffective and harmful."
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> And
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> "Economics' richness has not been reflected in public debate because economists have taken far too much licence. Instead of presenting menus of options and listing the relevant trade-offs - which is what economics is about - economists have too often conveyed their own social and political preferences.
> Instead of being analysts, they have been ideologues, favouring one set of social arrangements over others.
> Furthermore, economists have been reluctant to share their intellectual doubts with the public, lest they empower the barbarians."

A professor of religion expressed it this way: 'According to the models financial economists devised, investors are rational and markets operate efficiently in a world where there is no event that is unexplainable and no risk that is unmanageable. While claiming to be realists the true believers imagine an ideal world at odds with the new realities emerging in network culture. Their dream of a rationally ordered world where every risk can be hedged is as old as time itself. All such schemes are designed to escape time and history and thereby overcome the inescapable insecurity of life. In the final analysis, this dream is a religious vision in which the market is a reasonable God providentially guiding the world to the Promised Land where redemption finally becomes possible.' (Taylor, 2004, 238-9)

The above comment is shaded by the ideological views of the author but as Rodrik explained there is a need to present the various alternate value judgements. However the first step is to recognise that every approach has a set of presuppositions.

Lavoie (2006,7) has analysed the two major orientations of competing schools of thought in economics in the following table.

Presuppositions of the neoclassical and heterodox research programmes
Presuppositions

	Paradigms	
	Heterodox approaches	Neoclassical approach
Epistemology	Realism	Instrumentalism
Ontology	Organicism	Individualism
Rationality	Procedural rationality	Substantive rationality
Focus of analysis	Production, growth	Exchange, scarcity
Political core	State intervention	Free markets

The presuppositions outlined in that table will now be explained.
Realism versus instrumentalism

When theories are built they consist of models of varying degrees of abstraction. What is the most appropriate level depends on what you expect of the models. If the emphasis is on the ability of the model to accurately predict the value of items in the new equilibrium state then the model is instrumental. On the other hand if the emphasis is on capturing as much as possible how the economy actually works then the model is adopting a realism perspective. Triana (2009) argues that theory should be based on practical knowledge so that theory is realistic.

Organism versus methodological individualism

In neoclassical economics the emphasis is on the individual making economic choices. Whereas in the heterodox view the emphasis is on the individual as part of a social network and hence makes decisions which reflect cultural and social norms and ideology (Trigilia,1998/2002).

Procedural versus substantial rationality

Neoclassical analysis assumes that decision makers undertake a rational analysis of all the alternatives and choose the best outcome. Heterodox economics (including post-Keynesian analysis) assumes bounded rationality.

This paper suggests that accountants work with economists to ascertain whether if on the adoption of alternative assumptions from competing economic theories this would result in different views as to what is the most appropriate accounting information. To illustrate a few examples might assist but it is not suggested that these are the only or even the most important assumptions that should be explored.

(a)If we are not dealing with perfect markets but rather with monopolies and oligopolies (Parker, 1990) what information disclosures will most likely contribute to the best allocation for society as a whole (Smith, 2010, 329) ? This is not a trivial question because economists have shown that where the world does not conform to the ideal model improving one part of reality to conform to the model does not necessarily lead to a position which is closer to optimum when the other variables do not also conform to the model (Case, 2007; Smith 2010;Folsom, 2007)[i]. Also there is work in the area of Bertrand and Cournot competition which derive optimum solutions in oligopoly implications have not been explored in terms of implications for accounting conceptual frameworks. The tendency of business leaders to attempt to thwart the pressures of perfect competition was highlighted by Adam Smith in the Wealth of Nations and has been documented in the contemporary environment

(Smith, 2010) and yet the implications for accounting theory have not been explored. In a similar pattern business groups try to influence accounting regulation and this political theory is a branch of accounting but the implications for the choice of accounting theories themselves or the form these theories should take to at least partially counter those pressures have not been explored.

(b)Another area which is relevant is the role of financial markets. If it is assumed that they are purely based on rational analysis then we are assuming away one of the major problems facing accountants namely the implications of the instability of market prices. Soros (1997& 2008) pointed out that the financial markets are significantly influenced by expectations as to future behaviour of markets as opposed to economic fundamentals involved. There is ample room for research on how accounting theories and the resulting numbers following the application of those theories (conceptual frameworks) influence markets, and in turn the impact of markets on accounting theories and numbers. This is turn may need an examination of accounting and business cycles. Accounting standard setters have indicated in public meetings that they are reluctant to look at these areas because it would allow managerial discretion.

(c) It is assumed that the stock markets are major sources of new capital but it has been shown that in many periods the stock markets provide no new funds after taking into accounting new issues, dividends, and capital repayments (Henwood, 1998). (Henwood also points out that the rate of churn in share ownership suggests that many shareholders have very short run horizons or are acting purely speculatively rather than focusing on the long term contribution of the company and hence focus management on short term results). If the major source of funds in many periods are retained earnings, then perhaps the theories should focus on the impact of accounting on the retention and investment of those funds.

(d) Insufficient consideration has been given to measuring and managing risk (Stiglitz, 2010) and accounting has not adequately highlighted risks, nor has it addressed adequately the avoidance of off balance sheet transactions.

2.2 Stewardship and Ecological Assumptions

Another area that needs to be addressed is the assumed focus of accounting conceptual frameworks which is that they should be useful to existing and potential investors, lenders, and other creditors (McConnell, 2010). As Young (2006) pointed out, if the standard setters really believe this, then why have they not surveyed those parties to ascertain what information they want to make their decisions? Rather they have assumed what those users need, and that their needs are common, and they have provided information which they believe would be appropriate to ideal users of accounting. There is only one study known to the author which did a comprehensive survey of what users wanted in terms of an accounting issue (Day & Tibbits, 1992). It is important to realize that when the decision usefulness criteria was adopted that criteria was viewed as very controversial (Solomons,1986, 67).

Also the objective makes an assumption that either the stock market is the most important part of the system or that accounting can only play a limited role namely in informing financial markets. There are a number of objections to this set of assumptions. Firstly corporations were created by society to serve society and not the other way around. Further can a financial system which emphasises growth be sustained when there are finite resources (Shutt, 2005)?

Porritt (2007, 56) expresses this as follows: 'The economy is in the first instance, a subsystem of human society ....which is itself, in the second instance, a subsystem of the totality of life on Earth (the biosphere). *And no subsystem* can *expand beyond the capacity of the total system of which it is part'.*

Does this mean the emphasis on growth in financial markets and analysis misplaced? The need to address multiple dimensions of the system has been widely studied in stakeholder research (Banerjee, 2007).

Stakeholder theory says that all parties have to be kept happy if the organisation is to survive. Recent dissatisfaction by shareholders regarding executive remuneration, the attitude of workers to that, and the impact of financial institutions' behaviour on economic activity both reflect that a significant proportion of society believe that finance and business need to have a greater concern with societal issues. It should be apparent that perceived unfairness often enters into these sources of complaint. It thus raises issues such as to whether businesses can regard social and environmental issues as separate from economic issues as has been adopted by the triple bottom line approach. To illustrate one way in which the two could be integrated is to measure returns as financial returns on scarce resources (e.g. water, creation of carbon dioxide or other greenhouse gases, consumption of minerals).

Further the externalities of business have been gaining greater public attention. This could be summed up as saying there is a rise in community sentiments that there needs to be greater fairness in the system. Accounting has used the term fair but it has narrowed its interpretation to imply in accordance with generally accepted principles (Monti-Belkaoui & Riahi-Belkaoui, 1996). Is it time to make fairness, in the broad sense of the term, central to accounting theory development?

Spacek (1973) when he was chief executive of Arthur Andersen proposed an accounting court to decide matters of accounting principles based on a criteria of fairness to all stakeholders. Baumol [ii] (1982) devoted a book to fairness in an economic context and Pattillo (1965) based a whole book to its adoption in accounting.

3 Market Values versus Overcoming Constraints

The move to market value accounting should be a contentious issue in accounting. When Enron moved to mark to market accounting and subsequently to mark to model accounting it portrayed the arrogance that the creation of an idea is the critical element in the process. Most companies face substantial constraints that prevent them from growing their earnings. For most companies that constraint is the limited number of parties willing to buy the goods or services at the asking price. For others where there is high demand the constraint could be limited raw materials, limited skilled labour, or limited specialist production facilities or for unproven businesses limited access to capital. For pharmaceutical companies it is approval of new drugs.

It is suggested that any accounting conceptual framework which does not include explicit recognition of such constraints will allow over optimistic accounting.

4 Behavioural Assumptions

It is widely recognised that accountants often manage accounting earnings (Bartov &Mohanram, 2004) and that auditors sometimes assist in such processes (e.g. Enron and Lehmans) and yet there is no systematic consideration in accounting frameworks of how the goals adopted for accounting, and the adoption of narrow definitions of true and fair, and the degree of tightness or broadness of accounting treatments affect the quality of outcomes. Admittedly some of these may be considered informally but the lack of explicit consideration probably means the consideration is not extensive or as rigorous as it could be. It can be argued that the system depends on trust in the system and when there is widespread abuse of the system such as was disclosed by the large number of restatements of accounts following the introduction of Sarbanes Oxley and the deficiencies of accounting disclosed in the great financial crises that trust is becoming harder to sustain. The continuation of the system as we know it is under threat unless we better understand the behavioural implications of the system as they affect all players but primarily how they affect accounting and investing by managers, how accountants and auditors view their roles, and how long term investors view the integrity of the total system, and the attitude of the general public to the continuation of the system. In other words we have to view accounting in the context of the sustainability of the total system and not as an abstract technical question.

If the above analysis seems too abstract consider a related discipline namely law. The lawyer may see the role as simply one of drawing up contracts so as to maximise the benefits to the person who hires them. An alternative approach would be to devise a contract to protect the person who hires them but which at the same time allows the other party to the contract to have reasonable protection and to act in an efficient manner under the contract. In other words if the lawyer sees their job is to make it attractive to the other party to enter into the contract whilst providing adequate protection to their immediate client they will make their client more likely to achieve an agreement and reduce the ongoing expenses of administering the contract for all parties (Williamson, 2005; Gilson, 1984). It is suggested that accountants need to see themselves as serving the efficient and effective operation of the economic system rather than identifying with either management or shareholders.

5 The Level of Analysis

Other disciplines such as management see the need to consciously consider the level of analysis which they are addressing (Ghoshal, 2005, Van de Ven,1989, Weick, 1989) .

It is being suggested that accounting conceptual frameworks are currently formulated at a high level of abstraction, which while allowing manageable discussion avoids addressing many important issues. Unless consideration is also given to micro issues, such as the impact on specific industries, decision making of individuals in all important parts of society, and how those in turn affect resource investment decisions, levels of risk taking and the morality of the system the results will be suboptimal. In developing a conceptual framework it is probably too difficult to consider all levels at once but it is possible to switch between levels to see whether the macro analysis will work as expected at the micro level.

Mark to market is probably a simple area to illustrate the issue of levels. If it is suggested that the value of is represented by market prices then this could be tested at the micro level. This could show that in some industries prices are so volatile that it is impossible to know the price it will yield until the item is sold. This may cause a rethink of what is trying to be achieved by the valuation and how to deal with situations of this type. Unless the conceptual framework can explicitly and clearly and precisely explain the logic of the valuation method to be used it will invite criticism by businesses who want to do something else and don't see why they should be restricted, by politicians under pressure who view the directive as arbitrary, by the accountant who faces a different situation and are trying to understand what it means for them.

Further in accounting when standards are developed from the conceptual framework there is no attempt to continually revise the framework as difficulties are encountered in application of concepts to the standards. The difficulty of translation could suggest that the conceptual framework is too general to extrapolate to the application and therefore is no guide at all or of limited use in achieving a consistent set of guidelines. This could invite political pressures to bear.

6 Negative Exclusions

The difficulty of writing conceptual frameworks is often difficult in that it is hard to define a concept in the abstract. Gray (2010) encountered similar issues when trying to define sustainability. It was often easier to define what is not sustainable. It is therefore possible to include in an accounting framework statements of what is not acceptable.

7 Conclusions

The preceding discussion has reflected on current approaches to developing conceptual frameworks. The primary thrust has been that the current conceptual frameworks are at a high level of abstraction and as such involve one of many possible orientations. It has been suggested that such models do not reflect the total picture of the impact of choosing a particular conceptual framework and that by also considering multiple dimensions and a lower level of abstraction a more useful model **may** be generated[iii]. Even if the alternative models are not accepted by all, their development may have other benefits as one management theorist argued. Van de Ven (1989, 488) states: 'In particular, Scott Poole and I argue that the tensions, inconsistencies, and contradictions provide important opportunities to develop better and more encompassing theories. Thus instead of suppressing or dismissing these apparent paradoxes, either within or between theories, we propose four ways to consciously and tenaciously pursue them to improve our theories (a) accept the paradox and learn to live with it constructively; (b) clarify levels of reference (e.g., part-whole, micro-macro, or individual-society) and the connections among them; (c) take time into account in exploring when contrary assumptions or processes each

exert a separate influence; and (d) introduce new concepts which either correct flaws in logic or provide a more encompassing perspective that dissolves the paradox.'
It is an assumption of the paper that alternative theories will be subject to rigorous testing using whatever method is considered feasible given the nature of the theory.

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[i] Stiglitz (2010, 241) points out that even if there were perfect markets and no externalities we would still not he optimum allocation unless we also had the possibility of insuring all risks. Recent events have shown we are far from that ideal.

[ii] There is a field of study on fairness in the social sciences of which Rawls (1971/1999) is probably the best known. His work prompted the title of this paper. See also Barry (1973) for a review of Rawls and Akerlof & Shiller (2009) regarding fairness and economic activity.

[iii] Also note Friedman (2008, 179): 'The basic principle is not enough, however, because there are always crucial details left outside the theory. Laboratory tests, small-scale trials in the field, and tinkering are therefore necessary.'