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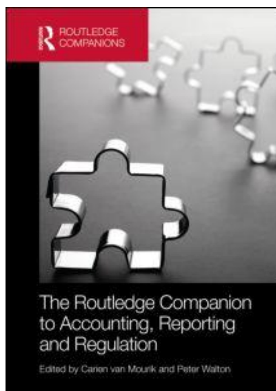

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The Public Interest in International Financial Accounting, Reporting and Regulation

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Part 3

(International) Accounting Standard Setting and Regulation

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The Public Interest in International Financial Accounting, Reporting and Regulation

Carien van Mourik

1. Introduction

Professional accountants in public practice (i.e. auditors) and both public and private accounting standard setters and regulators including the IASB (see IFRS Foundation, 2010: par. 2), claim to be serving the public interest. While some are sceptical about how seriously such claims should be taken, there is a growing literature that analyses what is implied by 'the public interest' and what implications different interpretations of the public interest might have for accounting, auditing, reporting and regulation. This chapter aims to provide an analysis of the growing literature on the subject.

A recent ICAEW report *Acting in the Public Interest: A Framework for Analysis* characterizes 'the public interest' as an abstract notion (ICAEW, 2012: 4, 12). It sets out a framework for evaluating proposals that are made with a claim to being in the public interest in general, but also talks about the accounting profession's public interest responsibilities.

Dellaportas and Davenport (2008) represent a systematic attempt to understand the public interest in accounting as viewed by the accounting profession. They attempt to answer the questions: Who exactly is the public, what are the interests of the public, and what does it mean to serve the public interest? Like Sikka *et al.* (1989), Lee (1995) and Canning and O'Dwyer (2001) before them, Dellaportas and Davenport (2008: 1095) conclude that '(t)he concept of the public interest in accounting appears to be disjointed and without clear or precise meaning and understanding.' Because of the ambiguity of the concept, it has no operational definition and will be interpreted differently by members of the profession and members of the public (Dellaportas and Davenport, 2008: 1089). Hence there exists an expectations gap with respect to the function of the statutory audit (see Chapter 9). In the same way, this ambiguity may cause a discrepancy between the expectations of the general public and accounting standard setters regarding the public interest function of accounting standards and regulation.

The journal entitled *Accounting and the Public Interest* and a special issue of the *Accounting, Auditing and Accountability Journal* in 2005 are entirely devoted to the public interest in accounting and discuss different issues that have a bearing on the public interest. Literature that directly and systematically deals with the public interest in financial accounting and reporting in an international context appears to be scarce or even non-existent.

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The public interest in accounting standard setting and regulation is often approached from perspectives focusing on the objectives of regulation or the costs and benefits of regulation. See for example Chapter 11 which considers the literature on arguments for and against accounting regulation and Chapter 12 which sets out the economic theory of accounting regulation. However, the concept of 'the public interest in international financial accounting, reporting and regulation' (PI) appears underdeveloped and has received rather less attention. A possible explanation is that, until relatively recently, financial accounting standards, economic policies and ethics were of a distinctly national nature.

This chapter is meant to present an overview of issues that have shaped thinking about the public interest in financial accounting, reporting and regulation, as well as perspectives on how to determine and pursue it. It also considers the question of how to extend these issues to an international context. The chapter proceeds as follows. In Section 2 it will first identify perspectives on what is the public interest and how to determine and pursue it. Then, in Section 3, it discusses how the relation between private standard setters and the public interest may have caused the search for accounting principles. Section 4 describes Demski's Impossibility Theorem and four responses in the literature which were adopted by the FASB and the IASB. Section 5 discusses how three academic 'revolutions' in accounting shape made it possible to regard the public interest in standard setting as a matter of technical competence and due process. Section 6 shows how the international public interest in financial accounting, external reporting and regulation creates social responsibilities on the part of the international accounting academy and the IASB, which both appear reluctant to accept. Section 7 concludes.

2. Perspectives on the public interest

This section discusses the difference between the common good and the public interest, and different perspectives on the public interest and how it should be determined.

2.1 The common good and the public interest

In everyday use, the 'public interest' often indicates the common good, which implies both the existence of something or things that are good for society at large, that is, all of us, as well as a shared understanding of what these things are. Douglass (1980: 104), however, draws a distinction between the 'common good' and the 'public interest':

> [t]he common good consisted in a number of specific objectives designed to promote general human well-being – such as peace, order, prosperity, justice and community. Government served the common good effectively, therefore, when it promoted not simply its own well-being but that of the larger society as well.

The common good has the following three characteristics:

- it includes everyone;
- the benefits are objectively beneficial; and
- the benefits are shared.

Douglass (ibid.: 107) claims that under the influence of Hobbes and the democratization of politics, the public interest increasingly came to be characterized as the aggregate of the private

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interests (often the material interests of individuals who defended their private property rights) of individuals. 'By making all valuation, including morality, a function of appetite Hobbes radically undercut the bases of the traditional common good doctrine' (ibid.)' As a consequence, according to this perspective, the public interest does not necessarily include everyone, the benefits might be perceived by the individual rather than be objectively determinable, and they need not be shared.

Cochran (1974) employed four categories of public interest concepts which include:

- normative theories of the public interest based on rationalist ethics close to the common good idea which apply to the members of a group or community;
- abolitionist theories which deny the validity of the public interest concept;
- process theories such as public choice theory (which sees the public interest as the outcome of a public choice process), conflicting interests theory (which sees the public interest as the outcome of a clash of conflicting interests), and due process theory (which sees the fairness of the procedure as the main issue in determining the public interest); and
- 'consensualist' theories which see the public interest as the outcome of public debate (Cochran, 1974: 329–31).

Below follows a discussion of four perspectives along the lines of the above categories, however, owing to the more technical nature of accounting, the last category does not really apply and in its place there is a technical view of the public interest based on the idea of objectivity and neutrality.

2.2 Rationalist ethics-based public interest theories

Rationalist ethics-based theories, such as deontological, utilitarian and contractualist theories assume that there are moral principles that provide administrators with guidance in balancing the needs and interests of different individuals, groups and the general public. Lipman described the public interest as 'something that is obtainable when men think rationally and logically, while acting in a disinterested and benevolent way' (reference in King *et al.,* 2010: 956).

'Deontological moral theories argue for a rule-based approach to ethics in which moral principles have an absolute and categorical prescriptive status' (Hutchings, 2010: 38).' Consequentialist or teleological ethical theories argue that the value of moral principles depends on the outcomes of adopting them (Hutchings, 2010: 29). Utilitarianism sees the common good as 'maximising the greatest benefit to the greatest number of people' (Dellaportas and Davenport, 2008: 1084), which assumes that this can be rationally calculated by individuals and groups. Under utilitarianism, for accountants and accounting standard setters to act morally is for them to act impartially. Contractualist ethics assumes that accountants and accounting standard setters would do so voluntarily in order to uphold the social contract which necessitates rational individuals to sometimes act in the public interest rather than in their private self-interest (Hutchings, 2010: 33–5).

Examples of rationalist ethical thinking include self-regulation by the accounting profession stressing its technical competence, and its search for principles such as independence, neutrality and objectivity after the Great Depression. Today's examples can be found in the codes of ethics and professional behaviour of professional accounting organizations, and the focus on technical competence of members of delegated regulatory bodies such as the IASB.

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2.3 Pluralism and abolitionist theories

By the 1950s, many political scientists dismissed the idea of the public interest altogether as 'too normative and theoretical because the public interest had no empirical referent' (King *et al.*, 2010: 957) and regarded the public interest as a rhetorical and symbolic device aimed at legitimizing public institutions, or judging public decisions. According to Dellaportas and Davenport (2008: 1085), abolitionist theorists deny that there is a public interest and 'see only potential groups that compete to advance their own interests'. Pluralism

> opposes the Hegelian veneration of the nation state, on the one hand, but fears the anarchistic and laissez-faire individualistic extremes, on the other, and ends up seeking safety in a society in which a number of important private associations provide a cushion between the individual and the state (Olson, 1971: 111–12).

It advocates protecting the public interest by having private associations of all kinds taking a larger constitutional role in society in order to balance state control by means of pressure groups. As will be shown below, an example of this kind of thinking can be found in the due process of the IASB. Its predecessor, the IASC, did not have a formal due process, but the IASB gave different interest groups the opportunity to influence the IASB's decisions on the principles and substance of accounting standards at the discussion paper and exposure draft stages (see also Chapter 16).

2.4 Public choice, process theories and Olson's logic of collective action

Under the influence of neoclassical economics and its methodological individualism, many came to regard the public interest as the aggregate of the preferences of rational and self-interested individuals. Rational Choice Theory paved the way for regarding the public interest as an empirical concept embodied in revealed preferences via social choice (in politics) or public choice (in economics) mechanisms. Arrow's (1950) Impossibility Theorem showed that the conditions necessary for public choice mechanisms to lead to Pareto-optimal (i.e. efficient) choices are unlikely to be met by any social choice mechanism. In addition, as will be discussed below, in the case of accounting standards, the outcome of public choice processes does not necessarily produce internally consistent standards.

Hence, the legitimacy of accounting policy makers and policies became even more strongly associated with due process and technical competence. Process theories assume that '(t)he process of interest group conflict resolution serves the public interest as long as standards of due process are observed' (Dellaportas and Davenport, 2008: 1085). Unfortunately, due process as a mechanism to improve public choice mechanisms has its limits as Olson (1971) makes clear in his theory based on self-interest and free riding which will be discussed in detail in Section 5.

2.5 The technical view of the public interest

Another approach, which is perhaps more particular to accounting standard setting and other more technical problems, is a theoretical framework. In addition to the public choice mechanism and due process, the intellectual authority of a consistent and theoretically sound conceptual framework would help to defend politically contentious decisions. In order to be able to substantiate their claim to professionalism, neutrality and objectivity, professional accountants

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and private standard setters, particularly in the USA and the UK, embarked on a search for the scientific and technical principles of financial accounting. The current IASB Conceptual Framework can be seen as an ongoing attempt to keep 'political interference' at bay.

3. Private standard setting and the public interest in financial accounting, reporting and regulation

A claim on the public interest implies a social responsibility. The social responsibilities of professional accountants, particularly those in public practice, accounting standard setters, accounting and financial regulators derive from the functions of financial reporting in capital markets and economies more generally. Financial reporting information prepared in accordance with the accounting standards of a jurisdiction and independently verified serves the public interest by promoting the efficient allocation of scarce resources in a society and economy through enabling capital and other markets to function efficiently (Duska *et al.,* 2011: 11). Interpretations of what these social responsibilities entail are many and varied, and appear to change over time.

3.1 Professional accountants in public practice

Carrying out professional responsibilities as an external auditor with integrity, competence, due care and objectivity whilst maintaining independence from the client should serve the public interest, which the *AICPA Professional Code of Conduct*, Section 53 defines as 'the collective well-being of the community of people and institutions the profession serves' (Duska *et al.,* 2011: 83). Note that 'the collective well-being' could be understood as the common good, whereas the 'community of people and institutions the profession serves' does not necessarily include the general public and probably indicates some notion of the public interest.

Usually, professional accounting organizations will each have their own code of ethics and standards of professional behaviour. In addition, there is the Code of Ethics issued in 2009 by the International Ethics Standards Board for Accountants (IESBA Code) and revised with effect from 1 January 2011.[1] Unfortunately, the IESBA Code is not freely available to the public. It describes the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour, and lays out a framework for dealing with ethical issues that may confront auditors and accountants employed by businesses.

3.2 Self-regulation and the search for accounting principles

According to Schroeder *et al.* (2001: 527), society has granted many of the professions autonomy, including self-regulation as a privilege. For the accounting profession, this may have been the case in countries such as the UK and the USA. In most European and other developed countries, public sector financial accounting regulation preceded the establishment of an organized accounting profession. This can in part be explained by the fact that in later industralized countries the state adopted a more interventionist role in order 'to encourage industrial catching up' (Foreman-Peck, 1995: 19). Gerschenkron's (1962) thesis of relative economic backwardness sets out institutional differences between early industrializing countries and laggards. The latter countries had financial systems where firms rely more on indirect financing through banks and other intermediaries rather than direct financing through capital markets. There, the accounting profession had neither the opportunity for self-regulation nor did it have the incentive to search for accounting principles that would legitimize self-regulation.

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Following the Great Depression, the US Securities and Exchange Acts of 1933 and 1934 established the Securities and Exchange Commission (SEC) as the authority in charge of developing accounting principles and standards. Under the influence of the accounting profession (particularly George O. May of the AIA), the SEC decided to delegate this responsibility to the accounting profession. The profession was then faced with the task of protecting its own and its customers' interests whilst meeting the requirements of the SEC (Merino, 2003).

Under the pressure of losing this opportunity for self-regulation, the American Accounting Association scrambled to come up with *A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements* (AAA, 1936). Its fundamental axiom was that accounting is the 'allocation of historical costs and revenues to the current and succeeding fiscal periods' (ibid.: 188). A revised statement was issued in 1941 followed by another revision entitled *Accounting Concepts and Standards Underlying Corporate Financial Statements* (AAA, 1948). These statements merely surveyed contemporary practices. *A Statement of Accounting Principles* by Sanders *et al.* (1938) warned against the abuse of conservatism but also advocated the use of adequate reserves.

The American Institute of Certified Public Accountants (AICPA)'s *Accounting Research Study No. 3* by Sprouse and Moonitz (1962) represented a systematic attempt at a coherent set of principles. Most of these were not adopted for some time, but its influence on the FASB and IASB Conceptual Frameworks is clearly recognizable. It advocated decoupling of accounting and taxable income, abandoning the realization concept and promoted the idea of conceptual primacy of the balance sheet, which translates into a balance sheet approach to the periodic determination of income. According to Sprouse and Moonitz (1962: 55), '(a)ccounting draws its real strength from its neutrality as among the demands of competing special interests'.

In *A Statement of Basic Accounting Theory* (ASOBAT) (AAA, 1966: 3), usefulness of accounting information was established as the all-inclusive criterion for its inclusion in financial statements. Its influence on the FASB and IASB Conceptual Frameworks can be found in this objective as well as in the use of qualitative criteria of useful accounting information. ASOBAT listed relevance, verifiability, freedom from bias and quantifiability (ibid.: 8). The AICPA adopted the decision-usefulness objective and qualitative characteristics of useful information in its APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (AICPA, 1970: pars 21–4). It extended the qualitative characteristics to include: relevance, understandability, verifiability, neutrality, timeliness, comparability and completeness.

ABP Statement No. 4 (AICPA, 1970: pars 6, 24) and *Statement on Accounting Theory and Theory Acceptance* (AAA, 1977: Preface) indicate the profession's frustration with the gradual realization 'that there are no easy theoretical answers to many of the urgent problems faced by the profession'.

4. Four consequences of Demski's impossibility theorem

Demski, using Arrow's Impossibility Theorem, proved that

> [n]o set of standards exists that will always rank alternatives in accordance with preferences and beliefs – no matter what these preferences and beliefs are, as long as they are consistent in admitting to the expected utility characterisation. . . . Further observe that the basic difficulty does not rest with a multiperson orientation (Demski, 1973: 721).

The conditions that a social choice mechanism must fulfil are unlikely to be met in practice. See also Bromwich (1992: 258). Ultimately, this means that financial accounting standard setting involves trading off one stakeholder's gain against another's loss.

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For public regulators in democratic jurisdictions, the main implication is that there may have to be complementary institutional responses to this trade-off, i.e. the government is likely to have in place redistributional mechanisms in order to compensate the losers. For private regulators, the main concern is their legitimacy to make these trade-offs. Private regulators will usually be more responsive to their constituents and less responsive to stakeholders outside the constituency. On top of that, they will often be less independent from their constituents and less sensitive to the general public interest. For an overview of advantages and disadvantages of public and private regulation, see Riahi-Belkaoui (2004: 138–41) and Dellaportas and Davenport (2008).

There were basically four responses to Demski's theorem. The first, by Chambers (1976), argued that current value accounting does not suffer from this problem. He claimed that information on 'the current money and money's worth of assets and the amounts currently owing to others at any time' is superior to any alternative class of accounting information (ibid.: 651)'. His argument rests on the idea that current value accounting is invariant with respect to choice because it does not need to take into account stakeholders' specifications of future states, beliefs or preferences. In other words, Chambers assumed that current value accounting serves all users' information needs equally well.

The second response, by Cushing (1977), explored the consequences of relaxing the assumption that users of financial statements have heterogeneous information needs based on Arrow's idea of 'Similarity as the Basis of Social Welfare Judgements'. He developed the idea of decomposing total expected utility differentials for all users, assuming that when a new standard increases the fineness of information this will increase all users' utilities (ibid.: 316). Gambling (1977: 142), on the other hand, held that with regard to conflict resolution, 'information can be counterproductive in certain situations where the dispute is not strictly "resolvable" – other than by the use of "authority", "arbitration", or outright "confrontation"'.

The third response indicated the need for a generally accepted conceptual framework which would make accounting regulation a technical rather than a public choice problem. Bromwich (1980: 289), like Demski (1973: 721), stressed that 'not all the obstacles to progress with the partial standards approach arise from the different preferences, beliefs and decision settings of individuals in a multi-person setting. Accounting standards that are determined by public choice mechanisms do not necessarily result in a system in which all standards are internally consistent. In addition, Bromwich (1992: 261–2) discusses problems with the true revelation of preferences: 'Therefore, … the assumption of homogeneity between individuals suggested by Cushing [1977: 311–13] may not open up wide avenues for progress in solving the problems of standard setting.'

The fourth response, by Johnson and Solomons (1984), is a pragmatic argument for both substantial and procedural legitimacy in the form of the FASB's ability to defend the rules it promulgates and the process by which it decides the rules based on technical competence and due process. According to Johnson and Solomons (1984: 165), Demski suggests that an accounting standard setting process must satisfy Arrow's conditions in order to be legitimate. Johnson and Solomons dismiss Demski's Impossibility Theorem as irrelevant to 'assessment of the legitimacy of a real world institutional process like the FASB . . . due to the inability of any real world accounting standard-setting process to meet Arrow's conditions' (ibid.: 165–6). Although the issue of legitimacy of standard setters is very important in itself, it is used by Johnson and Solomons to stand the issue on its head. In other words, they turn the problem, that setting financial accounting standards involves intentionally or unintentionally trading off one stakeholder's gain against another's loss, into a matter of assessing the legitimacy of the FASB to make this trade-off.

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Johnson and Solomons viewed the legitimacy of the FASB as a matter of a balance between procedural and outcome controls. They acknowledge potential difficulties in assessing process legitimacy on the basis of this approach.

> First, in order to be feasible, such a process must be compatible with the economic and political environment in which it operates. . . . Second, due to political and other costs involved, a private sector regulatory process like the FASB cannot adopt different decision-making procedures for each possible subset of issues that may come before it. . . . Finally, as a practical matter, the political viability of a private sector regulatory process like the FASB depends on its ability to sustain itself against criticism of both its rule-making procedures and the rules it promulgates (ibid.: 17).

The FASB developed a conceptual framework that, to some extent, combined all four approaches in one. Although the IASC Conceptual Framework was closely modelled on the FASB Conceptual Framework, the IASC did not adopt due process. Its successor, the IASB did.

5. Three academic accounting revolutions and the public interest in financial accounting, reporting and regulation

Three academic accounting 'revolutions' that would have an enormous impact on conceptions of the public interest were starting to gain momentum around the time that the FASB and the IASC were established in 1973. The efficient market hypothesis, the economic income ideal and the informational paradigm influenced the concept of the public interest in the conceptual frameworks of the FASB (1978) and the IASC (1989) and much of the mainstream financial accounting research in the past four decades or so. The FASB, given its mandate, had the American public interest in mind, whereas the IASC aimed for harmonization in the interests of its constituents, i.e. accounting firms, multinational corporations and investors in multinational corporations. In spite of its changed mandate, the concept of the public interest in the 2010 IASB Conceptual Framework and the IFRS Foundation's Constitution (IFRS Foundation, 2013) has not changed, nor have any challenges been taken seriously.

The three 'revolutions' do not stand on their own. They have their origins in classical and neoclassical economic thought and are interconnected because they share many of the core methodological assumptions regarding individuals, society and factual knowledge as well as the justification of epistemic knowledge and the role of researchers in this process. For these methodological assumptions see Chapter 2. They are also interconnected because they build on each other and, in this way, they continue to influence accounting practitioners, standard setters and regulators, mainstream academic accounting research and teaching. This section discusses the impact of these three 'revolutions' on conceptions of the public interest in financial accounting and reporting.

5.1 The efficient markets hypothesis

The first revolution in accounting to affect the concept of the public interest is the Efficient Markets Hypothesis (EMH) and the random-walk stock market model first formulated by Fama (1965). In a situation 'where stock prices follow random-walks and at every point in time actual prices represent good estimates of intrinsic values . . . the primary concern for the average investor should be portfolio analysis' (Fama, 1965: 40):

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> Portfolios which by diversification minimise the risk attached to obtaining a given level of expected or average return are called efficient portfolios. They allow all the risk attaching to each security to be diversified away. Rational investors will only hold portfolios that belong to this efficient set. . . . An individual's choice among efficient portfolios will depend on the amount of risk the individual is willing to bear (Bromwich, 1992: 206).

From an information economics perspective, the idea is that strong-form efficient markets fully and quickly impound all publicly available and private information in the stock price. Hence, the average investor does not need protection because he/she is protected by the information contained in the stock price and is, in effect, facing a fair gamble (Grossman and Stiglitz, 1980: 404–5). Accounting standard setting and regulation would not be necessary (Wyatt, 1983: 61). However, in the case of fully efficient capital markets, there would be little incentive for private searches for information as the benefit of obtaining this information would be offset by the cost. In other words, perfectly efficient stock markets would break down due to insufficient incentive to invest (Grossman and Stiglitz, 1980: 404–5).

Semi-strong form efficiency implies that all public information is quickly absorbed by the stock price, but it is possible to profit from private information. Investors need to protect themselves by holding a well-diversified portfolio. Investors need to be protected by full disclosure of accounting information, but what matters is the substance of the information rather than the form in which it is presented and the way it is disclosed (Bromwich, 1992: 215). Markets are said to be weak-form efficient when the stock prices reflect all the information contained in historical security prices. Weak-form market efficiency suggests that technical analysis on the basis of past stock prices alone would not be sufficient to beat the market in the long run. Accounting standard setters generally assume that capital markets are semi-strong form efficient.[2]

Market imperfections are often used as economic rationales for regulation. Lev (1988: 2–3) asked 'what public interest criterion *does* and/or *should* determine the choices made by accounting regulators? [Italics in original]' and defined inequity in capital markets as 'the existence of systematic and significant information asymmetries across investors' (ibid.: 1). He warned against its 'social consequences in the form of high transaction costs, thin markets, low liquidity and, in general – decreased gains from trade' (ibid.: 3) and argues for the regulation of disclosure because capital markets could break down when, 'suspecting gross information asymmetries, uninformed investors may quite rationally withdraw from trading in specific securities or from the stock market altogether' (ibid.: 7). He goes on to advocate an operational public interest criterion for disclosure choices in the form of a systematic decrease of information asymmetries and suggests *ex post* evaluation of accounting standards with respect to the realization of this objective.

So, financial accounting standard setters serve the public interest by establishing standards that prevent capital markets from breaking down either due to 'uninformed' investors' withdrawing from capital markets (Lev, 1988) or due to 'informed investors' having insufficient incentives to invest because private information searches will not be worth their while (Grossman and Stiglitz, 1980). Accounting standard setters and regulators do not appear to make the equality–efficiency trade off[3] at a conscious level. On the contrary, the IASB has so far refused to take into account that IFRSs may have consequences for distributional justice other than where it concerns investors. They place the burden to address this problem squarely on the national regulators.

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5.2 The economic income and wealth ideal

The economic wealth of an entity is the present value of its net assets at a point in time. In accounting it would be estimated as the difference between the discounted expected future cash inflows associated with the entity's assets and the discounted expected future cash outflows associated with the entity's liabilities. Economic income is the change in the present value of net assets between two points in time which does not arise from capital contributions or withdrawals plus the net cash inflow for the period (or less the net cash outflow for the period) (Bromwich, 1992: 37). It is also called subjective income because it is based on the manager's expectations regarding the entity's future cash flows, choice of discount rate and time horizon. As such, it is an *ex ante* concept of income, which, in the same way as budgeted income, under conditions of uncertainty is likely to differ from realized income.

Corbin (1962: 626) called the adoption of 'the economists "forward-looking" approach' in managerial and financial accounting 'The Revolution in Accounting' and seemed convinced that '(w)ith the tools of economic theory and accounting history, a rational foundation of accounting theory may be constructed'. *Accounting Research Study No. 3* by Sprouse and Moonitz (1962) had been heavily influenced by Canning (1929) and the idea that accounting income did not provide very useful information for investors. Some advocates of economic income echoed this view (e.g. Solomons, 1961; Staubus, 1961; Corbin, 1962; Lemke, 1966; Revsine, 1970). Their arguments managed to convince many people that economic income was the ideal income measure and that accounting income ought to be brought closer to the ideal by using current cost accounting. For example, Philips's (1963) 'The Revolution in Accounting Theory' held high hopes for a 'pure theory of accounting'. Philips argued that, 'if we accept, as the ideal for valuation, present market values at any given point in time, there are no conceptual problems of determining an appropriate discount rate or establishing degree of certainty or time of flow' (ibid.: 706).

In Statement of Financial Accounting Concepts No. 3 (SFAC No. 3) *Elements of Financial Statements of Business Enterprises*, the FASB (1980) defined comprehensive income resulting from 'a desire to incorporate in one final figure all non-owner changes in equity for a period' (Robinson, 1991: 108). The all-inclusive concept of income demands that all revenue and expense items be reported in the income statement and that no items bypass the income statement directly into equity. Clean surplus equity shows equity as share capital and retained earnings, and without revaluation or other reserves. Robinson (1991) argued that the time had come to report comprehensive income (including earnings) on the basis that the semi-strong form of the EMH 'assures us that the user community will be able to analyze the information in a statement of comprehensive income' (Robinson, 1991: 110).

In June 1999, the G 4+1 (the accounting standard setters of Australia, Canada, New Zealand, the UK and the USA, together with the IASC) produced a position paper on reporting performance which recommended reporting comprehensive income using a 'components' approach rather than a 'holding tank' approach to recycling (Cearns *et al.,* 1999: 54–6). This proposal meant:

- abandoning the realization concept in favour of recognition on the basis of measurable changes in market prices and/or interest rates; and
- abandoning the articulation of the financial statements.

As a consequence, comprehensive income for the period would no longer be reconcilable to net cash flow for the period. In other words, comprehensive income thus disclosed would be a surrogate for economic income and would render accounting net income meaningless.

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In April 2004, the IASB and the FASB agreed to carry out jointly a project on reporting comprehensive income.[4] In 2007, IAS 1 was amended to introduce comprehensive income into the income statement. Soon after, the *Exposure Draft: Presentation of Items of Other Comprehensive Income* proposed to disclose comprehensive income the main income concept and, like the G4+1 position paper, it advocated abandoning the recycling of items in OCI to net income upon realization (IASB, 2010b). This proposal did not make it because commentators demanded that the IASB clarify its income concept and conceptual approach to income determination and recycling in its conceptual framework (IASB, 2010c). In June 2011, IAS 1 was amended again to change the presentation of the comprehensive income statement so that items that may be recycled are shown separately from items that may not be recycled.

Although many deny that the IASB is moving towards a full fair value model (e.g. Cairns, 2007), the use of fair market values would accord with the idea of increasing the usefulness of accounting information by making it more forward looking (Whittington, 2005). In addition, the shift towards the balance sheet approach to the determination of comprehensive income, and the intention to do so without recycling items in OCI combined with the ideal of showing equity as a clean surplus, appears to be part of a move away from accounting income towards a surrogate economic income concept.

Three questions follow from this move towards comprehensive income:

- Is comprehensive income more useful for making decisions than accounting income?
- Would the disclosure of both accounting income and comprehensive income be more useful than disclosing one or the other?
- What is the connection between measurement at fair value raises and the characteristics of the markets for the assets and liabilities to be valued? (See also Bromwich, 2005: 64–5.)

Ideal markets are perfectly competitive, complete and well organized and will therefore enable the invisible hand to allocate resources most efficiently and fairly. What are the welfare consequences when markets are poorly organized, not perfectly competitive and incomplete?

5.3 The informational paradigm and decision-usefulness

Beaver (1998) called the shift from economic income measurement to an informational approach 'a financial reporting revolution'. The high hopes for economic income of the 1960s had been disappointed but the EMH and portfolio theory opened up a new perspective: the informational perspective. From this perspective, according to Beaver (1998: 26), the role of financial reporting information is to alter undiversified investors' beliefs about a security's unsystematic risk. The information perspective assumes that well-diversified investors have little use for financial reporting information (Beaver, 1998: 9, 26). Based on the logic of the EMH, the informational paradigm assumes that:

> for an information system to have value some of the signals must alter beliefs. If unexpected earnings can alter the beliefs of market participants in a systematic way, increases in stock prices would be associated with favourable unexpected earnings, and conversely for unfavourable expected earnings (Beaver, 1998: 89).

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Scott (1997: 100) put it as follows: 'This equating usefulness to information content is called the *information perspective* on financial reporting, an approach which has dominated financial accounting theory and research since 1968 [italics in original].' Ball and Brown (1968) provided the first evidence that security market prices do respond to accounting information in predictable ways and since then this research paradigm has proved very prolific and influential.

5.4 In sum

Standard setters and regulators adopted the assumption that markets were semi-strong form efficient, which allowed them to also adopt the full disclosure principle, and which caused the number of disclosures to skyrocket. Financial statements, notes and supplementary schedules in the annual reports ballooned. However, recognition on the face of the financial statements was limited by the materiality principle.

The materiality principle is interpreted by the FASB and IASB in the tautological manner that characterizes the influence of the EMH. It holds that information is material if it has the ability to influence investors' decisions (IASB, 2010a: QC11). This definition can only be operationalized when it is known what information investors take into account when they make their decisions. Furthermore, the primacy of investors' information needs is an assumption, not an undisputed fact, but it serves the purpose of being able to assume that stock prices reveal investors' preferences for anything in between recognition and measurement methods and disclosure policies. This is the logic behind the tautological decision-usefulness argument that accounting standards should be adopted on the basis of the strength of the association between stock prices and accounting numbers (or between market values and book values).

In 1978, the FASB's SFAC No. 1 adopted the information perspective, the IASC followed in 1989 and the IASB inherited it and kept it as the basis of its 2010 Conceptual Framework. However, this does not warrant the conclusion

> that the 'best' accounting policy is the one that produces the greatest market response. . . . Accountants may be better off to the extent that they provide useful information to investors, but it does not follow that *society* will be better off [italics in original] (Scott, 1997: 118–19).

The economic income and wealth ideal, again places primacy on market values, as a consequence of which, at least at the conceptual level, a shift from the transactions approach to the valuation approach to the determination of income appears to have taken place. Whittington (2008: 156–60) contrasts what he calls the 'fair value worldview' and the 'alternative worldview'. The former roughly corresponds to what Cairns (2007, and Chapter 7) calls the 'full fair value model' and in Chapter 3 is called 'the valuation approach to the determination of income'. The latter roughly corresponds to the transactions approach to the determination of income. At the standards level this shift has not been wholesale, but has primarily affected the valuation of financial instruments as it is there that the transactions approach is most deficient.

The combination of the informational paradigm and self interest theories leads Scott (1997) to describe two primary roles of accounting information. First, it acts to mitigate the adverse selection problem caused by information asymmetry between managers and shareholders, and, second, it provides a measure of managerial performance which acts to mitigate the moral hazard problem caused by information asymmetry between managers and shareholders (Scott, 1997: 3–4). Because of the focus on the role of financial accounting information in decision-usefulness, its role in contracting and monitoring has received rather less attention from accounting standard setters and researchers.

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6. The international public interest in financial accounting, external reporting and regulation

International financial reporting standards are meant to improve the functioning of international capital markets. The idea of a unified set of global accounting standards is premised on the assumption that financial and economic globalization serve the public interest. This section first briefly explores the idea that the social benefits of financial and economic globalization do not necessarily outweigh the social costs, or that the benefits and the costs are not evenly distributed. It then discusses the social responsibilities that globalization creates for the international accounting academy and for the IASB.

6.1 The two faces of globalization[5]: what does this mean for financial accounting, reporting and regulation?

Milanovic (2003) shows that the mainstream view of globalization as an automatic and benign force leading to converging world incomes and institutions is flawed. The financial deregulation and globalization of financial, capital and commodity markets that started in the 1980s have been rationalized because of the theoretical potential to reduce inequality and poverty. For example, according to Mishkin (2006: 5), economic and financial globalization leads to a reduction of poverty in developing countries that are willing and able to become export-oriented. He claims that financial globalization will lower the cost of capital, improve the allocation of capital, and help 'promote the development of better property rights and institutions, both of which make the domestic financial sector work better in putting capital to productive uses' (Mishkin, 2006: 8).

Economic globalization is supposed to be accompanied by convergence in countries' incomes for four reasons:

- low wages and a high return on capital should attract direct investment in poor countries and increase their economic growth rate;
- technological catch-up is cheaper than inventing new technologies;
- poor countries can make use of their comparative advantage when free trade allows them to specialize; and
- late developers do not need to reinvent the wheel when it comes to institutions, governance and policies that enable economic growth (Milanovic, 2011: 104–5).

In reality, capital primarily flows from rich countries to rich countries and from poor countries to rich countries (capital flight) in a phenomenon termed 'the Lucas Paradox', but less from rich to poor countries (see Milanovic, 2011: 106; Lucas, 1990; Mishkin, 2006: 7; Collier, 2008: 91). According to Milanovic (2011: 106–8, 225 n.5) the Lucas Paradox also applies to labour which migrates from rich to rich or from poor to rich countries. Technology is excludable through patents and intellectual property rights, and technological development is very much dependent on the institutional environment in a country. And, finally, the development of a country's institutions is path-dependent and therefore institutions that work well in one country cannot simply be replicated in another country. Mishkin (2006: 13) makes the point that good institutions need to be home grown.

Furthermore, the 2007/8 financial crisis and the following credit crunch and sovereign debt crises have proved that developed countries, too, can still be hit hard by financial crises. There are lessons to be learned about the limits of Adam Smith's invisible hand in economic orthodoxy (Basu,

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2011), how Keynes's animal spirits govern much of economic activity (Akerlof and Shiller, 2009), and the invisible fault lines that continue to threaten the global economic system (Rajan, 2010).

Questions were raised about the role of financial accounting and particularly fair value in exacerbating the credit crunch. Some accounting researchers came to its defence (e.g. Barth and Taylor, 2010) and others tried to weigh the arguments on either side (e.g. Laux and Leuz, 2009). However, an important issue raised by Rajan (2010: 7) also impacts the role of international financial reporting standards. It is the fact that '(b)ecause different financial systems work on different principles and involve different forms of government intervention, they tend to distort each other's functioning when they come into close contact.'

Financial reporting information needs vary between market economy and financial systems because performance is conceptualized differently, and because there is a great variety in the mix of social, legal, financial and economic institutions dealing with competition, co-operation, contracting, risk, uncertainty and moral hazard. Leuz's (2010) solution of a separate global reporting segment is based on the concept of institutional complementarity between market and government arrangements. However, as Leuz's (2010) new institutional financial accounting approach is based on the methodological assumptions of new institutional economics (see Chapter 2), it does not consider how the multinational corporations that might fit such a segment are the most likely to benefit from the discrepancy between economic and political globalization.

Basu names two consequences of the fact that political globalization is trailing behind economic globalization. One is erosion of democracy. Another is 'the tolerance of global inequalities that would not have been tolerated in any economy under any single government' (Basu, 2011: 182–3). The ability of multinational corporations to exploit the differences in national regulations and the lack of global governance create huge opportunities to seek 'high private rewards disproportionate to their social productivity' (Tobin, 1984: 294 in Skott and Ryoo, 2008: 858). A third consequence is a sharp increase in the market and political power of the financial sector where some firms have now become too big to fail, creating moral hazard due to government bailouts in the process. By the way, please note that the IASB only considers institutional arbitrage to the extent that companies engage in it to avoid IFRS.

6.2 The social responsibilities of the international accounting academy

As accounting educators, the academy is responsible for teaching accounting students at any level to think critically about the public interest in financial reporting and accounting standard setting. However, because the IASB presents its conceptual framework as objective truth rather than merely one possible perspective, accounting students too often simply memorise and absorb the IASB doctrine of decision-usefulness and protecting the interests of investors. When these accounting students become PhD students, professionally qualified practitioners, standard setters or teachers themselves, they are unlikely to start questioning the doctrine that they are familiar with, even though its primary epistemic justification was the accounting–technical competence and business experience of the IASB and FASB board members.

As social science researchers, the accounting academy is responsible for understanding that financial accounting is not a natural science. This means that international accounting researchers need to be particularly aware of their own and others' value judgements and methodological assumptions and how these affect research topics, questions, methods of analysis, sample selection and outcomes. In an international context even more than in a national context, there probably is no objective basis for making value judgements, although it is still possible to judge the research on epistemic criteria.

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As the fundamental issues in financial accounting, reporting and regulation theory (see Chapter 3) are even more urgent in an international context, researchers need to engage with these questions from different methodological perspectives and compare answers. They also need to engage with standard setters and regulators. So far, there have been remarkably few responses from accounting academics, even those who have made a career based on critical accounting research, to the IASB's invitations to comment on the Conceptual Framework discussion papers and exposure drafts or the public consultation on the Status of Trustees' Strategy Review.

6.3 The social responsibilities of the IASB

Following its public consultation on the Status of Trustees' Strategy Review of 5 November 2010, the IFRS Foundation's *Report of the Trustees' Strategy Review*[6] of April 2011 simply reasserts its definition of the public interest as that of investors in capital and financial markets. In addition, the Trustees now also acknowledge the importance of global financial stability and sound economic growth (IFRS Foundation, 2011: A1). In this report, the IFRS Foundation claims that sustainability reporting is not directly pertinent to capital allocation decisions (ibid.: 11).

This perspective allows the IASB to focus on the financial aspects of capital allocation decisions by investors and to defer issues to do with the economic, social and ecological sustainability until 'the system stabilises' and 'resources permit' (ibid.: 11, A4). It assumes that the IASB can legitimately trade off all stakeholders' interests in favour of the interests of investors in the public interest as long as it follows due process and demonstrates accounting–technical competence. Furthermore, it allows the IFRS Foundation to interpret its own responsibilities primarily in terms of benchmarking and oversight of the IASB's due process (IFRS Foundation, 2011: 15–19).

In essence, the IASB exists to develop and promote a single set of financial reporting standards in order to increase the global comparability of financial accounting information. As such, it is premised on the idea that the social benefits of financial and economic globalization outweigh the social costs. This may explain why the IASB does not explicitly define the meaning of the 'public interest in international financial accounting, reporting and regulation' (PI). The IASB does not recognize any social responsibilities beyond those associated with establishing high quality financial reporting standards in order to increase the global comparability of financial reporting information and its decision-usefulness.

However, in the interest of maintaining its institutional legitimacy, sooner or later, the IASB will need to define the PI it claims to serve. Social responsibilities following from this claim include:

- addressing the IASB's intellectual and institutional bias;
- assessing the appropriateness of the decision-usefulness objective in the variety of institutional environments where IFRS has been adopted or accepted; and
- improving due process in the particular case of the conceptual framework and more generally to mitigate public choice problems in accounting standard setting.

6.3.1 Institutional bias

The 2010 IASB Conceptual Framework was issued in September 2010. It was the result of a joint FASB/IASB project in which US accounting thought strongly dominated. For example, on 10 April 2010, in addition to the FASB members, there were seventeen IASB members, two of whom (one from Germany, one from South Africa) had not yet started. There were four

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members from the US, two from the UK, two from France, two from South Africa and one each from Australia, Sweden, Japan, Brazil, China and India. In the case of the IFRS Foundation, there were twenty-one trustees, among which five were from the US alone.

This American institutional bias in the IASB Conceptual Framework will not disappear simply by changing the mix of trustees and IASB members to 'reflect the world's capital markets, and diversity of geographical and professional backgrounds' (IFRS Foundation, 2010: pars 6, 26). To a certain extent, IASB membership will be self-selecting because every new board member has to subscribe to the existing conceptual framework (IFRS Foundation, 2010: par. 29) and 'be committed to serving the public interest through a private standard setting process' (IFRS Foundation, 2010: Annex, par. 8). Hence, the intellectual and institutional bias is already a firmly established part of the IASB and its conceptual framework.

6.3.2 Decision-usefulness

The decision-usefulness objective of financial reporting which forms the basis of both the IASB and FASB Conceptual Frameworks is a product of the USA's intellectual and institutional environment of the 1970s (FASB, 1978: SFAC No. 1, pars 9–16). Of course, the FASB is legally bound to serve the American public interest as defined by the American public choice process, and the IASC adopted the decision-usefulness objective in 1989 when it did not have or need due process. In addition, the 2010 IASB Conceptual Framework is the result of a convergence project between the IASB and the FASB which was never meant to question the appropriateness of the framework's intellectual foundations for other institutional environments or rebuild it from scratch.

According to the IAS Plus website, more than 80 jurisdictions require IFRS for listed and unlisted companies, and more than 100 jurisdictions require or permit the use of IFRS for domestic listed companies.[7] It is clear that all of these countries have very different institutional environments where the public interest is likely to be perceived in very different ways. It is highly questionable that the IASB's decision-usefulness objective and its shift towards the balance sheet approach to the determination of (comprehensive) income is equally suitable for the great variety of institutional environments where IFRS is currently used. Some of these countries do not even have a stock exchange. Possible reasons for accepting IFRS are discussed in Chapters 24 and 25.

6.3.3 The IASB conceptual framework and due process

Olson's (1971) *The Logic of Collective Action: Public Goods and the Theory of Groups* uses a theory based on self-interest and incentives to explain how

> unless the number of individuals in a group is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, *rational, self-interested individuals will not act to achieve their common or group interests.* In other words, even if all the individuals in a large group are rational and self-interested, and would gain if, as a group, they acted to achieve their common interest or objective, they will still not act to achieve that common or group interest [italics in original] (Olson, 1971: 2).

If this theory is true, the implication is that, even if the individual members of a group as large as the international general public really do know what is in their common interest, they will not act to achieve it unless they are coerced or unless the incentive for action provides a greater benefit than the cost of not acting. As a consequence, the policy process can easily be captured by small interest groups with the means and the incentives to act in their narrow private

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interests. In other words, the social choice approach to discovering what the public interest is may be very costly to society at large, but nobody is keeping score.

The IASB's due process, particularly when it comes to establishing the conceptual framework, does not ensure that the framework is coherent and internally consistent. There are several reasons for this:

- First, the logic according to which the elements of the conceptual framework fit together is unclear because the due process does not require epistemic justification or clarification of logic.
- Second, the IASB does not intend to change Chapters 1 and 3 (on the objectives of general purpose financial reporting and the qualitative characteristics of useful information) even though it has not formally decided on a performance concept and its measurement yet.
- Third, even when it comes to a performance concept and its approach to income measurement, the IASB is still presenting its work in progress as different elements. It presents the definition of elements of financial statements, separate from their recognition and measurement without clarifying any theoretical and logical connections between them.

The due process would need to include rules for both the epistemic justification of the concepts and the logical structure connecting the concepts. Ideally, it would also include rules for communication (perhaps based on Habermas's ideal speech situation) and the referencing to sources so that it becomes possible to trace the development of the ideas. The process would also need to be open and freely accessible to all.

7. Conclusion

The IASB needs to provide a stipulative and operational definition of the public interest in international financial accounting, reporting and regulation in order to lend credibility to its claim of serving the public interest. Such a definition will need to refer to the relation between performance concepts and the functions of financial accounting and external reporting in different institutional environments. In today's world where economic globalization has progressed much further than political globalization, and which is creating perverse incentives and opportunities for private gain at public expense, the public interest deserves to be taken seriously.

Notes

1 www.ifac.org/publications-resources/2010-handbook-code-ethics-professional-accountants.
2 The empirical evidence for the EMH in its semi-strong form, even in the US, appears ambiguous and inconclusive. This is not surprising, because ideological bias may play a part in research design and interpretation of the results on either side (Frankfurter and McGoun, 1999). Furthermore, in some countries with very different institutional environments, for example Arab countries, there is little evidence to support even the weak form of the EMH (Abdmoullah, 2010). Selected Asian markets showed excess returns before the 1997 Asian crisis (Chancharoenchai *et al.,* 2005). Socialist China, with its segmented capital market and many state-owned companies also shows little evidence of capital market efficiency (Wang *et al.,* 2009).
3 In economics, the general idea dates at least to Kuznets (1955), but the term equality–efficiency trade off and the general argument were probably made popular by Okun (1975).
4 www.iasplus.com/agenda/perform.htm, accessed 21 October 2011.
5 Title based on Milanovic (2003).
6 www.iasb.org/NR/rdonlyres/A490566E-EFF5-4F27-8DEF-D2ECCF9C5FFF/0/Trustees_Strategy_Review_2011.pdf, accessed 28 May 2011.
7 www.iasplus.com/country/useias.htm, accessed 6 September 2012.

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