

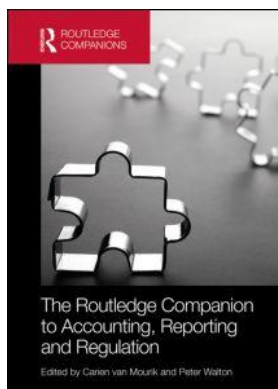
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Fundamental Issues in Financial Accounting and Reporting Theory

Carien van Mourik

1. Introduction

This chapter aims to outline different views on fundamental issues in financial accounting and reporting theory. Such fundamental questions include:

1. What is (or should be) the role of the reporting entity, capital markets and regulation in society?
2. What are (or should be) the objectives of financial accounting and external reporting in society?
3. How do we define and measure the reporting entity's performance so that this incentivises the managers of reporting entities and the participants in capital markets to best fulfil the roles outlined in (1) and financial reporting best meets the objectives defined in (2)?
4. What is (or should be) the role of the independent audit with respect to lending credibility to financial statements and annual reports?

Questions 1 and 2 require normative answers based on one's ideal view of society and the role of financial accounting and reporting in it. Answers to Question 3 will, therefore, depend on the normative answers to the first two questions. However, they are also determined by the a priori logic of financial accounting theory and the structure within which the concepts of performance, recognition, measurement, capital maintenance, financial statement presentation and disclosure form a coherent and internally consistent accounting and reporting model. As Gordon (1960: 606) put it: 'Given a definition of income, the next task is to derive the measurement rules in various transaction areas that follow from it.' The answers would then need to be corroborated by empirical evidence on the relation between the objectives and the outcomes produced and, if necessary, corrected. Similarly, Question 4 requires answers with partly normative, partly a priori analytical, but also partly empirically determined corroborative content.

After some forty years of dominance of empiricism and positivism in financial accounting and reporting research, questions with explicit moral, ideological, but also a priori analytical theoretical content have come to be avoided by mainstream accounting academics. These topics

came to be considered ‘unscientific’ and, particularly junior academics might ruin their career prospects and publication chances by engaging with them. This happened first in the US (Williams, 2003) but increasingly researchers in other countries followed suit.

By the start of the new millennium, the fundamental questions in financial accounting and reporting appeared to have been settled on the basis of the technical competence and authority of members of private standard setting bodies such as the IASB and FASB, and public choice mechanisms rather than epistemic criteria. Schroeder *et al.* (2001) and Deegan and Unerman (2006) call this the conceptual framework approach and Riahi-Belkaoui (2004) calls it the regulatory approach to the formulation of an accounting theory.

However, in the increasingly internationalized environment of the second decade of the twenty-first century, the conceptual framework approach suffers from the following problems. For example, in spite of the different mandates of the FASB and the IASB, the IASB Conceptual Framework has, to a surprisingly large extent, been established by the same people. Like the FASB, the IASB is a private standard setting body of which the members must have technical competence and business experience. It is doubtful that technical competence and business experience are sufficient to settle accounting theoretical and conceptual questions of such great economic and social importance in an international context. Furthermore, the same due process applies to the conceptual framework as to IFRSs. This due process was not designed to protect the integrity of the search and justification of accounting theoretical concepts or knowledge of the impact the allocation of resources and the distribution of wealth and income. Furthermore, the answers in the FASB and IASB Conceptual Frameworks to questions regarding the role of financial accounting, reporting entities and their performance were determined based on the institutional environment of the USA in the 1970s (as described in FASB 1978: SFAC No. 1, Par. 9–16) and have not seriously been reconsidered when the IASB applied them to the world in 1989, the IASB inherited them in 2001, and again reconfirmed them in 2010.

This chapter will present an overview of different answers to the above four questions found in the financial accounting theory literature. [Section 2](#) starts with two prior issues that pertain to the four questions, but warrant separate discussion: first, the choice for general purpose financial statements and, second, the structure and logic of financial accounting theory. [Section 3](#) discusses different theories on the roles of the reporting entity and capital markets in society, and [Section 4](#) outlines how different perspectives on the objectives of financial reporting translate into different concepts of performance. [Section 5](#) contrasts different perspectives on performance measurement, and [Section 6](#) discusses the consequences for the presentation and disclosure of income and capital in the financial statements. [Section 7](#) briefly outlines some key issues that lead to different perspectives on the main function of the statutory audit. [Section 8](#) concludes.

2. Prior issues

The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework – a reporting entity concept, the qualitative characteristics of, and the constraint on, useful financial information, elements of financial statements, recognition, measurement, presentation and disclosure – flow logically from the objective (IASB, 2010: OB1).

Although the above statement intuitively makes sense, the IASB Conceptual Framework does not clearly spell out the logic according to which all the other elements follow from the objective of general purpose financial reporting. Furthermore, it treats the objective as a given, but

in an international context building a conceptual framework on such an assumption requires conclusive evidence and careful justification. In this chapter, the role of reporting entities and capital markets in society comes prior to the objective of financial reporting, which in turn impacts the concept(s) of performance to be measured.

Historically, accounting regulators have focused on general purpose financial statements for the following reasons. First, particularly when accounting systems were still paper based, or computerized systems were clunky and inflexible, preparing different financial reports for different external users was considered too much of a burden on companies. Second, there was a fear that simultaneously preparing financial information on different accounting bases would endanger the continuity of financial reporting information and make it less comparable over time. Third, many jurisdictions used to adhere to the definite settlement of accounts principle; in other words, taxable income, distributable income and accounting income had to be the same. Even today, usually net income in the general purpose financial statements forms the basis for the calculation of income for distribution and taxable income.

The IASB, too, is concerned with general purpose financial reporting (IASB, 2010: OB2) which it interprets as information that helps the primary users, i.e. existing and potential investors, lenders and other creditors (ibid.: OB5) to assess the prospects for future net cash inflows to an entity (ibid.: OB3). For this purpose, investors need:

- information about economic resources and claims (OB13–14), in other words a balance sheet;
- information about changes in economic resources and claims which are the result of transactions and events (OB15–17) but also changes in market prices and interest rates (OB19), in other words a statement of comprehensive income that shows performance as derived from transactions as well as changes in market prices and interest rates (OB18);
- a cash flow statement showing operating, investing and financing cash flows (OB20); and
- a statement of changes in equity which gives insight into the causes of the changes in equity (OB21).

3. Functions of corporations and capital markets in society

Historically, the corporation had a social purpose so that towns, universities and guilds ‘had a life beyond that of their members’ (Micklethwait and Wooldridge, 2003: xvi), and early corporations had to be engaged in public works ‘to be awarded the privilege of limited liability’ (Micklethwait and Wooldridge, 2003: 46). Some consider the corporation a public creation to be governed by public law and regulation, which is supposed to act in the public interest. Others consider the corporation a private creation to be governed by the private law of contract (Dine, 2001: 13) with no other purpose than increasing the wealth of its owners (Post *et al.*, 2002: 8). The corporation’s capacity to amass capital from multiple sources enabled sharing of risk, fixed capital formation and investment in research and development on an unprecedented scale.

3.1 Corporations, private property rights and externalities

Limited liability companies, and particularly those that are publicly held, are a double-edged sword. Demsetz (1967) argues that private property rights are one means to counter the negative externalities that are often the consequence of communal property. Like Demsetz, Hardin

believed that private property rights form a solution, although this solution does not apply to public goods (Hardin, 1968: 1245). Becker (1977: 18–19) lists the following eleven elements that make up the ‘full’ or ‘liberal’ concept of ownership based on Honoré (1961: 107–47):

- the right to possess;
- the right to use;
- the right to manage;
- the right to the income;
- the right to the capital;
- the right to security from expropriation;
- the right to sell or bequeath the thing;
- the absence of term;
- the prohibition of harmful use;
- liability to execution (as repayment for debt); and
- residuary character.

However, ‘people may be said to own things in various restricted senses which omit any one or more of the incidents’ (Becker, 1977: 19).

In the case of the publicly held limited liability company, these private property rights have been modified in several ways. These correspond with the five core characteristics of corporations in (Armour *et al.*, 2009: Chapter 1), which include: legal personality, limited liability, transferable shares, centralized delegated management under a board structure, and absentee investor ownership. Consequences of these modifications include the agency costs resulting from the conflicting interests of and information asymmetry between:

- owners and management;
- majority shareholders and minority shareholders; and
- the firm (including its owners) and other contracting parties (Armour *et al.*, 2009: 36).

More generally, they will include the social costs resulting from misaligned private incentives and inadequate monitoring.

These modifications provide shareholders with protection against the external effects of de facto managerial ownership (Demsetz, 1967: 358). On the one hand, they are meant to serve society and induce economic growth by enabling risk sharing, fixed capital formation and technological development. On the other, these modifications to private property rights cause moral hazard potentially resulting in considerable social costs because they may reduce the shareholders’ efficiency as monitors (Alchian and Demsetz, 1972: 789). Other modifications of private property rights, such as holding companies, special purpose entities and offshore entities, create endless opportunities for private gain at public expense.

3.2 Capital markets, corporations and financial reporting regulation

In essence, capital markets and corporations are meant to serve society and induce economic growth and job creation by enabling risk sharing, fixed capital formation, technological development, participation in and the development of commodities and other markets, and providing opportunities for investing savings and funds generated from other sources. Financial reporting is currently the means by which managers enable shareholders to discharge them from their

stewardship obligations, provide accountability to other stakeholders and provide information to aid investors in their investment decisions. Financial accounting standards are necessary to ensure comparability across entities and over time.

Financial reporting regulation is, on the one hand, necessary to guarantee an amount of information that is enough to prevent capital markets from breaking down due to uninformed/unsophisticated investors withdrawing as they feel that the odds are stacked against them. Such a withdrawal would 'deprive the economy of the allocational and risk sharing benefits of large and efficient capital markets' (Lev, 1988: 7). On the other hand, information must not be such that the market for information becomes efficient. Grossman and Stiglitz (1980: 404–5) showed that, in theory, informationally efficient capital markets will break down due to a lack of incentives to spend resources on gaining an information advantage and hence to trade on this advantage and to invest. Because higher efficiency implies lower equality and vice versa, accounting standard setting and regulation involves an incentives–equity trade-off, also called efficiency–equity trade-off (McAleese, 2001: 201) which can be regarded as political and moral rather than accounting technical or theoretical in nature.

One could argue, however, that solely focusing on financial information and the financial interests of investors may contribute to lower or the wrong type of economic productivity across the globe. One reason is that the financial focus encourages diverting financial, human, natural and other resources away from productive activity with higher social returns towards activities with higher private returns (Shleifer and Vishny, 1998: 56–7). Another is that the financial focus does not encourage economic decision-making with a view to economic, social and ecological sustainability.

3.3 *Multinational corporations and regulatory arbitrage*

In today's world where political globalization trails behind financial and economic globalization (Basu, 2011), an international accounting standard setter such as the IASB needs to investigate how the ability of multinational corporations to exploit institutional arbitrage would impact the purpose, nature and substance of international accounting standards and their application and enforcement. Leuz (2010) and Hail *et al.* (2010) point to the fact that ignoring institutional diversity and complementarities when setting international accounting standards may impose social costs upon those countries that have very different institutional environments from the one that the standards have been designed for.

Defining the boundaries of the reporting entity presents a challenge in financial accounting theory as well as national and international accounting standard setting and regulation (e.g. IASB, 2009). On the one hand, the reporting entity could be the same as the legal entity. The challenge here is to define the legal entity, particularly in the case of multinational enterprises, international organisations, holding companies, business combinations and special purpose entities. On the other, the principle of economic substance over legal form (CSRC, 1965: 363) which can apply to transactions as well as business and other entities would require a definition of the reporting entity as an economic entity. The main challenge here is twofold. First, 'substitution of the concept of the economic entity for that of the legal entity raises the problem of the scope of the consolidation' (Moonitz, 1942: 237). In other words, the boundaries of the reporting entity must be determined on an appropriate basis of economic substance which is either based on legal ownership or actual control. Second, it raises the issue of the treatment of minority interests (Moonitz, 1942: 241–2).

Businesses will use loopholes in the law to structure transactions and entities so as to respect the letter of the law, if not always the spirit, to produce economic and/or financial gains, avoid losses, or present a favourable image. Window dressing in the form of repurchasing agreements and structuring ownership so as to circumvent or meet the criteria for inclusion in the consolidated financial statements is not unheard of. These criteria are usually based on the concept of legal ownership of the entity or effective control over the entity's assets.

4. Objectives of external reporting

This section presents an overview of five perspectives on the objective of general purpose financial reporting and one broader external reporting perspective. The proprietary, entity and enterprise theories belong to a group called the equity theories, which can be seen as unsuccessful attempts at formulating a comprehensive theory of financial accounting and reporting. Starting from two very different perspectives on the social objective of financial accounting, proprietary and entity theory deductively come to different conclusions about how transactions would need to be recorded, summarized and disclosed in the financial statements. Enterprise theory holds that, in addition to profit and the book-value of capital, information about value added must be disclosed. Van Mourik (2010) presents an overview of the literature on and the unresolved issues in the equity theories. For other comparative overviews see Sprouse (1957), Gynther (1967), Meyer (1973) and Zeff (1978a, 1978b). The true income and informational perspectives represent attempts to avoid the normative question of from whose perspective to account. Finally, sustainability reporting represents a move away from the single focus on financial performance and instead regards performance as a multifaceted concept aimed at promoting economic, social and ecological sustainability.

4.1 *Proprietary theory: stewardship and the determination of the owners' wealth*

According to Merino (1993: 170), in the first half of the twentieth century proprietary theorists in the USA successfully used proprietary theory to defend shareholders against the threat 'that the corporate form could pose to private property rights'. Proprietary theorists such as Hatfield (1909), Sprague (1913), and Husband (1938, 1954), insisted that the accounting process of companies must be conducted from the shareholders' perspective. On the proprietary or agency view of the firm, the objective of financial accounting is to determine the increase in the wealth of the company's owners.

For example, Hatfield (1909: 195) describes the profit and loss account as a proprietorship account recording changes in net wealth and sees revenue and expense accounts as 'subsidiary "proprietorship" accounts'. Proprietary theory is therefore based on the idea that, in the case of corporations as in the case of sole proprietors, it is possible to make a sharp distinction between equity and liabilities. This essential distinction is made on the basis of differences in profit and loss participation between equity and liability holders, and differences in decision rights with respect to the assets of the firm (Sprague, 1907: 53). Staubus (1952, 1959) developed the residual equity theory, according to which accounting must be done from the perspective of the residual equity holders, which for a going concern coincides with that of the common shareholders. Residual equity theory is regarded by some as a more restrictive form of proprietary theory (Belkaoui, 2004: 215).

4.2 Entity theory: the determination of dividends, creditor protection and accountability to the general public

Entity theorists such as Gilman (1939), Paton and Littleton (1940), and Chow (1942) held that accounting must take the perspective of the entity because ‘corporations are quasi-public institutions’ (Paton and Littleton, 1940: 2) which have responsibilities to investors, wage earners, customers, the government and the general public. Later, entity theorists such as Seidman (1956), Raby (1959) and, in particular, Li (1960a, 1960b, 1961, 1963) were convinced that in practice the corporation is operated for the purpose of its own survival (Kam, 1990: 306; Meyer, 1973: 119). Either way, ‘It is the imperative duty of management ... to strive for decisions based on a balanced consideration of all the rights involved’ (Paton and Littleton, 1940: 3). Entity theory views the entity as having a separate existence from its shareholders with whom it has an arm’s-length relationship. This relationship is regarded as not particularly different from that to the long-term creditors (Lorig, 1964: 566).

4.3 Enterprise theory: accountability for value added to society

Suojanen’s (1954, 1958) enterprise theory or social theory extended Paton and Littleton’s notion that companies have become institutions in their own right. Suojanen argued that companies must account from the perspective of the entity which is accountable to society at large for the value added it produces and for how this value added is distributed. Suojanen proposed that large companies prepare a value added statement in addition to the balance sheet and income statement so that its operations can be ‘assessed in terms of its contribution to the *flow* of output of the community’ [Italics in original] (Suojanen, 1954: 395).

4.4 The true income paradigm: true income meets the needs of all users

The above three theories have in common a normative assumption on the social objective of financial accounting and external reporting. In an attempt to avoid the normative question of whom to account for, the true income paradigm is aimed at identifying an ‘ideal income’ measure that would meet the needs of all users. Riahi-Belkaoui (2004: 339–41) mentions the following examples of scholars who used a deductive approach to identifying the properties that ‘ideal income’ should have: Paton (1922), Canning (1929), Sweeney (1936), MacNeal (1939), Moonitz (1961), Edwards and Bell (1961) and Sprouse and Moonitz (1962). Others mentioned by Beaver (1998: 2–3) include Paton and Littleton (1940), Chambers (1966) and Sterling (1970).

On the one hand, there are the scholars who see accounting income as the true income concept owing to the objectivity of measurement at historical cost. For example Paton and Littleton (1940) focused on the matching concept, the realization concept and the objectivity of measurement at historical cost as the means to determine true accounting income.

On the other, scholars advocated current value approaches. For example, Edwards and Bell (1961) advocated the concept of business income based on measurement at replacement cost, i.e. entry prices. The business income model computes:

a segregated income measure for the period of reporting, but it also enables traditional accounting income to be derived from it by eliminating unrealized holding gains and adding realized holding gains accrued in previous periods (Lee, 1985: 77).

If a financial capital maintenance concept is adopted, realized and unrealized cost savings, inventory holdings and capital gains of the period concerned will be treated as income. However, this would change in the case of a physical capital maintenance concept where only operating profit would count as income (Lee, 1985: 86).

Chambers (1966) and Sterling (1970) developed the idea of realizable income based on 'measurement of the periodic change in the capital of an entity when this is measured in exit value terms' (Lee, 1985: 93). Realizable income consists of realized and unrealized gains whereby any increase in wealth is treated as income (Lee, 1985: 102). However, Chambers' system of continuously contemporary accounting (CoCoA) includes a capital adjustment to account for changes in general purchasing power in the form of a capital maintenance reserve which is part of shareholders' equity (Deegan and Unerman, 2006: 147).

A third current value approach is current cost accounting based on deprival value or value to the business. The deprival value of an asset is either its net replacement cost or the recoverable amount. Unrealized value to the business changes and income statement provisions are transferred to a current cost reserve and then transferred to the income statement upon realization. The use of mixed values causes some to doubt the meaningfulness of the aggregate valuation of the capital figure (Lee, 1985: 109–20).

The idea was that income based on current values would be closest to the 'ideal income' measure, which was assumed to be economic income (Beaver, 1998: 3). Economic income is the change in the present value of future cash flows from one period to the next measured under conditions of certainty (Lee, 1985: 31).

4.5 The informational perspective: helping investors assess the amounts, timing and certainty of future cash flows

The American Institute of Certified Public Accountants (AICPA)'s *Accounting Research Study No. 3* (Sprouse and Moonitz, 1962), the Accounting Principles Board's *APB Statement No. 4* (AICPA, 1970), and the American Accounting Association's *A Statement of Basic Accounting Theory* (ASOBAT) (AAA, 1966) represented major steps through which in the late 1960s the objectives of financial reporting increasingly came to be defined from the informational perspective. In 1978 it was adopted by the FASB in their *Statement of Financial Accounting Concepts No. 1* (FASB, 1978). The IASB Conceptual Framework (IASB, 2010: OB2) is a more recent and international example of defining the objective of financial reporting in terms of the informational perspective.

Beaver (1998: 4) claims that the ensuing shift away from a focus on determining earnings towards a focus on the prediction of cash flows was partly due to an inability to reach a consensus on the 'best' method of reporting income. A second factor was the 'trend in security analysis . . . away from earnings-oriented valuation approaches to discounted cash flow approaches' (Beaver, 1998: 5). As a consequence, the main type of financial statement user is assumed to be the investors who invest in securities primarily for the purpose of maximizing their investment returns rather than shareholders aiming for a stable stream of dividends. Furthermore, information that serves investors is assumed to serve other users as well.

ASOBAT, which not only focused on the usefulness of accounting information for 'making decisions concerning the use of limited resources', also introduced four what we now call 'qualitative characteristics' (relevance, verifiability, freedom from bias and quantifiability) as criteria for the evaluation of accounting information (AAA, 1966: Chapter 2). This approach is still used today by the FASB and the IASB in their respective conceptual frameworks.

According to Scott (1997: 4), whose financial accounting theory textbook is based on information economics, the fundamental problem of financial accounting theory is how to reconcile the different roles of accounting information in one income number, 'the bottom line'. This is, however, only a problem if one is committed to general purpose financial statements. Information economics sees only two primary roles of accounting information. First, financial reporting acts as a mechanism to mitigate the adverse selection problem caused by information asymmetry between managers and prospective as well as current investors. Second, accounting net income is a measure of managerial performance which acts to mitigate the moral hazard problem caused by information asymmetry between managers and current shareholders. Net income serves both as an input in executive compensation contracts and it serves to inform the securities and managerial labour markets so that these can function more efficiently (Scott, 1997: 3–4).

Other perspectives on the quality of accounting information generated by the information perspective involve the quantification of earnings quality. This can be in terms of value-relevance of earnings (assessing the statistical association of accounting earnings measures with market value, i.e. stock price), the time-series behaviour of earnings (its statistical properties such as persistence and smoothness), and its predictive value. Dechow *et al.* (2010) provides a very informative literature review on the topic of earnings quality.

4.6 Sustainability reporting

Parallel to discussions in economics about the merit of using only financial measures of economic performance such as GDP, this question has also arisen in accounting and external reporting with respect to the performance of businesses, and especially large multinational corporations. Some considered the idea of total impact accounting, that is, the idea that externalities would need to be included in the financial statements. Early attempts at accounting for externalities by Abt (1977) and Estes (1976) were heavily criticized by Benston (1982: 97), who claimed that the measurement of social costs and benefits is 'beyond the ability or province of accountants'. He believed that measuring corporate performance using both private and public costs and benefits is 'conceptually impossible' and '*cannot be attained, now or ever*' [Italics in original] (Benston, 1982: 97). Rappaport (1977) and Zeff (1978a, 1978b) brought to attention the socio-economic consequences of accounting policies.

Social responsibility reporting and environmental impact reporting also developed since the 1970s but as the ideological climate changed in the 1980s and 1990s, these ideas did not make it into the mainstream ideas about performance and importance for economic decision making. However, as serious ecological and social damage appears to be done by humans making short-term decisions either in their own or in what they perceive to be the public interest, sustainability reporting might just be what we need to create incentives for more responsible decisions and actions by managers, investors, policy makers, regulators and the general public.

5. Concepts of income and capital

Accounting entities that strictly operate on a cash basis and that have little or no capital expenditure (investments in non-current assets) will measure their performance as the net increase or decrease in cash during a period. Cash accounting will be sufficient for only the tiniest of businesses which will likely be sole traders, but is also used in clubs, some not-for-profit entities, and at the other end of the scale in national accounts (the accounts of countries). All other entities operating as going concerns will be faced with, what Thomas (1969, 1974) called 'the

allocation problem in financial accounting theory'. This section first explains what the allocation problem is and how it impacts on performance measurement. It then sets out different concepts of performance and approaches to income measurement.

5.1 Performance measurement and the allocation problem in accounting

The allocation problem is really three problems instead of one. First, there is the problem of how to allocate revenues and expenses to a period in order to determine performance for the period (i.e. how to determine accounting income). Second, there is the question of whether or not to include unrealized gains and losses in the measure of performance. If not, this measure of performance would be called net profit or net income, and if unrealized gains and losses are included it would nowadays be called comprehensive income. The final question is whether or not to include changes in the value of intangible assets (or goodwill) during the period. If changes in the value of goodwill are included the measure of performance is called economic income. See Solomons' reconciliation of accounting income to economic income (Solomons, 1961: 376).

5.2 The transactions approach to income determination

What we could call 'archetypical' accounting income' is determined using the transactions approach. The transactions approach sees performance as income earned from the transactions and productive efforts of a reporting entity during a period where the entity is assumed to be a going concern. It is also called the income statement or revenue–expense approach to the determination of income. The archetypical accounting income concept does not include unrealized gains and losses. It defines assets as unexpired costs, values all assets and liabilities on the balance sheet at historical cost, and recognizes revenues on the basis of the realization principle and expenses on the basis of the matching principle.

The transactions approach is consistent with Schmalenbach's dynamic balance sheet where the activa (= items on the assets side of the balance sheet) include: cash, payments – not yet expenses, payments – not yet receipts, revenues – not yet expenses, and revenues – not yet receipts, and the passiva (= items on the liabilities side of the balance sheet) include: capital, expenses – not yet payments, receipts – not yet payments, expenses – not yet revenues, and receipts – not yet revenues (Flower, 1996: 178; see also [Chapter 3](#) of this book). The transactions approach is consistent with Paton and Littleton's (1940) idea of expenses as expired and assets as unexpired costs.

Most theorists have not defined the archetypical accounting income described above because they had to make compromises in response to challenges reality throws up. Therefore, in the case of unrealized gains or losses on inventory, the lower-of-cost-or-market valuation was deemed acceptable on the basis of prudence. Others, for example Dicksee (1903: 5) in the UK and Hatfield (1909: 81) in the US, distinguished between the valuation of permanent assets at cost and circulating assets at current values (in Storey, 1959: 235–6). Unfortunately, the transactions approach had its obvious limitations for capital maintenance purposes in periods of moderate to high inflation (e.g. Graham, 1949; Niswonger, 1949). Therefore, inflation presented another challenge for the transactions approach, which required adjustments for the purpose of capital maintenance. A third problem for the transactions approach comes in the form of long-term contracts for which revenues and expenditures require matching which invites the abuse of accounting policy. A fourth problem is presented in the forms of accounting for speculative transactions, hedging, futures and other financial instruments where using historical cost is often

not very meaningful (Whittington, 2005: 138–9). A similar challenge comes in the form of off balance sheet financing such as leasing, derivative transactions and financial instruments.

Hence, some theorists advocate the use of current cost, replacement cost or net present value in some cases and stick to historical cost in others. One problem for them is that income is determined and the assets and liabilities in the balance sheet shown on a mixed attributes basis, which is likely to hamper comparability and according to Chambers (1998) goes against the logic of measurement. Another problem is what to do with the unrealized gains and losses arising upon valuation. The transactions approach would show these in a revaluation reserve in the equity section of the balance sheet. In other words, the equity section will then show a dirty surplus.

As the transactions approach regards the income statement as the main financial statement and the balance sheet as a place for rest posts (see also [Chapter 3](#)) in the determination of periodic income, dirty surplus is not considered a problem. For this reason, the transactions approach to the determination of income is compatible with the objectives of financial reporting in accordance with entity theory and enterprise theory. It could fit with the stewardship objective as per proprietary theory to the extent that the relationship between the business and shareholders is a long-term one, that is, the entity must be a going concern and the shareholders' aim must be a return in the form of stable dividends. Performance measurement is expressed as earnings.

Critics pointed to the practice of using arbitrary reserves for income smoothing and earnings manipulation purposes. Sprouse (1966) criticized the existence of what-you-may-call-its in the balance sheet and, according to Basu and Waymire (2010), prodded the FASB towards the balance sheet approach. Solomons (1995) vocally proclaimed the conceptual primacy of the balance sheet and was an advocate of economic income because of the so-called objectivity of market prices. Others complained about the lack of relevance for investment decision-making of information based on historical costs (AICPA, 1973: 15–16).

5.3 *The valuation approach to the determination of income*

The 'archetypical valuation approach' defines performance and measures income as the increase in wealth (= net assets at current values) from one period to the next, and does include unrealized gains and losses in the determination of income for the period. It sees performance as an all inclusive income concept determined using the balance sheet approach (also called assets–liabilities or capital maintenance approach to income measurement) expressed as comprehensive income (Kieso *et al.*, 2004: 127 n.5). Consequently, it crucially depends on precise definitions and measurement (valuation) of assets and liabilities. Although, in principle, measurement of all the assets and liabilities in the balance sheet at historical cost is possible, the valuation approach would logically require valuation at the current sales price in an active market or, if that is not available, the replacement cost.

Although some appear to see the valuation approach and the economics approach to the determination as the same thing, this is not necessarily true. Economic income is a subjective income concept that includes subjective goodwill (Solomons, 1961). According to Lee (1985: 31), when measured under conditions of certainty, it is also termed 'ideal income'. Although many have argued for the inclusion of internally generated intangible assets and some for the inclusion of intangible liabilities in the balance sheet in order to reduce the difference in book and market values of net assets, subjectivity goes against objectivity and verifiability as the spirit of financial reporting.

Problems arising with the valuation approach start with the question whether to define ‘fair market value’ as entry value, exit value or value in use (Barth and Landsman, 1995: 101–2). They also include the difficulty of obtaining market values because markets for many assets and liabilities in the balance sheet are not equally active (and efficient) (Bromwich, 2007). As a consequence, market prices or current prices may not be established reliably, which introduces an element of arbitrariness and moral hazard into the valuation process (Ronen, 2008: 186). Similarly, there is the controversial issue of ‘own credit risk’ where, as the entity’s financial condition worsens the fair value of an entity’s liabilities declines, this decrease is accounted for as a gain in the entity’s income statement. See, for example, the IASB (2009) discussion paper *Credit Risk in Liability Measurement*. Finally, the question arises whether or not valuation applies to individual assets and liabilities, or groups also called cash generating units (see also Chapter 7).

As the balance sheet is considered the main financial statement, the determination of income as a measure of performance becomes a secondary aim. The equity section of the balance sheet must obey the clean–surplus relation if the increase in net assets is the measure of performance. For this reason, the valuation approach to the determination of income is compatible with the objectives of financial reporting in accordance with proprietary theory if the entity is not a going concern because the liquidation basis of accounting requires valuation at current sales values. In the case of a going concern, the reporting objective could be in accordance with the true income paradigm and the informational perspective to the extent that the markets for all the assets and liabilities in the balance sheets are complete and efficient. Market imperfections present a problem for the valuation approach to the determination of income because this introduces scope for moral hazard (manipulating asset and liability values and using off balance sheet financing and special purpose vehicles to misrepresent financial position and risk exposure) and estimation errors.

5.4 Dual concepts of performance

Dualistic approaches to performance measurement do not place conceptual primacy on either the income statement or the balance sheet, but give equal weight to the determination of income and the correct measurement of capital. These are different from the mixed attributes approaches to measurement as a result of compromises outlined above. Examples include: in Germany, Moxter’s dual approach, which will be discussed in Chapter 4; in Japan, the released–from–risk recognition concept in the 2006 Accounting Standards Board of Japan’s Conceptual Framework (ASBJ, 2006); and in IFRS the ‘amortized cost’ and ‘fair value through profit and loss’ and ‘fair value through equity’ approaches for different classes of assets and liabilities. The released–from–risk recognition concept takes into consideration managerial intention for assets and liabilities (not unlike the three–tier system for financial instruments in IAS 39) as well as the characteristics of the market for the assets or liabilities to be valued (again, not unlike the IAS 39 three–tier system) when recognizing income and increases in the value of shareholders’ capital (ASBJ, 2006).

5.5 Multidimensional concepts of performance: value added, triple bottom line, economic, social and ecological sustainability

Thus far, our discussion of periodic performance measurement has been limited to income (be it net cash inflow, accounting, comprehensive or economic income) as a measure of performance. In parallel to developments in economics where the question is raised whether gross national product (GNP) is still an appropriate measure of national economic performance, in

financial accounting, too, the question is raised whether income should not be measured including externalities or should be supplemented with other measures of performance that give due recognition to economic, social and ecological sustainability.

Suojanen's (1954, 1958) enterprise theory is associated with the introduction of a value-added statement. Value added statements have been used in Britain, Germany, South Africa and other countries since the 1970s. The value added statement shows the sources of net income and how value added has been distributed to employees, lenders, the government, minority interests and shareholders (Morley, 1979). Unfortunately, value added can be defined as net value added (after deducting depreciation) and gross value added (before deducting depreciation), and discretion exists as to the treatment of taxation (Burchell *et al.*, 1985: 387–90). Although meant as a social performance measure which could help to reduce conflict between the variety of stakeholders and introduce value added-based incentive schemes, calculative diversity and confusion about the benefits created a decline in the disclosure of and interest in value added statements in Britain in the early 1980s (Burchell *et al.*, 1985: 405).

Triple bottom line reporting, environmental reporting, total reporting, and other initiatives have been developed with the idea that performance is not only economic performance. Unfortunately, this is a complicated area because concepts need to be clearly defined and measurement developed, and securities, accounting and other regulators do not seem inclined to commit themselves to broadening their idea of performance. Chapter 26 discusses some of the issues involved.

6. Presentation and disclosure in the financial statements

Researchers who believed in the efficient markets hypothesis thought that issues regarding the presentation and disclosure of information in the financial statements or in the notes or in supplementary schedules were irrelevant. If capital markets were efficient in the semi-strong form, users of financial statements would not be fooled by the form in which the information was presented or where the information appeared as long as it was disclosed in the annual reports or elsewhere. This led to the development of the full disclosure principle which requires that 'no information of substance or of interest to the average investor will be omitted or concealed' (Riahi-Belkaoui, 2004: 225). However, empirical evidence regarding the efficiency of the US capital market is inconclusive, and in the case of many other capital markets it is clear that they are not efficient. Financial statement preparers did not require empirical evidence about the average investor to know that investors and analysts can be misled by the way information is presented. Furthermore, full disclosure has led to the problem of the disclosure of too much information (i.e. information overload).

6.1 Articulation or non-articulation

Thus far, standard setters have required the preparation and disclosure of financial statements that articulate because '[f]inancial statements are fundamentally related' (AICPA, 1970: Par. 35). For example, the income statement explains the change in the retained earnings account in the statement of changes in equity. The statement of changes in equity details which changes in equity derive from transactions with shareholders, which changes derive from the entity's performance, and which changes derive from changes in market prices. The cash flow statement reconciles the balances on the cash account at the beginning and the end of a period. Finally, the income statement and the cash flow statement can be reconciled via the accruals.

'An example of the non-articulated view would be the use of LIFO in the income statement and of FIFO in the balance sheet' (Riahi-Belkaoui, 2004: 175). Although, in the past, some have criticized the articulation requirement as unduly restrictive (AICPA, 1973: 16; Black, 1993; Cearn's *et al.*, 1999: 54–6), non-articulation amounts to reducing the information value of accruals because the reconciliation between cash flow statement and income statement will no longer work as intended. Articulation of the financial statements is essential in preserving the continuity and comparability of information from one period to the next.

6.2 *Income statement, cash flow statement and statement of changes in equity*

The current operating concept of income and the dirty surplus relation with equity have already been discussed in relation to entity theory and the transactions approach to income measurement. Similarly, the all-inclusive concept of income and the clean surplus relation with equity have been discussed in relation to proprietary theory and the valuation approach to income measurement. As we currently live with a mixed measurement and mixed recognition model, IFRS requires a comprehensive income statement where net income, other comprehensive income (OCI) and comprehensive income are disclosed separately.

For some items IFRS require recycling from OCI to net income upon realisation and for others it does not allow recycling. The principle behind this distinction is not clear. However, for those who take a valuation perspective, recycling amounts to double counting of comprehensive income. On the other hand, to those who lean towards the transactions approach, not recycling OCI to net income upon realization amounts to fudging net income, not respecting the distinction between income and capital, and adopting a non-articulation view. The reason is that in this case the cash flow statement can no longer be prepared using the indirect approach, reconciling net profit to net cash generated from operations. Although Cearn's *et al.* (1999) were aware of this consequence, they believed that the necessary information was readily available from the cash flow statement and recommended using the direct approach as a conceptually superior method for preparing the cash flow statement.

6.3 *Statement of comprehensive income*

For the purpose of predicting future income and future cash flows it is usually better to have less variable numbers to work with. Hence, in principle, an income statement can be presented in multiple steps where gross profit and operating income are the least variable and shown separately from extraordinary gains and losses. Net income will be more variable as it includes non-recurrent or extraordinary gains and losses. With the IASB's introduction of the comprehensive income statement in 2007, profit for the year is shown after finance costs, share of profit of associates, income tax expense and profit or loss from discontinued operations. It then showed the elements of other comprehensive income (OCI) to arrive at comprehensive income at the bottom line. An amendment to IAS 1 in 2011 required a new presentation that separates the OCI items that will not be recycled from OCI items that may be recycled. The conceptual basis for this classification has still not been addressed.

Comprehensive income includes changes in market prices that have not even been realized. Empirical tests of the persistence and value relevance of OCI and comprehensive income get mixed results (e.g. Jones and Smith, 2011). However, there would be no reason not to disclose both as long as the conceptual basis and the recycling issue are clear.

6.4 Balance sheet

Balance sheets can be presented in a horizontal or a vertical format either in order of increasing or decreasing liquidity. In the UK, a specific version of the vertical format, the net assets format, has been used for many years. The horizontal format is most compatible with the entity theory because it does not give priority to any of the providers of funds on the liabilities side of the balance sheet, whereas the net assets format is most compatible with proprietary theory because it shows equity as equal to net assets. Furthermore, the horizontal balance sheet format shows working capital as current assets balanced by current liabilities, whereas the net assets format shows current assets less current liabilities, i.e. the net working capital of the business.

7. The statutory audit

Financial statements and financial reporting can be seen as mechanisms in the service of corporate governance. For this purpose, it is important that there is an audit trail and that the information in the financial statements can be verified and understood as being in accordance with the pertinent standards and regulations. The statutory audit plays a crucial role in helping financial statements fulfil their corporate governance function by giving the information credibility. Surprisingly, financial accounting standard setters do not routinely make auditability an issue of concern when setting accounting standards. Hopefully, this is something that will change in the future.

The first fundamental issue with respect to the theory and practice of auditing is the fact that it is a three party economic arrangement.

In simple terms, management uses owners' money to hire auditors to provide a stamp of approval on management's reports on its own performance to owners. There is no basis for expecting that such an arrangement will satisfactorily serve either society in general or the investing public in particular (Staubus, 2005: 9).

The second issue, which is related to the first, is the fact that there is a discrepancy between what the public expects from the audit function and what auditors regard as their responsibility, i.e. the audit expectations gap. Chapter 9 outlines the main issues in auditing and Chapter 19 discusses auditing and international financial reporting.

8. Conclusion

At the end of this chapter, it will be clear that there may not be any definitive answers to any of the four fundamental questions. However, this must not deter accounting researchers from the wide variety of institutional environments in the world from engaging with the fundamental issues in financial accounting and reporting theory. National standard setters, but also those involved in developing international conceptual frameworks and international financial reporting standards, must deal with these issues, with or without academic research to help them.

Notes

1 Archetypical is used here as a model, not as an actual income determination approach used in practice.

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