HAS THE FINANCIAL ACCOUNTING STANDARDS BOARD BELIEVED A LIE?

An analysis of the forces that have shaped the FASB's objectives, and their effect upon the accounting profession

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Public accounting is an interesting dichotomy of two different, but complementary functions. Accountants perform an attest function which is an expression, of an opinion, that a communication of economic data is presented fairly. Also, the profession must develop ground rules, Generally Accepted Accounting Principles, for the preparation and reporting of financial information to the public. The conceptualization or paradigm of how the capital markets use the information that is presented to them is the basis for developing reporting standards. This is a widely discussed and hotly debated topic.

The maxim of this paper is to analyze how the accounting profession's world view has shaped capital market theory and its implications for financial reporting.

INSTITUTIONS

Examine briefly the institutional arrangements in the U.S. to promulgate accounting standards. Due to the stock market abuses in the early 1930's the U.S. government established the Securities and Exchange Commission (SEC), which was empowered to establish reporting requirements and accounting procedures for companies issuing or having their securities traded on organized exchanges. The SEC has delegated the establishment of accounting standards to the accounting profession. The accounting profession responded in 1939 by establishing the Committee on Accounting

Procedure (CAP) which began periodic issuance of Accounting Research Bulletins (ARB's).

The first formalized standard setting body was the Accounting Principles Board (APB) which was established in 1959. From 1961 to 1973 the APB issued thirty one opinions. This board was criticized by the profession and industry for its lack of timely response to key accounting issues. Fearing the loss of self regulation, the accounting profession established the Financial Accounting Standards Board (FASB). Changes were incorporated in this standard setting body to make it more responsive to current reporting issues.

IDENTIFICATION OF CURRENT WORLD-VIEW

W. F. Chau states concerning the current world-view of the accounting profession

> Accounting research has been guided by a dominant, not divergent, set of assumptions. There has been one general scientific world view, one primary disciplinary matrix. And accounting researchers...continue to share a constellation of beliefs, values, and techniques. These beliefs circumscribe definition of "worthwhile problems" and "acceptable scientific evidence"...they are often taken for granted and subconsciously applied [Chau 1986 p.602]

The accounting profession's disciplinary matrix is that of a positivistic philosophy of science. Ontologically (beliefs about reality), positivism believes that there is no causality in the world. "Scientific laws cannot be viewed as describing necessary connection between the activities of natural objects; instead they are viewed as stating regularities in the way things occur."[Peterson 1988] Conclusively we have no grounds for inferring the future behavior from its past behavior.

Epistemologically (beliefs about knowledge), positivism believes human beings only have the capability of gaining knowledge through sensory experience, and in the principle of empirical verifiability of theoretical constructs by theory-independent observation statements.[Schoepflin 1982 p.12] [Chau 1986 p.607] (see exhibit #1 for a complete outline of the professions world view)

J. Horrigan speaking about the effects of this world view concludes that

> the sweeping development of financial management Theory over the past twenty five years is truly one of the most impressive intellectual achievements in the history of business education. Economic equilibrium analysis and positivistic empirical research have transformed a previously descriptive, institutional subject into an elegant branch of knowledge [Horrigan 1987 p.19]

A framework now exists for the allocation of scarce resources by valuation models using the amounts, timing and risk of cash flows. This positivist world-view is reflecting in accounting research as diverse as the contingency theory of management accounting, multi-cue probability learning studies, efficient capital market theory, and principle agent literature. [Chau 1986 p. 606]

POSITIVISTS VIEW OF THE CAPITAL MARKETS

The efficient market hypothesis in essence states that you can not beat the market or that investment advisors could tell you anything of value. Also, that because of the way that the market uses information, many of the areas of standard setting thought to be of importance are now a waste of the FASBs

WORLD VIEW* **EXHIBIT #1**

BELIEFS ABOUT KNOWLEDGE
1. Theory is separate from observations which are used to verify or falsify
2. Data analysis will allow generalization
3. All human knowledge is a social artifact

BELIEFS ABOUT PHYSICAL AND SOCIAL REALITY
1. Physical realism
2. Human beings are passive objects; not makers of social reality
3. The single goal for firms and individuals is "utility maximization"
4. Societies and organizations are essentially stable; conflict is managed by design of appropriate accounting controls

RELATIONSHIP BETWEEN THEORY AND PRACTICE
1. The accounting profession specifies means not ends
2. Accountant should not be involved in moral judgments about the decision makers goals

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PARADIGMS FOR THE OPERATION OF THE CAPITAL MARKETS

EFFICIENT MARKET HYPOTHESES- Conceptualization of how the capital markets use finacial information
CAPITAL ASSET PRICING MODEL- Conceptualization of how the market prices assets (Driving variables= Amount, Risk, Timing of cash flows)

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FASB'S OBJECTIVES: SFAC #1 "OBJECTIVES OF FINANCIAL REPORTING"

The FASB has incorporated the above paradigms into its objectives

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RESULTS OF THE CURRENT WORLD VIEW: "CRISIS OF CONFIDENCE"

1. Because of the FASB's acquiesce to the above paradigms many reporting issues thought to be of importance are no longer of any value. Actually choosing between alternative methods of reporting is a matter of social choice which is an unresolvable problem
2.FASB is no longer the protector of the rights of the individual creditor and investor
3.GAAP is becoming the standard of fair presentation to the exclusion of any moral judgement on the part of the accountant
4. The profession must begin to recognize its social responsibility
6. Should the FASB serve the goal of increasing the allocative efficient of the capital markets

*The world view section of this exhibit is adapted from Wai Fong Chau JofA, Oct, 1986 p. 611

resources. Several examples suggested by W. Beaver, an efficient market proponent, are "issues regarding the definition of extraordinary items, interperiod tax allocation, earnings per share computations, accounting for equity securities." [Beaver 1973 p.52]

Consider more carefully the propounded arguments of efficient market proponents. Security prices fully reflect all available public information. Thus, in efficient markets security prices react rapidly and in an unbiased manner to any newly released information. The result is that security prices perform a "random walk", and that past behavior would be of no value in predicting its future course.

Notice how carefully the positivistic ontology, that there are no grounds for inferring future behavior from subsequent behavior, has molded the beliefs about the sociological phenomena of the operation of the capital markets. Thus, the only problem facing the market in aggregating individuals assessments of value into a unique market value is a distillation of the differences in attitudes toward risk. [Gonedes 1972] [Bever 1973] [Campbell 1982]

FASBs ACQUIESCE

W. Beaver, in 1973, several years subsequent to the introduction of the efficient market paradigm, asks this poignant question. "What if the mounting evidence in support of an efficient market finally becomes so overwhelming and compelling that it is accepted by all seven members of the FASB, all SEC Commissioners and staff and all congressmen?" [Beaver 1973 p.51] His prophetic cry has become reality for the accounting profession. The FASB has acquiesced to this conceptualization of the capital markets.

The FASB, since its inception in 1973, was chartered with a dual purpose. First, to develop a normative conceptual framework of accounting theory. Second, to establish standards for financial accounting. The intent was to develop a theoretical foundation of interrelated objectives and concepts that would lead to the establishment of consistent financial reporting standards. The FASB recognized that the objectives would be as stated in SFAC No.1

> Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities... thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective cash receipts.[FASB SFAC No. 1 para 33-37]

A careful analysis of this concept statement identifies the FASBs tactful compliance to the present conceptualization of the capital markets. The driving variables for the positivistic paradigms are information about timing, amount, and uncertainty of cash flows. Simply stating the above maxim. " The objective of financial reporting is to provide information about cash flows to sophisticated investors." The naive investor is no longer considered important because the markets "fully reflect" publicly available information. This means that in an efficient market the investor is playing a "fair game" with respect to published information and can no longer be hurt in the ways traditionally thought.

COUNTING THE COST

Previous to the 1970's, the accounting profession had not developed a theoretical paradigm for how the capital markets used financial information in pricing securities. This is not to say that the accounting profession operated without a world-view. The prevailing opinion prior to the introduction of efficient markets was that the markets priced securities naively. Meaning that the markets used past information to extrapolate future prices. This was chided by efficient market proponents as "casual empiricism", because the markets use historical information efficiently rendering past information useless in inferring future behavior. This struck at the conceptual core of accounting, because the entire amount of accounting thought and promulgated standards to this point was based on a historical cost model. A radical paradigm shift has taken place threatening to plunge the accounting profession into a crisis of confidence.

The efficient market paradigm suggests that the market uses a wide information set, and that capital markets will not be as naive to reflect pricing asymmetries because of various accounting methods. Because there is no cost to the firm for reporting various methods, and apparently no cost to the capital market in adjusting between various reporting methods, the entire discussion of financial reporting standards is trivial to the point of being bureaucratic chicanery.

Can any reporting issues of substance be found within this miasma? W. Beaver suggests several. First, a "worthwhile problem" would be to consider replacing the current historical cost model with market value or replacement cost accounting, because the capital markets must incur additional search costs to obtain this type of information. Thus, it would be in the best interest of the efficient market to report this type of information. Secondly, the FASB would be reduced to a preemptive role of expropriating insider information for the benefit of the capital markets. This process would be administrated by requiring additional corporate disclosures. The last barrier between the semi-strong and the strong form of the paradigm is that the market does not have insider information. According to efficient market proponents, if this last barrier of inefficiency could be broken down, the capital markets would mirror this positivistic paradigm.

Within the efficient market paradigm, financial accounting has been reduced to another part of the information processing industry. The very fact that the accounting profession is part of this industry obviates the fact that it must choose some information content to report. Which issues are of substance? Only a select information set can be chosen because if the profession chose to report all financial information the statements would become nonsensical. The very nature of choosing to report certain information will advantage some market participants and disadvantage others. Thus the financial reporting process has now been reduced to the fundamentally ethical question of how preferences must be weighted in determining financial reporting standards.

Within the positivistic disciplinary matrix, its epistemology rejects any moral judgments about the decision-makers goals. W. Chau, in his description of the current disciplinary matrix, writes "accountants...should not involve themselves with moral judgments about the decision-makers needs or goals." The FASB confirmed this preference for neutrality in its second concepts statement. [SFAC No. 2]

Consider the profound absurdity of the positivists' position. Because of the dogmatic adherence to the efficient market paradigm the accounting profession has been reduced to sole role of a social policy making body. E. Fama and A. Laffer confirmed this point in the Journal of Business July, 1971 pointing out the fact that it is entirely possible that future research will discover that financial statement data have no role to play at the individual investor level and that the sole role is that of a social one. Without a healthy epistemology, that allows for ethical decision making within which to carry out this social role, the financial reporting process would be impossible. Examine the position of the positivistic world-view.

> The choice among different accounting methods involves choosing among differing consequences, as reflected in the incidence of costs and security prices which affect individuals differently. Hence, some individual may be

> better off under one method, while others may be better off under an alternative method. In this situation, how is the optimal method to be selected? the issue is one of social choice, which in general is an unresolvable problem because of the difficulty (impossibility) of making interpersonal welfare comparisons.[Beaver 1973]

PARADIGM CHOICES

Extensive empirical tests of the efficient market paradigm have been conducted and most of them have not overturned the hypothesis, but does this make the theory and observations valid? With the current antithesis in what constitutes scientific evidence and methodology, the verifiability of the paradigm is in serious question.

Chau in his article on research methodology states.

> ... controversies within the philosophy of social science which have questioned realism and the empirical testability of theories. Beginning with Popper and continuing through the arguments of Khun, Lakatos, and Feyerabend, post-empiricist philosophy has generally agreed that observations are fallible propositions which are theory-dependent and therefore cannot act as the neutral arbitrator between competing theories. Indeed, the search for a permanent criterion of acceptability is now seen a futile exercise.

He concludes that

> accounting researchers work within some vague notion of an objective reality and of confronting theory with data.

Thus an equally credible paradigm could be developed resulting in the FASB choosing among transient voges in capital market models. Two addition research methodologies that are being discussed are the Critical Perspective, and the Interpretative Perspective, these could offer equally as credible and verifiable capital market paradigms. The FASB should reflect on the dominant assumptions they have accepted and, more importantly, the consequences of adopting this position. Such limitations only become clear when they are exposed to challenges of alternative world-views.

CHRISTIAN RESPONSE

A (not the) Christian response to the accounting profession would be to develop the multidimesionality of the profession in a redemptive way, by recognizing the creational mandate in Genesis 2, to develop and preserve our culture. Walsh and Middleton declare,

> Our humanity, in the image of God, is essentially a cohumanity. We are sociocultural beings, called by God to work together in developing and cultivating creation...culture refers not merely to intellectual and aesthetic pursuits,...but also such economic and political life,.. The cultural mandate is part of Gods original plan.[Walsh and Middleton]

A Christian response can begin to be developed by answering, in redemptive way, the following areas of the current world-view that come into direct conflict with Christian world-view.

The current world-view's ideology concerning the relationship between theory and practice believes that accountants should deal only with observation of the most efficient and effective means of meeting the informational needs. Accountants should not involve themselves with moral judgments about the decision-makers goals(see exhibit #1). Although financial reporting is a quest for truth (Fair Presentation), the critics suggest that individual morality cannot be relied upon to fairly represent financial information. Leading critics, such as

Carman Blough, the first chief accountant of the SEC, declare that fairness is too subjective, Accountants must have an operational definition for fairness that can measure the informational asymmetries of financial statements, and that GAAP should be the only test of reasonableness or honest presentation.[Stewart 1986] This view is currently held by the vast majority of public accountants. On these grounds, the AICPA in 1980 has proposed the elimination of the words "Present Fairly" in the opinion paragraph of the standard audit opinion. Instead of "Present Fairly", the opinion paragraph would state that the financial statements were "in conformity with GAAP, applied on a consistent basis" and not make any moral value judgments on whether the statements were fairly presented.

Is GAAP a reasonable test of fairness? Examine one example, U.S. Steel was the biggest money loser among the Fortune 500 companies, with a loss of $1.2 billion. Yet in 1984, the company showed $493 million in profit and was ranked number 37 in terms of profitability on the Fortune 500 list. However, the phenomenal performance did not come about because of some miraculous recovery in the steel business. Nor did any of these profits come about because of any changes in the oil industry, U.S. Steels largest product line since it acquired Marathon Oil in 1983. Instead, these earnings were generated by some complicated accounting changes. According to analyst's calculations, only $157 million in profits came from operations. The remaining earnings "can be attributed to a gallimaufry of nonoperating items, from asset sales to accounting adjustments."[Norton 1985]

It can be seen from the example that GAAP is a specific set of guidelines for the presentation of financial information and like any set of guidelines it is subject to abuses. I.C. Stewart writing about GAAP as a standard of fairness states,

> The difficulty this gives rise to, however, is that ends are being transformed into means. As in many other areas of society, doctrine is being converted into procedure. Fairness has no independent meaning apart from GAAP. The danger is that accounting standards may come to be regarded as possessing values in and of themselves quite independently of the conscience of the accountant who applies them.

This analysis does not decry the importance of financial reporting standards, In fact they are necessary for comparable and consistent financial information, but a serious problem is that "moral mysteries are being transformed into impersonal techniques."[Stewart 1986] A theistic basis for values requires that Christians exercise their moral capacity to disagree with the presentation of financial statement information even though the statements may be in conformity with GAAP.

A Christian response must address the fundamentally ethical question of how preferences should be weighted across individuals in determining financial reporting policies. There have been no substantial attempts to examine further this critically important and controversial issue. [Gaa 1986] Prior to SFAC No. 1, the AICPA report published in 1973 states the "Objectives of financial statements is to serve primarily those who have limited authority, ability, or resources to obtain information and who rely on financial statements as their principle source of information." Because of the FASBs acquiesce to the efficient market paradigm, the individual creditor and investor have been abandoned. A Christian response must balance the profession's social responsibility without abandoning the individual's interests in financial information.

The FASBs current objectives are to serve the allocative efficiency of the capital markets, as seen by the compliance with the efficient market paradigm. Should the FASB serve the goal of economic efficiency. The current world-view of mainstream accounting does not have as one of it expressed purposes an attempt to evaluate and possible change and institutional structure.

> Societies may be capitalist, or mixed, and markets may be monopolistic or firms exploitative. The accountant, however, is said to take a neutral value position by not evaluating these end-states. His/her task is simply to provide relevant financial information on the means to achieve these states. This supposedly neutral position runs into difficulties. This itself is a value position which cannot logically be agreed as "superior" to a position that judges goals in the name of some ideal.[Chau 1986 p.610]

PEDAGOGICAL IMPLICATIONS

1. After the instructor is aware of the world view (basic set of working assumptions) of his profession he/she can compare those propositions with that of a Christian world view.

2. Expose the students in your classroom to the lack of conformity between the profession's world view and that of the Christian world view.

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