In Focus

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In Brief

During the first half of the 20th century, few official bodies were dedicated to the promulgation of financial accounting standards, and accounting theory provided the primary basis for accounting education. Since the second half of the 20th century, however, the guidance issued by national accounting standards setting bodies has formed the primary basis for the practice and teaching of accounting. At present, the role of accounting theory and of national accounting standards setting bodies is beginning to diminish in the wake of the movement toward uniform international accounting standards. However developed and implemented, accounting standards can shape the behavior of businesses, governments, and individuals. This article traces the historical evolution of standards setting from accounting theory to conceptual framework, and explores some consequences of this evolution.

orical Evolution

Conceptual Framework in Financial Standards Setting

By C. Richard Baker and Alain Burlaud

Accounting theory in Europe and the United States has often been based on debates related to the resolution of practical issues, such as the proper way to measure assets and liabilities, the proper way to measure business performance, the determination of allowable dividend payments, the protection of creditors in the event of bankruptcy, and the taxation of corporations. The ways in which these issues have been addressed have differed among accounting theorists, and even among countries.

Accounting standards can significantly influence the behavior of enterprises, governments, and individuals, but the wider spectrum of stakeholders (i.e., employees, consumer groups, environmental groups, and the public) generally do not actively participate in the standards-setting process, and their interests are often not represented. Thus, an understanding of the evolution of the standards setting process is important for understanding its economic and societal consequences.

The Development of Accounting Theory and Doctrine

Germany played a prominent role in the development of accounting theory in the late 19th and early 20th centuries (R. Mattessich, H. Kupper, "Accounting Research in the German Language Area: First Half of the 20th Century," *Review of Accounting and Finance*, 2003, vol. 2, no. 3, pp. 106–137). The creation of uniform German accounting law dates to 1861, when the German Code of Commerce (ADHGB) required all companies to keep accounts and to prepare an annual balance sheet. This law did not, however, specify recognition and measurement criteria for financial statements, and disputes arose around the meaning of a particular section of the ADHGB explaining that assets and liabilities were to be measured at the "value" they had at the time the inventory was drawn up (J. Richard, "The Concept of Fair Value in French and German Accounting Regulations from 1673 to 1914 and Its Consequences for the Interpretation of the Stages of Development of Capitalist Accounting," *Critical Perspectives on Accounting*, 2005, vol. 16, pp. 825-850). Some legal scholars interpreted this phrase to mean that assets should be measured at market values that would allow the payment of dividends out of unrealized holding gains. In the event of bankruptcy, this might mean that creditors would be disadvantaged with respect to shareholders. To correct this problem, an 1870 law specified recognition and measurement rules to protect creditors by limiting dividend payments to the amount of realized profits (M. Hommel, S. Schmitz, "Insights on German Accounting Theory," in Y. Biondi, S. Zambon, *Accounting and Business Economics: Insights from National Traditions*, Routledge, 2014, p. 333).

Static and Dynamic Accounting

Debates concerning the protection of creditors and determination of dividend payments, which directly affect the measurement of assets and liabilities as well as profits, were crystalized in the "static"

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(asset/liability) versus "dynamic" (revenue/expense) views of accounting theory that emerged in the early years of the 20th century. According to Richard (2005, 2013), conflicts between capitalist entrepreneurs and providers of capital occurred pursuant to the development of the static view of accounting theory in the 19th century. The basic assumption underlying the static view was that every human enterprise has a definite life; therefore, it is necessary to consider the potential failure of a company, and then proceed as if the company would be put into liquidation. This concept of "fictional liquidation" required the valuation of assets at their market values at the binnerce sheet date in order to determine the amount necessary to pay the liabilities in case of bankruptcy (J. Richard, "The Three Main Schools of the French Financial Accounting Doctrine: A Historical Survey," in Y. Biondi and S. Zambon, *Accounting and Business Economics: Insights from National Traditions*, London: Routledge, 2013, pp. 249–271).

The transition to the dynamic approach to accounting theory occurred in the late 19th century as a response to pressure from shareholders who wanted regular dividend payments. This desire was not compatible with fluctuations in the market value of assets and liabilities. In contrast to the static view, the dynamic view is based on recognizing assets and liabilities at historical cost with depreciation of these assets and amortization of deferred charges where appropriate. Income is then determined by matching expenses against revenues. This dynamic view became the primary basis of accounting theory in the United States for most of the 20th century. The dynamic view had been elaborated in the work of the German accounting academic theorist Eugen Schmalenbach, whose theories are well known in Germany and continue to be taught in German universities (Hommel, Schmitz, 2014).

Accounting Theory in the United States

The development of accounting theory in the United States was largely due to the work of William Paton and John Canning. In his 1922 book, *Accounting Theory*, Paton presented a set of "assumptions" underlying financial accounting. In his 1928 book, *The Economics of Accountancy*, Canning was the first to develop a theoretical framework for the valuation of assets and the determination of accounting profit similar to that of the static approach. These works significantly influenced the development of accounting theory in the United States (S. A. Zeff, "The Evolution of the Conceptual Framework for Business Enterprises in the United States," *Accounting Historians Journal*, 1999, vol. 26, no. 2, pp. 89–131).

A. C. Littleton was another scholar with a significant influence on American accounting theory. Littleton, who was fluent in German, was particularly familiar with the German dynamic approach to accounting theory (Y. Biondi, "Accounting, Economics, and the Law of the Enterprise Entity: A. C. Littleton and the German-American Connection," in Y. Biondi, S. Zambon, *Accounting and Business Economics: Insights from National Traditions*, 2013, Routledge, pp. 363-386).

> The dynamic view became the primary basis of accounting theory in the United States for most of the 20th century.

Littleton argued that the primary objective of accounting is to render an account (accountability), and that this objective would be difficult to achieve if market values were used in accounting measurements. Littleton rejected market values because he believed that value is a subjective concept that cannot be measured reliably. He also dismissed the idea that labor cost determines value (A. C. Littleton, "Price and Value in Accounting," *Accounting Review*, vol. 4, 1929, pp. 149-159). He argued that an object's worth depends solely on future prices:

> Value is a subjective estimate of an article's relative importance; price, however, is a compromise between subjective estimates and is measured by the quantity of money for which an article can be exchanged. Value exists in one's mind alone and therefore is not objectively measureable. … Much of the use of the term "value" in accounting may be due to the view that value in business has a cost basis, that Price = Cost + Profit. As a matter of fact: Price – Cost = Profit. … If cost is a proper basis for the inventory of a stock of unsold goods, it must be for other reasons than that it expresses the value of the goods. As an expression of the investment in goods, cost is quite acceptable, but not as an expression of their value. Cost is a record of recoverable outlay, and not recorded value. … What something is worth will depend upon future prices. (Littleton, 1929)

Paton and Littleton participated in the preparation of "A Tentative Statement of Accounting Principles Affecting Corporate Reports," published in 1936 by the executive committee of the American Accounting Association (AAA) in the *Accounting Review* in order to assist the SEC, which had been created in 1934 ("A Tentative Statement of Accounting Principles Underlying Corporate Reports," *The Accounting Review*, 1936, vol. 11, no. 20, pp. 187-191).

The subsequent Paton and Littleton monograph, *An Introduction to Corporate Accounting Standards*, was based on the tentative statement (W. A. Paton, A. C. Littleton, *An Introduction to Corporate Accounting Standards*, *American Accounting Association*, 1940).

The Paton and Littleton monograph advocated the dynamic approach to accounting theory, involving the use of historical cost principle for asset and liability measurement and recognition; and using the matching principle (i.e., revenue and expense) as the basis for calculating profit. The SEC adopted the monograph as the primary theoretical basis underlying U.S. Generally Accepted Accounting Principles (GAAP), and it was also used for many years to teach accounting in the United States. More than any other accounting publication, this monograph was responsible for the maintenance of the historical cost principle in the United States. Historians note that the Paton and Littleton monograph was an exception to the general rule that academic theory has had little impact on accounting practice (R. K. Storey, "Conditions Necessary for Developing a Conceptual Framework,"

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Journal of Accountancy, vol. 151, no. 6, 1981, pp. 84–96). Generations of accounting practitioners learned accounting theory through the Paton and Littleton monograph (S.A. Zeff, "The Evolution Of The Conceptual Framework for Business Enterprises in the United States," *Accounting Historians Journal*, vol. 26, no. 2, 1999, pp. 89-131).

Moreover, major accounting standards-setting bodies, including the AICPA's Committee on Accounting Procedure (CAP), the AICPA's Accounting Principles Board (APB), and FASB, took positions that were consistent with those in Paton and Littleton's monograph. In fact, when the AICPA created the CAP in 1939 as the first accounting standards setter in the United States, one of its early decisions was to reject the idea of creating a new set of accounting theory or principles on the grounds that it would take too long and the Paton and Littleton monograph could serve the same purpose. Thus, the CAP began publishing Accounting Research Bulletins (ARB) to address immediate accounting practice issues, rather than basing its ARBs on a full statement of accounting theory or a conceptual framework (Zeff 1999).

In summary, accounting theory enunciated by academic scholars began to play an important role in the accounting standards setting process in the United States during the first half of the 20th century. Subsequently, the development of accounting standards was largely based on the influence of professional accounting bodies, such the AICPA, acting in tandem with regulatory authorities such as the SEC and the largest public accounting firms. This transition is discussed below.

The Transition to Standards-Setting Bodies

Accounting theory initially had an important influence on the development of accounting practice and teaching, but it could not lead to the standardization of accounting practices. The government (i.e., the SEC) and professional associations (i.e., the AICPA) believed that in order to standardize accounting practices, and provide financial information intended for society as a whole, recognized accounting standards setting bodies were needed to provide legitimacy and support for the enforcement of accounting standards.

Development of U.S. standards setting bodies. The enactment of the Securities Acts of 1933 and 1934 required publicly listed companies to prepare audited financial statements in accordance with GAAP—although there was no document or source specifying what GAAP consisted of prior to that time. To resolve this problem, the AICPA and the SEC created the Committee on Accounting Procedure (CAP) in 1938. From 1938 until 1959, the CAP issued 51 ARBs that came to define GAAP in the United States. In 1959, the AICPA revised the standards-setting structure by creating the Accounting Principles Board (APB), which was intended to have greater authority to promulgate accounting standards. From 1959 until 1973, the APB published 31 Opinions. Thus, between 1938 and 1973, accounting standards in the United States consisted primarily of ARBs and APB Opinions issued by the CAP and APB, whose members were mostly representatives of public accounting firms, along with a few academics (Zeff, 1984).

Accounting theory initially had an important influence on the development of accounting practice and teaching, but could not lead to the standardization of accounting practices.

In the 1940s and 1950s, the SEC, the leaders of the large public accounting firms, and academics discussed whether accounting standards setting should be based on a comprehensive set of accounting principles, and what these principles should be (S. A. Zeff, "Some Junctures in the Evolution of the Process of Establishing Accounting Principles in the U.S.A.: 1917-1972," *The Accounting Review*, vol. 59, no. 3, 1984, pp. 447–468). The leaders of the major firms had differing opinions over the choice between a uniformity of accounting or flexibility in the selection of methods (Zeff, 1984, pp. 458–459). In order to resolve these conflicts, the AICPA created the Special Committee on Research Programs, composed of preparers of financial statements, auditors, academics and the chief accountant of the SEC. In a report published in 1958, the Special Committee proposed the creation of the APB to replace the CAP, and the creation of a Research Division to support the APB.

In its report, the Special Committee identified three main levels of accounting theory: postulates (used by Paton in 1922), principles, and rules. Postulates were to be derived from the economic and political environment in which businesses operate. The report indicated that postulates should be few in number and should logically lead to the principles and the rules. The purpose of the Research Division was to determine the postulates and principles to be used in the promulgation of accounting standards (Zeff 1999).

Three levels of postulates. When the APB and the Research Division were created in 1959, Maurice Moonitz, professor of accounting at the University of California, Berkeley, was named director of accounting research. In this role, he authored Accounting Research Study 1, "The Basic Postulates of Accounting" (M. Moonitz, "The Basic Postulates of Accounting," Accounting Research Study 1, AICPA, 1961). This document describes three levels of postulates:

- *Group A: Economic and political environmental postulates.* This group of postulates is based upon the economic and political environment in which accounting exists. They represent descriptions of the aspects of the environment that are relevant for accounting. These postulates included quantification, exchange, entities, time period, and unit of measure.
- *Group B: Accounting postulates.* This group focuses on the field of accounting. These postulates form the basis for the construction of accounting principles. These postulates included financial statements, market prices, entities, and tentativeness.

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■ *Group C: Imperative postulates.* The third group differs fundamentally from the first two groups. These postulates are not descriptive statements. Instead, they represent a set of normative statements concerning what ought to be rather than what is. These postulates included continuity, objectivity, consistency, stable unit, and disclosure.

Following Accounting Research Study 1, Robert Sprouse, professor of accounting at Stanford University, joined Moonitz in coauthoring Accounting Research Study 3, "A Tentative Statement of Broad Accounting Principles for Business Enterprises." This document recommended that the realization principle be de-emphasized and that the use of market values should be expanded (R. T. Sprouse, M. Moonitz, "A Tentative Set of Broad Accounting Principles for Business Enterprises," AICPA, 1962, p. 15).

Given the SEC's hostility to the abandonment of historical cost, the document immediately created controversy. Thus, the APB devoted itself to the issuance of opinions that responded to practice issues, rather than basing its opinions on a comprehensive set of accounting theory or principles.

Trueblood Committee. A new attempt to create a complete set of accounting theory began in 1973 with the publication of the report of the AICPA's Trueblood Committee, "Objectives of Financial Statements" (Trueblood Report, "Objectives of Financial Statements: Report of the Study Group on the Objectives of Financial Statements," AICPA, Study Group on the Objectives of Financial Statements, 1973).

This document supported the views of a 1966 report issued by the AAA, "A Statement of Basic Accounting Theory (ASOBAT)," which argued that the primary objective of financial reporting should be usefulness for decision making (AAA, 1996, p. 1). This emphasis on decision usefulness—and in particular usefulness for decision making by investors and creditors—was the basis of Statement of Financial Accounting Concepts (SFAC) 1, *Objectives of Financial Reporting by Business Enterprises*, issued in 1978, which became the first element in FASB's Conceptual Framework. Since that time, SFAC 1 has been used in the development of FASB standards and in the development of additional elements in the Conceptual Framework of both the FASB and the IASB (Zeff 1999).

The Conceptual Framework. In the latter part of the 20th century, FASB's Conceptual Framework essentially replaced accounting theory as the basis for the development of accounting standards in the United States. The Conceptual Framework was developed primarily by FASB and its professional staff rather than by academic theorists; there was also little input from the general public in its creation. Possibly due to the failure of Accounting Research Study 3, which was authored by two academics and firmly based in accounting theory, the development of accounting standards has evolved so that it is now the work of an independent professional technocracy without representation from a broad spectrum of stakeholders. It would take a specific change in the accounting standards setting process in order for accounting theory to broadly represent stakeholders.

FASB's Conceptual Framework essentially replaced accounting theory as the basis for the development of accounting standards in the U.S.

The following section examines some of the challenges associated with this evolution away from accounting theory, and towards a greater reliance on conceptual frameworks and the institutional convergence of the standards setting process in a way that diminishes debate about alternatives.

Consequences of the Standards–Setting Process and Conceptual Framework

The 2008 global financial crisis has led to renewed reflections regarding the consequences of accounting standards setting and the purposes of a conceptual framework for financial reporting (A. Burlaud, B. Colasse, "International Accounting Standardization: Is Politics Back?," *Accounting in Europe*, vol. 8, no. 1, 2010, pp. 23–47).

It has been argued, for example, that the measurement of financial assets at market values has had a pro-cyclical, macroeconomic effect that exacerbates the impact of economic crises (A. Burlaud, "Les Comptes Doivent-ils Dire le «Vrai» ou le «Bon»? A Propos du Cadre Conceptuel de l'IASC/IASB," *Revue Française de Comptabilité*, vol. 467, 2013, p. 17). It is necessary to reconsider the accounting standards-setting process and its consequences.

One difference between the operating structures of the IASB and FASB is the relative degree of government supervision over the two boards. FASB's standards are subject to review by the SEC, as well as the U.S. government's legal authority, even though the board's operating structure facilitates its functioning in the private sector. The IASB's operating structure is different, because there is no external governmental authority supervising its actions, and its standards may be issued without any significant public debate. For example, the use of "fair value" in the measurement of agricultural assets was introduced without major input from countries that could be negatively affected by fair value measurements (e.g., agriculturally based economies in Africa and Asia; see C. Elad, "Fair Value Accounting in the Agricultural Sector: Some Implications for International Accounting Harmonization," *European Accounting Review*, vol. 13, no. 4, 2004, pp. 621–641).

Accounting standards can affect the functioning of financial markets, as well as the decisions of companies, governments and individuals, and yet there is little democratic input into the standards-setting process (E. Chiapello, K. Medjad, "An Unprecedented Privatisation of Mandatory Standard-Setting: The Case of European Accounting Policy," *Critical Perspectives on Accounting*, vol. 20, no. 4, 2009, pp. 448–468). Thus, the question of legitimacy for the IASB and its standards-setting process remains an unresolved issue (Burlaud and Colasse, 2010).

Despite questions about the legitimacy of the IASB, many standards-setting bodies are becoming more similar in their operating structures and procedures (P.J. DiMaggio, W.W. Powell, "The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in Organizational

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Fields," American Sociological Review, vol. 48, 1983, pp. 147-160; R. Ball, "International Financial Reporting Standards: Pros and Cons for Investors," *Accounting and Business Research*, vol. 36, supplement 1, 2006, pp. 5-27).

This type of institutional isomorphism has led to a paradoxical situation in which the operating structure of the IASB has mimicked that of the FASB, while the convergence between the IASB and FASB's standards appears to have been postponed indefinitely (Burlaud and Colasse, 2009).

Political Influence on Standards Setting

In 2002, the European Union issued Regulation EC 1606/2002, which defined the use of international accounting standards within the EU in an effort to obtain more influence over the IASB standards setting process. This regulation did three things: 1) It defined international accounting standards as those promulgated by the IASB; 2) it specified that for each financial year starting on or after January 1, 2005, companies governed by the law of a EU member state must prepare their consolidated accounts in conformity with international accounting standards, if their securities are traded on a regulated market; 3) the European Commission retained the authority to determine the applicability of specific standards within the EU. In pursuing this third point, the European Commission created an Accounting Regulatory Committee (ARC) composed of representatives of governmental authorities from each of the member states. The ARC can recommend approval or disapproval of IFRS standards for use by companies in the EU.

The EU's efforts to gain more influence over the standards-setting process intensified in 2004 with the debate over IAS 39, *Financial Instruments: Recognition and Measurement*. IAS 39 has provisions similar to SFAS 115. Financial instruments are required to be recognized when an entity becomes a party to the contractual provisions, and they must be classified into trading, available for sale, loans and receivables, or held to maturity. The classification determines the subsequent measurement of the instrument (typically amortized cost or fair value).

The provisions of IAS 39 prompted a reaction on the part of European banks, which pressured government authorities to overrule the standard (J. House, "IAS 39 Adoption Faces French Resistance, *Accountancy*, vol. 132, 2003, pp. 9–12). At the end of 2004, the ARC and European Commission recommended partial approval of IAS 39, with the exception of certain provisions pertaining to hedging and fair value measurement of financial instruments. In response to political pressures brought to bear on the IASB by various European governments, in June 2005, the IASB amended IAS 39 with provisions to reduce volatility in the financial statements of banks and other financial institutions.

Further exacerbating the political problems associated with IAS 39, in 2008, banks around the world faced substantial write-offs of their trading and available for sale securities portfolios. The accounting treatment of these losses differed substantially between U.S. GAAP and IFRS. Under U.S. GAAP, FASB interpreted the problems posed by the financial crisis to be one of the circumstances contemplated in SFAS 115, which provided an option to transfer securities from the trading or available for sale category into the held to maturity category (i.e., to suspend fair value measurement of the respective assets). Prominent U.S. banks made use of this opportunity (C. Laux, C. Leuz, "The Crisis of Fair-Value Accounting: Making Sense of the Recent Debate," *Accounting, Organizations, & Society*, vol. 34, no. 7/8, 2009, pp. 826–834). But European banks could not avoid reporting the losses, because IAS 39 required that "an entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued."

As a result, at the peak of the financial crisis in October 2008, the IASB decided to suspend its normal due process in order to issue an amendment to IAS 39 (P. André, A. Cazavan-Jeny, W. Dick, C. Richard, P. Walton, "Fair Value Accounting and the Banking Crisis in 2008: Shooting the Messenger," *Accounting in Europe*, vol. 6, 2009, pp. 3–24).

The IASB decision was preceded by intense lobbying efforts on the part of European politicians and banking regulators, which culminated in the European Commission threatening to prevent the application of IAS 39. The amendment to IAS 39 allowed companies to retroactively reclassify financial assets previously recognized at fair value into categories that permitted recognition at amortized cost, and avoid significant write-downs in the carrying value of financial assets (J. Bischof, U. Brüggemann, H. Daske, "Fair Value Reclassifications of Financial Assets During the Financial Crisis," 2014, http://ssrn.com/abstract=1628843).

External political pressures can bear down on the accounting standards setting process, and the legitimacy of this process remains an unresolved issue. The political interventions surrounding the implementation of IAS 39 also illustrate the weakness of the IASB Conceptual Framework, because the principle of fair value measurement of financial instruments was not effectively maintained in the face of a severe financial crisis.

How Standards Shape the Future

Accounting theory influenced the development of accounting standards during the first half of the 20th century, but it diminished during the second half of the 20th century in response to the rise of national standards-setting bodies. In the 21st century, the role of national standards setters has subsequently diminished with the creation of the IASB and the movement towards uniform international accounting standards. The primary influences on accounting standards setting currently come from international capital markets and global business enterprises. Since Jan. 1, 2005, IFRS is compulsorily applicable to consolidated accounts of all European listed companies. Apart from the purely technical aspects of this change, and its difficulties in implementation, there is a questionable lack of consideration of the consequences of accounting standards and the standards-setting process. Accounting standards—far from being neutral—contribute to shaping economic practices and social relations. Management practices can be fundamentally altered, induced into a short-term perspective in order to meet market expectations regarding profitability as defined under the standards. It appears to this author that the principles of reliability, stewardship and prudence—present decades ago in early accounting theory—have been replaced in favor of relevance. ❑

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