What's wrong with modern accounting?

Global modern accounting orthodoxy now assumes the raison d'être of financial accounts is to provide open and verifiable information to investors. Professor David Myddelton examines this shareholder-centric view and challenges the use of universal accounting standards across widely varying organisations as a useful measure of their potential. Ultimately, we may need to let go of some long held beliefs and look for a more radical approach that releases companies from this bureaucratic nightmare.

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The purpose of accounts

The main purpose of accounts always used to be for managers (the 'agents') to report to owners (the 'principals') on their stewardship of the funds under their care. But recently there has been a big change, dating back originally to a famous 1966 academic paper entitled 'A Statement of Basic Accounting Theory'. This may seem a long time ago; but it has taken many years for the revolutionary switch to work through, via various 'Conceptual Framework' documents. Accounting regulators around the world now assume that the major purpose of modern 'financial statements' is decision-usefulness for investors. This ambitious new system apparently aims to transform accounts from being a report on past transactions into instruments for predicting future cash flows.

The American Securities and Exchange Commission [SEC], set up after the 1929 Wall Street crash, has always believed that accounts should be for potential investors as well as for existing ones. In contrast, the UK Companies Act clearly distinguishes between prospectuses and accounts. And in the 1990 Caparo case, the House of Lords explicitly ruled out the 'decision-usefulness' approach.

Even if 'decision-usefulness for investors' made sense for listed companies whose shares are publicly-held and traded on a stock exchange, it can hardly apply to most small private companies and partnerships. Nor to charities or government departments or other non-business entities. In fact, this new approach (unlike stewardship) is totally irrelevant for the vast majority of bodies that produce accounts.

Technical problems

There are serious technical problems too. The new approach uses hypothetical estimates of current value rather than actual historical costs. Instead of the traditional method of matching expenses against achieved sales revenue to measure profit or loss, the current value approach measures 'comprehensive income' in effect by deducting one balance sheet from the next. That is truly revolutionary. Reported 'profit' (which may be called something different, such as 'comprehensive income') will comprise the increase in shareholders' funds (equity) from one balance sheet date to the next, after eliminating any new share capital raised during the period and any share buy-backs and dividends to shareholders. It will cause more volatility in annual accounts, and a much larger margin of error. It will also end up reporting unrealised amounts as profits, which has always been regarded as extremely dangerous.

The International Accounting Standards Board defines 'fair value' as: "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction". But this definition reveals a key fallacy. Many assets don't have active markets in which they are traded, but even where they do, 'fair value' is not a definite sum but a range of values. Anyone who thinks otherwise has completely misunderstood the nature of market transactions, on which accounts are supposed to be reporting!

General acceptance?

Nor is this new approach 'generally accepted'. In 1995 the Accounting Standards Board published a draft Statement of Principles of Financial Reporting for external comments. The responses showed that, with respect to eight key elements, the top UK accountancy firms all disagreed with most of them; and most of the top firms disagreed with each one of them. For example, Deloitte & Touche said: "... we don't regard the draft as a sound basis for a final Statement."Ernst & Young said: "... our overall view is that fundamental change to this draft is needed." And Price Waterhouse said: "... our reluctant conclusion is that the Board must start again."

But the Accounting Standards Board took little notice. I don't blame the standard-setters (who largely agree among themselves on their conceptual frameworks) for failing to achieve consensus as to the purpose of accounts. But I do blame them for imposing a revolutionary compulsory system of accounting which doesn't have general support from most accountants and business people.

Indeed the new system is even more cavalier in ignoring 'general acceptance'. For the 14-person International Accounting Standards Board can issue standards with only a simple majority of 8 to 6: it doesn't need two-thirds or anything like that. One standard, IFRS 4 on Insurance Contracts, actually had six members of the Board disagreeing with it! So now we don't even have 'general acceptance' for some of these new compulsory accounting standards among the members of the IASB itself!

Over-regulation

The 1948 Companies Act contained only a few pages on accounts and audit, mostly to do with disclosure not measurement. Apart from a modest number of voluntary Recommendations from the English Institute, those were all the rules we had. I have recently compressed them to eight A4 pages and stuck them on my office door.

According to the 1989 Dearing Report: "The purpose of accounting standards is to provide authoritative but not mandatory guidance on the interpretation of what constitutes a true and fair view". (Just like the English Institute's Recommendations used to do!) But the regulators ignored Dearing; and made accounting standards compulsory, which certainly increases their power. The new system seems to assume that regulators know best, and wants their views imposed on everyone.

As a result, to protect themselves against huge potential liabilities, auditors want the compulsory rules spelt out in excruciating detail. In less than ten years accounting regulations have increased from 800 to over 2000 pages! The average length of a UK accounting standard has risen from 12 1/2 pages to 85 pages! This is over-regulation gone mad! If we keep on like this, where will it all end?

Over the Christmas holiday I received great wodges of new regulations from the UK Accounting Standards Board: 325 pages of new standards plus 532 pages of 'explanations'. Add in 278 pages of Amendments to Financial Reporting Standards for Smaller Entities 2004, and you've got more than 1,100 further pages of gobbledygook. In a single month!

Disadvantages of standards

Under the soothing heading of 'international harmonisation' the standard-setters are now seeking a global monopoly. From next year, all listed groups in the European Union will have to use International Financial Reporting Standards [IFRS]. That means a huge upheaval, at enormous expense, with unpredictable consequences.

A supporter of the new system, David Damant, says "financial statements prepared according to international standards will be unintelligible to all but a few". That does seem rather a pity. After all, accounting isn't some technical exercise in metaphysics: it's a practical art which a very wide range of people need to be able to use and understand.

The stimulus for new accounting regulations has often been scandals such as Enron. Whether or not we have thousands of pages of regulations, such scandals recur down the ages: Royal Mail Steamship, Pergamon Press, Polly Peck, Queens Moat Houses ... As so often when regulation falls short of what it promises, the 'solution' is to reinforce failure by more of the same.

But the existence of standards actually does harm. It legitimises bad methods of accounting (such as expensing research expenditure, or forbidding amortisation of goodwill); and all the paraphernalia of regulation falsely raises the public's expectations of accounts. It is extremely ambitious to attempt to summarise the complicated financial affairs of large multinational enterprises in just two or three financial statements. The results can only ever be very approximate. The most sensible motto for a reader of accounts is 'caveat lector' -- let the reader take care.

Conclusion

My conclusion is: if we must have standards, let them be voluntary not compulsory, deal with disclosure not measurement, and apply only to listed companies not to all the other bodies that produce accounts.

But in fact I believe we should scrap the lot. All we really need is a single sentence in the Companies Act requiring accounts to give 'a true and fair view' of financial performance and position. Full stop.

Admittedly that is very different from the flawed American approach of requiring company accounts to accord with 'Generally Accepted Accounting Principles' (the famous US GAAP) which, despite the name, has nothing much to do with principles but simply means slavishly complying with every last comma of US Accounting Standards. No question in the US of 'a true and fair view' such as we require in the United Kingdom (and, thanks to our influence on this topic, in the European Union too).

Then, in the UK at least, we could have healthy competition between honest and competent professionals exercising their subjective judgement and allowing accounting practices to evolve freely as conditions change.

In such a 'free market' auditors would be more at risk than now, because they would no longer be able to justify their 'opinions' merely by box-ticking against detailed 'standards'. Auditors' prosperity would depend on their reputations - both for competence and for independence.

It is unlikely to be in a company's long-run interests to deceive its own members, though directors might take a shorter-term view. Setting up audit committees comprising only non-executive directors already tries to guard against this. Nor probably would auditors gain in the long run if they abetted any such attempt. This does not guarantee the complete absence of short-term deception in acounts, but it is doubtful whether any other approach could do so either.

How could one tell whether or not a particular set of accounts did indeed give 'a true and fair view'? (The indefinite article is the key word here!) Regular surveys of accounting practices could reveal which were 'generally accepted'. In specific disputed cases, possibly some form of 'jury', perhaps only half a dozen strong, could be drawn from lay people working in some area of accounting or business, taking evidence from leading accountants of the day. (For a start, we might ask such a jury to review the 'conceptual framework' on which standard-setters seem so keen. I doubt if it would survive such a test.) If several reputable professional accountants testified that, in their opinion, a set of accounts gave a true and fair view, no court of law would be likely to find otherwise.

But of course the climate would be very different from today, with users needing to exercise robust common sense in not expecting too much of accounts.

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David Myddelton's latest book, "Unshackling Accountants", has been published by the Institute of Economic Affairs. It is available for purchase or you can download the full copy free of charge from http://www.iea.org.uk/files/upld-publication241.pdf?pdf