

An Economics Perspective on Financial Reporting Objectives

Anthony D Miller – Corresponding author
Durham University Business School
Queen's Campus
Stockton
TS17 6BH
United Kingdom
Tel: 44 191 3345896
Email: anthony.miller@durham.ac.uk

David Oldroyd
Newcastle University Business School
5 Barrack Road
Newcastle upon Tyne
NE1 4SE
United Kingdom
Tel: 44 191 2081707
Email: david.mccollum-oldroyd@ncl.ac.uk

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Tony Miller is a lecturer in accounting at Durham University Business School. David Oldroyd is a professor of accounting at Newcastle University Business School. They are both members of the technical committee of the British Accounting and Finance Association's Financial Accounting and Reporting Special Interest Group, which David Oldroyd chairs.

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Summary at a Glance

The paper examines IASB and FASB's stated objectives of financial reporting, and in particular the decision to disregard the motivational aspects of stewardship information. The paper shows this view to be flawed from a theoretical perspective and considers the practical consequences.

Abstract

The paper examines the decision of IASB and FASB to subsume stewardship within the sole financial reporting objective of informing investment decisions rather than seeing it as separate and distinct. This view is shown to be flawed from a theoretical economics perspective given the differences in the underlying properties of accounting information. In answer to the question of what difference the boards' policy would make, the paper outlines consequences in relation to accounting standard-setting and contracting with managers.

Key Words: Conceptual Framework, Regulation, Reporting Objectives, Stewardship

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In 2010, the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) published Chapters 1 and 3 of a revised Conceptual Framework (CF), also known in the U.S. as Concepts Statement #8. These pronouncements still stand notwithstanding that the IASB is in the process of issuing its own CF, which has reached the exposure draft stage. There are no plans currently in the U.S. to revise Concepts Statement #8. One of the most controversial aspects of Chapter 1 of the 2010 version is the omission of stewardship as a distinct objective of financial reporting. According to this view, the sole purpose of financial reports is to provide forward-looking information to facilitate investment decision-making, focusing on future payoffs, and characteristics such as risk (FASB 2010, OB2, OB3). Although the IASB has subsequently modified its position regarding stewardship to the extent that the ED now refers to the concept several times explicitly by name, the board continues to see stewardship as part of the process of facilitating investment decisions (IASB 2015a, 1.2). The *Basis for Conclusions* document that accompanied the ED summarises the current position:

For the following reasons, the IASB rejected the idea of identifying the provision of information to help assess management's stewardship as an additional, and equally prominent, objective of financial reporting:

- (a) information about management's stewardship is part of the information used to make decisions about whether to buy, sell or hold an investment ...
- (b) introducing an additional primary objective of financial reporting could be confusing. (IASB 2015b, BC1.10).

The decision in 2010 to treat stewardship in this way was taken in the face of significant opposition (PAAinE 2007; AAA Financial Accounting Standards Committee

2007; Kothari et al. 2010; Lambert 2010; Walker 2010; Pelger 2016), and still remains contentious. Proponents of stewardship as a distinct objective of financial reporting failed to convince FASB members especially that a stewardship perspective would make any difference in practice (Zeff 2013; Pelger 2016).

This paper considers whether this view is valid. It approaches the problem from an economics angle and therefore compliments the work of other authors who have examined the issue from a non-economics perspective and drawn similar conclusions (Bayou et al. 2011; Murphy et al. 2013; Williams and Ravenscroft 2015). An information-economics viewpoint is particularly helpful given that the IASB and FASB frame their CFs in a similar language, referring to the qualitative characteristics of information and the costs/benefits of providing it. Essentially, the paper makes two points: Disregarding the motivational aspects of stewardship information is theoretically unsound. Also, there are ramifications for practitioners concerning future standard-setting and the contractual arrangements with managers. The paper continues by examining the theoretical position before moving on to the practical implications.

Two Valuable Characteristics of Information

One of the difficulties faced by IASB/FASB in distinguishing the stewardship objective from the decision-usefulness one is that stewardship can be perceived as lacking ‘an autonomous rationality’, due in part to the fact that stewardship information about the past can indeed be useful to investors in assessing future cash flows (Pelger 2016, p. 61). However, this does not imply that stewardship information cannot be distinguished from information for investment decision-making, or that it does not serve a separate and crucial purpose.

Borrowing from economic theory, information can be regarded as an economic product or service. Lancaster (1966a; 1966b) models the demand for products and services in terms of consumer preferences for the underlying characteristics of products. For example, food products supply a ‘bundle’ of nutrients, additives and energy levels, and consumers are presumed to have demands for products depending on the ‘bundle’ of underlying characteristics each one offers. Similarly, a model of car offers a number of characteristics of value to consumers, such as style, engine performance, fuel economy, levels of pollutants, and so on, which distinguish the vehicles. The same argument applies to information. According to economic theory, accounting information possesses two fundamental characteristics. First, it will assist users in making decisions that are contingent on information signals, which is the role privileged by IASB/FASB. Also, it will be useful in situations where the interests of economic agents are in conflict and there is uncertainty about how they will act. Information can then be used to align those interests through the provision of incentives based on outcome data (Ijiri 1983; Ball 1989; Christensen and Feltham 2008), which is the aspect of stewardship that two boards disregard.¹ Following the food and car analogy, any given piece of information may possess either or both of these characteristics in varying amounts, but this does not mean that they do not perform different functions or that it would be reasonable to model user-demand on the one attribute alone.

Focusing on the underlying characteristics of information shows what is and what is not distinct. Information with the decision-usefulness characteristic acts on decision-makers’ beliefs, while information designed to influence agents’ behaviour mitigates incentive problems. The latter need not affect beliefs about investment opportunities in any way. Nevertheless, it has value in deterring undesirable behaviour.

Qualitative Characteristics

Turning now to the CF specifically, FASB/IASB identify relevance, timeliness and verifiability as properties of valuable information, alongside faithful representation, comparability, and understandability (FASB 2010, BC1.23, QC4). Comparing these pronouncements to the results from the economic theory of accounting, relevance and timing are the most important determinants of whether information is valuable from a decision-maker's perspective (Feltham 1972; Ijiri and Itami 1973). Conversely, relevance and timing are less important as far as influencing an agent's behaviour is concerned, while verifiability assumes greater significance (Ijiri 1971; Gjesdal 1981).

Relevance means the potential of information to alter a decision. This is clearly necessary for decision-useful information to have value. Timeliness is also paramount. If the information is received too late, it loses its potential to affect decisions and therefore ceases to be relevant.² This is not the case for stewardship information which can be produced retrospectively and still retain its value through the incentive effects produced. In this scenario, agents take better decisions not because they have better information but because they are motivated by the prospect of future performance evaluation.

Verifiability, for its part, is of major significance in influencing agents' behaviour because verifiable information makes for a more effective contracting variable in the design of agent rewards. Because the information on agents' performance can be verified, contracts can be enforced by a court of law. Without verifiability, contracts become unenforceable in law, which weakens the incentive properties of the accounting information provided (Ijiri, 1971; Arrow 1983; Laffont and Martimort 2002: Ch 6).

In summary, the underlying properties of the two information types are different. They each perform distinctive functions in the technology of financial reporting. The focus of incentive based stewardship information is on linking the reward of managers to measures of

past performance, whereas for decision-useful information, it is on predicting future outcomes. For these reasons, these two valuable characteristics of accounting information cannot be regarded conceptually as one.

Practical Implications

The conceptual distinction between decision-usefulness and incentive based stewardship information would be unimportant if there were little demand for the latter or the practical consequences of dispensing with it were insignificant. This is not the case.

Turning first to the question of the volume of demand for stewardship information to control managerial behaviour, problems of agency and asymmetric information are arguably self-evident given the contemporary international focus on corporate governance structures following the Cadbury Report (1992). Accounting scandals occur with regularity despite monitoring from boards of directors, shareholders and debtholders (e.g. Burrough and Helyar 1990; Clarke et al. 2003; Tirole 2006, Ch. 1; Fallon and Cooper 2015). Lee (2006 p. 421) portrays the situation as an undeclared war between the protectors of the public interest and those corporate managers who regard the information in financial reports as their private domain. Such behaviour is not in the interests of the capital providers, the class of account-users prioritised in the CF, who risk financial losses. Unsurprisingly, therefore, some 86% of respondents to IASB/FASB during the consultation phase leading to the publication of Chapters 1 and 3 in 2010 opposed the plan to encompass stewardship within decision-usefulness rather than seeing it as an independent aim (Pelger 2016).

If the demand by users for stewardship information to incentivise managers appears not to be in doubt, the question remains what difference omitting it would make in practice. Accounting standard-setting and contracting with managers are two of the areas likely to be affected.

Standard-setting

Quite reasonably, IASB/FASB set out a cost-benefit test, referred to as the ‘cost constraint’, to be used when developing future accounting standards; i.e.) that the costs of reporting financial information should be justified by the benefits (FASB 2010, QC35). However, there are two difficulties associated with this approach as it is currently configured. First, the boards ignore the impact of alternative information sources in their assessment of benefits; and second, they ignore incentive problems within corporations. Both omissions are likely to lead to the cost-benefit test being incorrectly applied to decisions over accounting disclosures in future accounting standards.

Alternative and more-timely public information sources include forecasts by company officials, dividend announcements, information concerning financing arrangements, real investment, labour and board management issues, and government or regulatory decisions, all of which act as signals of profitability, risk or investment quality (Waymire 1984; Dielman and Oppenheimer 1984; Myers and Majluf 1984). Hence, the decision-usefulness of accounts is reduced to the extent that either the disclosures are already in the public domain or are fully reflected in the prices of securities. Although IASB/FASB acknowledge the need for investors to seek information beyond the accounts (FASB 2010, OB6), they give no consideration to the interactions between the various sources. According to information economics, however, such interactions will inevitably affect the value of accounting disclosures.³

Ignoring incentive problems compounds the mismatch of costs and benefits, not simply from a stewardship point of view, but from a decision-usefulness perspective as well. Decision-useful information provided to external parties of a company is a communication of information held by the corporation’s agents. Such information may well allow an external

decision-maker to take better decisions, but it has also been shown to create agency problems where managers have access to the information that companies communicate (Christensen, 1981).

Contracting with Managers

As noted above, the verifiability of accounting information takes on a much more significant role under stewardship than investment decision-making because it makes for a more effective contracting variable in the design of agent rewards. Without verifiability, a contract becomes unenforceable in law, and this possibility will weaken the incentive properties of the information (Arrow 1983; Laffont and Martimort 2002: Ch 6). The importance of verifiability in influencing managers' behaviour through contracting suggests that it should be given higher priority in the CF than its current status as a secondary enhancing property of information (FASB, 2010, BC1.23, QC4; IASB, 2015a, 2.22).

In fact, IASB go as far as suggesting that an acceptable alternative to providing measurements that are capable of verification might be to require 'disclosures that enable the users of financial statements to understand the assumptions used' (IASB 2015a, 6.61).⁴ Such an approach may be necessary in trying to capture the future cash inflows and outflows arising from certain types of asset and liability that are hard to measure, intangibles being one example. The balance sheet approach, which measures income as the increase in net assets/economic resources over a period, is the chosen method of IASB/FASB for promoting the decision-usefulness objective in financial statements.⁵ But for this to work properly, companies must be able to value all their assets and liabilities, which introduces the added uncertainty of predicting the future. The danger for contracting is that the current shift in emphasis 'from financial reports providing verifiable backward-looking data to providing more valuation-relevant fair-value estimates is likely to lower the explicit use of accounting

numbers in contracting, which traditionally has been an important role for accounting’ (Shivakumar 2013, p. 379). Hence, in cases where non-verifiable information has decision-usefulness, it will seldom be used to hold agents to account.⁶

Concluding Comments

The paper has examined the decision of IASB and FASB to treat stewardship as part of the decision-usefulness objective of financial reporting rather than seeing it as separate and distinct. This view has been shown to be flawed from a theoretical economics perspective given the differences in the underlying properties of accounting information. In answer to the question of what difference not recognising the incentive properties of stewardship information would make, the paper has outlined consequences in relation to the cost-benefit test applied in accounting standard-setting, and contracts linking managerial rewards to verifiable outcomes.

The argument is not that the stewardship objective is more important than the decision-usefulness one, but that both characteristics of information are valuable, and that both should be recognised in the CF. Reconciling the two in the one financial report is not an easy task given their differences. Previous attempts to do so have contributed to what Lee (2006, p. 421) describes as the ‘subjective, flexible, and inconsistent’ nature of financial reporting, resulting in ‘accounting numbers with ambiguous economic meaning’. However, ignoring the incentive properties of stewardship information is not the answer.⁷

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¹ See Feltham (1972), Demski (1980), Strong and Walker (1989), Laffont and Martimort (2002), Christensen and Demski (2003), Christensen and Feltham (2003), and Christensen and Feltham (2008) for elaboration on these two characteristics of accounting information.

² Faithful representation has no obvious analogue in the information-economics literature, while comparability and understandability are absent due to the assumption of rationality and a focus on the gross value of costless information.

³ There is a wealth of evidence to support this conclusion: e.g.) Ball and Brown (1968); Brown (1970); Ball (1972); Brown and Kennelly (1972); Foster (1973, 1975); Arnold and Moizer (1984); Emanuel (1984); Bernard and Ruland (1987); Kothari (2001); Elwin (2013).

⁴ Craig et al. (2017) criticise the ED for countenancing the inclusion of estimates that are not auditable by virtue of the uncertainties.

⁵ See Kvif (2008) for a criticism.

⁶ See Feltham and Wu (2000) for an illustration of this concerning the use in contracting of stock price as a proxy for the effects of unverifiable information acquired privately by investors.

⁷ An alternative way forward that was tried in the 1970s in relation to current cost accounting, might be for accounts to contain dual representations of the same economic events (Abdel-Khalik 2010).