



“Twisting words”? A study of the construction and reconstruction of reliability in financial reporting standard-setting

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ABSTRACT

Qualitative characteristics serve to operationalise the objective of financial reporting and aim at shaping accounting discourses of standard-setters and their constituents. In the recent revision of their conceptual frameworks, the IASB and FASB decided to replace “reliability”, arguably one of the most important properties of accounting, with “representational faithfulness”. The aim of the present paper is to shed light on the boards’ decision through a historical analysis of how reliability appeared in standard-setting and by tracing its abandonment in detail. Our study reveals that the standard-setters’ construction and reconstruction of reliability attempted to undermine traditional practitioner understandings along the lines of objectivity/verifiability in order to extend the boundaries of appropriate financial reporting in the direction of current/fair values. However, as the introduction of more abstract concepts raised difficulties in reconciling the new terminology with everyday accounting practice, this turn created confusion among constituents and board members. Our paper also contributes to further our understanding about decision-making processes in standard-setting. In particular, we show how a group of board and staff members was able to establish the replacement of reliability in spite of (and partly taking advantage of) constituents’ concerns and widespread confusion about the terms.

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Introduction

In 2010, the IASB and FASB proclaimed in their revised conceptual frameworks that the single objective of financial reporting is providing useful information for valuation decisions of capital providers (OB 1¹), which in their view

also encompasses stewardship concerns (OB 4).² Qualitative characteristics serve to operationalise this objective by introducing concepts which standard-setters can employ as arguments in the development of new or revised standards. Young (1996) regards the conceptual framework as a form of institutional thinking which limits both the definition of, and solutions to, accounting problems. Within this institutional function of the framework, qualitative characteristics define the boundaries of what the standard-setters deem “appropriate” financial reporting. This is reflected in the recurrent use of qualitative characteristics in the framing

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¹ References to the conceptual framework for financial reporting (IASB, 2010) are abbreviated in the following way: OB refers to the first chapter (objectives), QC to the third chapter (qualitative characteristics) and BC to the basis for conclusions. References to the Discussion Paper (IASB, 2006) are abbreviated as DP, references to the Exposure Draft (IASB, 2008a) as ED. References to the IASC (1989) framework, which was adopted by the IASB in 2001, are abbreviated by F.

² Stewardship had been a separate objective in the former IASC (1989) framework and was also mentioned as a separate consideration in SFAC 1 (FASB, 1978) (cf. Zeff, 2013, p. 264).

of accounting problems by standard-setters, practitioners and academics. For instance, Bushman and Indjejikian (1993), p. 765, observe that “[a]n issue of fundamental importance to accountants concerns the qualities possessed by, or that should be possessed by, accounting information.”

In the standard-setters’ previous frameworks (SFAC 2 (FASB, 1980); IASC, 1989) one of the most important properties of financial reporting has been the characteristic of reliability. In particular, the trade-off between relevance and reliability, established in SFAC 2.90 and F.45, has shaped accounting discourses over the last decades (Johnson, 2005). This is revealed by a mere look in accounting textbooks (e.g. Deegan & Unerman, 2011, p. 225 ff.), as well as recent academic literature (e.g. Allen & Ramanna, 2013). However, when the IASB and FASB finished their work on the first part of the framework revision project in September 2010,³ which was concerned with the rewriting of the objective and qualitative characteristics of financial reporting, the term “reliability” had been dropped and replaced by “representational faithfulness”.⁴ This decision was motivated by the boards’ observation that the term “reliability” gave rise to misunderstandings as (at least some) constituents perceived it to mean precision or exactness of accounting information (DP BC 2.26), or placed too much emphasis on single subcomponents – in particular on verifiability (IASB, 2005, par. 41). Although the boards considered the move to representational faithfulness to be a change in terms rather than in substance (BC 3.24), simply reflecting a better terminology of the boards’ understanding (DP BC 2.27–28), the boards’ constituents were heavily opposed to this alteration (IASB, 2007a, par. 56; IASB, 2008b, par. 51 f.). It is notable that this was not the only issue in the 2010 framework revision which raised concerns. The singular focus on valuation usefulness and the waiving of a separate stewardship objective was met by a large resistance (for critical positions, cf. Lennard, 2007; Whittington, 2008a; for an analysis of the boards’ decision-making on stewardship cf. Pelger, 2013), while the elimination of conservatism was also intensely debated (cf. Barker & McGeachin, 2013).

Motivated by the recent decision of the IASB and FASB to replace reliability, this paper addresses the question of how the construct of reliability first emerged in accounting standard-setting and why it vanished in the recent framework overhaul.⁵ This question is important not only with regard to analysing the observed disputes between constituents and the boards, but also relates to general patterns in recent financial reporting reforms by the IASB and FASB

(Power, 2010; Whittington, 2008b) that apparently try to shift the boundaries of appropriate financial reporting (Walton, 2006).⁶ To address the outlined research question we firstly analyse the way in which the construct of reliability appeared and consider its precursors. This historical study relies on the normative *a priori* US accounting literature that was published in particular during the 1960s and 1970s, before the first written frameworks for financial reporting came into existence. Secondly, we thoroughly scrutinise the way reliability was replaced by representational faithfulness in the framework revision project by the IASB and FASB. For this purpose, we drew on all published material from the due process and, furthermore, conducted interviews with key actors who were involved in the decision-making as either board or staff members.

Our paper’s contribution to the literature is twofold. First, we present a long-term case study of the development of the idea of reliability in accounting literature and standard-setting which adds to histories of conceptual thinking in financial reporting. These have so far mostly emphasised the objective of financial reporting (Murphy, O’Connell, & Ó hÓgartaigh, 2013; Ravenscroft & Williams, 2009; Young, 2006) and only partly referred to qualitative characteristics (Zeff, 2013). We follow Young (2006) in the aim to reveal how taken-for-granted notions in standard-setting (such as reliability) were constructed and how they have been redefined by the accounting community, attempting to contribute to a “sociology of accounting reliability” (Power, 2010, p. 198). In this paper we show that the construction and reconstruction of reliability followed from the standard-setters’ aim to extend the boundaries of appropriate financial reporting by changing conceptual language. Firstly, reliability was constructed in SFAC 2 as a compromise between the traditional (evolutionary) practitioner idea embodied in the concept of verifiability and more recent academic notions of faithful representation. Secondly, as constituents continuously ignored the faithful representation part of reliability and repeatedly used their understanding along the lines of verifiability to dismiss fair value accounting, the standard-setters reconstructed reliability to establish a single focus on faithful representation. However, the standard-setters’ attempt to alter traditional practical understandings by using ever higher levels of abstraction led to very different views among constituents and board members about what “faithful representation” means and what it implies. Hence, the standard-setters’ construction and reconstruction of “reliability” against traditional understandings of verifiability by employing ever higher (more academic) levels of abstraction appears to be a permanently failing project.

Second, in contrast to the philosophical evaluations of central principles embodied in conceptual frameworks (Bayou, Reinstein, & Williams, 2011; Hines, 1991; Macintosh, Shearer, Thornton, & Welker, 2000; McKernan, 2007; Shapiro, 1997) we provide empirical context by meticulously tracing the boards’ deliberations on reliability

³ The framework project by the IASB & FASB, launched in 2004, was initially split into eight phases, but only the first phase has been finished. In September 2012 the IASB decided to pursue the rest of the project as an IASB-only project. The project comprehensively deals with the remaining phases on elements, measurement, reporting entity and presentation and is intended to be finished by autumn 2015 (cf. IASB, 2013, p. 14).

⁴ In the literature we found both terms, “faithful representation” and “representational faithfulness”. While SFAC 2 uses the latter, the new SFAC 8 employs the first term. Since we could not distinguish differences in meaning in the examined publications, we use both terms interchangeably.

⁵ Fig. 1 in the appendix shows a timeline which gives an overview of important contributions as well as surrounding events during the period of our analysis.

⁶ Note that we do not argue in favour of any specific characteristic, including reliability, but rather focus on tracing the development of the construct of reliability in the standard-setting discourse.

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