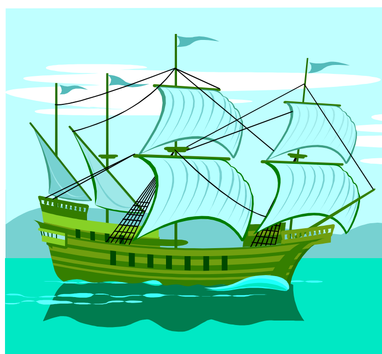
# Accounting- that's telling a story:

or What's a conceptual framework? By Roger Collinge FCA

**Preface**

The purpose of this paper is to trace, briefly, the history and purpose of accounting, and identify the essential ingredients and their purpose, in order to highlight what the author, writing on behalf of the UK Shareholders' Association (UKSA), sees as actions that need to be taken to realign accounting standards more closely with their original purpose.

## Introduction



When a Venetian merchant sent out his ship to trade he wanted to know what had happened and what had been spent bringing back the treasures of the east. He wanted an account and listened to that account when his ship came in. He was the auditor of that account. If he had been on the voyage himself he would not have needed that account as he would have had direct control, but he couldn't go on all the voyages so his captains had to account for what they had done with his money, his ship, his stores, his goods. The captain had been acting as trustee of someone else's money- the merchant's.

When the voyage was finished the merchant would sell what had been brought back, pay off the crew and possibly sell the ship. So he knew what profit- or loss- he had made. It was all turned back into cash. Accounting was simple.

But the Doge noticed all this money being made and did not want to wait 2 or 3 years for the ship to return or all the voyages to be completed; he needed to tax the profits being made. It was ever thus. So accounts had to be drawn up each year so the Doge could have his share as tax. So the merchant could not wait until everything was sold and all costs paid before he drew up accounts. Ships would have suffered wear and tear. Prices for the goods being brought in would have changed. A way of accounting for these on a regular basis had to be devised and so balance sheets appeared, and so did lots of arguments as there were many different views as to what figures should be in those balance sheets. Accounting had become complicated.

People have been wrestling with those complications ever since.

## 1 Company Accounts: why do they matter?

They matter because the directors of a company are using someone else's money- the shareholders'. They are effectively acting as trustees of that money – an idea recognised in English law. The law requires that they show what they have done with that money. The idea has been expressed as being one of stewardship. Just as a noble's steward had to account to his lord for what he had done with his master's money.

So as shareholders ourselves we need that account. We need that account in a reliable and consistent form so that we can judge for ourselves whether our money has been wisely used or not. Thus the prime purpose of accounts should be to provide that account of stewardship.

## 2 Company Accounts: who are they for?

The shareholders must come first, as the owners.

However, with the creation of limited liability companies, the law recognised that not only shareholders would have to deal with this new legal entity but also suppliers, creditors and bankers. So in addition to accounting to the shareholders as owners, the companies had to file accounts publicly as a price to pay for the privilege of limited liability and because of the valid interest in those accounts from creditors. Thus accounting came to have creditors as a separate group with an interest in the accounts.

As in Venice then, so everywhere now, the taxman also wants to know about the company and its results.

Stock markets have long been around so those who buy and sell on them need to know how the company has been faring and also, importantly, how it is likely to fare in the future.

Thus there is a whole raft of people interested in an account of how the company has been doing, and that is even before taking in the modern idea of other 'stakeholders' such as employees, trade unions, environmental groups and so on.

## 3 Company accounts: how to add up the numbers

**The law: True and fair**

Given the importance of the accounts to a wide audience, much consideration has been given to the way in which they are to be drawn up. The English law on the subject is contained in the Companies Act 2006. This contains many rules which apply, but, importantly, it has delegated the drawing up of detailed rules to regulatory bodies. It also takes into account laws emanating from the European Union (EU). So there is now no single source of accounting rules and unravelling them can be tricky.

The over-riding requirement in English law is that the accounts shall show "a true and fair view". This term originated in the 1947 Companies Act, which itself drew upon a report compiled, surprisingly, in the middle of the Second World War. One can only assume that, even in war time, it was thought worth putting effort into ensuring the best possible company accounting.

This term "true and fair" has never been fully defined in law. An eminent Queen's Counsel commented in 2001 that "the meaning remains the same over time, but the content may change". This is both a problem and a benefit. Life has moved on since 2001 (never mind 1947) and has in many ways become more complicated. So while the content may have changed for the better, defining what is "true and fair" remains tricky. Perhaps the analogy of an elephant can be used- easy to recognise but hard to define. Note also that the law requires "a" true and fair view not "the" true and fair view; it recognises that there can, reasonably, be more than one such view.

**The law: distributable profits and prudence**

The law has a part dealing with the accounting rules and a separate part dealing with the calculation of distributable profits. Unfortunately these do not use identical wording and this has created problems. The distribution part talks about prudence and providing for likely losses. The accounting part has delegated these subjects to outside regulatory bodies such as the setters of accounting standards.

The law requires companies to be able to calculate what profits they can legally distribute even though those may differ markedly from the profits recognised under accounting standards. Strangely, the law does not actually require disclosure of the profits which are distributable as against those which are not.

**Accounting standards:**

Since at least the 1960s, extensive work has been done to introduce standard ways in which the numbers are to be added up. These are clearly beneficial when they improve both consistency and comparability between accounts and facilitate compliance with the law.

Currently, the body charged with drawing up such standards is called the International Accounting Standards Board (IASB). It draws up standards known as International Financial Reporting Standards (IFRS). Somewhat confusingly these were previously known as International Accounting Standards (IAS), a term referred to in the law.

These IFRS become a part of the law when they are approved for use in the EU, by a process followed by the European Commission using a body called EFRAG*. This process requires the Commission to ensure that the IFRS it approves are in compliance with EU law. So far it has approved substantially all proposed standards, but there is concern about certain of these approvals, particularly around the question of prudence.

**Conceptual Framework**

Accounting standards deal with many different points that arise in accounting, from who are accounts for, to how do you decide what to put in them? One might have expected the standards to be based on some logical framework of principles which could be used to inform how a new standard should be written. Years ago, the UK's own standards body, the Accounting Standards Board, (ASB) had four fundamental concepts for accounts. They were that the accounts would be drawn up on the assumptions that:-

- the company was a going concern;
- all costs and income relating to a period would be included in the accounts even if they had not actually been paid in that period (the accruals concept);
- the accounts would be drawn up on a prudent basis; and
- the figures would be calculated on a consistent basis taking year by year.

The various standard setting bodies periodically updated and in some respects diluted these concepts. The ASB produced its 'Statement of Principles' in 1999. The IASB subsequently issued a 'Framework', which was partly updated in 2010, with two chapters then being issued dealing with" The Objective of Financial Reporting" and "Qualitative Characteristics of Useful Financial Information" as they were called. Intended chapters on all other topics were postponed. Thus the IASB has been issuing standards without having a clear statement of any underlying conceptual framework. This is an unfortunate intellectual position to be in, as it begs the question of how to ensure consistency, but it may also illustrate the difficulty of laying down a conceptual framework.

* European Financial Reporting Advisory Group

Aware of this problem, the IASB has recently issued a discussion paper setting out arguments for and against different approaches to the elements of financial statements - assets and liabilities on the one hand and revenue recognition, measurement and presentation on the other. Initially it said that it will not re-address the two chapters issued in 2010. Those chapters dealt, amongst other things, with prudence, accountability and reliability -- areas which have come in for considerable criticism from UKSA amongst others. How prudent and reliable were the accounts of banks which went bust not long after getting clean audit reports which said their accounts showed a true and fair view? Recently however the IASB has decided to propose the reintroduction of the concept of prudence.

Our Venetian merchant would not have been very happy if, having had an account which showed a profit because that account was not drawn up prudently, he ended up with next to nothing.

UKSA believes that the IASB needs to reconsider its position on a number of these areas. UKSA understands why the IASB does not want to readdress issues it thought it had settled as recently as 2010, but if these issues are not readdressed it is very hard to see how IFRS can comply with the legal requirements in Europe.

**Prudence**

Apart from the legal requirement for prudence which exists at least throughout the EU, the omission of this concept as a basis for accounting standards cannot be right. The IASB argues that except in conditions of uncertainty prudence can be a biased concept. Its position presumes that the norm is certainty and that in consequence prudence is not ordinarily required, but the evidence shows that there can never be certainty.

Two examples: First, few if any foresaw the financial crash of 2007/8. Second, The Times reported in 2013 that a major drop in the price of gold by about 25% should "statistically" only happen once in 6,700 years- but it actually happened that January.

To quote the IASB's own 2010 framework, prudence is defined as "the inclusion of a degree of caution in the exercise of judgements needed in making estimates…". The IASB also, quite rightly, commented that 'prudence' does not allow for the deliberate understatement of assets or income, nor the overstatement of liabilities or expenditure. This is what should be brought back.

Our Venetian merchant would surely have been aware of the risks for his stocks – including such things as rats, storms and theft and prudently allowed for such losses.

**Reliability**

The IASB argues that, for certain assets, what it calls "fair" values should be used which, by the very name, implies the need for judgement. At the same time, by prescribing in great detail how accounts are to be drawn up, it seeks to reduce the areas of judgement that can be applied to accounting numbers. There are many who question this. Some argue that where there are markets for assets to be so valued, those markets do not necessarily provide a useful value. It has recently become well known, for example, that banks have manipulated markets. Where there is no active market for an asset, then the rules allow for that "fair" value to be estimated, using assumptions as to what it might be worth – a process requiring a large area of judgement.

Probably our merchant would have recognised that his captains would want to give the best account they could and so wanted to put in the assets for what they thought those assets would fetch. By definition merchants were optimists and risk takers. But he might well have said, "Put everything in at cost- the market for frankincense is hopeless and I've no idea what it might be worth when we get to sell."

**Accountability**

Our merchant would have recognised the idea of stewardship - that of looking after money and assets for someone else. Today it seems that in some parts of the world the word has lost its meaning and so the word now used is accountability. But the underlying idea is still there. The directors of a company have the responsibility of looking after the money invested in the company by the owners, managing it as well as they can for the owners and giving a true account of their endeavours.

At present, accountability is not a separate or main objective of accounting according to the IASB. Many think it should be clearly stated as the main objective, as that is what the company owners want. "What have you done with our money?" is what we want to know. In some respects this will not change what current accounting standards seek, but in other areas (several are listed by EFRAG in a leaflet) it could have a significant effect and, in particular, it will change the mental approach under which standards are drawn up.

## 4 What needs to be done

IASB needs to accept that it must readdress the first two chapters of their conceptual framework. Until this is done there will be no recognition of the real problems.

**Prudence**

The IASB only recognises prudence "in times of uncertainty". It does not recognise that life is ALWAYS uncertain and that prudence should at all times be applied. This criticism is not to condone artificial profit smoothing. It requires both clear accounting and strong auditing, but is ultimately no more subjective than many aspects of the present standards. Furthermore, there is still great doubt, within the EU, as to whether IFRS do comply with the legal requirement for prudence. It is unacceptable for shareholders and others to be dependent on directors faced with this uncertainty.

**Reliability**

The accounts of banks have proved completely unreliable. The IASB needs to go back to basics and recognise that the most sophisticated ways of calculating the so called "fair" values are inherently subjective. By recognising that fact and requiring prudence in making these judgements it can pave the way for more realistic and therefore more reliable accounts.

**Accountability**

The IASB needs to reinstate accountability, that is stewardship, as the main objective of accounting and thereby change attitudes and ensure that the owners do get a full "true and fair view".

## 5 Conclusion

Accounting became complicated when period accounts had to be drawn up. But the loss of clarity as to what they were for, as to whether they could report values as well as, or instead of, cost and what can now be seen as an intellectual arrogance that uncertainty had generally been abolished, have led standard setters down the wrong path. The IASBs need to retrace its steps and set off down another path which recognises that owners deserve comprehensible, prudent and reliable accounts to tell them clearly what has happened to their money.

That is what our Venetian merchant wanted and his descendants deserve no less.

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