

# Financial Accounting Research, Practice, and Financial Accountability

Invited Submission for *Abacus* 50<sup>th</sup> Anniversary Special Issue

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# Financial Accounting Research and Financial Accountability

## Abstract

Financial accounting is essential to financial accountability, which is essential to a prosperous society. There are many examples of how improvements to financial accounting, supported by research, have enhanced financial accountability. Such research requires a strong relation between accounting academics and practice; this relation has ebbed and flowed during *Abacus's* life. The relation seems to ebb when accounting academics embrace related fields and flows when the relevance to accounting practice emerges. Economics and finance have provided new perspectives and meaningful insights about the information investors need to make informed decisions. Regardless, there are many intriguing and open questions awaiting accounting research that can provide insights into how financial accounting—and thus financial accountability—can be improved. Thus, the future is bright for financial accounting researchers who do research relevant to accounting practice and want to contribute to a prosperous society.

# Financial Accounting Research and Financial Accountability

## *Introduction*

The aim of this article is to reflect on the role of financial accounting research in supporting financial accountability—in its broadest sense—and offer ideas for future research that can continue this role.<sup>1</sup> Abacus's 50<sup>th</sup> anniversary is an opportune time to do this. As historian Jacob Soll chronicles in his book “The Reckoning: Financial Accountability and the Rise and Fall of Nations” (Soll, 2014), financial accounting is the foundation of a prosperous society. Throughout history, societies that kept a keen eye on financial accountability prospered, but those societies declined when financial accountability was disregarded. The book makes clear that accountants, including accounting researchers, have a responsibility to ensure that financial accounting is designed to, and delivers, high quality information that supports sound economic decision-making and the efficient allocation of resources, and thereby supports a prosperous society.<sup>2</sup>

The relation between the accounting academy—and, thus, accounting research—and accounting practice has ebbed and flowed during *Abacus*'s life.<sup>3</sup> When Abacus was founded, the relation was strong. Although the relation ebbed when capital markets research became central

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<sup>1</sup> The Free Dictionary offers a broad definition of accountability as “The responsibility of the person or organization responsible for a task to take credit for all positive outcomes and blame for all negative outcomes. Accountability is desirable in finance and economics because it promotes efficiency. See also transparency.” See <http://financial-dictionary.thefreedictionary.com/Accountability>.

<sup>2</sup> See, also, the Accounting Vision Model developed by the Pathways Commission in 2014. The Pathways Commission reflects the joint efforts of the American Institute of Certified Public Accountants and the American Accounting Association (AAA). See <http://commons.aaahq.org/hives/a943df3efc/summary>. The Vision Model was developed to answer the question “What is Accounting?” for those unfamiliar with the field. Although this Vision Model also applies to management and governmental accounting, this article focuses on financial accounting and reporting.

<sup>3</sup> The term “accounting practice” encompasses all arenas in which accountants outside of academia play a role. For example, accountants employed by firms, auditors, accounting standard setters, and regulators and other accounting policy makers.

to much of financial accounting research, it flowed again once it became clear that lessons learned from capital markets research could inform what financial accounting information supports investors capital allocation decisions.<sup>4</sup> With the maturity of capital markets research, the relation between accounting research and practice has ebbed again. This time, the recent expansion of accounting research to focus on topics such as the effects of physical characteristics of the conveyor, and the linguistic style, of accounting information rather than its content illustrates the weakening of the link between accounting research and practice. Although this expansion could enhance our knowledge of how aspects of the communication of accounting information affect its interpretation, there is much we do not yet know about the characteristics of the accounting information being conveyed. Thus, the future is bright for financial accounting researchers who wish to play a role in supporting financial accountability and, thus, a prosperous society.

### ***Enhancing financial accountability***

The academic accounting literature offers numerous examples of how financial accountability is enhanced with the availability of high quality accounting information and how accounting research provides evidence relating to what information supports economic decision-making. One example is pension accounting in the United States (US). Before the issuance of Statement of Financial Accounting Standard (SFAS) No. 36 by the US Financial Accounting Standards Board (FASB) (FASB, 1980), information relating to the funded status of the firm's defined benefit pension plans—i.e., pension plan assets and liabilities to employees under the plans—was not disclosed in financial statements. Thus, users of financial reports lacked information about these often sizable assets and liabilities, and were hampered in their ability to

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<sup>4</sup> Beaver and Dukes (1972; 1973) and Gonedes and Dopuch (1974) reveal the difference of opinion among academics regarding the extent to which the new capital markets accounting research could address practice, particularly standard setting, questions.

make sound economic decisions (Landsman, 1986). SFAS 87 (FASB, 1985, now Accounting Standards Codification (ASC) 715), requires firms to apply accrual accounting to their defined benefit pension plans and disclose additional information about plan assets and liabilities, as well as components of pension cost. The progress relating to defined benefit pension plan accounting thereby mitigated a previous information deficiency (Barth, 1991; Barth, Beaver, and Landsman, 1992). A related, and perhaps more visible, example is the accounting for, and disclosures related to, other post-employment benefit plans. Until the issuance of SFAS 106 (FASB, 1990, now ASC 712), firms had been promising post-employment health care and other benefits without accounting for them (Amir, 1993). Investors had some information about these promises, which enabled them to make assumptions regarding the magnitude of these obligations. However, investors know less than the firm about its promises and, thus, the assumptions necessarily were based on incomplete information. Interestingly, once these off-balance sheet liabilities were recognized in financial statements, firms took action to reduce them (Fronstin, 2010).<sup>5</sup>

A third example is the accounting—or lack of accounting—for employee services paid for with the firm's equity instruments, i.e., share-based payment. Before International Financial Reporting Standard (IFRS) 2 (IASB, 2004b) and SFAS 123R (FASB, 2004, now ASC 718) the recognized expense was zero for employee services paid for using at-the-money share options with fixed terms even though investors viewed the cost of these options as an expense of the firm (e.g., Aboody, 1996; Aboody, Barth, and Kasznik, 2004). Since firms have been required to recognize an expense based on the value of the options granted, rather than their intrinsic value,

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<sup>5</sup> These post-employment benefits are covered by International Accounting Standard (IAS) 19 (IASB, 2001), originally issued by the International Accounting Standards Committee in 1998. The requirements in IAS 19 are similar to those in ASC 712 and 715.

there has been a decline in the use of such options.<sup>6</sup> Measuring and recognizing economic costs is a key role of financial accounting that can lead to greater financial accountability and more informed decisions.

A fourth example is the accounting for derivatives. Before the effective date of SFAS 133 (FASB, 1998; now ASC 815) and International Accounting Standard (IAS) 39 (IASB 2004a), derivative assets and liabilities were measured at cost. The cost of many derivatives is zero and therefore, without subsequent re-measurement, these derivatives essentially were unrecognized. ASC 815 requires fair value measurement for derivatives. Using fair values for these instruments brought to light the enormity of some previously off-balance sheet assets and liabilities, which investors endeavored to incorporate into their investment decisions (Venkatachalam, 1996).<sup>7</sup>

Yet another example is the accounting for asset securitizations, which were a focus of the recent financial crisis. The opaque and questionable accounting for these transactions was purported to be associated with the meltdown of financial sector, which some allege was a cost of the lack of adequate accounting information required by ASC 860 and IFRS 7 (IASB, 2005) (Barth, Ormazabal, and Taylor, 2012). Most recently, fair value accounting for financial instruments (ASC 820; ASC 825; IAS 39, IASB 2004a; IFRS 13, IASB, 2011) has been blamed for precipitating the recent financial crisis. However, claims that accounting and reporting for asset securitizations, special purpose entities, and fair value accounting played a role in the recent financial crisis is not supported by evidence (Barth and Landsman, 2010; 2013).

Nonetheless, that accounting is alleged to have played a role in and of itself is testament to the

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<sup>6</sup> There may be other reasons for the secular decline in the use of stock options as a form of compensation, e.g., changes in tax rates (Aboody and Kasznik, 2008). Nonetheless, the decline is striking—see, e.g., Figure 1 of Irving, Landsman, and Lindsey (2011).

<sup>7</sup> Using fair values for derivatives does not provide investors with all of the information they need because fair values mask the leverage inherent in derivatives (Barth and Landsman, 2010).

perceived importance of accounting to the well-functioning of product and capital markets and, thus, to society's prosperity.

These examples highlight the importance of financial accounting to society and the role research can play in providing evidence to support or refute what is believed to be true and in providing new insights into potential shortcomings of current accounting as well as offering insights into potential improvements. There is need for more of this research—research employing the scientific method—and thought pieces based on integrating our collective knowledge.

### ***Relation between academia and practice during Abacus's life***

*Abacus* was founded in 1965. Beginning one year later, 1966, the Australian professional accounting bodies jointly operated the Australian Accounting Research Foundation (AARF), which ultimately encompassed both the Accounting Standards Board (AcSB) and the Public Sector Accounting Standards Board (PSASB).<sup>8</sup> Accounting standards in the US were set by the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants. The FASB was not formed until 1973, and the publication of the Conceptual Framework was not to come for another ten years. When *Abacus* began publication, the thinking in research and financial accounting practice were fairly closely aligned. Financial reporting research around this time was normative, with principles relating to the characteristics of measurement of assets, liabilities, and income argued from deductive reasoning. This normative, deductive reasoning approach made the research readily accessible to accountants in practice not only because the language was familiar to practicing accountants, but also because the approach did not use data analysis or mathematical techniques unfamiliar to them. Some thought leaders of the time were

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<sup>8</sup> See <http://www.aasb.gov.au/About-the-AASB/For-students.aspx#qa1440> for further information on the history of accounting standard setting in Australia.

Edwards and Bell (1961), Chambers (1962; 1965; 1966), Moonitz (1961), Moonitz and Sprouse (1962), and Jaedicke and Sprouse (1965).

Research changed dramatically with the advent of capital markets-based research, together with its focus on accounting as generic information signals (Ball and Brown, 1968; Beaver, 1968). The information perspective was not new to academics (Graham and Dodd, 1934), but the advent of capital markets research provided a new impetus for embracing it. Although financial accounting standard setting did not embrace this change directly and immediately, not many years later a conceptual framework for financial reporting was developed that embodies an information perspective. This perspective is evident in the objective of financial reporting specified in the framework, which is “to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity” (FASB, 2010; IASB, 2010 ¶OB2). The framework also clarifies that the primary users of financial reports are those outside providers of capital who cannot otherwise demand the information they need to make their economic decisions (FASB, 2010; IASB, 2010 ¶OB5).

The framework incorporates economic concepts. For example, the framework defines comprehensive income as the change in net assets of the period, other than those attributable to transactions with equityholders in their capacity as equityholders. This definition resembles a Hicksian economic view of income as the change in wealth (Hicks, 1946). Although, at first, the focus on accounting’s information role in capital markets seemed distant from accounting’s traditional role in practice of recording and measuring the effects of the firm’s transactions, basing the framework on an information perspective and economic concepts in fact brought academia and practice closer together.



Although the advent of capital markets research in the late 1960s initially seemed to drive a wedge between financial accounting research and practice, some researchers used capital markets research to shed light on practice-motivated questions. This effort gave rise to “value relevance” research, in which researchers test whether a particular accounting amount has a significant relation with equity share prices or returns. Because share prices summarize investors’ consensus beliefs about the value of the firm’s equity, such a relation is evidence that the accounting amount is relevant to investors and sufficiently reliable to be reflected in share prices, which are the two primary characteristics of useful accounting information set forth in the framework.<sup>9</sup> Some researchers also use value relevance techniques to learn about accounting measurement (Barth 1991; Choi, Collins, and Johnson, 1997), including fair value measures (Barth, Beaver, and Landsman, 1996; Song, Thomas, and Yi, 2010).

Value relevance research aimed at standard setting has its supporters and critics (Gonedes and Dopuch, 1974; Barth, Beaver, and Landsman, 2001; Holthausen and Watts, 2001). Perhaps because the academic criticism discourages researchers from employing value relevance designs or because such designs seem overused and generate few new insights, value relevance studies are less prevalent today. Nonetheless, researchers have not abandoned capital markets-based research aimed at learning about financial accounting. Instead, they have developed alternative approaches to address a wider variety of questions. For example, Barth, Hodder, and Stubben (2013) uses the implications of option-pricing theory to provide evidence on whether employee stock options share key characteristics of equity or liabilities.<sup>10</sup>

### ***Re-invigorating the relation between academia and practice***

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<sup>9</sup> In 2010, the FASB and IASB replaced the term “reliability” with “faithful representation,” which clarified the original intended meaning of the term reliability (FASB, 2010; IASB, 2010).

<sup>10</sup> Not all capital markets accounting research is aimed at addressing specific financial accounting standard setting questions. Two examples are the large literatures on earnings management and conservatism (see Healy and Wahlen, 1999 and Watts, 2003 for reviews).

Academia and practice seem to be drifting apart again. A visible, potentially contributing development is another broadening of the scope of what is considered financial accounting research. Accounting research has a long history of being informed by economics and finance, particularly in relation to the functioning of capital markets. In addition, insights from psychology enable us to understand how the way in which information is communicated affects how users of the information process and interpret it. Recently, accounting research is expanding beyond these fields, and examining topics such as the effects of physical characteristics of the conveyor of accounting information and the linguistic style of the information (e.g., Hobson, Mayew, and Venkatachalam, 2011; Jia, Van Lent, and Zeng, 2014). However, these studies focus on characteristics of how accounting information is communicated rather than on the content and characteristics of the information being communicated. The impact of the former on financial accounting and accountability is yet to be established, whereas the latter traditionally is the focus of financial accounting research.<sup>11</sup>

There are clear benefits of accounting research embracing individuals from different fields with relevant, complementary expertise and knowledge. Broader and new perspectives can rejuvenate a field and enrich it. Concurrent with the advent of capital markets-based research in accounting was a reaffirmation that accounting is related to economics and finance.<sup>12</sup> This reaffirmation created the opportunity for individuals with those interests to become accounting academics. Their broader perspective helps clarify accounting's role in the capital markets, which points to aspects of accounting that need attention or improvement. Their participation in accounting research also reveals new perspectives with which to view nettlesome

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<sup>11</sup> Perhaps future research will provide insights into how to design information content based on understanding the likely conveyor's characteristics—and manner of delivery—to achieve a particular objective relating to the recipient's interpretation of the information. That is, research might identify how the content of the information might interact with the characteristics of the conveyor and delivery—as well as the characteristics of the recipient.

<sup>12</sup> Paton and Littleton (1940), among others, identified this relation before the advent of capital markets research.

problems (e.g., Barth, Hodder, and Stubben, 2008; 2013). However, a cost is that more accounting academics are interested in questions other than those of interest to accounting practice, including accounting standard setting. For example, some researchers with strong finance backgrounds focus more on how to profit from situations in which accounting information is not fully impounded in equity prices (e.g., Richardson, Tuna, and Wysocki, 2010).

Top academic journals are embracing this perspective on accounting as a field far broader than its links to economics, finance, and psychology would imply. This broadening results in less journal space devoted to financial accounting research aimed at improving the content of accounting information. This, in turn, has the potential to weaken the link between accounting research and practice (Kaplan, 2011). Another factor potentially contributing to the weakening of this link is the perception by some academics that standard setting decisions are rarely based on concepts (e.g., Allen and Ramana, 2013). Instead, standard setting decisions often seem to be aimed at pleasing preparers of financial statements, or their auditors, rather than providing the most relevant information to users of financial statements. This perception raises the question of whether standard setters are interested in what can be learned from academic research. This perceived lack of impact on standard setting decisions reduces the motivation of academics to pursue research aimed at informing those decisions.

### ***Open questions for research***

Any weakening of the link between academic research and practice cannot be attributed to a lack of interesting, unresolved potentially researchable questions. Many of these questions are not new—they remain open because they are difficult to answer. They are difficult to answer for two reasons. First, answering them requires in depth knowledge of accounting institutions—fortunately, that is the comparative advantage of accountants. Second, answering them requires

creativity in developing appropriate research designs based on available data—fortunately that is a challenge innovative researchers welcome. The following is a partial list of these questions, all of which could result in knowledge that enhances financial accountability. The questions are framed as motivating questions, i.e., practice questions that motivate the research; re-framing them as research questions is left to the researchers who seek to address them.

1. What is the best way to measure assets, liabilities, equity, income, and expense? Although this question has been the focus of considerable thought over many years, it remains unresolved (see, e.g., Chambers, 1962; Dean, et al. 2010). A key shortcoming of the current conceptual framework is that contains no concepts on measurement (Barth, 2014). Perhaps the absence of measurement concepts reflects the lack of progress relating to measurement in financial reporting (e.g., Chambers, 1998) or perhaps it reflects the acknowledgement that in an incomplete and imperfect world, measurement in accounting is not possible (Beaver and Demski, 1979).<sup>13</sup> It likely is not fruitful to go over old ground that failed to resolve the measurement question. However, measurement is fundamental to financial accounting and financial accountability and, thus, deserves renewed efforts at developing measurement concepts.
2. Should financial accounting focus on assets, liabilities, equity, income, and expense items, or are there other items that we should measure? If there are other items, what are they and why should we measure them? How should the interrelations among these items be portrayed? Which interrelations are important? Joint use in operations? Joint use in any activities? Creation of synergies? These questions relate to measurement and to display.
3. How can we recognize or otherwise faithfully represent intangible assets that increasingly comprise a larger portion of the economic value of firms in an information and technology

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<sup>13</sup> See Storey and Storey (1998) for an historical perspective on the development of the conceptual framework.

age? These assets typically are unrecognized today because it is not easy to faithfully represent them in an historical cost, transactions-based measurement framework.

4. Research has begun to focus on risk reporting, but there is little quantitative information in financial statements about the risk of assets, liabilities, equity, income, and expense—either inherent risk or estimation risk (Ryan, 2012). What information is needed? What is the best way to provide that information?
5. What is the best way to summarize, aggregate, and present information in financial reports to aid investors and other outside providers of capital in their decision-making? Research tells us much about investors' decision making—both as individuals and in markets—and it seems clear that financial statements do not reflect all the information they need (Hodder, Hopkins, and Wood, 2008). What additional information do investors need and is that information best provided in financial statements? If not, why not? Is there information in financial reports that is irrelevant?
6. Financial reports are criticized as being out-of-date before they are published. Yet, they appear to have information content. What is the role of periodic—e.g., quarterly, semi-annual, or annual—financial statements in a world with continuous information flow? What does this role imply for the content of financial reports?
7. What are the costs of not providing high quality financial statements? Although researchers have identified some aspects of quality, the construct of “quality” is inherently difficult to quantify and, thus, assess as high or low (e.g., Francis, LaFond, Olsson, and Schipper, 2004; Barth, Landsman, and Lang, 2008). What aspects of financial statements are the most important to be high quality, and why? Also, the framework explains that the costs of

providing—or not providing—accounting information are broad.<sup>14</sup> Researchers have identified cost of capital as a key cost (e.g., Francis, LaFond, Olsson, and Schipper, 2004; Barth, Konchitchki, and Landsman, 2013). Is it possible to identify all major costs, even if we cannot measure all costs? What features of financial statements reduce or increase these costs?

8. What are the boundaries of financial reporting in terms of the extent of forward looking information incorporated into financial reports? All accruals are estimates of the future and fair values reflect current estimates of all factors related to the item being measured (see, e.g., Barth, 2006). When do these estimates of the future cross the boundary between financial reporting and forecasting?
9. The academic literature is replete with studies showing that individuals responsible for financial reporting, such as firm managers, respond to incentives. Is there a way to provide incentives for high quality financial reporting? What are the incentives and how would we create them?
10. What particular aspects of enforcement are needed to ensure the quality of financial reporting? Although some studies focus on enforcement indicators when determining how accounting amounts provide information to capital markets, these studies do not identify which aspects of enforcement are crucial (Ball, 2006).
11. What is the relation between financial reporting and contracting (Lambert, 2010)? Is it simply that it is not cost effective for firms to invest in two reporting systems? Is there any role for establishing accounting standards or principles for accounting used in contracts? If

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<sup>14</sup> For example, the framework states that “Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it” (FASB, 2010; IASB 2010; QC35–QC39).

so, what is that role and what would the basis be for establishing such standards or principles? How would the particular needs of contracting parties be served by such standards or principles?

12. Accounting amounts are used not only at the firm level, but also at the economy level, e.g., by governments, to make policy decisions. How do financial reports by individual firms aggregate to the economy wide level? Is there a way to enhance the economy-wide use of accounting amounts without diminishing their informativeness at the firm level?

### ***Conclusion***

Financial accounting researchers have an important role to play in society. Financial accounting is essential for financial accountability, which is seen as essential for a prosperous society. Accounting research is informed by knowledge in related fields such as economics, finance, and psychology. Recently accounting research has begun to embrace fields associated with how accounting information is communicated, including the physical characteristics of information conveyors and the linguistics of the information, with no apparent connection to the information being conveyed. Interaction with related fields brings broader and new perspectives and can rejuvenate a field and enrich it. However, pursuing a new research area without considering its possible relation to accounting practice risks losing the connection between accounting research and practice and, thus, financial accountability. Regardless, there are many intriguing, unanswered research questions the answers to which could provide insights into ways to improve financial accounting and reporting. This article identifies only a few.

To address these questions and provide these insights, the relation between accounting academics and accountants in practice needs to be strong. A strong academic-practice relation helps researchers to identify and thoroughly understand the accounting question and to be

creative in developing research designs to address them. As Robert Kaplan said in his 2010 American Accounting Association Presidential Scholar Address, accountants need to re-assert our role in society and to reaffirm our place as a learned profession. Thus, a goal to which accounting academics should strive is research motivated by practice and practice motivated by research. Only then will academic researchers help facilitate financial accountability and contribute to a prosperous society that can base decisions on high quality financial information.



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