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Harmonisation or discord? The critical role of the IASB conceptual framework review

Geoffrey Whittington *

CFPA, University of Cambridge, Judge Business School, Trumpington Street, Cambridge CB3 9DD CB2 1AG, United Kingdom

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ABSTRACT

The IASB has achieved great success in extending the adoption of international financial reporting standards, but it has also encountered opposition at national and regional levels. Some of this opposition arises from differences in national accounting cultures, which are embedded in the market structures and institutional and legal frameworks within which business entities operate. These issues are particularly apparent in the debate on the IASB's revision of its conceptual framework, which expresses its own vision of an international accounting culture. An important example is the issue of whether *stewardship* should be a distinct fundamental objective of financial reporting.

1. Introduction

The IASB was created in 2001 as a successor to the IASC. The new body is a full-time professional board with strong support staff. It was designed to be an independent world standard-setter, reflecting the new demands created by the IOSCO endorsement of International Accounting Standards and the European Commission's decision to require the use of those standards in the group accounts of companies listed within the EU (both decisions made in 2000). The IASB inherited a remarkable legacy from its predecessor body, not only in terms of the standards that it had promulgated but also in terms of international support and goodwill. Since the IASC was essentially a voluntary body, created by the accounting profession and its stakeholders rather than legislators or government regulators, this level of support is evidence of the underlying demand for international accounting standards in the global capital market.

* Tel.: +44 122 3764027; fax: +44 122 3760576.
E-mail address: gw12@cam.ac.uk

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Since its creation, the IASB has achieved some notable successes. The expected implementation of its standards in the European Union has taken place without significant problems (ICAEW, 2007), Australia has adopted the standards for all companies, as a legal requirement, and many other countries have moved towards adopting the IASB's standards (IFRS) including many that plan complete convergence of domestic standards with IFRS for listed companies. These include significant economies such as Brazil, Canada, China and India. More than 100 countries now recognise international standards for some purpose (IASB Insight, Q4, 2007). The most notable achievement has been the recent decision by the United States Securities and Exchange Commission (SEC) to accept IFRS accounts for foreign registrants on US capital markets without reconciliation to US GAAP. Furthermore, the SEC is consulting its constituency on the possibility of allowing domestic US listed entities to use IFRS rather than US GAAP.

The IASB has also had significant achievements in setting new standards. Not only did it complete the Improvements project, which was a requirement for IOSCO support, but it has also promulgated eight new IFRS standards. Amongst these is IFRS2, which requires that share-based payments be accounted for by being expensed through the profit and loss account at the time when the related benefit is received. This issue was expected to arouse strong resistance, as it had already done in the USA, and its passage was perhaps eased by the Enron scandal, which made it unpopular to oppose transparent accounting. Other important new standards were IFRS3, which outlawed pooling of interests accounting for business combinations, and IFRS7, which requires much more extensive, and hopefully more effective, disclosures relating to financial instruments.

The IASB's story is not, however, one of unalloyed success. For example, the acceptance of IFRS in Europe has been marred by the two 'carve-outs' (one, on the fair value option, subsequently withdrawn) of the provisions of IAS39, Financial Instruments, and the EU bodies (first the Commission and latter the Parliament) have made clear their wish to have greater control over the standard-setting process and their fear that the IASB is dominated by what is sometimes referred to as 'Anglo-Saxon accounting', i.e. dominance by the English-speaking countries. This fear has been aggravated by the convergence process with the FASB, which was a necessary condition for persuading the SEC to relax the reconciliation requirement, under the so-called 'road map'. The IASB's agenda is now aligned with that of the FASB, and new standards are being developed on a joint basis. Criticism of the agenda and the IASB's work has not been confined to Europe or to a particular section of the constituency, although banks have been particularly vocal in their criticism of the hedging provisions of IAS39 and listed companies were mostly critical of the tentative proposals for reconstructing the income statement in the project on performance reporting.

Apart from criticisms about the agenda and the content of standards, there have been tensions over the implementation, interpretation and enforcement of IFRS. With regard to *implementation*, apart from the EU 'carve-outs', Australia has restricted certain options within the standards, and there is fear that, if this practice becomes more widespread, the international comparability of the standards will be lost: one country might require one option whilst another country required the alternative. A related issue is the *interpretation* of the standards. The IASB's own interpretation body, IFRIC, has been parsimonious in the number of interpretations that it issues, in order to avoid the extent and detail of official interpretations that exists in the FASB's canon in the USA, and which is sometimes characterised, perhaps unfairly, as a system of 'rules-based standards'. Efforts are being made by groups of regulators, such as CESR in Europe, to prevent interpretations from becoming too detailed or from becoming divergent across regulatory regimes, but the danger remains. A related danger is that the *enforcement* of the standards may vary significantly across jurisdictions, so that the quality of so-called IFRS financial reports is not comparable. This type of anxiety led to extensive investigations by the SEC prior to its withdrawal of the reconciliation requirement, and the SEC was clearly satisfied that enforcement has, hitherto, been of consistent quality. However, the anxiety must remain, as the range of countries using IFRS widens, that the IASB has to rely on various national regulators to assure the quality of implementation.

2. Discord over the content of IFRS

This paper is concerned with one particular but fundamental aspect of international discord over IFRS, namely the *content* of the standards and the *conceptual basis* for such discord.

Many of the arguments about the content of IFRS do not have a conceptual root. Some are due to *transition*. It is usually costly to change from one system to another. There are the obvious financial costs of setting up new systems but equally important are the adjustment costs of adapting to using and interpreting new data. Insofar as objections to IFRS arise from these transitional pains, it might be expected that they would subside after adoption, when even reverting to the previous system would cause further disruption and might therefore be opposed.

Some other objections to IFRS are based on *control* or, at the national level, the assertion of *sovereignty*. This involves an understanding that IFRS are useful for global comparisons, combined with a wish to be in charge of the contents, perhaps summarised as "everybody should use the same standards… and I should set them". This is clearly apparent in the EU 'carve-outs': in one (the fair value option) the European Central Bank was clearly anxious to demonstrate its influence as a regulator, and in the other (hedge accounting) a powerful industry lobby group (the European banking industry) was concerned to maintain control of its own environment. Another example is the Australian carve-out of certain options in IFRS, which are an example of a sovereign country asserting its right to vary the standards to meet what it perceives as national needs.

The pains of transition and the wish to control the standard-setting process are natural human reactions that are worthy of study in their own right. However, both are reinforced by a third factor, which is central to this paper, namely the *culture* of the individual constituency. By culture, we mean the institutional framework of accounting, including the market environment in which it operates, and the specific practices and beliefs about the role of accounting that has grown up within that framework. A constituency for these purposes is any group that has a common view as to the appropriate content of a particular standard. Thus, for some purposes, countries may be constituencies, but so may industry groups (such as bankers) and so may other preparer groups (such as auditors) or users (such as financial analysts), but our main focus will be on national differences. The institutional framework includes the structure of markets, company law, tax law, regulation, and inherited practices of accounting and corporate governance.[1]

Insofar as accounting culture, as defined above, creates different views as to the appropriate content of financial reports, it represents a fundamental and possibly intractable, source of disagreement about IFRS which needs to be understood and resolved if IFRS are to be interpreted and implemented in a consistent manner across different constituencies. This is particularly so if the standards are to take the so-called *principles-based* form that is currently widely supported (e.g. by the SEC (2003)). A principles-based system has more generally stated standards, whereas a rules-based system contains detailed specific rules that give less scope for individual judgement in implementation. The way judgement is exercised can obviously be culture-dependent. One way in which IASB can attempt to overcome this possible source of cross-constituency variation is through the *conceptual framework*, which, in effect, is the IASB's statement about its own accounting culture, including the objectives of financial reporting and the desirable properties of the information to be included in financial reports. Thus, signing up constituents to the conceptual framework is a critical step towards true harmonisation, in addition to the more traditional roles of the framework in providing consistency across standards and giving guidance in circumstances that are not covered by the extant standards (provided for by IAS8). This gives rise to the paradox that, although the conceptual framework is intended as a means of harmonisation, the process of developing it can be a source of discord. By examining fundamental assumptions, the development of the conceptual framework will clarify some existing cultural differences. In this context, we consider the progress of the IASB's conceptual framework revision project.

3. The IASB/FASB conceptual framework revision project

The joint conceptual framework project of the IASB and the FASB was initiated in 2002 as a direct result of the Norwalk Agreement, under which the two boards agreed to work jointly on future

[1] Zeff (2007) provides a more extensive discussion of accounting culture and its international variety, particularly in relation to the adoption of international accounting standards.

Table 1
IASB conceptual framework revision: timetable as at 30 June 2008

Phase	Already published	Planned		Final
		2009	2010	Year
A: objective and qualitative characteristics	DP (July 2006) ED (May 2008)	F		2009
B: elements and recognition		DP	ED	2011
C: measurement		DP	ED	2011
D: reporting entity	DP (May 2008)	ED		TBD
E: presentation and disclosure				
F: purpose and status				
G: application to not for profit entities				
H: remaining issues				

Abbreviations: DP, discussion paper; ED, exposure draft; F, final chapter; and TBD, to be determined.
Source: IASB web site: iasb.org.uk/Current+Projects/IASB+Projects/IASB+Work+Plan.htm.

standards and to align existing ones. The phases of the proposed framework project and its position on 30 June 2008 are shown in Table 1.

Clearly, a common conceptual framework is a necessary pre-requisite for common standards. The objective of the conceptual framework project was to remove existing differences between the two frameworks, to fill gaps in them, and to make improvements where necessary. The task was expected to take several years, but it was made less onerous by the fact that the two frameworks already had many common features: the IASC's Framework (1989) had drawn heavily on the prior work of the FASB, although it was very much briefer. In particular, both frameworks had a strong decision-usefulness orientation and both failed to prescribe a preferred method of measurement. On the other hand, filling gaps such as measurement, which had been left unresolved because of their controversial nature, was likely to be difficult. Moreover, the extensive due process of the IASB would give an opportunity for comment by those (such as many EU countries) who had not 'bought in' to the framework when it was first devised.

In view of the latter problem, the IASB was perhaps optimistic in its original intention to issue the first two chapters (phase A of the project) as an exposure draft, rather than a discussion paper (which normally precedes an exposure draft), on the ground that they would be non-controversial. After due consideration, it was decided to follow the usual practice of making the initial publication a discussion paper, and this proved to be a wise decision, because the first two chapters were strongly criticised by some constituents. These criticisms are symptomatic of the cultural differences between what is sometimes referred to (simplistically) as the Anglo-Saxon approach, embodied in the existing framework but expressed more forcefully in the (draft) new framework, and the continental European position. The central issue was that of *stewardship*.

4. The stewardship issue

Chapter 1 of the discussion paper, issued in 2006, was entitled 'objectives of financial reporting'.[2] No issue could be more important for the international harmonisation of financial reporting than starting from a commonly accepted objective. The objective defined in chapter 1 is to provide decision-useful information to current and prospective providers of finance. Such an objective is assumed to be met by providing information that will assist in the prediction of future cash flows to the entity, and the same set of information is assumed to be of potential use to a wider group of users of financial information. This type of information leads to a focus on *pricing* in financial markets: the information provided is that which investors would use in a buy/sell decision. All of this is included in the current IASB Framework (IASC, 1989). What is new is that the needs of *stewardship* are assumed to be met within the decision-

[2] An exposure draft was subsequently issued in May 2008. This expands the discussion of stewardship but does not change the fundamental position of the discussion paper that stewardship is not a separate objective of financial reporting.

usefulness objective. In the current IASB Framework (but not that of the FASB), stewardship is defined as a separate objective, so this represents a change of emphasis. This proposed change was opposed by two members of the IASB in an alternative view to chapter 1.

The idea of stewardship advanced in the alternative view is one of *accountability* by the management board of an entity to its proprietors. This is an *agency* relationship. Its information requirements overlap with those of decision-usefulness; the favoured steward in the biblical parable of the talents was the one who created the greatest wealth for his master, or, in modern terms, maximised the present value of future cash flows. However, there are also differences of emphasis and perspective. A stewardship or agency relationship recognises that the agent has an incentive to misrepresent performance. This is the justification for *prudence* in financial reporting: a requirement of the existing IASB principles which has been dropped in the proposed chapter 2. It is also the justification for a high level of detail in reporting related-party transactions and directors' remuneration. Also, the relationship involves *monitoring* the actions of the steward or agent, so it will be concerned with *past transactions and events* (another term that is currently being considered for deletion from the framework) to a greater extent than decision-useful information that is focused on predicting future cash flows. The stewardship relationship is also *interactive*: information in financial reports may prompt the principals to influence the actions of management, so that future cash flows are endogenous to the process rather than predictable as exogenous variables.[3]

This stewardship perspective also brings into question the adoption of the *entity* perspective (adopted by the previous framework and in the proposed chapter 1) as opposed to the *proprietary* view of the reporting entity. It is possible to regard the management board as having a special duty of accountability to *present shareholders*, in their capacity as proprietors of the business. This would require that the specific needs of this group should be met within the financial statements, although it would not necessarily preclude the provision of information relevant to a wider group of investors. It is therefore a welcome development that the IASB has announced recently (in 2008) its intention to investigate further the implications of adopting an entity perspective, although it has (in May 2008) issued an exposure draft of chapters 1 and 2 which retains the essential features of the discussion paper, including the assumption of an entity perspective.

Stewardship does not necessarily apply solely to current shareholders: others also may have a right to this type of information, although shareholders typically have a central role in corporate structures. For example, in a number of European jurisdictions, such as the Netherlands, employees are given a formal role in corporate governance and are represented on supervisory boards. Thus, stewardship can also require the provision of information relevant to such wider groups, and this will not always be well described as information relevant to the prediction of future cash flows.

5. Cultural origins of stewardship

Stewardship undoubtedly has cultural origins, in the sense described earlier. Its deletion as an independent objective in the proposed framework caused no difficulty to the FASB because it is not a critical component of the present FASB framework. Support for stewardship has come most strongly from Europe.[4] The reason for this is probably that the USA has the deepest and most liquid capital markets, including the market for corporate control, so that disciplining of management takes place primarily through the capital market. More specifically, the threat of take-over and the rewards of stock options and other market-related payments are the primary influences on management of listed companies in the USA. In Europe, on the other hand, there are different traditions of corporate governance, relying more on direct controls such as the exercise of voting rights and legal powers and less on market sanctions, such as the market for corporate control.[5] In Germany, for example, corporate reporting is strongly embedded in the law, there is a long-standing tradition of banks exercising voting rights as agents of

[3] Lennard (2007) elaborates some of these arguments.

[4] See, for example, the critique by PAAinE (2007), which is a collaboration of EFRAG and the leading national standard-setters of the European Union.

[5] Franks and Mayer (1990) provide empirical evidence on the relative roles of the market for corporate control in the UK, France and Germany.

shareholders and using that power to be represented on boards of directors, and there are two-tier boards of directors, with employees and others represented on the supervisory board. In some European countries the different framework of corporate law and governance has led the concept of stewardship to go beyond accountability to shareholders to include tax authorities, employees and others in the wider community.

The UK is often regarded in the rest of Europe as part of an 'Anglo-Saxon' system and certainly it has a stronger capital market tradition and a greater shareholder orientation in its concept of stewardship than the rest of Europe. Nevertheless, the UK differs from the USA in important respects. A manifestation of this is the Code of Corporate Governance, which attempts to regulate and improve the conduct and accountability of boards of directors, reinforcing the dialogue between directors and shareholders. The Code is the responsibility of the Financial Reporting Council, which is also the parent body of the UK Accounting Standards Board, which took the lead in drafting the PAAinE critique of the proposed withdrawal of the stewardship concept as a separate objective in the IASB framework.

An interesting analysis by Bush (2005) has explored the different legal systems governing financial reporting in the UK and the USA. He suggests that the UK's orientation to stewardship to present shareholders originates in the fact that its financial accounting is governed by company law. For example, the requirement to file accounts on the public record arises, in the UK, from incorporation under the Companies Acts, so that the requirement to file is not confined to listed companies. The US orientation towards the provision of decision-useful financial information to capital markets, on the other hand, may be influenced by the fact that the authority for financial reporting rests with the Securities and Exchange Commission, under the Securities Acts. Thus, public filing of accounts is required under the authority of the Securities Acts, so that it applies only to entities whose securities are publicly traded and it is a natural consequence of this that accounts should be viewed as serving the decisions of market participants rather than the needs of stewardship to the present shareholders. This view of the legal origins of the US market orientation of financial reporting is controversial, and some of the institutional aspects of the argument have been questioned in a recent review by Benston (2008). However, there are undoubtedly differences between the US and UK approaches to the role of financial reporting, and these are reflected in the fact that the UK ASB's statement of principles (1999), unlike the FASB framework (and the IASB's current exposure draft), acknowledges an independent role for the stewardship objective.

Outside Europe and the USA, there is a wide variety of corporate governance and regulatory systems, and it is unlikely that the market price oriented decision-usefulness model will satisfy all of their needs. For example, if, as is hoped, China converges with IASB standards, the issue of state ownership interests in private sector enterprises seems likely to affect the nature of accountability: this has already been seen in the IASB's recent proposal for the revision of its standard on related-party transactions (IASB exposure draft, 2007).

6. Why it matters

It may seem, superficially, that the stewardship issue is merely a matter of semantics. In fact, the view of stewardship affects subsequent decisions in the framework and in the standards themselves.

With regard to the framework, chapter 2 of the discussion paper is entitled qualitative characteristics of decision-useful financial information, and the concept of decision-usefulness, rather than stewardship, dominates its contents.[6] Notably, it is proposed to substitute the previous concept of reliability by the concept of representational faithfulness. The latter is concerned with capturing the substance of an economic phenomenon, whereas the former suggests a concern with data suitable for the monitoring role of a principal. Equally, prudence, which was previously part of the IASB's framework, is now excluded on the ground that it gives rise to bias. Prudence reflects a degree of caution designed to counteract the agent's incentive to report an optimistic view: this is well established in accounting

[6] The discussion here refers explicitly to the discussion paper (2006) but it is equally relevant to the revised version of the exposure draft (2008).

standards through the requirement for impairment tests, which require losses of value below carrying amount to be reported, but not gains above carrying amount.

The predominance of the decision-usefulness as opposed to the stewardship view is also reflected in the preliminary decisions made in relation to phase C, elements and recognition. The proposed definitions of assets and liabilities delete the references in the present definitions to '*arising from past transactions and events*'. Past transactions and events are a fundamental component of stewardship information and their removal suggests a concern solely with forward-looking valuation rather than with giving an account of how the present situation arose, as in stewardship. *Recognition* has not yet been addressed directly, but both of its current criteria have been challenged by the preliminary decisions. The reliable measurement criterion has been challenged by the removal of reliability as a desirable characteristic. The second criterion, the probability that the gain or loss will accrue to the entity,[7] has been challenged by the removal of '*expected* to flow' from the element definitions. In the recent standard on business combinations (IFRS3), the recognition criteria for acquired intangibles were similarly overridden by an *assumption* that they are reliably measurable and recent IASB proposals on the revision of IAS37 (liabilities) have removed the 'expected to' criterion for the recognition of liabilities and what were formerly known as provisions (exposure draft, 2005). Recognition criteria provide a filter for providing reliable information consistent with a stewardship approach, whereas a decision-usefulness approach might include any information that was regarded as valuation relevant, however unreliable.

Looking further ahead, the IASB is likely to face a difficult task in resolving the measurement issue. The recent exposure by the IASB (November 2006) of SFAS157 on fair value measurement has already aroused controversy and aggravated existing fears among some constituents that fair value will emerge as the IASB's favoured measure. The debate about fair value has often revolved around the trade-off between relevance and reliability, and some participants perceive historical cost to be justified as reliable record of past transactions, consistent with stewardship.[8] The substitution of 'representational faithfulness' for reliability in chapter 2 of the proposed Framework has therefore been criticised by those who hold this view.[9]

7. Conclusion

The IASB's recent achievements are considerable, but formal acceptance or recognition of IFRS needs to be supported by a genuine meeting of minds about the principles that they embody. For this to occur there must be agreement about the conceptual framework that underlies the standards. The current project to revise the conceptual framework is an essential part of this process, but it is uncovering some fundamental cultural differences that need to be resolved, particularly in relation to the role of the stewardship objective. These differences are embedded in the different market environments and systems of corporate governance in which IFRS is applied.

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[7] This is what the ASB's statement of principles describes as *element uncertainty*. It represents uncertainty as to the existence of the element (which determines whether it should be recognised) rather than uncertainty as to its outcome (which will affect the amount at which it is measured when it is recognised).
[8] This view is well articulated in the academic literature, for example by Ijiri (1975).
[9] This argument is elaborated in Whittington (2008).

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