In Defense of Stewardship

By David Oldroyd and Anthony D. Miller

The idea of stewardship as a prime objective of financial reporting appears to have been laid to rest by FASB and the International Accounting Standards Board (IASB) with the publication in 2010 of the first phase of their Conceptual Framework for Financial Reporting (see "Chapter 1, The Objective of General Purpose Financial Reporting," and "Chapter 3, Qualitative Characteristics of Useful Financial Information"). The boards have maintained their original position, formulated before the current financial crisis broke, that the overriding purpose of financial reports is to provide information "that is useful in making decisions." The notion of assessing stewardship—which is no longer referred to explicitly—is identified as a subset of assessing "an entity's prospects for future net cash inflows," which is itself regarded as a subset of decision-usefulness.

A Look Back

Given the number of objections raised in the discussion paper and exposure draft stages of the conceptual framework, doubts remain over the viability of the stance taken by FASB and the IASB. One way to evaluate their position is to reflect on the reasons why financial accounting exists in society and what it is capable of achieving in practice. It is not a coincidence that the development of accounting in prehistory accompanied the adoption of farming (Denise Schmandt-Besserat, *Before Writing*, vol. 1, University of Texas Press, 1992). The distinguishing feature of agricultural society, compared to hunter-gatherer society, is property, in the form of land and surplus. This has a number of ramifications, including the creation of differential levels of ownership and reckoning technology to facilitate economic exchanges. The distinguished accounting theorist W. T. Baxter summed up the situation by stating that accounting started as a means of tracking exchanges and that "this is still its main task, without which business would collapse" ("Towards Greater Logic and Utility in Accounting," *Accounting, Business and Financial History*, vol.9, no.2. 1999).

Baxter was speaking specifically about tracking trading transactions, but he might also have added investment in enterprises, with accountability systems serving to reduce the risk of entrusting funds to third parties. Thus, the existence of accounts enabled the concentration of investment and the sharing of risks through the creation of a new type of business entity in the 16th and 17th centuries—the joint-stock company. The earliest example in the English-speaking world is the Company of Merchant Adventurers of England for the Discovery of Lands Unknown. Although the accounting arrangements are unclear, accounts were prepared in 1567 for the first 15 years of operations to allow the shareholders to receive what was due to them in the form of dividends (T. S. Willan, *The Early History of the Russia Company*, Manchester University Press, 1956). From the beginning, the raison d'être of accounting systems has been to facilitate trade and investment through this ability to attest property rights and obligations, a key feature of which has been to provide evidence to allow property owners to enforce their rights in courts of law (D. Oldroyd and A. Dobie, "Bookkeeping," in J. R. Edwards and S. P. Walker, *The Routledge Companion to Accounting History*, Routledge, 1999).

Stewardship fits into the equation through the ability of accounts to communicate events at a distance. According to the archaeologist Schmandt-Besserat, the earliest accounting records, kept by a system of clay tokens predating the inven-

(Continues on page 8)

(Continued from page 6)

tion of writing, represented a huge leap for mankind precisely because events could be communicated to other parties at a distance. In the modern era, the separation of ownership from management is not the main reason for the creation of agency relationships and accounts; rather, it is the need of shareholders to evaluate operations at a distance. The desire to safeguard property entitlements explains the existence of legally enforceable control mechanisms to hold stewards accountable. Hence, company directors have a legal obligation to provide the auditors—and ultimately the courts—with sufficient evidence relating to the company's activities. It follows that the idea of holding stewards accountable is the product of financial accounting's three most elemental properties: property entitlements, controlling events at a distance, and legal evidence. Where these certainties are compromised, the risk of engaging in trade can become too great.

Decision-usefulness, for its part, has existed as an adjunct to stewardship accounting for most of its history. R. J. Chambers was one of the first accounting theorists to champion it, and his plea that providing such information should constitute a primary objective of financial reporting has been taken up by standards setters since the 1970s. Yet the antecedents of the concept lie in the capacity of stakeholders to make use of whatever information is available to them at the time in order to inform business choices, and hence extend beyond stewardship.

Is Stewardship Still Possible?

FASB and the IASB's discussion of the limitations of financial reports in their new Conceptual Framework is tacit acknowledgement that stakeholders will still use the information in accounts for decisions, whatever their explicit purpose. In other words, the stewardship objective does not obviate decision-usefulness; rather, it necessitates that it is premised on verifiable information.

The question remains whether financial reporting is capable of sustaining either the stewardship or decision-usefulness objectives in practice. To wit, consider the long history of corporate failures involving misleading accounts (T.A. Lee, "The war of the sidewardly mobile corporate financial report," *Critical Perspectives on Accounting*, vol. 17, 2006). Considering stewardship first, providing legally attestable evidence is undermined by the many situations in financial reporting that require the exercise of judgment due to the complex nature of contracts and activities. Property rights become blurred in a world of shared or deferred assets and liabilities, as well as shifting trading relationships where even the boundaries of what constitutes the reporting entity can be difficult to determine.

The stewardship objective is compromised further by the game-play aspects of financial reporting articulated in agency theory. The tendency of agents to indulge in earnings or impression management is a recurrent theme in the history of financial reporting (M.J. Jones and D. Oldroyd, "Financial accounting: past, present and future," *Accounting Forum*, vol. 33, no. 1, 2009). The quadrangular relationship between property entitlements, controlling events at a distance, the accountability of agents, and legal evidence still holds true—only now, property entitlements become clouded by business complexity and the accountability of agents by self-interest.

Business complexity and self-interest undermine decision-usefulness as well; however, the difference is that decision-usefulness—as articulated in the Conceptual Framework—introduces the added uncertainty associated with predicting the future through valuing assets. The balance sheet approach, which measures income as the increase in net assets and economic resources over a period, is the method chosen by FASB and the IASB. For a balance sheet approach to work, companies must be able to value all their assets to capture their future economic benefits. The fact that FASB and the IASB preclude the recognition of home-grown intangibles is evidence that this method becomes untenable when significant uncertainties exist over the valuation of assets—in this case through the lack of a purchase transaction against which to gauge value.

The More Important Objective?

It follows that the debate over the objectives of financial reporting is in reality a question of degree. FASB and the IASB both acknowledge financial reporting's inherent limitations and accept that the "vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term." Recognizing financial reporting's limitations, however, does not mean that there are no advantages to be gained from ranking stewardship and decision-usefulness, given the real implications for practice relating to the valuation of assets and liabilities and the recognition of gains and losses. Indeed, the order in which stewardship and decision-usefulness are ranked is important because their information needs can be conflicting. For example, promoting decision-usefulness has led FASB and the IASB to require valuations of assets where there is no market, and hence a lack of objective evidence, which has historically been one of the cornerstones of effective stewardship reporting. The benchmarks for reviewing purchased goodwill for impairment are a case in point. Fair value and the present value of future cash flows (in IFRS) are entirely a matter of judgment for an asset that cannot be separated from the rest of the business and tends to lose its original character in the reorganizations that follow takeovers.

A conceptual solution to the ranking of stewardship and decision-usefulness as objectives is therefore impractical due to the inherent limitations of financial reporting. What remains is the more pragmatic question of which objective is going to produce the best result for society at large or, more pessimistically, the least harm. Unfortunately, the logic underlying financial accounting's existence—not to mention the damage to society that corporate managers have proved capable of inflicting where there is a lack of accountability, which is an age-old phenomenon—suggests that FASB and the IASB may have made the wrong choice. The ideal that accountants should be useful to decision makers is not in question, only that it should supersede stewardship. ❑

David Oldroyd, PhD, *is an accounting professor at Durham University, Durham, U.K., as well as chair of the technical committee of the British Accounting and Finance Association's Financial Accounting and Reporting Special Interest Group.* **Anthony D. Miller** *is an accounting professor at Newcastle University, Newcastle upon Tyne,*