

Thinking Beyond the Black Box: Sterling Shows Accountants the Way toward Relevance

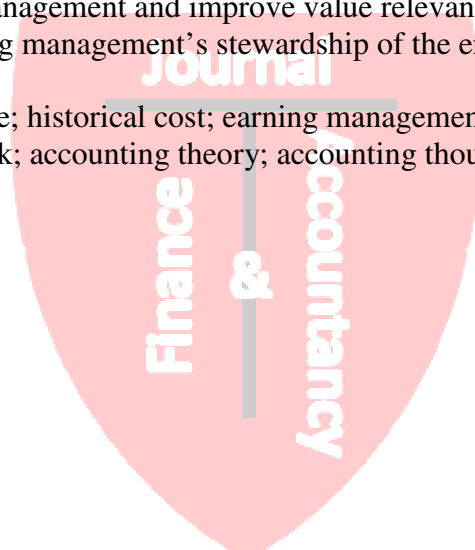
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ABSTRACT

GAAP is a contributing factor to accounting irregularities. A universal tool used by corporate management operating within an accounting system that has been created by accountants to serve the "user needs" of their corporate masters. This paper provides a synthesis of literature that focuses on the contributions of Robert R. Sterling, and the significance of exit values to contain earnings management and improve value relevance for the objectives of decision making and assessing management's stewardship of the entity's economic resources.

Keywords: Sterling; fair value; historical cost; earning management; fraud; relevance; reliability; GAAP; conceptual framework; accounting theory; accounting thought.



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Everyone agrees that accounting information should be useful. As with other abstractions (e.g. truth, justice, fairness), however, we run into difficulty when we try to apply the concept.
Professor Robert Raymond Sterling, 1975: 44

1. INTRODUCTION

In the mid 1980's financial reporting, captured at least 75 percent on average of the true market value of major corporations; however, today the figure has dropped to a paltry 15 percent. That leaves 85 percent of a company's true market value, which cannot be explained by traditional financial analysis. Baruch Lev in 2001 was concerned that the disconnect between a company's book value and their market capitalization was more than six times (Lev, 2001); in 2016 Lev and Gu released the book *The End of Accounting and the Path Forward for Investors and Managers*; in 2018 Netflix and others were trading at more than forty times book! EPS is the familiar earnings per share that is supposed to measure corporate profit as determined by GAAP; but economists have long recognized that profit is something of a mystery, and that economic profit is by no means the same thing as accounting profit. Peter Drucker was scathing about EPS: "What it really represents is 'taxable earnings.' It is what is left after all the charges a tax collector accepts as deductible. But this is a purely arbitrary figure that has little to do with business performance." And "the essential thing about profit is that there is no such thing there are only costs" (Bartley, 2003).

FASB's principal mandate in standard setting is to enhance decision-usefulness (Statement of Financial Accounting Concepts No. 8, September 2010) as the basis for investors and creditors in their credit allocation decisions.

Exit value accounting arguments are familiar if not fit full episodes in the history of accounting thought. For example, an early proponent was MacNeal, who, following the Great Depression and stock market crash in the US, identified the "vital defect" in accounting practices as its disharmony with "commonsense" and that "all accounting figures, whether for assets or income, are of little value." (Lee, 2005).

Later criticisms of corporate financial reporting were sounded by Walter Schuetze (former KPMG partner, founding member of the Financial Accounting Standards Board (FASB), and Chief Accountant of the Securities and Exchange Commission and its Enforcement Division) and Wolnizer in their 2004 book, which provided an insight into the thinking of a practitioner and government officer who was so critical of historical cost accounting warning that published accounting numbers were meaningless to investors and wide open to managerial manipulation. Schuetze warned of the consequences of the continued use of historical cost accounting within GAAP. Enron, WorldCom, Tyco, and Global Crossing were the visible harvest of the use of GAAP and a representative sample of the cost of ignoring criticism and advice from advocates as Sterling.

2. RELEVANCE AND RELIABILITY

Sterling stated that AICPA bulletins follow a method, which has been described as the "crisis" or "fire truck" methodology. They wait for a fire and then rush to-put-it-out. Often the previous set of accounting principles is inadequate for the resolution of a crisis, and a new principle is introduced *ad hoc*, with the purpose of explaining the practice. He believed that this inductive approach commits the elementary fallacy of getting "ought" from "is." In other words,

concluding that what is, is what ought to be (Sterling, 1967: 95). His reaction to *A Statement of Basic Accounting Theory* (ASOBAT), (American Accounting Association, 1966) was that there was little that was new, and nothing included that would shock or stimulate.

Sterling's goal was not simply to criticize the work of others, but to put forward a theory of his own. The primary qualitative characteristic was relevance, and that all transactions or events that failed to meet that standard should be excluded; his view is that historical cost is irrelevant to economic decisions and should be excluded. He challenged anyone to demonstrate that historical costs are relevant to economic decisions. He argued that the current exit value of a held asset is relevant to almost all-economic decisions.

Preparers use a wide array of accrual and deferral methods in preparing financial statements. These methods are mathematical constructs whose applications results in outputs of dollar amounts that are quite precise. Yet, though precise, they may not faithfully represent the economic reality or event that is being depicted in the financial statements. Sterling stated: "...as far as the mathematical methods used in accounting refer to reality, they are not certain; as far as they are certain, they do not refer to reality" (Sterling, 1985: 28).

Today, the financial reporting model is a hodgepodge style approach in presenting more statistics so that management will satisfy more receivers, but rather than fulfill the needs of a disparate group of users, it often neglects the element of relevance – preferring to overwhelm them with material that maybe faithfully representative but is not economically (i.e. materially) relevant. Transmitting more information was a proposed value driver within ASOBAT, along with the recommendation of both historical and current costs - the motivation for this proposal was quite correct in that no single statistic is relevant to all purposes (Sterling, 1967: 105). But to propose that a different statistic be prepared for each purpose overlooks the constraint of resources that can be allocated to the reporting system. Everything about a firm cannot be reported, nor should everything be reported. What Sterling proposed was information to be reported must be relevant to some "decision model" (Sterling, 1967: 95), but his concern of the model that originated with Shannon and Weaver was the finite capacity of the channel and the possibility to be inundated with relevant information (Sterling, 1967: 104). His views are very prescient when one considers the voluminous and complex nature of financial reporting today.

Sterling's warnings were largely ignored. Section 108 within the Sarbanes-Oxley Act of 2002 requires the SEC to investigate the existence and feasibility of principles-based accounting standards (PBAS). PBAS is a system of accounting standards based on concepts and principles in the FASB conceptual framework. PBAS is intended (as with auditing standards) to require more professional judgment from preparers and auditors, fewer exceptions for preparers, and less guidance. It therefore appears to be compatible with the call for standards, that require information that is not only reliable and relevant, but includes the accompanying qualitative enhancing characteristics of comparability and understandability for users in the decision-making process. But the intention of FASB appears to be aimed at providing greater consistency and comparability within the conventional system of historical costs and fair values (Lee, 2005). In contrast, Sterling's call for exit value accounting is intended to eliminate flexibility by the use of independently verifiable data such as market prices. According to Lee, Schuetze claimed that financial fraud would "virtually cease to exist"; "earnings management would cease as an issue"; and "my sister would understand it (accounting) if exit value accounting were implemented (2003: 151). Common sense reasoning would find accounting as a practical task that would be simple and transparent, void of preparer manipulation, and auditor compromise, and using straightforward procedures to report matters such as assets and liabilities in exit value terms

(Lee, 2005).

The FASB definition of an asset as a probable future economic benefit is so complex, so abstract, so all-inclusive and so vague that it cannot be used to solve problems. It does not require exchangeability of that which is called an asset, and it leads to the conclusion that all expenditures could be considered for inclusion as assets (Lee, 2005). Present-day financial statements are replete with estimates of monetary amounts that are viewed as being sufficiently reliable. Present-day measures of many assets and liabilities are based on estimates such as collectability of receivables, salability of inventories, useful lives of equipment, the likelihood of loss in environmental litigation. Although many may perceive those measures as being more precise than fair values measures, others disagree (Johnson, 2005). In the conceptual framework reliability is about faithful representation and verifiability, not precision. In addition, many of the present-day financial measures may be less reliable than fair value measures.

3. CURRENT ACCOUNTING SYSTEM

The current accounting scandals are similar, if not identical to those that preceded them. The present system of accounting is susceptible to earnings management, and as previously claimed by Arthur Levitt the widely-publicized accounting problems were in danger of undermining the U.S. capital markets (Levitt, 1998). According to Loomis (1999), He criticized a business community for accounting tactics as improper revenue recognition, unjustified restructuring charges, and the artifices called “cookie-jar reserves.”

Accounting literature defines earnings management as “distorting the application of generally accepted accounting principles.” (Rosenfield, 2000: 106). Earnings are the primary means in the evaluation of senior managers, so they manage their earnings precisely because they are permitted to do so (Sterling, 2003). It is in their self-interest to manage earnings. It is also well known that issuers often prefer to report the highest income possible, though it is tempered by the need to achieve stability (smoothing.) (Rosenfield, 2000).

In 1994, the Wall Street Journal ran a front-page story detailing the many ways that Jack Welch and his team smoothed earnings at General Electric (GE). Among them were the careful timing of capital gains, and the creative use of restructuring charges and reserves. According to an account from a GE staff member to a Fortune writer, the people at GE received calls from other corporations (AIG, Champion International, and Cigna – saying, “Well, this is what companies do. Why is this a front-page story?” (Loomis, 1999). The fundamental problem in crossing the line in accounting is that it obscures facts that investors ought to know, and left without the knowledge of the true value of the business.

The accumulation of cases, the constant eruption of accounting frauds, keeps suggest that beneath corporate America’s disciplined march to profits lie great expanses of accounting rot waiting to be revealed. Not a week goes by that the words “restatement of earnings” are not uttered. Levitt unveiled a list of five accounting problems. They were “big-bath” restructuring charges, acquisition accounting, “cookie jar reserves,” “the abuse of materiality,” and revenue recognition (Levitt, 1998). The Committee of Sponsoring Organizations of the Treadway Commission (COSO), studied 200 alleged frauds carried out by publicly owned companies in the 11 years ended in 1997. 50 percent had a revenue-recognition component.

The question that needs to be asked is whether earnings management results less from distortion of the application of GAAP than from the application of inherently faulty GAAP. Realization and allocation cause the failures of GAAP. Realization and allocation are central

concepts, but they are the very reason why GAAP does such a poor job of reporting the real-world effects of economic events (Rosenfield, 2000). The first failure is that GAAP confines the events issuers are permitted to report mainly to those that change the quantities of assets and liabilities, such as purchases, sales, receipts and payments. The *realization convention*, whereby only so-called changes in assets and liabilities are to be reported. However, according to FASB “price changes, interest rate changes ...and similar events” also affect entities. They go on to say that “to compare performance by comparing only realized gains (gains reported when quantities change) implies a definition of performance that many people would regard as incomplete and, therefore as an unreliable representation.” FASB concludes that “information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information.” FASB is on record as favoring the reporting of price changes when they occur, though it doesn’t permit such reporting (Rosenfield, 2000).

The American Accounting Association (as cited in Rosenfield, 2000: 109) characterized a result of FASB’s failure to reexamine GAAP in this way: “The most general criticism to be leveled at financial statements in their present form is that they are seriously incomplete ... Because they are substantially transaction based [and thus report only changes in quantities], they fail to recognize ... value changes [not] associated with the transaction” such as increases in the prices of land and buildings.

McDonalds is an excellent example of how historical cost misleads. According to Kiyosaki and Lechter (1997), in 1974 Ray Kroc, the founder of McDonald's, was asked to speak to the MBA class at the University of Texas at Austin. Ray asked the students in what business he was? The response from a student was that he was in hamburger business. Ray laughed quietly and said his business was real estate (Kiyosaki and Lechter, 1997: 85). Several people today might still think that McDonald's is in the hamburger business. The land is recorded at the cost and the appreciation of the land is not allowed to be shown on the financial statements. If McDonald's were forced to record the fair value of their land, the figures would tell investors the reality about McDonald's without any need for Ray to say it. The figures would catch a normal person's attention. A person with reasonable skills and talents will question why the value of McDonald's land had high value and keeps increasing. The pattern repeats until a person comes to conclusion that choosing the land was not due to chance. Specific locations have been bought. The person would question what alternative uses could fast food franchises do with land with such value. Are not all assets available for sale? Is management acting in the best interest of the shareholder by not maximizing or providing a return on a material asset? Curiosity might push the person to begin to ask whether McDonald's should be in the hamburger business or real estate business.

The second basic failure is - allocation. Allocation, though arbitrary (Thomas, 1974; see also the *Statement on Accounting Theory and Theory Acceptance* (SATTA), 1977; Al-Adeem, 2017a), characterizes most of financial accounting – depreciation, reporting on inventories, investments, income taxes, pensions, and liabilities. Allocation uses smooth, systematic formulas, such as straight-line and double-declining-balance formulas for depreciation, and the compound interest formula for reporting on liabilities. They are selected at the beginning of the period of allocation. How can issuers have that foreknowledge about events that may occur after they select the formulas? And events do not occur as regularly as the use of the formulas implies (Rosenfield, 2000).

Accountants defend allocation mainly based on realization and objectivity. According to Leonard Lorenson, a past member of the AICPA accounting standards staff: “The real goal of

those who support allocation is to stabilize reported income” (as cited in Rosenfield, 2000: 111). Moreover, Former SEC Chief Accountant Walter Schuetze said: “allocation is used for managing earnings to smooth the hills and valleys of change.”

A remedy? “[T]he best way to abate earnings management is to adopt a different system of accounting” according to Sterling (2003).

4. ROLE OF THE CONCEPTUAL FRAMEWORK IN LEGITIMIZING AND DEVELOPING THE ACCOUNTING PROFESSION

Accounting is a discipline without a theory of its own (Al-Adeem, 2017b; Al-Adeem and Fogarty, 2010; Belkaoui, 2004; Chatfield, 1977; Gaffikin, 1987; King, 2006; Lee, 2009; SATTA, 1977). Practiced accounting is in need for theatrical foundation, though (Archer, 1993; Ijiri, 1967; Maskell, 1955; McCredie, 1957; Wright, 1914). Founding professional accountants’ expertise on a body of knowledge legitimizes their power (Hines, 1989). Without a common body of accounting knowledge from which accounting procedures and methods are deduced, the accounting profession should experience assortment of practices which may be based on incoherent rules, principles and concepts¹.

In addition, businesses are complex and transactions necessitate the emergent of new accounting treatments. Accountants keep inventing and developing new practices and accounting methods to address issues that have not been experienced. Without a fundamental and common belief of how things ought to be thought, accounted for and treated, divergence and dispute among accountants emerge causing inconsistency featuring of practiced accounting. The FASB’s conceptual framework project services as a frame of reference upon which accountants can rely when they face new transactions and issues, which FASB and other organizations existed before FASB, had not addressed. The main goal of the conceptual framework is "to develop concepts useful in guiding the board [FASB] in establishing standards and in providing a frame of reference for resolving accounting issues" (Schroeder et al., 2001: 17). Having a unified frame of reference in accountants' minds while addressing issues assures to some extent homogeneity among them. Accountants should search for solutions from the same point of reference.

Stressing the importance of the conceptual framework Robert Herz, former Chairperson of the FASB, made it clear in his presentation (2005): “...without a framework, standard-setting is based only on individual concepts held by each member of the standard-setting body.”² Similarly, Bullen and Crook (2005: 1) assert: “Without the guidance provided by agreed-upon framework, standard setting ends up being based on the individual concepts developed by each member of the standard-setting body.”

The conceptual framework project developed by the FASB was thought to be finished by 1985 (Gore, 1992); a product of six statements: Statements of Financial Accounting Concepts No.1 (SFAC No. 1): “Objective of Financial Reporting by Business Enterprises” issued in 1978; Statements of Financial Accounting Concepts No.2 (SFAC No. 2): “Qualitative Characteristics of Accounting Information” issued in 1980; Statements of Financial Accounting Concepts No.3 (SFAC No. 3): “Elements of Financial Statements of Business Enterprises” issued 1980; Concepts Statement No. 4 (SFAC No. 4): “Objectives of Financial Reporting by Nonbusiness

¹ For a brief yet a profound understanding of the conceptual framework, see Johnson, 2004

² We thank the FASB Staff particularly Dawn Tosches for sharing the presentation with us after we contacted them to get a copy of the presentation which we got via email on January 15, 2019. We contacted the FASB because we could not locate the slides.

Organizations” issued in 1980; Statements of Financial Accounting Concepts No.5 (SFAC No. 5): “Recognition and Measurement in Financial Statements of Business Enterprises” issued 1984; Statements of Financial Accounting Concepts No.6 (SFAC No. 6): “Elements of Financial Statements” issued in 1985. Several writers (e.g. Kieso et al, 2004; Schroeder et al., 2001) discuss the six statements in a unified fashion, attempting to help readers to vividly observe the connectivity of the conceptual framework and thus to visualize it holistically as one a body of knowledge^{3 4}.

However, over the years more concepts statements were added. In 2000, the Statements of Financial Accounting Concepts No.7 “Using Cash Flow Information and Present Value in Accounting Measurements” was issued. The FASB issues the Statement of Financial Accounting Concept No. 8 (SFAC No. 8) to replace both SFAC No. 1 and SFAC No. 2. Concepts Statement No. 8 titled Conceptual Framework for Reporting- chapter 1, the Objective of General Purpose Financial Reporting, and Chapter 3, Qualitative Characteristics of Useful Financial Information⁵. The project was indeed the longest and the most expensive research program in the history of accounting (Gore, 1992; see also Macve, 1997: 103).

Because professional judgment is what makes accounting a profession and what title accountants to their claimed status in society as professionals (West, 2003; see also Hines, 1989), and because conceptual issues are hardly ever completely settled by accounting authorities (Hendriksen and Breda, 2001: 3), neither does the conceptual framework take professionalism away from accountants nor the conceptual framework neglect the critical role played by the corporate managers and their auditors in preparing and provide attestation of the representation of financial statement to the financial position of enterprises faithfully. Practicing accountants are often obligated to apply their own judgments in abstract issues (Hendriksen and Breda, 2001: 3). Evidently, paragraphs 6 and 7 of SFAC No. 2 state:

Accounting choices are made at two levels at least. At one level they are made by the Board or other agencies that have the power to require business enterprises to report in some particular way or, if exercised negatively, to prohibit a method that those agencies consider undesirable. An example of such a choice, made many years ago but still accepted as authoritative, is the pronouncement by the Committee on Accounting Procedure of the American Institute of Certified Public Accountants that “. . .the exclusion of all overheads from inventory costs does not constitute an accepted accounting procedure” 3 for general purpose external financial reporting.

Accounting choices are also made at the level of the individual enterprise. As more accounting standards are issued, the scope for individual choice inevitably becomes circumscribed. But there are now and will always be many accounting decisions to be made by reporting enterprises involving a choice between alternatives for which no standard has been promulgated or a choice between ways of implementing a standard.

³ For a brief on the first seven statements, see Wolk et al. (2004, ch.7).

⁴ The Concepts Statements are available at the FASB’s website:
<https://www.fasb.org/jsp/FASB/Page/PreCodSectionPage&cid=1176156317989>

⁵ Some accounting writers partially comment on SFAC No. 8 (see Previts and Flesher, 2015; Al-Adeem, 2017a). The reporting entity is also discussed (see for example, Biondi, 2005, 2009, 2011, 2012; Schroeder et al., 2010: 70-71)

In making judgments about the fairness of financial statements on the basis of uniform standard, GAAP provide the auditor with a framework (Schroeder et al., 2001: 15). GAAP are truth for accountants (Kelley, 1951; Previts as cited in Al-Adeem, 2017a: 5). Financial statement are the accountant's means of conveying information that cannot fully reflect the underlying economic reality of the enterprise (White et al., 2001: 1). Like observed phenomena in social sciences, the impossibility of absolute truth (Kerlinger, 1979: 61) if exists (Al-Adeem, 2018a) makes quantification of perceived reality (see Al-Adeem 2017b) in accounting probable, but not certain. Not realizing such a proposition has contributed to the failure of the conceptual framework of FASB as well as other conceptual framework projects (Hines, 1991). Fairness in financial statements are conditional (see Alhumaid, 2009); that is, they are only fair to the magnitude that the principles are reasonable and fair and the statements conform with such principles (Schroeder et al., 2001: 14; see also Monti-Belkaoui and Riahi-Belkaoui, 1996; Williams, 1987). Accordingly, recalling that the fairness of the contents of the financial statements depend on and are conditioned by the fairness of GAAP and knowing that the current framework leaves room for the local auditor and the management, Enron, and Worldcom, both of which were audited by Arthur Anderson, among other scandals the market keeps experiencing may not due to chance. Sterling early in his career criticized GAAP and recognized the negative impact of GAAP, particularly the opportunities that GAAP offer to managers to manipulate the financial statements

5. STERLING'S DISMAY WITH THE CURRENT FRAMEWORK

In their seminal work, Berle and Means (1932: 182-183) argue that accountants fail to set standards partially due to the room in the standards that is left for the faith of those who direct the firm and their accountants⁶. Sterling may agree with such a position. According to the email we received from Sterling (personal communication) on November 5, 2005, Sterling apparently holds a position in "adopting a system that makes the numeral depend on events beyond the control of management." He does not seem a supporter of issuing more accounting rules. Despite the efforts made by Arthur Levitt, SEC Chairman, to prevent managers from managing earnings, experiencing fraud continues, Professor Robert Sterling may notice.

In 1981, Sterling was given the opportunity to draft the Recognition and Measurement phase of the Conceptual Framework. However, the dispute with the FASB members and him about using current prices instead of historical cost as a valuation basis for accounting measurement (Sterling, 2003: V) prevents him from adding it an achievement for him. The argument made by the FASB members against him reminded him, he later commented, with his "elementary accounting text" (Sterling, 2003: V). Education system contributes to the embeddedness of a paradigm (Kuhn, 1992). People who gained in a field of knowledge within an education system gradually, going from the bottom to the top, take what they learn for granted, and believe in the solutions that the paradigm suggests for the issues facing people in that field. It is, thus, difficult for those to see the incompleteness and the deficiency of the proposed solutions and to appreciate the radical solutions proposed by alternative paradigms (Kuhn, 1992). The fear that their expertise would become obsolete may be the reason for the accountants' imposition of an unfamiliar system of accounting (Zeff, 1999: 124). The only thing wrong with those proposed

⁶ Also cited in Hendriksen and Breda (2001: 66) as a secondary source.

solutions, in the eye of those who were nurtured and trained to think as such under certain paradigm, is that those solutions do not belong to the paradigm to which they subscribe. The historical cost paradigm provided cover for those accountants, including some FASB members, from ideological biases, or having a pragmatic, applied or experiential view as to the importance of the qualitative characteristic of relevance of fair value measurements on decision-usefulness in financial reporting. The inclination of historical cost measurement was a concession made by FASB's for the survival of SFAC No. 5 (Kirk 1989: 100-103, as cited in Zeff, 1999: 115; see also Al-Adeem, 2017a).

Contradicting the historical cost principle may have been enough reason to reject fair value measurements despite the benefits that the fair value measurements would bring and possibility its suitability to corporate business model (Al-Adeem, 2017a). According to Previts and Merino (1998: 268), Littleton (1929) put forward that while economists might believe that "the value of asset is determined by supply (cost of production) and the demand (for both consumer and productive goods), accountants need not worry about demand." In Littleton's view (as cited in Previts and Merino, 1998), accountants ought to care with the measurement of the supply. Previts and Merino (1998: 268) commented that, "Historical cost theorists used this rationale to reject all suggestions that accountants measure replacement or reproduction cost, which required a focus on present or future estimates of productivity based on demand."

Writing in 2003, Sterling revealed his unsuccessful attempts in getting sufficient agreement which then made him to decide to leave the Board. Two years later SFAC No.5 was issued. As to SFAC No. 5, Sterling (1982: 104) argues that managers are in need of instruction on changes in recognizing revenue and valuing assets and adjusting for inflation as opposed to worry about abstract and theorization.

6. THE UNSUITABILITY OF THE CURRENT FRAMEWORK TO THE FAIR VALUE MEASUREMENTS AND THE NECESSITY OF DEVELOPING A NEW FRAMEWORK

The FASB conceptual framework was considered a critical element by accounting academics; for example, Wolk et al., (2004) reported that the conceptual framework was thought to be a 'theory' of financial accounting bonded in a document. Defining the conceptual framework as "a coherent system of interrelated objectives and fundamentals that lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements," Kieso et al., (2004: 28, emphasis in original) perceive the conceptual framework as a constitution for the accounting profession

While the conceptual framework may not fully represent a constitution defined as a "body of fundamental principles according to which a State or organization is governed" (Gore, 1992)⁷. Gellein (1988 as cited in Gore 1992: 55) admits that "whilst the need to include objectives, qualitative characteristics and elements was clear from the start, beyond that plans were somewhat uncertain." An example would be the general areas of recognition and measurement were known, but the way in which they were to be fitted together was imprecise (Gore, 1992). Although the conceptual framework covered important issues, "the task of seeking

⁷ Pelham Gore was funded by Price Waterhouse, by the Institute of Chartered Accountants in England and Wales' CATER fund, and by the International Center for Research in Accounting at Lancaster University to conduct a technical analysis for the FASB's conceptual framework. The project was encouraged by Professor Edward Stamp who passed away before the project finished. Professor Stamp was later honored by a book edited by Mumford and Peasnel (1993) to which great accounting writers contributed, including Professor Robert Sterling.

satisfactory to resolve many of them cannot have been helped by evident lack of coherence in its completion” (Gore, 1992: .55).

The embeddedness of the historical cost as the preferred measurement base limits the functionality of the conceptual framework - according to Kieso et al., (2004), the historical cost principle is an implication of the going-concern assumption (see also Sterling, 1968). Nothing has constrained, or arguably damaged, to the development of accounting theory like what the going-concern axiom has done (Professor Helmy Nummer as quoted in Shahattah 1987:41). “[T]he historical cost principle would be of limited usefulness if eventual liquidation were assumed” (Kieso et al., 2004: 37). Under valuation bases other than historical cost principle, the business enterprise is assumed to be in liquidation state.

Evidently, although the historical cost is a principle for valuation, using fair value to record and report information is increasing (Kieso et al., 2004: 38). Using the fair value reflects the accuracy of Sterling’s (1982) argument that managers and practitioners are interested in such a valuation basis.

Evaluating and diagnosing of FASB’s conceptual framework, Sterling (1982) suggested that the current framework has skipped the second step in building a framework concerning interconnection between concepts and the conclusions about specific practices. Specifically, [he] (1982: 106) criticized FASB for using history as guide, while the FASB should have honed the concepts “to make them logically fertile.” Speculatively, FASB might have been under the pressure to “try to use the concepts as premises for reasoning to specific practice standards without providing the logical connections” (Sterling, 1982: 106).

The constant development, for example the issuance of SFAC No. 8 which characterizes the transition from conventional and *conservative* financial accounting thought (see Merinon, 1993) to reflect a more *pragmatic* approach to contemporary financial accounting thought, that possibly validates arguments made by *accounting thought reformers*. What was not acceptable during the time of Professor Williams Paton regarding the entity theory as a reporting entity in corporate reporting (see Paton, 1922; Previts and Merino, 1998: 213; Al-Adeem and Fogarty, 2010:24-25; Merino, 1993) has been mandated by the FASB, a professional organization leading the accounting profession, making one to believe such a transition in the financial accounting thought can be metaphorically labeled as a *paradigm shift*. In the same token, Professor Paton’s realistic natural surroundings led him to express dissatisfaction and regretted calling for the use of historical cost in 1940 monograph he coauthored with Professor Ananias C. Littleton to the extent that Professor William Paton wished for the thesis to be put-out of print. Disclosures about fair value of financial instruments mandated the Statement of Financial Accounting Standards No. 107 strengthens the argument that historical cost, although an objective value measurement that can be verifiable, may need meet the characteristic of relevance for users of financial statements. In fact, reporting historical cost for such assets may be misleading and in violation of Rule 203 of the Code of Professional Conduct of the American Institute of CPAs, or AICPA. To generalize, corporate reporting may need to be forward oriented as opposed to be backward (Al-Adeem, 2017a; for on forward accounting see Kohler, 1963),

Arguably, constructing a framework based upon historical cost and observing practitioners who prefer and use fair value as their basis for valuation create a contradiction within the accounting discipline. The discipline cannot afford living in such a contradiction. Therefore, user needs call for a framework compatible to business models whose material assets reflect human capital, intangibles, trademarks, customer lists, and analytical data history and branding. Because of some material deficiencies from which the current framework suffers, it is

not shocking news then to see when FASB has chosen to accept, when applying GAAP to be misleading to allow/permit fair value measurements. Working on a new framework may be the appropriate step because implementing the fair value measurement must be within a suitable framework so that contradictions will not occur.

In 2005, the FASB and The International Accounting Standards Board (IASB) work jointly on a conceptual framework. The new framework considers relevance as an essential qualitative characteristic. Confirming or correcting previous evaluations (confirmatory value) is one of characteristics that should be met so that the information is considered relevant. The confirmatory value substitutes the feedback value that the current framework requires.

Faithful representation requires enhancing characteristics of completeness, verifiability and neutrality. Sterling identified the severe problems that “muddy language” has caused (2003: VI). According to Sapir-Whorf (1956 as cited in Sterling 2003: VI), “muddy language is productive of error.” It is good that the Boards recognized and worked on solving problems existed in the current framework.

However, the FASB/IASB joint project on the conceptual framework has not yet been realized. In an update giving by James Leisenring, a FASB member in 2012⁸ the bodies could not agree upon an approach to enable them to define the elements of the financial statements⁹. The bodies attempted both known approach: the asset/liability approach as well as the revenue/expense approach (see Al-Adeem, 2017; for analysis and critique on two approaches see Biondi et al. 2014).

7. POSSIBLE CONSEQUENCES OF IMPLEMENTING THE FAIR VALUE MEASUREMENTS

Chambers and Wolnizer (1991: 197) conducted a historical study that examined the verbal usages of “true and correct” -- which was later changed to “true and fair.” Their study covered a period up to 1844. In their investigation, they included both “the range of terms used to signify the duty to ensure that accounts were public bodies and business firms” and “relevant clauses of partnership agreements” (198). The premise was that since “legal documents and legal practice rely heavily on precedent...there would be identifiable usages of terms like ‘true’, ‘correct’ and ‘fair’ prior to the middle nineteenth century” (198). The study findings point toward “the idea that true accounts should be kept and true periodical summaries should be survived” (211). Accordingly, truthful records and summaries that consist with “dated facts” protect members of companies and other parties (211).

Giving that “the basic conditions of commercial intercourse have not changed in the past 150 years” (Chambers and Wolnizer, 1991: 10), the question posed: why fair value was relevant in the past while now accountants resist against implementing such a measurement? Probably because in the past, investors, whether in public firms or in partnerships, acted as owners. That is to say, investors were active and cared about their investments. They guarded and watched for their investments. The traditional saying, “guard your sheep” might have been present in minds

⁸ In a presentation given at the 2012 mid-year meeting of the Financial Accounting Reporting Section American Accounting Association in Chicago, the United States of America.

⁹ Currently the IASB is revising its Conceptual Framework for Financial Reporting. The intended effective date for mandating it is January 1, 2020. A summary of the project is available via: <https://www.ifrs.org/-/media/project/conceptual-framework/fact-sheet-project-summary-and-feedback-statement/conceptual-framework-project-summary.pdf>

of newly exposed individuals to investment opportunities in corporate model of business. Guard that belongs to you did not go way from them. They might have been using this traditional saying in their daily life, while they were at the same time investing their money in public businesses or joint ventures. Today, an average investor has a job and 'hires' an agent to invest their 401(k) in the capital market. They may choose a mutual fund, to invest on their behalf which may elevate the agency issue to yet another tier (see Bricker and Chandar, 1991). Because of the transition from financial capitalism to managerial capitalism, investors might not perceive investing in the capital market as a joint venture with managers who run giant corporations. In the current era of international or global capitalism, the perception of shareholders toward multinational corporations where their money invested may have been even departed even more from where they were in guarding and standing to protect their capital. This is especially a concern in a corporate world where maximizing the shareholders' value in a "myth" (Stout, 2012).

Fair value measurements are hoped to encourage investors to actively participate in corporations. The new measurements potentially weaken the excuse that financial reporting is complicated and that the language which auditors use is not easy for many individuals. Interested investors can consult with them to decide upon the accuracy of the fair values provided by managers and audited by auditors. Communicating those specialists should not be difficult to the investors. The language used to communicate is, at least, easier than the language used among auditors, for example GAAP and the standards proposed by FASB. The ability to validate values with an independent professional valuation (other than the one that the management consulted with) provides sort of trustworthiness that may not be available when relying on an opinion which, according to Al-Adeem (2015), is prepared by a party that appears as independent while this party may not be able to be independent in fact due to the surrounding of this party's existence in corporate settings (see also KPMG, 2004, as cited in Sanchez, et al., 2007: 259).

Another consequence would be on the major player—the auditor. Auditors will have to know how to make sure the evaluation is done properly. Valuation is not a new concept. Menelaides et al. (2003) prescribes how the auditor applies SAS 101 [which deals with fair value]. SAS 101 "addresses considerations relating to the measurement and disclosure of assets, liabilities and specific components of equity presented or disclosed at fair value in financial statements" (Grego and Zollo, 2003: 38). Auditors need to assess the appropriateness of the valuation model used for estimating the fair value of an asset even when management relies on valuation specialist to prepare the estimate (Menelaides et al., 2003). In addition, other source for learning are the accreditation program offered by the AICAO for CPAs who specialize in business valuation in addition to professional valuation services offered by many CPA firms (Menelaides et al., 2003: 74-75). Even if the auditor cannot perform valuation him/herself, the auditor can still consult with professional valuation specialist while implementing SAS 101 (Grego and Zollo (2003: 38).

To survive within fair value measurements environment, the auditor must know and to gain specialized knowledge which will be the key driver to have clients. Put differently, the movement toward fair value requires auditors to know about the industries of clients which ultimately pushes auditing toward specialization. Auditors should be allowed to advertise for their services similarly to valuation professionals and brokers because auditors will be in a market and this market is mature enough to punish those who do not play properly. No criteria or standards to which auditors can depend upon within the new system. Auditors can no longer use the phrase that "according to GAAP" or "comply with GAAP" to justify their lobbying with the

management. The mask that auditors have been wearing for years will be removed. Investors will change their perceptions about auditors.

The new view is the root and origin of the auditor work --- Fair value was, according to Chambers and Wolnizer (1991), the precise task for auditors in the past. Chambers and Wolnizer (1991: 197) reported that c.84 of the UK Joint Stock Companies Act 1844 stated, "The auditors were required to state whether in their opinion 'the balance sheet is a full and fair balance sheet...properly drawn up to exhibit a true and correct view of the state of the company's affairs.'"

The fair value measurements call for a new party to take part in corporations. According to Menelaides et al., (2003), managers tend to engage with outside specialist to prepare fair value measurements although managers are not required to do so. The willingness to obtain objectivity is what motivates and drives managers to consult with outside specialists (Menelaides et al., 2003). Four parties will exist: managers, auditors, fair value specialists and shareholders in addition to other parties that already participate in the modern corporate firm (e.g. board of directors). The new party already exists as a profession. The American Society of Appraisers provides testing and accreditation in several disciplines including business valuation. Its members follow "uniform standards of professional appraisal practice, which are recognized in the United States as generally, accepted standards of professional appraisal practices" (Menelaides et al., 2003: 74). Valuation professionals are available in the market, even in emerging markets. For example Saudi Arabia valuers and assessors have been organized as professional and have been licensed and regulated by a newly established organization, the Saudi Authority for Accredited Values (TAQEEM)¹⁰.

While managers arguably [or hypothetically] can force auditors to create a coalition with them (Al-Adeem, 2015, 2018b), it might be theoretically difficult for managers to force or even attract both the valuation professionals and auditors to cooperate with them and create a grand coalition, which might not be in the best interest of shareholders. The difficulties of creating such a coalition is born because the more the parties are involved the more conflict of interests and thus the more complicated the game becomes on managers to play. It is argued that even attracting the valuation professionals alone to cooperate with managers is not as easy as to force auditors. Auditors survive on doing audit for corporations. The desire to survive is more obvious with Big Audit Firms which are in tremendous need to do audit to giant corporations especially after passing the Sarbanes-Oxley Act (Al-Adeem, 2015, 2018b). On the other hand, valuation professionals are in a market and supply their services to various types of clients, one of which are corporations. Losing clients might be a heavy cost and the fear of being out of business might be a serious consequence that would restrict and prevent valuation professionals from cooperating with managers. Further, even if the valuation professional whom the management consults with lobbied with it, it is unproblematic to shareholders to validate and confirm the fair values by simply check with other specialists.

8. CONCLUSIONS AND CLOSING REMARKS

The success of the fair value measurement depends on several factors. Such attainment is conditioned by the extent to which a new framework fulfills the role of a constitution; and its success contingent upon clarity within the new framework which is conditioned by the clarity of

¹⁰ Information of the organization available via this link: <http://taqem.gov.sa/about/Pages/aboutus.aspx>

the language that is used. Thus, it is up to an accounting board, considering developing a conceptual framework, to determine the magnitude of the success of the fair value measurements. Sterling (2003: VI) suggests that abandoning “linguistic legerdemain and use clear language to state our thoughts as precisely as possible” will “result in a significant improvement in the formulation of our ideas as well the debates about and discussion of those ideas.”

Moreover, unlike the historical cost measurements, the fair value measurements are practically attached to economic reality. Communicating valuation specialists is not as difficult as reading a 10k and other corporate reporting which is difficult due to the need for specialized knowledge (see West, 2003). Opportunity knocks for investors to take part in guarding their investments. It will be up to the investors to play an active role the corporate setting by not letting managers and auditors play it alone under the mentorship of the board of directors and its committees who may not be as thought to be in fulfilling their role (see Adelpo, 2012: 2; Al-Adeem, 2015; Fogarty, 2003; Healy and Wahlen 1999 as cited in Nelson et al. 2002: 176; KPMG 2004 as cited in Sanchez et al. 2007: 242)

Valuation professionals have a critical role to play in the new accounting systems. They ought to work for those who hire and pay them (investors, especially the shareholders). Acknowledging that “absolute ‘truth’ is forever impossible” (Kerlinger, 1979: 61), those professionals are not required to come up with the precise fair values for all items. The limitation of the impossibility of agreeing on fair value should not be held against the new system because according to Mr. Jones (as cited in Jopson, 2006), “There are huge problems with fair value. But there are also huge problems with historic cost.”

The fair value is an economic oriented approach. Along with the other approaches available, investors should be able to have a better idea about their investments. Those approaches can be viewed as attempts for determining the resources that are available for investors and the obligations on those resources. Therefore, by considering the variety of perspectives (approaches), investors possess now different lenses to view their investments from different angles which will increase their knowledge about corporations. This change will ultimately benefit investors.

In closing, Professor Robert Sterling’s understanding of the necessity and the role of the conceptual framework in developing financial accounting theory and the importance of the framework for the practitioners justifies deeming him a *contemporary reformer in the development of accounting theory*. Some of his early writings (e.g. Sterling 1975, 1981) demonstrate his clear distinction as well as preference on the basis of relevance between historical cost and current value. Throughout his intellectual voyage and wrings he never virtually lost sight on what he was calling for. The IASB prompts relevance over readability as primary characteristics for corporate reporting signifies the credibility of his scholarly and profound understanding. Participants in the market are best serviced by forward accounting where the emphasis is on relevant information for decision makers.

This paper was first ‘presented’ in 2006 while Professor Sterling was available for a conversation/communication; obviously, this paper is now submitted after his passing. We wish that this article serves as testimony for generations yet to come of his contribution as to the critical role that relevance contributes to decision-usefulness in financial reporting. Other accounting writers have addressed roles he has played and highlighted his character as well as achievement during his life as a scholar (e.g. Chambers, 1997) as a teacher and mentor (e.g. Johnson, 1997) as an administrative (e.g. Windsor, 1997) and at the FASB (e.g. McBeth, 1997;).

and as a deceased scholar (Lee and Wolnizer, 2012); yet is alive with us with printed thought.

It is believed that what has been written thus far insufficient for understanding his views. He himself admitted that for a quarter of a century of contributing to accounting and the development of accounting thought and clearing his position and the ground he was basing his views, he had to continue writing on the same viewpoint wishing that after 25 years he was understood (see Sterling, 1988). The *Quest for a Science of Accounting* combined by (Lee and Wlnizer, 1997) contained a collection of Professor Robert Sterling in one volume.



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