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AN ECONOMIST VIEW ON ACCOUNTING ETHICS

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1. Moral Reasoning of an Accountant

George Oliver May¹ is said to have been often reluctant to judge any financial information as “true” or not. To May, financial information was only as reliable as the integrity of the people releasing it, because accounting was an imperfect art based on artificial constructs of time, such as a quarter, a half or one year, that bore little resemblance to how companies made profits².

Reacting to infamous accounting scandals such as Enron, WorldCom, and Tyco, the National Association of State Boards of Accountancy proposed in 2005 that educational institutions for accountants should include two stand-alone courses in ethics, one related to general business dilemmas and the other focused on specific accounting topics.³ Whether the decision is coerced by his superior or motivated by “creative” ideas of the accountant himself, certain associations can be assumed between ethical reasoning and epistemological beliefs in the context of accounting practices. Accounting professors conducted an investigation of the relationships between moral reasoning and epistemological beliefs in an accounting context using a sample of 140 senior accounting students in Mid-western U.S. universities.⁴ The students were given 63 evaluative statements⁵ in Schommer questionnaires and their answers “yes” or “no” were scored and statistically handled to calculate scores of each student. The study attempted to assess the students’ epistemological beliefs by applying Schommer questionnaires.⁶ The study was also based on a premise that moral development stages could be tested through examining the subjects’ epistemological cognition of a certain situation, drawing upon the Kohlberg’s six-stage theory for a model of moral development.⁷

Examining the test results, the authors concluded that there was no significant association between accounting students’ moral reasoning and their epistemological belief.⁸

Gary Frank *et al.* argue that while Kohlberg’s model is widely applied in studies of development of accounting ethics, it has inherent limitations, because, “as Kohlberg himself pointed out, most individuals

¹George Oliver May (1875 – 1961) was a British born accountant to become an American citizen in 1909. He acquired senior partnership of Price Waterhouse & Co. (then Jones, Caesar & Co.) in the United States office in 1911 and held that position until his retirement in 1940. He is often referred to as a British father of American Accounting.

²Brewster, Mike, *UNACCOUNTABLE How the Accounting Profession Forfeited a Public Trust* (John Wiley & Sons 2003), p.68

³The proposal states :”Substantial support exists for inclusion of an ethics requirement
”http://www.nasba.org/files/2011/04/Education_Framework-16Jan06.pdf

⁴Mintchik, Natalia M., Timothy A. Farmer “Association Between Epistemological Beliefs and Moral Reasoning: Evidence from Accounting”, *Journal of Business Ethics* 2009, 84: pp.259-275

⁵The examples of such statements are: (1) Knowledge acquisition is a gradual process which requires time. (2) Effective knowledge acquisition includes integration. (3) Ability to learn is a skill rather than a talent. (4) Knowledge acquisition includes learning how to handle ambiguous situations. (5) Single answers and truths rarely exist. (6) Concentrated effort is not a waste of time. (7) Social authority is the primary driver of knowledge acquisition. (8) Knowledge is uncertain, socially constructed and changing phenomenon. (9) Effective acquisition of knowledge is positively associated with the hard work. (10) Knowledge acquisition assumes the critical evaluation of knowledge sources. (11) People are able to learn how to learn. (12) Learning is the life-long process.

⁶Marlene Schommer-Aikins is probably one of the most “productive” educational psychologists in the field of “fact finding research” of epistemological beliefs, comprehension, ways of knowing things and so forth. She statistically analyses the answers to the questionnaires, which are given to the subjects of analysis. The answers are scored and the scores of the answers are interpreted as signifying the subjects’ degree of understanding and beliefs.

⁷This well-known theory holds that the basis for ethical behavior has six identifiable developmental stages: 1. to avoid the rule-break which may result in punishment and physical damage, obedient to the rule for its own sake; 2. to follow a rule only when it is to someone’s immediate interest; 3. to live up to what is expected by people close to him or what people generally expect in his role; 4. to fulfill the actual duties to which he has agreed. Laws are to be upheld; 5. to be aware that people hold a variety of values and opinions that most values and rules are relative; and 6. to follow self-chosen principles, whether they are laws or social agreements or philosophical principles which he believes as valid. (Kohlberg, Lawrence, *Essays on Moral Development Volume II, The Psychology of Moral Development*, New York: Harper & Row, 1984).

⁸Mintchik, Natalia M., Timothy A. Farmer, *op. cit.* p.267

never move beyond the law and order stage”.⁹ An ethical education for future accountants should aim at overcoming this limitation and become a force for development of the level of moral reasoning higher than simply observing rules and legal codes. They propose, drawing on an essay by S. M. Mintz,¹⁰ to develop moral reasoning ability through reflexively learning virtue ethics. They place an emphasis on ethics of accountants rather than on accounting ethics. They conclude that accounting students are immature in a Kohlberg sense, groping uncertainly, barely attaining the stages 3 and 4. It is unlikely for individuals to attain higher moral reasoning ability until their late 30’s or beyond, that will be achieved as a result of life experience. Therefore, teaching a future accountant business ethics is a quandary.¹¹

2. Corporation and Accounting Ethics

Most of the firms which employ accountants are incorporated artificial (or legal) persons, which are legally granted exclusive rights and control over the property belonging to them. The property consists of income and loss (negative income), which are of flow concepts, and assets and liabilities (negative assets), which are of stock concept. In accounting terms a firm should be a going concern, i.e., an entity that continues to “live”. In so far as losses are covered with credits from others and the ratio of liabilities to assets is so regarded by others that the ratio is still good enough to withstand further borrowings, the firm will continue to be a going concern. When others judge that the loss is so huge and the ratio of liability to asset is so high, that it is too risky to provide further credits with the firm, it loses solvency and ceases to be a going concern. This is the state, which is commonly called bankruptcy.

In a formal sense the firm is owned by its stockholders and managed by its fiduciaries. In modern corporations, however, there exists anonymity in the relationships between the two and as a result the fiduciary duty of the management becomes fictional.¹² Consequently, both formal owners of the firm and its fiduciary bodies lose their identity. “Ethics is not missing from corporate life, but it can be obscured or marginalized by the character of the [modern] corporation itself,”¹³ The unethical corporate practice is a consequence of the modern corporation’s self-concept rather than of bad intentions or faulty judgments. Dennis Dunchon and Brian Drake argue that the lack of corporate identity induces a firm to indulge in collective narcissistic identities. Although a reasonable amount of healthy narcissism encourages an individual to perceive his needs and desire to be balanced with others, excessive narcissism makes an individual egoistic and conceited. It is further argued by the authors that “a narcissistic identity predisposes the organization toward unethical and illegal behavior.”¹⁴ It is a worthwhile function for an organization to focus on such external goods as profits and corporate reputation, but the inclination toward those external goods is allowed only to the extent necessary for the sustenance and development of the practice. However, “[t]he extreme narcissist so much desires external goods that it will behave unethically to obtain them.”¹⁵

3. ACCOUNTING AND ORGANIZATIONAL NARCISSISM

The above argument is augmented by Joel H. Amernic and Russel J. Craig that accounting practices tend to facilitate an extreme organizational narcissism because of the imprimatur of generally accepted accounting practices (GAAP), certification by auditors, and the putative reform attempts by the accounting profession and regulatory authority.¹⁶ The accounting language has three salient communication and

⁹ Frank, Gary, Emeka Ofobike and Suzanne Gradisher, “Teaching Business Ethics: A Quandary for Accounting Educators”, *Journal of Education for Business* 85: 2010, p.134.

¹⁰ Mintz, S. M. “Accounting ethics education: Integrating reflective learning and virtue ethics”, *Journal of Accounting Education*, 24, 2006.

¹¹ Frank, Gary, Emeka Ofobike and Suzanne Gradisher, *op. cit.*, p.138

¹² Berle, Adolf A., Jr., Gardiner C. Means. 1939. *The Modern Corporation and Private Property*. New York: the Macmillan Company, Book I Chapter I and Book II Chapters IV to VI.

¹³ Dunchon, Dennis, Brian Drake. “Organizational Narcissism and Virtuous Behavior”, *Journal of Business Ethics* 2009, 85:301-308, p.301

¹⁴ *Ibid.*, p.304.

¹⁵ *Ibid.*, p.306. Such terms as “external goods” and “practice” are used in the context of MacIntyre, Alasdair, *After Virtue—a study in moral theory*—1985 Duckworth London. Also refer: Moore, Geoff, “RE-IMAGING THE MORALITY OF MANAGEMENT”, *Business Ethics Quarterly*, Vol.18,Iss.4

¹⁶ Amernic, Joel H., Russel J. Craig. “Accounting as a Facilitator of Extreme Narcissism”, *Journal of Business Ethics* 2010, 96:79-93

governance roles. The accounting language evaluates the executives' remuneration in terms of ROI, market value of the company and earnings per share of the company stock; it endows an executive with the power to exert significant influence over the corporate policies; and an executive can set the "tone at the top" and influence ethical attitudes of the firm through exercising the financial accounting language.¹⁷ When a corporate executive sets the corporate goal at achieving high market value and profits per share of the company stock rather than at being socially responsible entity, the firm acquires destructively narcissistic traits. Once the tone at the top is set, the employees not only mirror the behavior of their leaders, but also are prompted to collaborate with their leaders to achieve the pre-set goal.

A business organization is classically defined as follows.

An organization comes into being when (1) there are persons able to *communicate* (emphasis added) with each other (2) who are willing to contribute action (3) to accomplish a common purpose.¹⁸

The accounting language provides business organizations with the most powerful means of communication. It appears objective and persuasive because of its quantitative nature. It asserts authority as it involves such a process as auditing and approving accounting documents. The epistemic context that underlies the terms of this language, however, is logically constructed but its nature is intricate. Some of the terms of this language could allow a variety of epistemic inferences. Take "profit", for example. A simple definition of profit in economics is that it is an excess of the receipts over the spending of a business in a specified period of time.¹⁹ In so far as we live in a society dominated by what economists refer to as "real economy", where money simply plays a role of the means of exchange and its function is nothing but a veil covering real economy, the term profit can be defined as an excess of the receipts over the expenditure in a period. However, the actual economy in which we live is not a real economy but a monetary economy. In a monetary economy the concept of profits has to be extended to cover such earnings as resulting from credit transactions and asset revaluations as well as cash transactions and changes in holdings of real as well as financial assets. In spite of such a broad extension of the concept of profits, the framework of value has to be consistent with respect to both real and monetary economy.

4. Economic Value

It is generally interpreted that money provides a quantitative unit of value, just as yard and pound are the quantitative units for physical length and weight*. Money has been traditionally regarded and still is regarded as a unit to measure the value of goods, services and assets. In comparison to the physical units such as weight and length, which are so rigorously defined as measured in terms of the weight of carbon atom and velocity of light, the basis for the measurement unit of value of goods, services, and assets appears to be weak and spineless. For a just society the measurement unit of value should not be arbitrary and without backbone. Economics has a long tradition to define the measurement unit of value. It began with the labor theory of value, advanced by Adam Smith in a rudimentary form and later elaborated by David Ricardo.

"A man is rich or poor", says Adam Smith, "according to the degree in which he can afford to enjoy the necessaries, conveniences, and amusements of human life." Value, then, essentially differs from riches, for value depends not on abundance, but on the difficulty or facility of production. By the invention of machinery, by improvements in skill, by a better division of labour, or by the discovery of new markets, where more advantageous exchanges may be made a million of men may produce double or treble the amount of riches, of "necessaries, conveniences, and amusements," in one state of society that they could product in another , but they will not on their account add anything to value; for everything rises or falls in value in proportion to the facility or difficulty of producing it, or in other

¹⁷ *Ibid.*, p.81.

¹⁸ Barnard, Chester I. *The Function of the Executive*. 1938/1968 Harvard University Press, p.82.

¹⁹ Black, John, *Oxford Dictionary of Economics*, (1997, Oxford University Press), p.373.

*SI=Système International d'Unités (International System of Unit) defines that the amount of substance is proportional to the number of mole, which is defined as the amount of containing equal number of elementary entities as there are atoms of 0.012kg of the isotope carbon¹². SI also defines the unit of length or meter as the distance covered with the light in the 1/299,792,458 second of time. (*Chronological Scientific Table*, 2008. edited by National Astronomical Observatory, Tokyo: Maruzen Co., Ltd., p.353.)

words, in proportion to the quantity of labour employed on its production.²⁰

The labor theory of value is valid even today as a rationale for the cost of production and the value of a product. It cannot serve, however, as a rationale for the exchange value, which is determined through an interaction of demand and supply of goods, services and assets exchanged in the market. The labor theory of value as a rationale for an exchange value has been totally replaced with the marginal utility theory, which was advanced by Karl Menger, Stanley Jevons, and Léon Walras. The marginal utility theory is based upon the subjective perception of utility by a consumer and it tends to decrease as consumption increases. This psychological tendency of a consumer was named the law of diminishing marginal utility.

The want which we have for things, or the utility which things have for us, diminishes gradually as consumption increases. The more a man eats, the less hungry he is; the more he drinks the less thirsty. The more hats and shoes a man has, the less need he has of a new hat or a new pair of shoes.²¹

The term value signifies two different things: it expresses the utility of some particular objects and at the same time it expresses the power of purchasing other goods which the possession of that object conveys and the latter meaning is referred to as the exchange value.

The value, that is the exchange value, of one thing in terms of another at any place and time, is the amount of that second thing which can be got there and then in exchange for the first. Thus the term value is relative, and expresses the relation between two things at a particular place and time.²²

The consistency between the value of utility and the value of exchange can be maintained *when and only when the supply of goods, services and assets is sufficiently elastic in response to both increasing and decreasing demand*. Increasing demand pushes the exchange value higher; a higher value affords an incentive to increase the supply; and an increase in supply will bring the rising exchange value back to equilibrium. If the supply is inelastic vis-à-vis increasing demand, the exchange value will nominally go up, absorbing the excess demand in the nominal increase of exchange value. If this phenomenon takes place with respect to the markets of all goods and services symmetrically and simultaneously, it is a phenomenon called price inflation, which does not, however, disrupt the consistency between the value of utility and the value of exchange. In so far as the price increase is symmetric, it is a monetary phenomenon, in which money simply plays a role of the means of exchange and the real economy will remain unaffected. However, if price increase of goods and services in a particular market takes place asymmetrically against other markets, the consistency between the value of utility and the value of exchange in the economy as a whole cannot be maintained. Economics theories assume that the price elasticity is homogenous in general and on the average with respect to all the items of goods and services in the market as a whole. In practice as well this elasticity homogeneity is assumed to prevail provided that the market is free and supply reacts to demand steered by price incentive or disincentive. The price index is an index of the prices of goods and services of period t , $t+1$, $t+2$ and so forth and it is calculated on a basis of the prices of the base period as 100, which economists call "bench mark". The prices of each period are weighted with the total values of the goods and services purchased in the period. If the index refers only to retail prices, it is called the consumer goods price index and if it refers to all the goods produced, including investment and government purchases as well, it is called GDP deflator.

The price index is based on a flow concept of goods and services and it does not cover the value of exchange of assets, such as securitized corporate stocks and realties. Other indices have been devised to accommodate the value fluctuations of assets, such as Dow Johns Industrial Average of the U.S. and Urban Land Price Index published by Japan Real Estate Institute. However, the change in those indices of assets, which are of stock concept, is not reflected in the GDP deflator, which is derived from the flow.

5. YARDSTICK OF VALUE

One of the most cumbersome questions, which bothered John Maynard Keynes, when he wrote *The*

²⁰ Ricardo, David, (1821/1911), *The Principles of Political Economy and Taxation*, (Everyman's Library 1962), p.182.

²¹ Walras, Léon, (1874/1926), translated by Jaffé, William, *Elements of Pure Economics* (1977, Fairfield: August M. Kelly), p.461.

²² Marshall, Alfred. *Principles of Economics, Eighth Edition*. 1922 London: Macmillan and Co., Limited, p.61.

General Theory of Employment Interest and Money, was the choice of units with which to measure economic quantity. The Keynes's struggle with the choice of economic unit has settled into money and labor.

It is my belief that much unnecessary perplexity can be avoided if we limit ourselves strictly to the two units, money and labour, when we are dealing with the behaviour of the economic system as a whole; reserving the use of the units of particular outputs and equipments to the occasions when we are analysing the output of individual firms or industries in isolations; and the use of vague concepts, such as the quantity of output as a whole, the quantity of capital equipment as a whole and the general level of prices, to the occasions when we are attempting some historical comparison which is within certain (perhaps fairly wide) limits avowedly unprecise and approximate.”²³

By using money and labor as the unit to measure the aggregate economic quantity of a national economy Keynes has succeeded to shed some light on the quantitative relationships between aggregate effective demand and general level of employment. However, Keynes's explanation on the functional relationships among and between interest rates, liquidity preferences, level of investment and savings mostly remained vague, complicated, and even confused. It was J. R. Hicks, who unraveled the entangled argument of Keynes, advancing the *IS-LM* analysis.²⁴ The *IS-LM* model has acquired a wide acceptance by the economic academism and became one of the standard analytical tools introduced in the textbooks of macroeconomics. However, John Hicks himself had the following to say, almost half a century after his publication of the *IS-LM* Model.

The relation which is expressed in the *IS* curve is a flow relation, which (as we have seen) must refer to a period, such as the year we have been discussing. But the relation expressed in the *LM* curve is, or should be, a stock relation, a balance-sheet relation (as Keynes so rightly insisted). It must therefore refer to a point of time, not to a period. How are the two in the fitted together?²⁵

Economics asserts that value concepts of asset or stock and income or flow can be converged through a capitalization rate technique, provided that there is no speculation on assets. Capitalization rate is defined as the ratio between the net operating income produced by an asset and its capital cost or the original price paid to buy the asset plus interest. Suppose, for example, one purchases a house at \$500,000, the useful life of which is 50 years. He arranges a loan, in which both interest and principal should be repaid in equal installments once every year for 50 years at a fixed interest rate of 8% p.a. For simplicity sake it is assumed that no repair cost of the house is involved and the present value of the house is equal to its future value. Under these conditions it is calculated that an annual repayment of interest and principal will be \$41,743 and the total repayments of principal and interest in 50 years will be: $41,743 \times 50 = \$2,087,150$.²⁶

If he rents this house and obtains rental income (flow) of \$3,479 every month for 50 years, the value of stock (house) is said to be in equilibrium with the value of flow (rent). Suppose, then, the case that he sells the house, 50 years after the purchase, at \$1,000,000, *ceteris paribus*, and deducts the capital gain of \$500,000 from the total repayments of principal and interest in 50 years, the rent that equilibrates flow and stock will be reduced to \$2,645. In a pure theory of economics capital gain should not be included in income. Economics presupposes that capital gain or loss is shared by all the economic entities in real terms provided that the market is freely competitive. In this particular case, if the capital gain of \$500,000 is known to the renter *ex ante*, the renter will charge \$2,645 monthly from the beginning. In actuality, however, the future value of his house is not known to him or more precisely speaking, there is uncertainty with respect to the future value of his house.

“[P]eople are likely to include in their view of income any capital gains they earn. Capital gains are increases in the value of assets, and accordingly do not represent production (output) in any way. The national income accounts used to calculate GDP, which are designed to focus on the production of

²³ *ibid.*, p.43.

²⁴ Hicks, J. R. “Mr. Keynes and the “Classics: a Suggested Interpretation”, *Econometrica*, 1938 Vol. V, p.153

²⁵ Hicks, John. “*IS-LM*: an explanation”, *Journal of Post Keynesian Economics*, Winter 1980-81, Volume III, No. 2, pp.150-151

²⁶ MS Excel PMT function was used with parameters; interest rate =0.08, number of payments=50, present value=\$500,000, and future value=\$500,000.

goods and services, do not include capital gains.”²⁷

A cause of such “misunderstanding” as including capital gain in the income may be psychologically explained as follows. Psychologists have shown that people’s decisions in ambiguous situations are influenced by whatever available anchor is at hand. When you must come up with an estimate, and you are unsure what to say, you take whatever number is before you. Amos Tversky and Daniel Kahneman demonstrated this tendency clearly in an experiment involving a wheel of fortune.²⁸

In the above hypothetical case of renting a house “whatever available anchor” at the beginning of his business is the present value of his house and if his capital gain is \$500,000 in 50 years, such a gain will be taken as his “windfall benefit”. A somewhat more sophisticated expression for the windfall benefit is “reward for risk-taking”.²⁹

6. TWO-FOLD DIFFICULTIES TO SET ACCOUNTING STANDARDS

The difficulties to set up accounting standards are two-fold. First, the present world finds it considerably difficult to establish the measurement unit of values, which can be applied both to values in exchange and value in use with ethically acceptable consistency. Contemporary sociologists define “social institution” as referring to complex social forms that reproduce themselves such as governments, the family, human languages, universities, hospitals, business corporations and legal systems³⁰ Money is certainly a social institution in this respect and the origin of this institution was the division of labor. With a full development of the division of labor “[e]very man thus lives by exchanging, or becomes in some measure a merchant, and the society itself grows to be what is properly a commercial society.”³¹ The difficulty comes from the fact that a demarcation line between the deposits of money used for the purposes of industry and those used for the purposes of finance is getting increasingly unclear. Furthermore, the balance between the two has been almost entirely lost with the phenomenal development of the so-called computerized “megabyte money” which circulates around the world in a great magnitude at the speed of light.

“[A] division between the deposits used for the purposes of Industry, which we shall call the *Industrial Circulation*, and those used for the purposes of Finance, which we shall call the *Financial Circulation*. By *Industry* we mean the business or maintaining the normal process of current output, distribution and exchange and paying the factors of production their incomes for the various duties which they perform from the first beginning of production to the final satisfaction of the consumer. By *Finance*, on the other hand, we mean the business of holding and exchanging existing titles to wealth (other than exchanges resulting from the specialization of industry), including Stock Exchanges and Money Market transactions, speculation and the process of conveying current savings and profits into the hands of entrepreneurs.”³²

What is quoted above is a classical interpretation of the function of money and a majority of economists believe that it is theoretically correct. However, the reality today of megabyte money is as described below and this quotation refers to a situation in 1991 and the scale must have been swelled many times greater in 2012.

The speculative markets now dwarf the “real” markets. For example, Kenichi Ohmae, the economist who heads McKinsey & Company’s Tokyo consulting practice, estimates that \$20 billion to \$25 billion is exchanged every day in the world’s foreign currency markets to cover global trade in goods and services. The huge figure is more than enough to account for all the Toyotas shipped from Japan to the United States and Europe, all the disk drives shipped from San Diego to Tokyo, and all the airline seats sold between countries in 1991. It is enough to cover all the grains shipped internationally and all the oil, coal, and ore that is sold in the global markets each day during the same year. But big as it

²⁷ Stiglitz, Joseph E., *Economics second edition*, 1997 New York: W. W. Norton Company, p.572.

²⁸ Shiller, Robert J., *Irrational Exuberance*. 2000 New York: Broadway Books, p.137.

²⁹ Knight, Frank H., *Risk, Uncertainty and Profit*, (1957 reprint, Dover Publications, New York), p.23

³⁰ Miller, Seumas, “Social Institutions”, *The Stanford Encyclopedia of Philosophy (Fall 2008 Edition)*, Edward Zalta, editor, URL=<http://plato.stanford.edu/archives/fall2008/entries/social-institutions/>

³¹ Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations*, edited by R.H.Campbell and A.S.Skinner. (1776/1981 Indianapolis: Liberty Fund), p.37.

³² Keynes, John Maynard, *A Treatise on Money*, 1935 London: Macmillan and Co., p.154.

is, \$25 billion is still a small fraction of the \$800 billion that changes hands every day in the world's currency markets. It goes for options trading, stock speculation, and trade in interest rates.³³

One of the consequences of such phenomena is "delinking money from value"³⁴ and yet accounting standards have to rely on money as a unit to measure both the value in use and the value in exchange.

The other difficulty in setting up accounting standards is of more ethical nature. Financial reporting is directed at three principal parties, which are investors, creditors and tax collectors. In today's financing equity plays far greater role than debt, and entrepreneurial efforts will be directed toward keeping the prices of the firm as high as possible in the capital market. In the capital market firms are evaluated in terms of various indices, such as liquidity ratio, quick (acid-test) ratio, price/earning ratio, market/book ratio, return on sales ratio, return on assets ratio, return on equity ratio and so forth. These ratios are calculated from the figures published in financial reporting and an entrepreneur will desire that the published figures facilitate higher stock prices in the capital market. Those figures are all constructed out of every single transaction. The methods to organize original materials to structure the figures in financial reporting are not necessarily unified with respect to all the reporting entities. A wide margin of arbitrariness could be allowed and if avarice slips into such a marginal space, the figures could be so structured that the value of the firm is reported in the capital market higher than they should actually be. The vital figures which influence the price of securitized stock in the capital market are revenues and earnings.

The purpose of financial reporting is to generate the confidence toward the firm among stakeholders. A fair basis for those stakeholders has to be maintained with respect to information about the financial position, performance and changes in financial position of the firm, so that a wide range of stakeholders can make a meaningful judgment. Externally published financial statements are structured from the same sources of information as used internally by the management of a firm and external stakeholders have no full access to such internal information. It is necessitated, therefore, to establish a standard for accounting and reporting in the disclosure of internal information of a firm. Financial accounting must be prepared and reported in accordance with standardized rules and principles, so that profits and loss or assets and liabilities of firm "A" and those of firm "B" are comparable on a fair basis.

One may trace back the history of modern standard setting of financial reporting to the Great Crash in 1929.

The first serious attempt to create formalized generally accepted accounting principles began in 1930, primarily as a consequence of the stock market crash of 1929 and widespread perception that an absence of uniform and stringent financial reporting requirements had contributed to rampant stock market speculation of the preceding decade that culminated with that crash. Previously, GAAP had largely been defined by academic writings and general industry practices. The American Institute of Accountants, which was renamed in 1957 the American Institute of Certified Public Accountants (AICPA) created a special committee to work with the New York Stock Exchange toward the goal of establishing standards for accounting procedures.³⁵

Another institution born in the U.S. after the crash of 1929 was Securities and Exchange Commission (SEC), a federal agency of the U.S. government created by the Securities Exchange Act of 1934. Since the establishment of SEC, the Commission and AIA (AICPA) have worked closely to protect the interest of the stake holders involved in the trade of securitized stock of corporations. The federal government also enacted the Securities Act in 1933, which was the first federal legislation to regulate the trade of securities. The Act has been amended several times and the latest amendment was approved on August 11, 2010 through P.L. 111-229. The amended Act stipulates that "[SEC] considers, in adopting accounting principles, the need to keep standards current in order to reflect changes in the business environment, *the extent to which international convergence on high quality accounting standards is necessary or appropriate in the public interest and for the protection of investors*".³⁶ (emphasis added).

³³ Kurtzman, Joel, *The Death of Money*, 1993 New York: Simon & Schuster, p.64

³⁴ Korten, David C., *When Corporations Rule the World*, Kumarian Press and Berret-Koehler Publisher, p.188

³⁵ Epstein, Barry J., Ralph Nach, Steven M. Brag, *GAAP 2010: Interpretation and Application of Generally Accepted Accounting Principles*, Hoboken, New Jersey: John Wiley & Sons, Inc., p.2.

³⁶ <http://www.sec.gov/about/laws/sa33.pdf>, Sec. 19 (last visited December 30, 2010)

7. INTERNATIONAL EFFORTS TOWARD STANDARD SETTING

Series of corporate scandals taking place one after another in the beginning of this century, the subprime mortgage crisis that was one of the first indicators of the 2007-2010 world financial crises, and the declaration of bankruptcy in 2008 of Lehman Brothers bear a resemblance to the 1929 Great Crash.

Many cases [of those corporate scandals] involved accounting tricks used to inflate earnings and to protect the value of a company's stock. Some cases involved efforts to defraud investors through misleading advice or schemes that broke the rules, such as after hours trading of mutual funds. And in other cases, the motive was to directly benefit the personal wealth and ego of the top executive—for instance, spending millions of dollars of company money on personal art work, lavish parties or home improvements.³⁷

Just as the initial action was taken toward the establishment of U.S.GAAP after the Great Crash in 1929, a new international action is being taken toward the establishment of International Financial Reporting Standards=IFRS. There are some views that IFRS is a challenge to U.S.GAAP, in which it is argued whether there should be “adoption” of IFRS or “convergence” of U.S.GAAP to IFRS.³⁸ It is further argued that U.S.GAAP is “rule-based” and IFRS is “principle-based”.³⁹ However, the two are not necessarily of nature to provoke a confrontation each other. Rather, IFRS should be viewed as a joint effort across the Atlantic Ocean and U.S.GAAP is also principle-based in its original structure. The Financial Accounting Standard Board=FASB has been the designated organization in the private sector since 1973 for establishing standards of financial accounting reporting (U.S. GAAP) and has already addressed the following.

The FASB believes that the ultimate goal of convergence is a single set of high-quality, international accounting standards that companies worldwide would use for both domestic and cross-border financial reporting.....The FASB and the IASB have been working together toward convergence since 2002. The two Boards have described what convergence means and their tactics to achieve it in two different documents—the Norwalk Agreement issued in 2002 and the Memorandum of Understanding (MoU) between the IASB and the FASB, originally issued in 2006 updated in 2008.⁴⁰

The MoU between IASB and FASB originally issued in 2006 and updated in 2008⁴¹ stipulates, for example, that the two Boards would achieve common standards to improve and simplify the accounting for what is commonly called “merge and acquisition” under the name of “business combination”. The FASB completed the project of business combination in accordance with IFRS-3 on 10 January 2008 and the post-implementation review after the revised standards have been applied for two years is planned for the first half of 2012.⁴² The consolidation of SPE was one of the much debated issues in the Enron case. In order to fund the new investments to cover-up the loss, Enron resorted to a financial practice, which could raise fund without affecting their consolidated balance sheet. For that purpose Enron set up SPE, a FASB-approved practice. When the sponsor itself set up an SPE, its “independence” from the sponsor's consolidated balance sheet could be maintained, according to the then prevailing GAAP approved by FASB, if 3% capital of the SPE came from an independent party. It was what accountants called “non-consolidation equity requirement of SPE”. As McLean and Elkind pointed out “there is no rationale why it is 3%”.⁴³ An investigation later revealed that Enron abused the 3% rule.⁴⁴ The interpretation of SPE by IFRS is clear as specified in SIC-12.⁴⁵

³⁷ Guynn, Jack, “Ethical Challenges in a Market Economy”, *Vital Speeches of the Day*, Academic Research Library. April 15, 2005.

³⁸ Gornik-Tomaszewski, Sylwia, Steve Showerman, “IFRS in the United States: Challenges and Opportunities”, *Review of Business* (Jamaica, Spring 2010, Volume 30, Issue 2)

³⁹ Bernardi, John, “VIEWPOINT: Prepare for IFRS Now, Not Later”, *American Banker*, New York: Feb.11, 2010, Volume 175, Issue 23, p.6.

⁴⁰ <http://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156245663>

⁴¹ The Norwalk Agreement

⁴² http://www.fasb.org/project/bc_acquisition_method.shtml (last visited December 31, 2011)

⁴³ McLean, B. and P. Elkind, *The smartest guys in the room: the amazing rise and scandalous fall of Enron*. 2003, New York: Portfolio, p.157.

⁴⁴ Powers, William, Jr., *Report of Investigation by the Special Investigation Committee of the Board of Directors of Enron Corp.*, 2002, Austin, Tx. “Andersen indicated recently that it made error in 1999 in analyzing whether Swap Sub qualified for non-consolidation.” (quoted from p.83 of the Report)

⁴⁵ An SPE shall be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. In so far as the interpretation of SPE is concerned, IFRS and FASB are already converged or FASB has

The FASB believes that if a business enterprise has a controlling financial interest in an SPE, the assets, liabilities and results of the activities of the SPE should be included in consolidated financial statements with those of the business enterprise, which is referred to as the primary beneficiary of the SPE.⁴⁶

The IFRS is a system intended to set financial reporting standards acceptable to the stake holders of internationally operating business entities on a fair and comparable basis. The organization is governed by 22 full-time trustee members, representing 16 countries, which are Australia (1), India (1), Japan (2), Canada (1), China (2), Korea (1), Spain (1), South Africa (1), U.K. (1), France (2), Germany (1), U.S.A. (5), the Netherlands (1), Hong Kong (1), and Brazil (1). The figures in the parenthesis show the number of trustees from respective countries.⁴⁷

8. FINANCIAL SCANDAL OF OLYMPUS CORPATION

The following is an episode how the fair value of capital, one of the basic IFRS concepts, was abused for a corporate egoism. The financial scandal of Olympus Corporation, a Japan-based leading manufacturer of endoscopes, microscopes and digital cameras, has all of sudden become an issue, when British-born executive Michael Woodford was discharged on October 14, 2011. Woodford alleged that the dismissal was related to his efforts seeking answers to the US\$2.2 billion acquisition deal in 2008 of a British medical equipment maker Gyrus Group, which Woodford judged not worthy of such an investment. Woodford and other management further challenged the legitimacy of the US\$687 million paid to a middle-man as a fee for this acquisition. The repercussions spread from London to Tokyo resulting in Tsuyoshi Kikukawa's resigning on October 26, 2011 from his position as chairman, president and CEO of the company and he was replaced by Shuichi Takayama. On November 8, 2011 the company admitted that the company's accounting practice was inappropriate and that fees for the acquisitions had been diverted to cover up losses which had resulted from unsound and risky investments dating back to 1990's.⁴⁸ The company blamed the inappropriate accounting on former presidents, executives and auditors. The loss resulting from the unsound investments amounted to as much as 100 billion yen (US\$2.6 billion) and the amount was too great to be written-off without impairing the capital-asset ratio necessary to maintain the adequate level of the company's stock market prices. The former presidents decided to hide the loss by transferring the negative assets to paper companies established in the Cayman Islands and amortized the loss by diverting money paid as fees for merge and acquisition. On March 28, 2012 the company was indicted for having violated the Securities and Exchange Act and the case is currently pending in court.

The IFRS (IAS) defines fair value of a financial asset as follows.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.⁴⁹

An additional guidance is supplemented as follows.

adopted the interpretation by IFRS as shown in the following FASB statement. (IFRS, *IFRS Official pronouncements as issued at 1 January 2009*, 2009, London: IASC Foundation Publications Department, P.2690)

⁴⁶ <http://www.fasb.org/jsp/FASB/Page.n?070102.shtml> (last visited January 4, 2011)

⁴⁷ <http://www.ifrs.org/The+organisation/Trustees/Trustees.htm> (last visited April 30, 2012)

⁴⁸ One of the blemishes in the recent history of Japan's financial practice was the designated pecuniary trust other than money trust, often referred to simply as "fund trust", which the Ministry of Finance officially permitted in 1980's to stimulate domestic economy. Under this scheme corporations could open special accounts with financial institutions, in which they deposited cash and financial institutions operated the deposited fund in the stock market to return capital gains to the depositors. The banks lent lavishly to corporations, which deposited bank-financed cash with the fund trusts, which the banks operated in the stock market. This cycle sustained the stock market boom. Financial assets held by the investing corporations were evaluated in terms of mark-to-market when the stock prices were rising and after the stock market crash many corporations reported their financial assets at historical value, namely at purchase prices. Such irregular accounting practices were audited by many CPAs as acceptable and tax authorities were not particularly objecting such a practice so long as their tax revenues were secured. Once stock prices started falling, nobody was willing to purchase the stock and the phantom wealth was reduced to a sheer piece of valueless paper and only debt, which had once financed the stock purchase, remained in the books of the investing corporations. The consequence of this "asymmetrical" or "arbitrary" mixture of mark-to-market and historical value evaluation of financial assets threw managers of the bankrupted corporations into an abyss of despair.

⁴⁹ This definition is given in the glossary of *IFRS Official Pronouncements as issued at 1 January 2009*, p.2768.

The best estimate of fair value at initial recognition of a financial instrument that is not quoted in an active market is the transaction price unless the fair value of the instrument is evidenced by other observable market transactions or is based on a valuation technique whose variables include only data from observable markets.⁵⁰

In 2008 Olympus acquired a Japanese firm, Altis Corporation, producing fuel oil by dissolving plastic waste, at 21.6 billion yen (US\$270 million). When this company was purchased by Olympus in 2008, the company reported its profit before tax as 5 million yen deficit. Olympus requested Isaka Certified Accounting Office to evaluate the future value of Altis. The certified accounting office submitted a report to Olympus that the future value of this firm in 2012 would be 47 billion yen (US\$588 million). It meant that the future shareholders' value of a sunk deeper in red company would increase by 17 times in four years. The method used by the accounting office to calculate the future shareholders' value of Altis was Discounted Cash Flow method, which is "a valuation technique", but used data were not "from observable market". Furthermore, a disclaimer agreement was concluded between Isaka and Olympus that Isaka would not be held responsible for whatever consequences of the evaluation report.⁵¹

9. CONCLUDING REMARK

It can be surmised that IFRS, in its essential characteristics, bases the conceptual framework of income on stock, not on flow while US GAAP interprets income basically in terms of the flow concept. In view of the prevalent resistance on the part of GAAP to adopt "income as a change in the value of asset",⁵² IFRS introduces a somewhat conciliatory concept called "comprehensive income". The comprehensive income is defined as consisting of profit before tax, which is calculated by deducing all the expenses incurred during the term from the revenue, *and* the difference between the fair value of the financial assets of the present term and that of the previous term. Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. An additional supplementary guidance that a fair value can be determined by a valuation technique whose variables include only data from observable markets would also hold valid, just and legitimate unless the interpretation of this guidance is intentionally and abusively extended to justify unethical motives.

⁵⁰ IFRS, *ibid.*, pp.1992-2080 (IAS-39)

⁵¹This internal document of confidential nature was temporarily available on an internet site. The author of this paper was able to retrieve a PDF copy from the net and had it printed.

⁵² Ohlson, James A., Stephen Penman, *et. al.*, "A Framework for Financial Reporting Standards: Issues and a Suggested Model", *Accounting Horizons*, Vol. 24, No.3, 2010, pp.471-485.