Classical, Stewardship, and Market Perspectives on Accounting: A Synthesis

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INTRODUCTION

The second half of the twentieth century has generated a rich variety of perspectives on business organizations and accounting. Existence of different, often conflicting perspectives of the same object or event is a classical theme. Kurosawa's film Rashomon and the ancient Indian parable of four blind men and the elephant are but two examples of the multifaceted nature of social phenomena. Multiple perspectives can, but need not, engender conflict; they can also enrich and deepen our understanding of the subject. Few things in business or society have a unique, right way of being looked at. A common theme may underlie even the most diverse perspectives. The purpose of this chapter is to identify and emphasize this commonality among perspectives on accounting and to develop a rich synthesis from them.

A synthesis presumes an understanding of various points of view. I cannot be sure if my understanding of these points of view will satisfy their proponents. Perhaps it is best that I summarize my own perspective of accounting first. I then identify what is common among these perspectives and how they relate to one another.

ACCOUNTING AND ECONOMIC THEORY OF ORGANIZATIONS

Beginning some 60 years ago, Barnard, Cyert, March, Simon, and their colleagues built the modern theory of organizations (see Barnard, 1938; Cyert and March, 1963; Simon, 1947, 1952). One of the key ideas to emerge from the work of this “Carnegie school” is that we can usefully think about an organization as a
set of contracts or an alliance among many individual economic agents. The result is a simple but powerful synthesis of economic and organization theories. This model of organizations provides a fertile soil that can help sustain a robust theory of accounting. Simply stated, if organizations are contract sets or alliances, accounting is their operating mechanism to make them work. Most, if not all, accounting concepts and aspects of accounting practice can be integrated into the contract model of the firm (see Figure 2.1; Sunder, 1997).

By entering these contracts, agents make promises to deliver resources and are promised delivery of resources in return for their performance. Agents enter these contracts when they believe that what they receive (or expect to receive) from their participation in the organization is worth the sacrifice they are expected or intend to make. For an organization to succeed, its production technology and set of contracts must satisfy each one of its participants by delivering enough resources to them in exchange for the resources they contribute to it. When this crucial condition cannot be fulfilled, dissatisfied agents abandon the alliance; it may collapse unless an alternative set of contracts that fulfills this condition can be put together.

Before moving further, we must define the terms used in the preceding definition, "economic agents," and a "set of contracts." An economic agent is a person or an organization who complies with a simple condition of consistency between its preferences and actions. Whenever an opportunity arises, the agent chooses its preferred course of action out of the set of actions available and known to it. If the person chooses courses of action whose consequences are dominated by the consequences of other available actions, the person could not be thought of as an economic agent. Such choice is not consistent with its preferences and objectives. It is difficult to build a social model without assuming at least a minimal level of behavioral consistency.

A contract is simply a mutual understanding among two or more economic agents about one another's actions. A lunch date is a contract. So are hiring a welder, buying a share of stock, and promising a delivery schedule to a customer. In all these examples, each party makes (an implicit or explicit) promise to take a specific action that is relevant to the other party. In the sense I use the term, a promise does not have to be legally enforceable in order to qualify as a contract. But it can be. All promises do not have to be explicitly stated. Many aspects of the promise can be left to social convention and mutual understanding. Nor does a promise have to be written down in order to qualify as a contract.

Contracting individuals have their own purposes or goals. They choose to enter contracts and comply with them. We can assume that they join an organization only when they like the expected consequences of such participation (compared to the alternative opportunities for employment of resources they have to offer). In this concept of organizations it is not necessary to assign a goal to the organization itself. Organization is seen simply as a set of contracts among purposive individuals. To use another analogy, economic agents are the players who seek their goals; organization is an arena or the tournament in which they perform and by whose rules they agree to abide.

Neither the contract theory of organizations nor the theory of accounting based on it is specific to business. Both are applicable to a broad range of organizations, whether they are in business, government, society, or even religion. However, for the purpose of illustration, it is useful to take an example, and, given our present interest, we shall consider the example of business organizations. A business corporation can be thought of as an alliance among those who contribute capital (shareholders, bondholders, banks), labor (employees), management skills (managers), cash (customers), equipment and supplies (vendors), public services (government), support (community), and so on. In exchange for their contributions, various agents may receive dividends, interest, salaries, wages, benefits, products, cash, tax payments, clean air, and so on. Depending on their purpose, different people look at the contract set at varying levels of detail and specificity. For our present purposes of developing a rough sketch of a theory of accounting, we do not go into further detail.
Functions of Accounting

Accounting is necessary to measure economic transactions in business operations. It helps organizations to set standards and control the sequences of economic transactions to measure a company's financial position, performance, and changes in financial position over time. Accounting is also useful in external reporting, which is the process of providing financial statements to external decision-makers, such as investors, creditors, regulators, and other stakeholders. Accounting provides information that is useful in making informed decisions about the allocation of resources, evaluation of investment opportunities, and assessment of performance. It is important to note that accounting is not just a set of rules and procedures, but it is a dynamic and evolving field that is constantly adapting to new business environments and regulatory requirements.
Accounting performs its fifth function by making at least a minimal set of information common knowledge among the negotiating parties to help reduce the chances of such bluffs, empty threats, and deadlock. This is the primary purpose of what has come to be known as public disclosure in large organizations.

In summary, I view accounting as the operating mechanism of organizations that makes it possible for them to function. My next step is to examine various alternative perspectives on accounting through these colored glasses. I believe that this economic theory of organizations approach can help us look at these views in a unified manner.

A SYNTHESIS

In this section, I explain the relationship of my perspective on accounting to other perspectives. For the most part, there is no direct conflict among them. Each perspective emphasizes different aspects of accounting and makes different trade-offs between the specificity of its assumptions and the range of phenomena it seeks to explain. Let us start by looking at common elements of these perspectives.

From the vast accounting literature, I have selected three broad themes in accounting for the present discussion, without any claims to exhaustive coverage. The selected themes are classical, stewardship, and market-based.

First, accounting is an answer to the practical problem of running an organization. Control of resource flows in a way that preserves the integrity of the organization is a common fundamental problem of running the business aspects of a kingdom, a temple, a medieval manor, a farm, a family-run grocery store, a textile mill, a bank, or a multinational corporation. All perspectives on accounting start out by sharing this basis.

All organizations collect and disburse multiple factors in various markets. The modern commercial environment is characterized by relatively well developed markets for many factors. This has not always been the case. Land often belonged to the king, and the farmer had no right to sell it. People were not always free to sell their labor to anyone they pleased. Development of markets for factors of production is virtually synonymous with the creation of modern commercial/industrial civilization (see Karl Polanyi, 1944). The extent of the development of specific factor markets is highly dependent on space and time. The kind of accounting system that best serves the needs of the organization depends on the extent of the markets in which the organization functions. I cite examples in the following discussion in which the assumed or actual extent of market development is the crucial variable in many accounting perspectives and controversies.

As markets develop and collapse over time in a society, the organizations that constitute that society also adapt to the changing market structures. In the latter part of the twentieth century, publicly held transnational corporations are clearly the dominant form of organization. But this phenomenon is not peculiar to the twentieth century; the first joint-stock company (British East India Company) was formed less than 400 years ago. The three major perspectives on accounting I would like to discuss here are linked to three proximate levels of market development. Hatfield (1924: 8) wrote:

In part the new significance of accounting is due to sub-division of ownership and the severance of ownership and control so characteristic of the corporate form of business organization. If the substitution of small partnership for the individual trader called for improvement in bookkeeping methods, how much more would improvement occurred when the partnership was displaced by the corporation with its owners numbered by the tens of thousands.

But still more significant has been the great investment of fixed capital characteristic of modern production and made possible by the organization of corporations. The use of fixed capital on a large scale increases incalculably the difficulty of determining the profits earned in any given year. Paciolo made no serious effort to do this. Business in his day was congeries of disconnected ventures. . . . As these ventures fell in, the profit gained in the completed transaction was ascertained, somewhat roughly, it is true, but fairly satisfactorily. But no attempt was made to deal with unfinished operations.

But today business is a continuum.

At any time and in any society, diverse organizational forms coexist, as do the forms of accounting that serve their needs. Even at the frontiers of technology, the personal computer revolution took place not in the laboratories of giant multinationals but in the garages of lone entrepreneurs. In their organizational form, these entrepreneurs are closer to the people for whom Paciolo wrote his treatise than they are to Fujitsu, IBM, or NEC.

Environment, size, and form of each organization vary in time and space. All accounting perspectives use a subset of all possible organizations as a prototype. Usually, it is the dominant form of business organization in the society where the perspective is developed. The accounting system discussed under each perspective is designed to fit the chosen prototype.

For our purposes, we can use Hatfield's key events as boundary lines for these prototypes: separation of ownership and control defines the first boundary line, and subdivision of ownership into a large number of small pieces defines the second. A crude correspondence exists between three organizational forms defined by these boundaries, on one hand, and three perspectives on accounting I would like to discuss next.

Classical Perspective

Through most of recorded history, most economic activity of society was carried on by individual farmers, herdsmen, craftsmen, or traders acting alone or in small kinship groups. The business activities of most of these individuals were simple enough to call for little more than counting. Accounting originated with traders who engaged in more complex forms of business activity by engaging in trade with many
Methods

people, often on a repeat basis or on credit. Accounting was differentiated from
mere counting by establishing the cause-and-effect relationship between the sacri-
ifice and benefit aspects of each transaction (see Ijiri, 1975, 1993). This cause-and-
effect driven organization of transactions in double-entry bookkeeping gave it
balance and usefulness as a powerful instrument of control over the flow of
resources.

The classical perspective on accounting developed in various parts of the world
during the millennia preceding the Industrial Revolution. This perspective was
meant to serve the dominant business organization of the day—the traders. Today,
the oldest available codification of this system is Part 1, Section 9, Treatise 11 of
Pacioli’s Summa de Arithmetica, Geometria, Proportioni et Proportionalita (Re-
view of Arithmetic, Geometry and Proportions), entitled “Particularis de Computis
e Scripturis” (Particulars of Reckonings and Their Recording); see J. B. Geijsbeek
(1974 [1914]). This system developed in response to the personal needs of the
wealthy, the merchants, and their businesses.

The classical perspective on accounting included counting, recording, and
communication. Counting became necessary in civilizations where quantities larger
than four or five had to handled; human cognitive ability to discriminate among
various quantities diminishes sharply beyond this threshold. Recording was an
aide-mémoire for those whose affairs included so many transactions over periods
of time that memory could not be relied on to keep track of the resource flows.
Yamey (1977: 14) quotes the old English preamble of Robert Loder’s farm accounts
in early seventeenth-century England:

A Bock [for my] rememberance; what seed wheat and barley I yearly sowe and [how mu]ch
I wenow and sell in the same yeare. Item what h[ay] I ha[v]e yearly growing: . . . Item how
my quite rentes are yearly pay’d me; Item of the valewin some yeares of my aplies and
cherries. Item of the quantitte of whole which I have yearly growing; and how many shep I
sheared for it; Item of money owing me; Item what paymesent I owe the Kinge; Item how I
pay my servauntes theyr wages; Item what my charges in the harvesting and making hay
hath bine in some yeares; Item how and what I pay for tieth of my orchardes; Item how much
wood I buy: . . . Item how many landes I yearly dounge with the potte, and which are
douged at alle; and o[f] such other remembrances.

The communication function of accounting is exemplified in the baked clay
tablet, sent by the wife of a merchant, listing in cuneiform writing the merchandise
sent to him from home in ancient Sumeria, now displayed in a museum. The view
of accounting that relies on these three basic functions can be labeled the classical
view. This is codified by Pacioli in his treatise. This form of accounting, designed
for simple form organizations, has long been known as bookkeeping. Even to this
day, bookkeeping is what laymen understand accounting to be.

If we return to the functions of accounting in a contract set, bookkeeping is
concerned primarily with the first two—measuring and recording of resource
inflows and outflows related to the organization. The books help merchants keep
track of their resources and obligations and causal relationships among them. It
helps them know who owes them what and why, and what they owe the others by
properly organizing the data on resource flows with respect to each contracting
party in the organization. For merchants, most of these parties are their customers,
suppliers, and possibly a small number of employees. They do not have sharehold-
ers, auditors, or managerial hierarchy to worry about. For small and simple
organizations bookkeeping is all the accounting that is necessary to implement their
contract set.

Stewardship Perspective

Stewardship accounting evolved to address the separation of ownership and
control. It adds the interests of two parties to the counting and recording aspects
of accounting recognized in the classical perspective. The aide-mémoire function
of accounting is important even in organizations that have only a single layer of
management, usually consisting of the sole proprietor. When organization expands
to include two or more levels of management, a new problem arises. Now account-
ing must include not only the one who gives account but also the one who takes
account. Ijiri (1975) labels them the accountee and the accountant, respectively. It
is easy to see that stewardship played an important role in the accounts of temples and
sovereigns since antiquity, as well as merchants or lords of manors who employed
people (stewards) to handle the estates for them. The essence of the stewardship
view of accounting is to see the problem that accounting solves as the problem
of organizations. Organizations differ from individuals in that they involve actions,
thoughts, information, and motives of more than one person. The stewardship
view can be differentiated from the classical view of accounting in its emphasis on
accounting as the solution to the problem of organizations.

The fundamental problem of running organizations is that no one person in the
organization has all the information in his or her possession. Since people acquire
most of the information needed for doing their jobs on the job itself, they have
preferential, even exclusive access to such information. A branch of the stewardship
perspective, labeled the agency theory of accounting, tries to deal with the con-
sequences of the combination of this information asymmetry with the private interests
of individuals. Diversity of private interests motivates individuals to utilize the
information in their possession to advance their own interests, which may diverge
from the corporate interests. This goal incongruence is the focus of agency theory,
and most attention in this perspective is centered on ways of minimizing its impact.

Accounting apparatus developed to deal with the stewardship problems has
come to be known as managerial accounting. Planning and budgeting, divisional
and managerial performance evaluation and compensation, decentralization, trans-
fer pricing, capital budgeting, and activity-based costing are all concerned with the
problem of control in organizations with managerial hierarchy. Managerial ac-
counting is built on the foundation of the basic accounting records of bookkeeping
and therefore encompasses it. But accounting needs of large, hierarchical organi-
mean of performance by John Snow companies with a large number of subsidiaries.

Capital Market Perspective

The key concept of corporate reporting, 'ear of managers' accounting,' allows for the development of a model that incorporates the performance of the firm. This model, however, is based on a number of assumptions that require further investigation. The model is presented in two parts: a quantitative section and a qualitative section. The quantitative section focuses on the development of a model that incorporates the performance of the firm. The qualitative section discusses the implications of the model for the firm's management and for the market.
of the firm. Financial reports remain an important source of information, but there are many other sources equally and sometimes more important and timely than financial reports. Investor reliance on financial reports as a source of information is attenuated but not eliminated.

Another consequence of widely held, actively traded stocks in a market with small transactions costs is that the stock price is highly responsive to events and reports that are thought to affect the prospects of the firm. Prices can respond to information within a matter of minutes or hours. In the early years of development of the financial reporting model, corporate managers could use secret reserves to smooth out the financial reports over a period of time in order to minimize share price movements in response to transient events. Financial reporting rules have progressively narrowed this as well as other areas of managerial discretion, largely because of fear of misuse for personal benefit. Elimination of discretionary reporting is a double-edged sword; even self-serving reports by managers in a discretionary regime end up revealing a great deal about what kind of managers they are (see Levine, 1996).

A third consequence of the financial reporting model has been the shift of emphasis from stock variables (balance sheet) to flow variables (income and cash flow statements). Given the imperfection of the markets for fixed assets of industrial corporations, their historical book values are poor indicators of the future earning power of the corporation. Projection of current earnings and cash flows into the future for the purpose of security valuation carries its own significant risks. Investors' and analysts' need for a sustainable earnings figure that can be projected into the future has given rise to lengthy debates and detailed rules on isolation of nonrecurring income items from the rest.

The greatest impact of market-based research on accounting thought has been to make the accountants aware of the existence of the alternative sources of information for the stock market, and the complex interaction among these sources, and the behavior of the market itself. Market-based research has forced many accountants to replace thinking of accounting in mechanical terms by thinking in economic terms. Accounting reports can definitely mislead investors, but the existence of the market limits the extent to which this can happen. Yes, accountants can withhold information, but the existence of the market limits the extent to which information can be withheld.

Of course, for the vast majority of firms in the United States, ownership shares are not traded in liquid markets. Most firms are simply not large enough to justify sufficient effort to search for information about their future prospects. What is true of General Electric or AT&T is not true of smaller firms, even if they are listed on stock exchanges. Then an even larger number of firms that are publicly held (defined in the United States by the Securities and Exchange Commission (SEC) jurisdiction over firms that have more than 500 shareholders), even though their shares are not listed on any exchange. In international markets also, shares of most firms are not actively traded. To that extent, the findings about the large firms with liquid trading in the New York, Tokyo, or London stock exchanges are not generalizable to others.

Development of markets for securities as well as for goods and services has led some to argue, especially during periods of significant price movements, that the historical cost valuation be replaced by market valuation of assets and liabilities. There are two obstacles to the use of current prices. First, all markets are imperfect in varying degrees, and errors of measurement in market-based prices must be weighed against the errors of using historical costs for current prices (see Lim and Sunder, 1990, 1991). Second, the benefits of providing more precise economic values for the purpose of security valuation and trading decisions must be weighed against any reduction in the effectiveness of the financial reporting system for implementing and enforcing the firm's contract set. While several proposals for market valuation have been tried out in the United States during the twentieth century, none have survived.

Financial reporting can be thought of as the most developed and inclusive form of accounting. It incorporates all five functions of accounting listed earlier (measurement of resource inflows and outflows, reporting on contract fulfillment, providing information to factor markets on costs and benefits of occupying various contractual slots in an organization, and making an agreed upon subset of information public to minimize conflict and deadlocks at the time of contract renegotiation). Public disclosure is an especially important part of financial reporting model that is absent in the bookkeeping and stewardship forms.

CONCLUDING REMARKS

To summarize, we can think of organizations (including business firms) as a set of contracts or alliances among many people who join them with the expectation of gain. We can think about accounting as the mechanism to define, implement, enforce, modify, and maintain this system of contracts. Organizations differ in their design, depending on the goals and resources of their participants and the environments in which they function. So do their accounting systems.

Narrowing our focus to business organizations, they can be crudely divided into three groups on the basis of two criteria—separation of ownership from control and subdivision of ownership into small holdings of a large number of shareholders. Owner- or partner-managed small businesses, professionally managed businesses with closely held ownership, and professionally managed businesses with diffused shareholdings are the three types of organizations that result from application of these criteria.

From the vast literature on accounting, we can also identify three basic accounting models and relate each model to one of the three categories of business enterprises. The classical double-entry bookkeeping model corresponds to the owner- or partner-managed small businesses; the stewardship model corresponds to the professionally managed closely held firms; and the financial reporting model corresponds to the professionally managed firms with diffuse shareholdings.

The three accounting models are not mutually exclusive. The stewardship model incorporates the bookkeeping model; the financial reporting model, in turn, incor-
orates the stewardship model. While the last category of organization and the accounting model to serve its needs are an invention of recent centuries, all three forms of organizations as well as their corresponding accounting models are practiced widely in modern industrial-commercial societies. Thus, the three major models of accounting complement one another across business organizations in society, as well as within business organizations with diffuse ownership or separation of ownership and control. Economic theory of organizations helps us develop a unified perspective on accounting that has enough room to nest the classical, stewardship, and market perspectives in harmonious relationship with one another.

REFERENCES


