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On the Balance Sheet-Based Model of Financial Reporting

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SYNOPSIS: FASB adopted a balance sheet-based model of financial reporting about 30 years ago, and this model has been gradually expanded and solidified to become the required norm around the world. This article argues that the balance sheet orientation of accounting standard-setting is flawed for the following reasons. First, accounting is supposed to reflect business reality, and thus the essential features of the financial reporting model need to reflect the essential features of the underlying business model. However, the balance sheet orientation of financial reporting is at odds with the economic process of advancing expenses to earn revenues, which governs how most businesses create value, and which represents how managers and investors view most firms. Second, the adoption of the balance sheet approach was driven by conceptual considerations; standard-setters argued that the concept of assets is more fundamental and logically prior to the concept of income. However, this article argues that the concept of income is clearer and practically more useful than the concept of assets, especially with the recent proliferation of intangible assets. Third, earnings is the single most important output of the accounting system. Thus, intuitively, improved financial reporting should lead to improved usefulness of earnings. However, the continual expansion of the balance sheet approach is gradually destroying the forward-looking usefulness of earnings, mainly through the effect of various asset revaluations, which manifest as noise in the process of generating normal operating earnings. During the last 40 years, the volatility of reported earnings has doubled and the persistence of earnings is down by a third, while little has changed in the properties of the underlying business fundamentals.

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