

Challenging the Conceptual Foundation of Accounting Standards: A Focus on Analytical, Conceptual and Critical Thinking

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Abstract

Both accounting practitioners and academicians have stressed the need for greater student development in the areas of analytical, conceptual and critical thinking. This study illustrates how an analysis of the current reporting requirements for stock dividends and splits may be used to develop skills in these areas. Students evaluate the “economic substance” of stock dividends. That evaluation leads to two important issues. First, what role does “management intent” play in the determination of economic substance. Second, should popular beliefs or preconceptions play a role in the determination of economic substance? A brief historical analysis suggests that the deficiencies associated with the reporting of stock dividends and splits result from the decision by accounting policymakers to affect an economic consequence. The study provides two examples of the financial reporting “fall-out” resulting from the decision by policymakers to relegate the reporting of economic substance to a level of secondary importance. Students are then challenged to construct reporting requirements that more accurately reflect the economic substance of stock dividends and splits. Lastly, the paper addresses possible reasons why policymakers have never reexamined these reporting requirements.

Background

The traditional tendency of accounting educators to emphasize accounting rules and procedures via lectures and textbook problems has been widely criticized. A broad-based coalition of the accounting profession has observed “Our rules-based, memorization, test-for-content, and prepare-for-certifying-exam educational model is inefficient, but more importantly, it does not prepare students for the ambiguous business world they will encounter upon graduation” (Albrecht and Sack 2000). The largest public accounting firms jointly issued a “Perspectives” paper stating that “Accounting knowledge cannot focus solely on the construction of data. The ability to apply decision rules embodied in the accounting model is only part of the goal. The focus should be on developing analytical and conceptual thinking versus memorizing rapidly expanding professional standards” (1989). Echoing this observation, the Accounting Education Change Commission (AECC 1990) has noted a need for creative and logical thinking, rather than memorization of professional standards.

This paper illustrates how the current reporting requirements for stock dividends and splits may be used to help develop skills in these areas, as students are challenged to analyze and then critique the conceptual and theoretical foundation of these reporting requirements. This reporting topic was chosen for two reasons: First, these reporting requirements have long been a source of consternation, not only for students, but for educators as well. In particular, educators often find it difficult to rationalize or defend the capitalization of retained earnings for stock dividends

(but not for stock splits) and the inconsistency in the dollar amount to be capitalized (market value versus par value via the 20-25% rule). Second, these reporting requirements present many conceptual and theoretical issues for students to analyze. In the classroom activities described below, students are first required to determine the “economic substance” of stock dividends and splits. Students are then asked to evaluate the extent to which current standards faithfully represent the economic substance of stock dividends. This evaluation requires students to critique the authoritative rationale upon which the accounting standard is based. Evaluation of the authoritative rationale raises three important issues;” First, what role (if any) does “management intent” play in the determination of economic substance? Second, should popular beliefs or perceptions held by the general public regarding a reporting issue play a role in the determination of economic substance? Third, should value which may accrue to the stockholders as a result of a stock dividend be a factor in the determination of the amount of capitalization? This question requires an understanding and application of the entity concept. The study then examines the relevance of research efforts that have questioned these reporting requirements.

Lastly, students are offered a brief historical analysis which provides an explanation of why so many conceptual and theoretical shortcomings are embodied in the current reporting requirements for stock dividends. The historical analysis provides a vivid example of the reporting problems that may result when the goal of reporting economic substance is not the primary reporting objective of standard-setters. The historical analysis also demonstrates to students both the importance of examining such issues from a historical perspective and the relevance of historical research.

The remainder of the paper describes how students may be asked to construct new reporting requirements for stock dividends and splits and offers an explanation of why standard setters have not reexamined this reporting topic. Exhibit 1 includes a step-by-step process for classroom coverage.

Summary of Current Reporting Requirements for Stock Dividends and Splits

Accounting Research Bulletin (ARB) No. 43, Chapter 7, Section B contains the current reporting requirements for stock dividends and splits which were issued by the Committee on Accounting Procedure (CAP) (American Institute of Accountants 1952). The ARB states that a corporation’s “...representations to its shareholders as to the nature of the issuance is one of the principal considerations in determining whether it should be recorded as a stock dividend or split-up” (ARB No. 43, Ch. 7B, para. 16). If managers choose to characterize the stock distribution as a stock dividend, then a portion of retained earnings must be transferred to the paid-in capital accounts. If the size of the stock dividend is less than 20-25% of outstanding shares, the amount of the transfer (capitalization) should be the market value of shares issued, subject to legal requirements (usually par or stated value) which represent the minimum amount to be capitalized. Stock dividends in excess of 20-25% should be characterized as “stock split-ups (splits) effected in the form of a dividend” with a transfer of retained earnings to paid-in capital accounts. Here, only the legal minimum need be capitalized, which is usually par or stated value per share. For stock splits, no capitalization is required “other than to the extent occasioned by legal requirements.” (ARB No. 43, Ch. 7B, para 10-15).

Classroom Presentation Of Conceptual And Theoretical Issues

Representational Faithfulness and the Differentiation of Stock Dividends and Splits

Instructors might include a discussion of representational faithfulness and the differentiation of stock dividends and splits in their presentation regarding stock dividends and splits. As part of an effort to construct a conceptual framework, the Financial Accounting Standards Board (FASB) issued the “Statement of Financial Accounting Concepts No. 2 – Qualitative Characteristics of Accounting Information” (FASB, 1990). The Statement describes the concept of “representational faithfulness” as an “ingredient” of the primary decision-specific quality of reliability. The Statement further observes: “Representational faithfulness is correspondence or agreement between a measure or description and the phenomenon it purports to represent” (FASB, 1990, pp. 717-721). In an earlier pronouncement issued by the Accounting Principles Board, the Board stated: “Substance over form. Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. ...Accountants emphasize the substance of events rather than their form

so that the information provided better reflects the economic activities represented” (APB Statement No. 4, Chapter 5). Instructors should emphasize that reporting economic substance and striving for representational faithfulness are the cornerstones of integrity in the financial accounting process.

Critical analysis of the current reporting requirements should begin by asking students to determine the economic substance of a stock dividend and the economic substance of a stock split. Students should compare and contrast the two. After the students have presented their results, they should be asked to challenge the “representational faithfulness” of the current reporting requirements for stock dividends, based on their analysis of economic substance. During the ensuing discussion, the instructor should present the following definitions which are extracted from the current authoritative pronouncement.

(A) <u>The Event</u>	(B) <u>The Desire</u>
“The term <u>stock dividend</u> as used in this section refers to an issuance by a corporation of its own common shares to its common share-holders without consideration and under conditions indicating that such action is prompted mainly by	a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interest in accumulated corporate earnings without distribution of cash or other property which the board of directors deems necessary or desirable to retain in the business”
“The term <u>stock split-ups</u> as used in this section refers to an issuance by a corporation of its own common shares to its common share-holders without consideration and under conditions indicating that such action is prompted mainly by	a desire to give the recipient outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares”

The definitions in column (A) describe an event which is identical in either case. The justification for the diverse treatment of these two identical events lies solely in management’s desire (Column B) (ARB No. 43, Ch. 7, para. 1&2).

The instructor should note that the Committee selected the “desire” of management as the crucial variable with which to differentiate between these two types of distributions. Historically, the FASB has promoted the reporting of “substance over form” and that they strive for “representational faithfulness.” The instructor should then ask students: Is it representationally faithful to record identical events so incongruently? The distinction drawn between the “(A) The Event” and “(B) The Desire” (above) should lead students to question the validity of current reporting requirements that may result in inconsistent treatments of these identical economic events. (See also Exhibit 1.)

Economic Substance and Management’s “Desire” or Intent

The next step would be for the instructor to use the above “event” and “desire” comparison to further question the relationship of management’s desire or intent in the execution of a transaction to the determination of economic substance for the transaction. Specifically, the instructor should pose the question: Should policymakers view the **intent** of management as **the key determinant** of the economic substance of a transaction?

Before attempting to answer this question conclusively, the authors have found it very helpful to expand the context of this question to the problem of determining the economic substance of a lease. Here, students might be presented with the following question: If management desires or intends that a lease be accounted for as an operating lease, does that necessarily ‘make it’ an operating lease? The instructor’s comments in the ensuing discussion might include the following: The answer to the above question is no since accountants must search beyond the surface or form of a transaction to identify the economic substance; this is the fundamental, first order reporting problem. After economic substance has been determined, management’s intent or desire may sometimes be relevant in resolving a “second order” reporting problem. For example, the intent of management is considered in the

determination of whether marketable equity securities are classified as a current asset or a noncurrent asset. However, the intent of management is not relevant to the determination of the economic substance of a marketable equity security, i.e., is it an asset or not an asset?

Rationale Underlying the Capitalization of Retained Earnings at Market Value per Share

After raising students' doubt concerning the conceptual validity of current reporting requirements, the instructor should ask students to critique the rationale underlying the authoritative justification concerning the capitalization of stock dividends at market value. As part of the critique, students should be asked to develop a "position statement" either in support of, or against, the capitalization of retained earnings at market value per share. (The authoritative rationale presented below (ARB No. 43, Ch. 7, para. 10) is partitioned in sections A through D for the purpose of subsequent analysis.)

- A. As has been previously stated, a stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received.
- B. Furthermore, it is to be presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains unchanged.
- C. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued.
- D. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except in the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

Popular Misconceptions as the Basis of Accounting Standards

After the students have prepared a position paper, they should be encouraged to present their views and debate the issues. Following their presentations, the instructor should lead a discussion and include the following observations: The Committee appears to assert in parts A and D (above) that if shareholders believe they are receiving a dividend at market value, then reporting requirements should respond to this belief. Also, the Committee argues that management should capitalize retained earnings in an amount equal to market value because stock dividends are characterized as "dividends", i.e., a distribution of assets (even though they are not asset distributions) and because recipients look upon them as a distribution of earnings, usually in an amount equivalent of fair value of additional shares received. A logical extension of this rationale would be that accounting standards should be based on popular beliefs and misconceptions no matter how naïve or ill-conceived these opinions may be.

The Entity Theory

The students' evaluation of the authoritative rationale also presents an opportunity for a real-world "hands-on" application of the entity theory. Historically, the reporting authorities have engaged the entity theory for conventional corporate financial reporting. A statement of this espousal is reflected in the current pronouncement concerning stock dividends:

...it is generally agreed that the problem of determining his (shareholder's) income is distinct from the problems of income determination by the corporation itself, the income of the corporation is determined as that of a separate entity without regard to the equity of the respective shareholders in such income... (ARB No. 43, Ch. 7, para. 6)

Ironically, in the *same pronouncement*, the Committee appears to have *reversed its opinion* to the effect that financial accounting should report the effect of corporate transactions upon the wealth of the firm as well as the wealth of the individual shareholder. In parts A, B, and C (above), the Committee clearly considers the impact of stock dividends on the market value and changes in the market value of shares held by stockholders to justify the use of market value to determine the valuation of stock dividends. This consideration of market value constitutes a clear breach of the entity theory.

Why So Many Conceptual Deficiencies and Inconsistencies?

The obvious question is: Why would accounting policymakers construct financial reporting requirements which appear to be so lacking in conceptual rigor? Historical research reveals that much confusion surrounded stock dividends in the first half of the last century (Tucker, 1985). Most of the confusion was related to the economic substance of stock dividends. Many people, including several U. S. Supreme Court Justices, viewed stock dividends as constituting income to the recipient. Consequently, both the New York Stock Exchange and the Committee on Accounting Procedure came to view the use of small recurring stock dividends as an abusive financial practice, since they believed that many investors viewed this particular type of stock dividend as income. To make it more difficult for corporations to sustain a series of small dividends from retained earnings, accounting policymakers required the capitalization of retained earnings at fair market value per share for stock dividends of less than 20-25% of outstanding shares (Tucker, 1993). Zeff (1978) has cited the current reporting requirements for stock dividends as one of the earliest in which standard-setters considered "economic consequences" in the construction of reporting requirements.

Instructors should point out that the historical research suggests that the primary objective of standard setters was to impact managers' behavior regarding the use of stock dividends. It appears that the secondary objective was to do so in a manner which was most justifiable from a conceptual and theoretical perspective. In this scenario, the Committee first decided that the reporting requirements should be constructed to discourage small stock dividends and then "backed into" the rationale as best it could. However, the result is an authoritative pronouncement that is difficult to understand and is replete with theoretical and conceptual inconsistencies and deficiencies.

The instructor might use this as an example of what may result when the primary objective of accounting policymakers is to affect an economic consequence rather than to construct accounting standards which are conceptually and theoretically sound. For example, a study by Zucca and Kirch (1996) provides instructors with an example of the financial reporting "fall-out" that results from the confusion caused by the theoretical and conceptual deficiencies described earlier. They examined the accounting treatment of "midrange" stock distributions ($\geq 25\%$ and $< 100\%$ of outstanding shares). The study found no significant relationships between the accounting treatment and either the distribution size, the announcement characterization or the legal requirements. The study also found that a majority of the distributions are recorded by a transfer from paid-in capital in-excess-of-par to the stated capital account which they noted is not a treatment specifically discussed in either the accounting authoritative literature or accounting textbooks, but does meet minimum legal requirements. The authors concluded that "...firms are not consistently using any single measure when recording their midrange distribution, thus reducing the comparability of the financial statements." (Zucca and Kirch, 1996)

Recommended Reporting Requirements for Stock Dividends

Finally, students should be asked to construct new reporting requirements which they feel would most closely reflect the economic substance of stock dividends. After allowing students to present their recommendations, the instructor should allow students to debate and defend their recommendations. The instructor then should offer some observations which include the following: The comparison of stock dividends and splits made earlier demonstrates

that these two distributions are congruent economic events. Therefore, as was done with the term "reserves", the term "stock dividend" should be eliminated. Any pro rata free distribution of stock, regardless of management's intent or desire, should be described as a "stock split" and accounted for as a stock-split. The current reporting requirements for stock splits do faithfully represent the economic substance of these distributions (ARB No.43, Ch.7, para.15). With this simple approach, the cosmetic difference between stock dividends and splits as well as the related confusion would be eliminated.

Why Haven't These Reporting Requirements Been Reexamined by Standard Setters?

Given the numerous conceptual deficiencies and inconsistencies of the current reporting requirements, instructors might ask students why standard setters have never changed the reporting requirements for stock dividends. There are two likely reasons that standard setters have not reexamined the current reporting standards. First, the current standards have no impact on earnings, cash flow or liquidity measures. Another reason is that stock dividends are seldom used by management. A review of *Accounting Trends and Techniques* (American Institute of Certified Public Accountants 2007) reveals that on average, only 1.19% of the 600 firms in the study declared a stock dividend in any given year during the period 1995 to 2006 (See Table 1). Given the lengthy and often contentious agenda of accounting regulators, they may simply feel that the reporting requirements for stock dividends is a low priority item since stock dividends are seldom used.

The instructor may also want to address the relative frequency of stock dividends to stock splits. The data presented in Table 1 reveals that on average, 8% of the 600 firms in the study declared a stock split in any given year during the period 1995 to 2006. This contrasts sharply with an average of only 1.19% of firms using stock dividends.

Another question that may arise in this discussion is "Why do companies choose to declared stock dividends?" The traditional wisdom regarding stock dividends is that many managers use stock dividends as a substitute for a cash dividend to conserve cash. A relatively mature company having cash flow problems might declare a stock dividend to conserve cash. Here, the company can declare a "dividend", issue additional shares to be received by shareholders with no outflow of cash other than administrative and processing costs. Conversely, growth companies that are reinvesting most of their cash flow in inventory and capital expenditures may use a stock dividend to enable a company to declare a "dividend" while conserving cash.

Conclusion

This study illustrates how the current reporting requirements for stock dividends may be used pedagogically to help develop analytical, conceptual and critical thinking. Students are challenged to analyze and then critique the conceptual and theoretical foundation of these reporting requirements. In doing so, students are required to determine the "economic substance" of stock dividends and splits and then evaluate the extent to which current standards faithfully represent the economic substance of stock dividends. This evaluation requires students to critique the authoritative rationale upon which the accounting standard is based. The critique of the authoritative rationale leads students to question the role of "management intent" and "popular beliefs" in the determination of economic substance. The illustration suggests that determining the economic substance of a transaction based solely on the desire or intent of management or popular beliefs is theoretically unsound. An accounting issue is examined which requires an analysis and understanding of the entity theory.

A brief historical analysis is presented which provides an explanation of why so many conceptual and theoretical shortcomings are embodied in the current reporting for stock dividends. Here, the illustration provides a vivid example of the reporting problems that may result when the goal of reporting economic substance is not the primary reporting objective of standard-setters. In addition, the study recommends that the term "stock dividends" be eliminate and that all pro rata free distributions of stock be referred to as "stock splits" using the current reporting requirements for stock splits. The study also offers several possible reasons that may explain why standard setters have not reexamined this issue in more than 50 years. Finally, the study provides accounting educators with a more plausible alternative to the seemingly inconsistent and contradictory official rationale regarding the current reporting requirements for stock dividends.

Table 1

**Accounting Trends and Techniques
Frequency of Stock Dividends and Splits 1995 to 2006**

Frequency of Stock Dividends and Splits 1995-2006												
	95	96	97	98	99	00	01	02	03	04	05	06
Stock Dividends	11	7	7	9	18	12	4	6	4	3	2	3
Stock Splits:												
Less than 3:2	5	2	3	4	5	1	0	2	3	1	3	1
3:2 to 2:1	10	12	10	12	8	3	6	3	4	7	9	9
2:1	31	44	60	60	36	36	21	18	12	38	31	29
Greater than 2:1	2	5	7	7	5	6	0	0	0	1	1	2
Total Stock Splits	48	63	80	83	54	48	27	23	19	47	44	41

Accounting Trends and Techniques publishes an annual survey of financial statements of 600 companies registered with the Securities and Exchange Commission.

Exhibit 1

This table presents a step-by-step process to aid instructors in preparing a classroom presentation of the issues and concepts examined in this paper. Questions that the instructor may use to address the issues and guide the presentation are in *italics*. Answers to the questions are found in the related section of the paper.

Economic Substance and Faithful Representation

1. Conduct a class discussion regarding the importance of reporting the “economic substance” of transactions and financial conditions and achieving “representational faithfulness” in financial reporting.
2. Question to the class: *How do current reporting requirements define stock splits and stock dividends?*
3. Discuss the economic substance of stock dividends and stock splits using the “The Event” and “The Desire” analysis.
4. Have each student verbally take a position either in support of or against the current reporting standards and have each give a brief explanation of why they are taking their position.
5. Question to the class: *What is the crucial variable or element that standard setters used to differentiate stock dividends and splits?*
6. Question to the class: *Should policymakers select the intent or desire of management as the key determinant of the economic substance of a transaction or financial condition?*
7. Question to the class: *Is it representationally faithful to use different terminology to describe these two identical economic events? Is it a representationally faithful to record and report these two identical economic events so differently?*

Rationale Underlying the Capitalization of Retained Earnings at Market Value per Share

1. Conduct a classroom discussion that challenges the Committee’s rationale for capitalizing small stock dividends at market value per share.
2. Students should be asked to develop a “position statement” either in support of, or against, the capitalization of retained earnings at market value per share.

Popular Misconceptions as the Basis of Accounting Standards

1. Question to the class: *Should popular beliefs and misconceptions held by investors be the basis for constructing accounting standards?*

The Entity Theory

1. Conduct a classroom discussion of the entity theory and the Committee's incorporation of that theory into the current reporting requirements.
2. Question to the class: *How is the entity theory discussed in the current reporting requirements?*
3. Question to the class: *Describe how current reporting requirements are inconsistent with the entity theory?*

Why So Many Conceptual Deficiencies and Inconsistencies?

1. Question to the class: *What was the confusion regarding the economic substance of stock dividends?*
2. Question to the class: *What appears to be the reason that small dividends are capitalized at market value per share?*
3. Question to the class: *What seems to be the primary objective of standard setters in constructing the current reporting requirements?*
4. Question to the class: What is the "fallout" that resulted from standard setters not having selected "economic substance" as the primary reporting objective?

Recommend Reporting Requirements for Stock Dividends and Splits

1. Students should be asked to construct new reporting requirements that they feel would most closely reflect the economic substance of stock dividends. After students present their recommendations, the instructor should allow students to debate and defend their recommendations.

Why Haven't These Reporting Requirements Been Reexamined by Standard Setters?

1. Question to the class: *Why haven't these reporting requirements been reexamined by standard setters?*

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