

## ***Chapter 2: The financial reporting environment***

### **Solutions**

- 2.1 Accounting standard-setters have an expectation that the readers of general purpose financial reports have a ‘reasonable knowledge’ of accounting. Specifically, the IASB Framework states that ‘users are expected to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence’. Hence, there is an expectation that financial statements are not tailored to meet the needs of people who have not, in some way, studied financial accounting. Students should be encouraged to consider whether this expectation is in itself ‘reasonable’.
- 2.2 As Chapter 2 states, there is an expectation held by accounting standard-setters that users of financial statements have a reasonably sound knowledge of financial accounting. For example, within the IASB Framework (which is also the Australian Accounting Standards Board (AASB) Framework) reference is made to users who ‘are expected to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence’. Within the United States Conceptual Framework Project, reference is made to the ‘informed reader’.

Hence, a view has been adopted by the regulators that users of financial statements should have a certain level of knowledge, and when accounting standards are being developed, this level of knowledge is assumed. In defence of this position, we could probably argue that if such an assumption was not made then the development of accounting standards would be much more difficult and time consuming given that the standard-setters would need to consider how uninformed users might react to the particular standards. The position adopted is also consistent with other professions which also typically assume a certain level of expertise when developing guidance for their profession’s members (however, we need to be careful with justifications like this—just because others do a certain thing does not mean it is the ‘right’ thing). If users find it necessary, there are many experts who would be available to provide advice on how particular numbers were derived. Of course, such advice will generally be at a

cost which does raise the issue that it can be costly for some individuals to gain an understanding about the operations of organisations that perhaps have an impact on their ongoing existence. Hence, while there is arguably a ‘right-to-know’, for people without an accounting knowledge, this right can only be exercised at some cost.

- 2.3 In making this judgement, students should consider the various articles that frequently appear in newspapers and various discussions that occur on television and radio in relation to an organisation’s profits. Rarely is any mention made of the accounting methods used, even though the profits ultimately reported are directly a product of the many decisions that would have been made regarding how particular items should be accounted for (if possible, direct reference should be made to a number of articles which discuss organisations’ reported profits). Hence, it does appear as if profits are often held out as some form of ‘hard’, objective measure of organisational performance.

In considering why the media might behave in this manner, one possibility is that those responsible for writing the stories are ignorant that financial accounting relies upon a great deal of professional judgement and they might believe that every decision made by accountants is clearly mapped out by a comprehensive system of rules. Alternatively, the writers might consider that people simply do not want to be ‘bogged down’ in the fine detail. As another possibility, the accounting profession, through such vehicles as conceptual frameworks, may have successfully cultivated an impression (with the people in the media, and others) that the practice of accounting is *objective*, and the output of the accounting system is highly *comparable* between different entities—meaning that one organisation’s profits can appropriately be compared to another.

The implications of this approach to reporting profits in the media is that one entity’s performance as represented by its *profit* might simply be compared to another, and that the entity with the higher reported profit might be considered to be more successful, and therefore to represent a better investment. Its management might also be considered in a more favourable light than the management of the entity with the lower reported profits. Implications such as this however, assume that readers and media listeners do not appreciate that

profits are directly related to the various accounting choices made. Advocates of an efficient market perspective might however, argue that as long as the information about accounting method selection is made public somewhere, such as in the annual report, then the market (for example, the capital market) on average, will be able to understand how the adoption of particular accounting methods affected reported profits and hence the market will not simply fixate on the final numbers reported. There are differences in opinion about the efficiency of markets, such as the capital market.

A further point that could be raised in relation to this question is that accounting 'profits' are not a comprehensive measure of organisational performance, given that accounting profits typically disregard many of the social and environmental implications of a reporting entity.

2.4 Some of the arguments in favour of regulating the practice of financial accounting are provided in the text and include the following:

- Markets for information are not efficient and without regulation a sub-optimal amount of information will be produced.
- While proponents of the 'free-market' approach may argue that the market *on average* is efficient, such *on average* arguments ignore the rights of individual investors, some of whom can lose their savings as a result of relying upon some unregulated disclosures.
- Those who demand information can often do this as a result of power over scarce resources. Parties with limited power (limited resources) will generally be unable to secure information about an organisation, even though that organisation may impact upon their existence.
- Investors need protection from fraudulent organisations that may produce misleading information, which due to information asymmetries, cannot be known to be fraudulent when used.
- Regulation leads to uniform methods being adopted by different entities, thus enhancing *comparability*.

There was also a view that major adverse events such as the Great Depression, and more recently, collapses such as Enron, WorldCom and HIH, were due to

the fact that financial information being provided about particular entities was misleading and did not enable readers to be aware of impending problems. Whether a 'better' system of accounting could have reduced the likelihood of events such as the Great Depression or unexpected corporate collapses is however, a highly debatable point.

2.5 Arguments in favour of eliminating regulation are often referred to as 'free-market' arguments. Advocates of a 'free-market' approach typically base their arguments on an assumption that markets (such as capital markets, labour markets and product markets) are efficient and that the markets will provide various incentives and penalties to ensure that managers, on average, do as the market expects. For example, if the capital market expects an entity's managers to provide information and the managers elect not to, then the market might penalise the entity by charging a higher price for funds advanced to the entity (to compensate the investors for the higher risk that they face as a result of having limited access to information to enable them to monitor their investment). Further, it is also believed by some people that the absence of information probably implies that the reporting entity has *bad news* that it has elected not to disclose (it is a 'lemon'). The textbook also identifies a number of other arguments that have been advanced to support a 'free-market' approach to providing accounting information. These include the following:

- Accounting information is like any other good, and people (financial statement users) will be prepared to pay for it to the extent it has use. This will, it is assumed, lead to an optimal supply of information by entities.
- Because users of financial information typically do not bear its cost of production, regulation will lead to oversupply of information (at cost to the producing firms) as users will tend to overstate the need for the information.
- Regulation typically restricts the accounting methods that can be used. This means that some organisations will be prohibited from using accounting methods that management believe best reflect their particular performance and position. This is considered to impact the efficiency with which the firm can inform the markets about their operations. This

will have implications for the costs involved when a firm needs to attract investment capital. This perspective is very critical of the ‘one-size-fits-all’ approach to accounting standards wherein the IASB is now responsible for developing accounting standards that are to be used by organisations operating within different industries and within different countries throughout the world (students should be encouraged to consider whether, for example, an accounting standard on inventory (IAS 2) is equally relevant for a motor vehicle manufacturer in China and a food producer in Australia.)

- 2.6 As the separation between the ownership and management of an organisation increases this generally leads to an increase in the demand for accounting regulation. As separation increases, parties with a financial interest in an organisation will have less direct knowledge of the operation of the organisation. They will then become dependent upon financial information being generated by the organisation. To help ensure that appropriate information is being provided to the external parties, regulation will be introduced to help ensure that generally accepted principles are being used in the preparation of the information, and to assist external parties to make assessments of one organisation’s financial position and performance relative to another organisation (the attribute of comparability).

Of course, the above argument is a ‘pro-regulation’ argument. As this chapter has demonstrated however, researchers that embrace an anti-regulation stance would not favour the introduction of regulation irrespective of changes in the degree of separation between management and ownership. Such researchers would argue that there are ‘market-based’ incentives for organisations to provide sufficient reliable information and that failure to produce such information will lead to market-based penalties being imposed upon the organisation.

- 2.7 Pursuant to capture theory, while regulation might initially be introduced in the public interest, the regulatory mechanisms are often subsequently captured by those groups that are subject to the regulation. The regulated parties seek to capture the regulatory process so that they can then act to ensure that any subsequent regulations do not disadvantage them. This chapter referred to the

work of Walker (1987) who provided evidence that the Australian accounting profession was able to capture the government controlled accounting standard-setter (at the time, the standard-setter was known as the Accounting Standards Review Board). Across various industries there has been historical evidence of related regulatory bodies being captured by vested industry interests.

- 2.8 This is an interesting question in the sense that it emphasises that one's view of the world influences whether one is prepared to accept a particular theoretical perspective. If we reject the view that individual behaviour can be explained in terms of self-interested, wealth-maximising behaviour then we would reject private economic interest theories of regulation. If we were trying to explain the regulatory process then we would search for an alternative theory that was more in accordance with our views (unless advocates of the private economic interest theory of regulation are able to convince us that their assumption is reasonable) about individual behaviour, alternatively, we might attempt to develop our own theory (however, most researchers rely on existing theories). Whatever theories and assumptions we adopt we must remember that perspectives about how humans behave cannot be expected to hold in all situations. While there might be a great deal of anecdotal evidence that some regulators behave as if in their own self-interest, hopefully there is also evidence that many regulators also take action in the public interest. Students should be encouraged to consider their own assumptions about what motivates regulators and therefore, what theories best correspond with their own views.

- 2.9 This is an interesting and topical question. Climate change is accepted (by most people) as being one of the greatest threats (if not, the greatest threat) to the future of man-kind and other inhabitants of the planet. Quests towards ecologically sustainable development, which incorporate actions to reduce ongoing contributions to climate change, necessarily put the interests of future generations above current quests to maximise our own wealth and self-interest.

However, if we accept the basic tenets of the private interest theory of regulation then we would probably reject a view that regulators would put the interests of the planet and that of future generations above their own. They would only put in place mechanism to reduce climate change if such actions were believed to be

directly beneficial to them. Since business corporations have a great deal of power within society, and because their views and support could have direct implications for the reappointment of the regulators, the opposition of business organisations might further reduce the likelihood that 'tough' regulation, with associated costs, would be put in place to combat climate change. For evidence of this we can consider the actions currently being undertaken by the Australian (and other) governments to combat climate change. To many people it would appear that the government action (or inaction) is due to a concern not to damage relations with business associations and because of the economic impacts such actions might take.

Arguably (and of course this is a value-laden belief), economics-based theories, which at their core adopt assumptions that self-interest (tied to wealth maximisation) drive the actions of individuals, do not provide great hope for real efforts to address ongoing ecological problems.

- 2.10 If we embraced the central tenets of either capture theory or the private interest theory of regulation then we would probably accept that 'objective' accounting standards (which favour no particular group) would only be developed if their creation coincided with furthering the interests of the standard-setters. This can be contrasted to the perspective we would adopt if we believed accounting standards were developed in the public interest, as would be suggested by public interest theory. However even under public interest theory, 'objective' accounting standards would only be developed if the overall benefits to society exceed any associated costs. Any consideration of costs and benefits also acts to undermine the objectivity of the accounting standard-setting process (cost benefit calculations inevitably include an element of subjectivity).

Hence, regardless of the theoretical basis adopted, we might question whether accounting standards will always be developed that 'fairly present information about the financial position and performance of a reporting entity'.

- 2.11 Accounting standard setters throughout the world typically consider the economic and social implications that could potentially arise, if particular accounting rules were put in place. That is, while a particular method of

accounting might be considered to provide the most accurate and efficient reflection of a reporting entity's financial position and performance (and of course, this in itself will be based on views about what are the most appropriate ways to measure and recognise elements of accounting—and there is much debate here), if it is considered that the proposed method might lead to unacceptable economic or social hardship for some members of the community, inclusive of the reporting entity, then the method may not be introduced even though it was otherwise considered to be the best method available.

Considerations of the costs and benefits of new accounting rules require a great deal of judgement and various costs and benefits have to be traded off against one another (and depending upon who is doing the analysis some costs and benefits might be included, or ignored, when doing the analysis). Considerations of costs and benefits can be very subjective. Many different parties will make lobbying submissions to the standard-setters in which they indicate how they will be impacted by the proposed requirements. Not all people will be satisfied by the outcome of the standard-setting process, with some believing that their case was not appropriately considered, and as a result, believing that they bear a disproportionate amount of the costs relating to the new requirements. If accounting standards were developed in a 'neutral' manner, then rules might be put in place on the basis of their theoretical merit and not as a result of considering the costs and benefits that might follow.

By considering various costs and benefits as part of the process of developing accounting standards, the final result will be that the accounting standards themselves will be an outcome of various cost/benefit trade-offs and political considerations. The standards will be different to those that would be developed solely on the basis of providing the most objective picture of the organisation's performance and position (and, of course, there will be differences of opinion as to what is an 'objective picture'). It could therefore be argued that given the process involved in developing accounting standards, in which various cost/benefit decisions are made and in which various lobbying submissions are considered, then the standards themselves are not developed in an objective manner. Without objectively-developed accounting standards it is questionable

whether financial reports developed in accordance with the standards can themselves be objective.

- 2.12 Free-market advocates would argue that if the users of financial accounting information are not required to pay for the information, then they will tend to overstate their demands and needs for information in an effort to encourage regulators to mandate additional disclosures. The free-market advocates believe this creates unnecessary costs for organisations as they will end up producing information that people would not demand if they knew they would have to actually pay for it. Free-market advocates argue that accounting information should be treated like other goods, and forces of supply and demand should be left to operate freely to determine the optimum amount of information to supply.
- 2.13 This is an argument that would be provided by people who are opposed to regulation and who would prefer that organisations be free to select the accounting methods that best reflect the underlying operations of the entity. It is an anti-regulation argument.

The basis of the argument is that organisations have various market-based incentives to provide information that best reflects the financial performance and financial position of the reporting entity. There is a view that the more efficiently an organisation is able to provide accounting information, the less the perceived risk of investing in an organisation. That is, there will be incentives for managers within organisations to select those accounting methods which best reflect the underlying financial performance and position of the entity (often referred to as the ‘efficiency perspective’).

Regulators might decide to restrict the accounting methods available to an organisation. (Perhaps the regulators release an accounting standard that prohibits various accounting methods; for example, they might release an accounting standard that requires all entities to expense research expenditure as it is incurred—even those entities that have undertaken research that will lead to significant economic benefits.) If this is the case, then the argument is that the reporting entity will no longer be able to select the most appropriate (or

‘efficient’) accounting methods, and hence the accounting information will not best reflect the financial performance or position of the entity.

If the information does not best reflect the underlying transactions, then users would not be able to monitor the entity as well as they might otherwise have been able to and this in itself will increase the perceived risk of investing in the entity. This in turn will lead to higher costs for the entity to attract funds.

While the above arguments (which are based on an efficiency perspective) argue against restricting the accounting methods that reporting entities can use, it should be appreciated that from an ‘opportunistic perspective’ there is a counter view. If we believe that managers might be opportunistic, then it might be preferable to restrict the available accounting options, as this will go some way towards restricting the propensity of managers to be ‘creative’ rather than objective when selecting accounting methods.

- 2.14 The basis of Hines’ (1989) arguments is that the accounting profession develops conceptual frameworks (which identify qualitative characteristics such as *objectivity*) primarily to provide benefits to themselves as a profession and that conceptual frameworks are ‘devices’ used to ensure the ongoing existence of the accounting profession by boosting the profession’s public standing. Conceptual frameworks are considered to represent a means of increasing the ability of a profession to self-regulate, thereby counteracting the possibility that government intervention will occur. Hines (1991, p.328) argues that ‘since the objectivity assumption is the central premise of our society... a fundamental form of social power accrues to those who are able to trade on the objectivity assumption. Legitimacy is achieved by tapping into this central proposition because accounts generated around this proposition are perceived as *normal*’.

If we are to accept Hines’ argument, then notions of ‘objectivity’ are nothing more than a façade. Hines also suggests that when accounting professions are in crisis (with threats of government intervention) this appears to be the very time that they undertake projects associated with developing conceptual frameworks.

- 2.15 The accounting standard-setting process is a political process in which constituents typically provide various submissions during the period in which accounting standards are developed (and for some accounting standards this period has been as long as a number of years). Depending upon the force of the argument, some arguments will have more effect on the regulators than others. Further, standard-setters have publicly stated (in vehicles such as conceptual frameworks) that they consider the economic and social implications of potential requirements as part of the process of developing new standards. Once the potential costs and benefits to various constituents are considered and weighted, which necessarily requires much judgement about the nature and relevance of the costs, and once the views of various constituents are taken into account, it is indeed difficult to believe that the ultimate accounting standards have been developed in a manner that can be considered objective (As we have seen in this chapter, there are a number of theories of regulation which suggest that regulators are driven by issues associated with their reappointment, rather than the public interest.). If accounting standards are developed on a basis that is less than objective, then the financial statements themselves can arguably not be considered as objective either (even though objectivity is promoted in various conceptual framework projects).
- 2.16 The argument is, that in developing accounting standards it is important and perhaps appropriate to consider the costs that might be imposed on some parties if the standards are put in place. That is, there may be some unacceptable economic consequences that might result from implementing the standards (at issue here is from whose perspective are the economic consequences deemed to be unacceptable—it would generally be considered that it is from the standard-setters' perspective). However, once we start considering the costs and benefits that might result (and the recognition and weighting of the respective costs and benefits would arguably be different depending upon whose perspective is adopted) rather than the merit of the standards themselves, we really cannot argue that the standards have been developed in an unbiased manner.
- 2.17 Hines challenges the view that accounting provides an account of the performance of an entity that is a faithful representation and objective. Rather than objectively recording a *snap-shot* of an underlying reality, accountants

actually *create* a reality. She believes that accountants are actually responsible for determining which factors should be recognised in the accounting process and which should be ignored. If accountants identify and record particular phenomena then the phenomena effectively become *real*. If accountants ignore particular issues (for example, the great majority of accountants ignore the social and environmental externalities caused by a business) then these issues are not highlighted and are therefore not, apparently, of any relevance. The practice of accounting identifies those issues for which the firm will be accountable—which issues are relevant. If managers do not want to be accountable for particular aspects of an entity's performance then perhaps the best strategy is not to record information about those aspects. If information about those aspects is not recorded and subsequently reported, then perhaps nobody will consider the particular aspects to have any relevance, and managers will not have any associated accountability.

There is also a view that accounting numbers can themselves generate consequences. If a company elects to use a particular accounting method, which leads to it recording a substantial loss, then this loss might cause panic and a rush by investors to withdraw their funds, even though the firm might have been able to trade out of difficulties. Had different methods been used, which perhaps painted a *rosier* picture, there might not have been such an adverse reaction. The accounting numbers themselves, which are based on many assumptions, led to actual outcomes that were very *real* for investors, customers, employees and others. If accounting used other performance indicators, apart from profits (such as contributions to the local communities or to employees) then stakeholder reactions might be different.

2.18 This chapter has provided a number of reasons why accountants might be considered to be *powerful* individuals. These reasons include the following:

- Consistent with the views of Hines, accountants can select which items or events should be *captured* by the accounting system, and this in turn impacts the extent of accountability managers have.
- Support for a company is often related to the performance of the company from an accounting perspective. Hence, if the accountant uses

particular methods that mean that a *profit* is reported then this may have positive consequences for a company relative to a situation where a *loss* is reported.

- Many contracts exist (for example, management bonus plans, debt contracts) which rely upon the output of the accounting process. Such contracts have direct cash-flow consequences for people both inside and outside the organisation and the cash-flows can be directly impacted by the accounting methods which have been chosen.
- If the accountant uses accounting methods which lead to a reported loss, this reported loss might be used as a justification for reducing the number of employees, support for community-based projects, and so forth.
- Consistent with the views of Gray (1992), for people to be able to make informed decisions and have ‘power’ to create change, they need information. The accountant often plays a part in determining how much information is to be released to the organisation’s stakeholders.
- Organisations that are profitable are often considered to be ‘good’ organisations worthy of support. They are considered to be *legitimate*—hence the accountant, through accounting, can have the effect of making a firm appear legitimate and thus it will attract community support.

2.19 If an organisation is required to publicly disclose information about a particular aspect of its performance then various stakeholders will have knowledge about that aspect of the organisation’s performance and will act accordingly. Conversely, if no information is publicly available about particular aspects of an organisation’s performance then people will not be sufficiently informed to take action in support of, or against, an organisation. In a sense, they would not have ‘power’ to create change.

Of course, some theorists might argue that if ‘the market’ requires such information and the organisation does not supply the information, then ‘the market’ will penalise the organisation. But such market-based arguments ignore the actions and expectations of many ‘non-financial’ stakeholders – unless the market believes they have the power to influence the financial position or performance of the reporting entity.

In relation to this question we can consider the accounting treatment of greenhouse gas emissions. Traditionally, the release of carbon gases into the environment have not been accounted for in financial accounting terms (unless particular fines were imposed). This has meant that many carbon intensive firms have shown massive profits at the same time they were making real contributions to climate change (of course, these views would be challenged by ‘climate-change skeptics’). Arguably, this is why relatively low efforts have been undertaken by corporations to reduce carbon emissions.

However, had the accounting profession developed an approach to account for carbon emissions and to place a cost thereon, then this would have had the very visible impact of reducing reported profits – and this would have been very visible. Reduced profits would have had the implications of reducing dividends. Those with a financial stake in the organisation would have then had a very good reason to encourage organisations to reduce their impacts on climate change – the impacts that accounting would be making ‘real’.

Given the above comments, a somewhat provocative question to pose to the students would be: is the accounting profession in part responsible for climate change? Some interesting and diverse views should follow.