1 Issues in Financial Reporting

The path to knowledge cannot be found without visions and an overall picture.

– R. Mattessich

Today's dynamic business environment is heralding a revolution in the need for, and the way in which, accounting data is utilized. This has resulted in talk of 'an accounting revolution' (Beaver, 1998) and the possible 'redefinition of accountancy' (Elliott, 1998: 7). However, it is all too easy to become caught up in this stampede for change, but how far can accounting change and for it still to be called accounting?

This chapter seeks to explore the major issues facing contemporary financial reporting – this will include its interrelationship with external auditing and the provision of assurance to those outside the reporting entity. After all, '[e]ffective reporting and accounting, and external scrutiny from auditors, are essential for effective corporate governance' (Company Law Review Steering Committee, 2001: para. 8.1). To understand the financial statements, one needs to appreciate the auditors' work and opinion, and, conversely, to understand the auditors' work and opinion, it is necessary to appreciate the scope and limitations of the financial statements. All too often, financial reporting and external auditing are treated and discussed in isolation despite being inextricably linked. However, the final figures in the financial statements may come about as a result of negotiations between management and their auditors – with the auditors examining the reasonableness of management's justifications for their representations. Indeed, the modern audit with its emphasis on high-level business risks could almost be viewed as the 'audit of motivations' – to understand the figures in the financial statements, it is important to understand management's motivations. Financial reporting and auditing are not just technical subjects, but they encompass a multitude of judgements and assumptions. This may go some way to explain why it is possible for a company to collapse not long after the publication of a set of accounts with an unqualified audit opinion. Auditing is not just about vouching the contents of the accounting records – it is just as important to understand accounting data in context. Therefore, this book explicitly recognizes

and seeks to explore the interdependences between financial reporting and auditing.

THE SCOPE OF THE PROBLEMS FACING FINANCIAL REPORTING

The changes taking place in the commercial environment have resulted in the accountancy profession critically reviewing its role and the relevance of its curriculum. A number of these developments in the commercial world are set out by Albrecht and Sack (2000: 5–6):

- technological developments resulting in the inexpensive preparation and dissemination of information, thus decreasing the cost and expertise necessary to produce the financial statements
- the globalization of business arising from 'instantaneous information' in tandem with quick and reliable methods of transportation
- the growth in pension funds and other institutional investors with a resultant increase in their power to influence businesses.

Albrecht and Sack quote a participant in their study as summarizing the situation as follows:

> *We are moving into an age of instant gratification – that seems to be true whether it's children, clients, or whatever – they want instant gratification and you have to provide the answers now! We not only have to provide the answers, but the right answers. As companies change, they can't get information fast enough and if they can't get it from us [accountants], they will get it somewhere else. (2000: 6)*

This concern may be exacerbated by the view expressed by the US Accounting Principles Board (APB, 1970: para. 40) that '[a]ccounting is a service activity'. It considered that the function of accounting 'is to provide quantitative information primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making resolved choices among alternative courses of action' (para. 40). This is very different from a definition in 1941 that stated: 'Accounting is an art of recording, classifying and summarizing in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character, and interpreting the results thereof' (cited by the American Institute of Accountants' Committee on Terminology, 1953: 9). This change in

definition shows that the concern about accounting and financial reporting being left behind as the business world develops is not a new phenomenon.

The major driving forces behind the developments in contemporary financial reporting include the following.

Globalization

This has given rise to the push for the international harmonization of accounting standards and the resultant debate about whose standards should be adopted. In the European Union, by 2005 publicly traded EU incorporated companies will have to follow the international financial reporting standards of the International Accounting Standards Board (IASB) – formerly the International Accounting Standards Committee (IASC). Over the final quarter of the twentieth century, there was increasing recognition of the politicization of the standards-setting process (Armstrong, 1977; Solomons, 1978; Zeff, 2002) and the implications of the economic consequences of accounting standards and policies (Zeff, 1978). Therefore, the adoption of international standards needs to be viewed as much in a political context as in an accounting one. However, '[i]nternational accounting standard-setting is currently in crisis' (Horton and Macve, 2000: 26).

The influence of management

This is a critical constituency when it comes to developments in accounting: 'Management is central to any discussion of financial reporting, whether at the statutory or regulatory level, or at the level of official pronouncements of accounting bodies' (Moonitz, 1974: 64). One of the reasons for the failure of the current cost experiment in the early 1980s was the lack of support from financial statement preparers (they were not convinced of the validity of the exercise). Current values are now starting to creep into the financial statements, and '[s]ome corporate executives concerned about the volatility of reported results have claimed that standard-setters have a hidden agenda to undermine the bedrock of historical cost by introducing piecemeal requirements for current value measurement' (Miller and Loftus, 2000: 5). There is a concern that the standard setters may be requiring data for external reporting that management does not find useful for its own internal uses. The debacle regarding current cost accounting in the 1980s should not be forgotten.

Extreme market pressures

The pressures from the capital markets are forcing management to achieve earnings targets:

> *These pressures are exacerbated by the unforgiving nature of the equity market as securities valuations are drastically adjusted downward whenever companies fail to meet 'street' expectations. Pressures are further magnified because management's compensation often is based in large part on achieving earnings or other financial goals. (Panel on Audit Effectiveness, 2000: 3)*

One consequence of these market pressures is the danger of 'aggressive earnings management' that 'results in stakeholders, and the capital markets generally, being misled to some extent about an entity's performance and profitability' (Auditing Practices Board, 2001: 3). Recent financial scandals may be viewed as coming about as a result of extreme disclosure and earnings management.

The informational perspective of the financial statements

The emphasis is now on the provision of information to enable the users of the financial statements to take decisions and to make assessments of future cash flows of the reporting entity. Since the 1960s, users have been actively involved in dialogue about accounting principles and are represented on some accounting standard-setting bodies. 'An outsider, however, might find it remarkable that accounting knowledge should be articulated not only by professional accountants, but also by accounting information users – much like doctors and patients collaborating on the development of medical knowledge' (Hines, 1989: 80). In 1994, the AICPA issued a report containing the findings of a special committee aimed at improving business reporting. The intention was to 'influence future agendas of standard setters and regulators and the direction of their projects'. Its adoption of 'a customer focus' orientation was explained as follows:

> *Just as successful businesses align the features of their products and services with the needs of their customers, so, too, should the providers of business reporting. Recognizing this, the Committee concentrated on the information needs of users to help identify and evaluate ideas for improvement. (AICPA, 1994: 4)*

The user-primacy, decision-oriented view has not gone unchallenged, and it may have resulted in unrealistic expectations about what the financial statements are capable of delivering. While analysts may want to predict the future, others may still wish to understand the past – shareholders will want dividends, governments will want taxation and information for their statistics, and employees will be interested in a fair return for their efforts. In Germany, the protection of creditors has been the driving force behind corporate reporting. Bankers are interested in predicting future cash flows, but as they are generally in a privileged position, having access to the company's budgets, they will not have to rely on the financial statements to make their predictions. Increasingly, companies are having private meetings with key stakeholders (Holland, 1997; Marston, 1999).

Scott (1994: 62) considered that there 'is the increasing evidence that investors may not be as rational and security markets may not be as efficient as previously believed. This threatens the foundation upon which most financial accounting research over the last 25 years has been based, and has led to calls for a "return to fundamentals".'

The debate about financial performance

The 'statement of financial performance' (ASB, 2000) combines the statement of total recognized gains and losses and the profit and loss account, one reason for this being that users seemed to be ignoring the 'statement of total recognized gains and losses'. However, there is a question as to what is meant by the word 'performance' and whether just focusing on 'financial performance' will really indicate an enterprise's overall performance. The operating and financial review aims to expand on the contents of the financial statements, but in the management accounting area, the recognition of the limitations of financial performance indicators has resulted in the search for complementary indicators, such as the balanced scorecard (Kaplan and Norton, 1996). These issues are now being recognized in relation to external reporting (Upton, 2001).

Advances in technology

This has resulted in a questioning of the relevance of the financial statements: 'The demand for more timely and broader information comes from decision makers, such as potential investors, creditors, customers and suppliers, who are doing, or may want to do, business with an entity' (CICA, 1999: 2). However, because of the multitude of decisions involved, '[i]t is likely that

decision makers' information needs will be met at least in part by real-time access to corporate databases, a possibility that is increasingly feasible given advances in information technology' (CICA, 1999: 2), whereby users would be able to access the data they considered relevant to their decisions.

> *Technology-driven information systems are capable of capturing, organizing and disseminating information in 'real time'. Investors can quickly access information and consequently have expanded their demands for both financial and non-financial information. Some of that information is 'traditional' historical financial data, and some of it is new. (Panel on Audit Effectiveness, 2000: 172)*

It is even suggested that greater disclosure may result in a lower cost of equity capital for some firms (Botosan, 1997). However, if users are ignoring data in the financial statements, one has to wonder how they would cope with this cornucopia of financial data:

> *Accounting is the instrument used to treat a mass of enterprise facts so that the flow of transactions becomes intelligible. . . . It is hard to overestimate the contribution to understanding made by compressing a mass of facts and by setting up the resulting data in ways that permit comparisons to be made. The mind cannot grasp very many separate facts at once, and figures lose most of their significance unless the eyes can see quickly whether they are larger or smaller than they were. (Littleton, 1953: 25)*

In the age of the database, the relevance of double-entry bookkeeping has been questioned (Doost, 2000). However, it is likely that some sort of accounting control system will still be required. There is the danger that real-time reporting may be the ultimate in short-termism.

The development of the knowledge economy

This has implications for financial reporting with its current emphasis on tangible assets. There is a concern that the financial statements may not reflect this development:

> *For the past two hundred years, neo-classical economics has recognized only two factors of production: labour and capital. This is changing. Information and knowledge are replacing capital and energy as the primary wealth-creating assets, just as the latter two replaced land and labor 200 years ago. In addition, technological developments in the 20th century have transformed the majority of wealth-creating work from physically-based to 'knowledge-based'. Technology and knowledge are now the key factors of production. . . . We are now an information society in a knowledge economy. (Enterprise Development Website, 2000: 1)*

This is already having an impact and is leading to a questioning of the usefulness of the financial statements:

> *Research by Arthur Andersen into 10,000 public companies showed that by 1998, under 30% of their market capitalization was represented by book value. More than 70% of their value fell outside the public measurement and reporting system. This is a dramatic shift from just 20 years before, when book value provided 95% of market value. (Lindsey, 2001: 117)*

But before the usefulness of the financial statements is criticized, it is important to be clear about what they are trying to show.

The rise of corporate governance

Though accountability has long been seen as one of the reasons for financial reporting,

> *A series of spectacular corporate failures and financial scandals . . . including BCCI, Polly Peck and Maxwell, highlighted concerns about the standard of financial reporting and accountability. These concerns centred around an apparently low level of confidence in both financial reporting and in the ability of the auditors to provide safeguards which the users of company annual reports sought and expected. (Davies et al., 1999: 223)*

Recent years have seen the rise in importance of corporate governance, and this could be seen to culminate in the Company Law Review (2001), which viewed corporate governance as being central to future developments in corporate reporting and accountability. It is important to view the financial statements in the context of corporate governance (and not vice versa), and it should be remembered that corporate governance encompasses much more than just financial reporting (Short et al., 1999). Therefore, it would seem reasonable that issues like corporate social responsibility and environmental accounting should be viewed in terms of corporate governance rather than financial reporting per se. If a problem is greater than accounting, it should not be considered in just an accounting context.

While all these developments have been occurring, the auditors have had to try to respond, as well as react, to criticisms of their own work.

Independence

This can be viewed as the key quality of the external audit; however, auditors have frequently been criticized for their perceived lack of independence: 'How unfair may the financial statements be and yet be deemed fair in accordance with GAAP?' (Briloff, 1986: 27). If auditors are not independent, the relevance of the audit can quite rightly be questioned. In order to help bolster the independence of the external auditors, larger companies have established audit committees.

Globalization

As a consequence of globalization 'today's complex economic world requires a break from the auditing traditions that have evolved from the early balance sheet audit' (Bell et al., 1997: 12) – in particular, the emphasis on the business risk approach to auditing (Lemon et al., 2000).

> *Industrial-age companies ran on tangible assets such as inventory, machinery, buildings and land. Post-industrial, information-age enterprises run on intangible assets, including information, human resources, and R & D. If we are to analyze the risks facing the audited company and understand its operations, we must understand these new ingredients for value creation and destruction. (AICPA chairman-elect, R.K. Elliott, quoted by KPMG [1999: 18])*

Audit developments

As a result of the above factors, there has been a perceived change in audit emphasis – from 'audit efficiency' (aiming to reduce audit costs) to 'audit effectiveness' (with an emphasis on whether the audit is achieving its objective). This has resulted in a re-engineering of the audit process, which will need to continue (Panel on Audit Effectiveness, 2000), and in the drive to add value to the external audit.

Assurance services

The pressure to 'add value' to the external audit has resulted in the consideration of how to extend the audit function. The Elliott Committee (1997a) identified opportunities for assurance services to expand to the new types of information used by decision makers. It defined 'assurance services' as 'independent professional services that improve the quality of information, or its context, for decision makers' (p. 1).

A comprehensive real-time database approach to external reporting

This would have major implications for the external auditors, as '[i]nformation provided on a real-time basis to investors inevitably will raise the question of its reliability' (Panel on Audit Effectiveness, 2000: 172). The perceived need for more timely assurance has given rise to the notion of 'continuous assurance' through a 'continuous audit' (CICA, 1999). Because of the pace of business and the speed of digital communication, it is suggested that the people who were users of the financial statements want continuous assurance about the systems and controls within an organization.

Fraud

'Accounting history is littered with examples of financial information used as a means of deception' (Edwards, 1989: 143).

> *Fraudulent financial statements are of great concern not only to the corporate world, but also to the accounting profession. Every year the public has witnessed spectacular business failures reported by the*

> *media. . . . These catastrophic events have shocked the public, undermined auditors' credibility in their reporting function, and eroded public confidence in the accounting and auditing profession. . . . Events such as unreported revenues, manipulation of losses, inflated sales, fraudulent write-offs of uncollectible accounts, unusual related-party transactions, misappropriation of assets and many other irregularities have spearheaded several court rulings and shaped the auditing standards. (Vanasco, 1998: 60)*

The detection of fraud is an often cited expectation of the external auditors. In Victorian times, the audit did have the detection of fraud as its primary objective (Lee, 1986: 31); however, auditors are now required to plan their work in order to have a reasonable expectation of detecting material misstatements arising from error or fraud (APB, 1995: para. 18).

Given the multiplicity and magnitude of the problems relating to the production and utilization of the financial statements, it is critical that there is a firm conceptual basis underpinning financial reporting in order to have a foundation from which to tackle these issues:

> *Accountants must respond to these challenges. But the response should come after a careful study of the foundations upon which accounting has been constructed. The most dangerous trap that accountants can fall into is to be confused and demoralized by the numerous challenges from the neighboring areas of accounting in business and economics and to justify their theories and practices here and there with a humble apology to these neighbors. Accounting has its own way of thinking about, observing, and organizing business phenomena. What is more important, accounting has its own discipline and philosophy, which have developed over centuries. This does not mean that they should not be changed. It emphasizes that the response to the challenges should be made keeping in mind the effects of this response upon accounting foundations. (Ijiri, 1967: ix)*

One way of tackling the multitude of problems facing financial reporting is to build upon accounting theory. The importance of the interrelationship between theory and practice was set out by Littleton as follows:

> *Because accounting theory and practice are inseparably connected, neither can stand alone. To understand practice fully, we need to*

> *understand theory as well. And to understand the integrated structure of accounting theory, we need to know something of the totality that is accountancy, and something of its related fields. (1953: 1)*

The changing nature of accounting does have implications for theory development. What impact would all the developments mentioned have on accounting theory? While it would be expected that practice would change over time, would theory really be expected to change? If it does change, does this mean that it was flawed, or indeed could any proposed changes to the theory be flawed? How far can accounting change for it still to be called accounting?

STRUCTURE OF THE BOOK

Chapter 2 will examine the notion of 'accounting theory', noting that this phrase is usually used in the sense of financial accounting and financial reporting. The main concerns raised in this chapter relate to the ill-defined, broad scope and political nature of 'accounting theory'. It raises the question of whether it is appropriate to think in terms of 'accounting theory'. While decision-usefulness appears to have been the cornerstone of conceptual developments since the 1960s, agency theory and communication theory are explored as alternative conceptual bases from which to view financial reporting.

In order to obtain a feeling for the scope and limitations of financial reporting, Chapter 3 will examine the development of accounting and corporate reporting. It seems that the notion of stewardship predates the earliest forms of accounting by hundreds if not thousands of years. Though early forms of accounting were used for stewardship purposes, the nature of these earliest forms may have been more akin to management accounting than financial accounting; therefore, it may be problematic whether the concept of stewardship can simply be transferred to the external reporting. One of the problems is that most users are so divorced from the running of the business that they may not have the appropriate level of knowledge required to assess the management's stewardship. Early accounting records were forms of internal control – as businesses grew in size, better records were needed for control purposes (hence the development of double-entry bookkeeping). The size of business enterprises continued to increase, leading to the development of permanently invested capital, and thus requiring the life of the business entity to be divided into artificial accounting periods – so that a return could be made to the owners for that period. This led to the development of the periodic calculation of profit (on a prudent basis).

Chapter 3 also emphasizes the importance of viewing financial reporting in the context of corporate governance, and not vice versa.

Chapter 4 will look at more recent developments in financial reporting and the regulation of accounting. In particular, it will examine the development of the belief that the objective of the financial statements is to enable users to take economic decisions and to enable them to make their own predictions of future cash flows. The quest for the development of a conceptual framework will also be examined in this chapter, but given the weakness in 'accounting theory' and the politicization of the standards-setting process, there may be a question as to whether such conceptual frameworks are really conceptual.

In Chapter 5, the development of the company external audit will be examined in order to see how it has changed over time in line with changes in the business environment. The views of senior auditors will be presented on the development of the audit process. In particular, the change in audit emphases – from systems work and vouching to examining the business risks – will be covered. The four 'generations' of audits will be discussed as well as the potential fifth-generation 'continuous audit'. The recognition of 'adding value' to the audit and the extension to assurance services will also be examined.

In Chapter 6, the management–auditor relationship will be explored. External auditors are required to have independence of mind, and there is a concern that this may be compromised by financial and personal considerations. However, auditors can form opinions only on things of which they are aware. The potential for management bias in the preparation and presentation of the financial statements is ever present. This chapter suggests that the external audit may more properly be viewed as the audit of motivations – and this may help to explain some of the problems faced by the auditors. While outsiders may wish the auditors to look specifically for fraud, this is problematic. The word 'fraud' may be a useful umbrella term, but it is very vague – it could encompass anything from a false expense claim to a fictitious overseas subsidiary. Therefore, auditors plan their work with a reasonable expectation of detecting material misstatements. On occasion, it has been known for fraudsters to be unable to identify their own fictitious entries in the accounting records! This does raise implications for the external auditors.

Chapter 7 will examine the message the auditor is trying to communicate at the end of the audit. As communication theory has been identified in Chapter 2 as being applicable to financial reporting, it would also seem to be appropriate to relate it to the audit report. Communication theory may help to explain why readers struggle with the auditor's message. Chapter 7 will report the views of senior auditors on what they consider to be the auditors' message at the end of the audit. Auditors do not seem to view their role as being to eliminate bias or minimize bias, but seem to prefer to view their role as being to examine the reasonableness of management's justifications for its

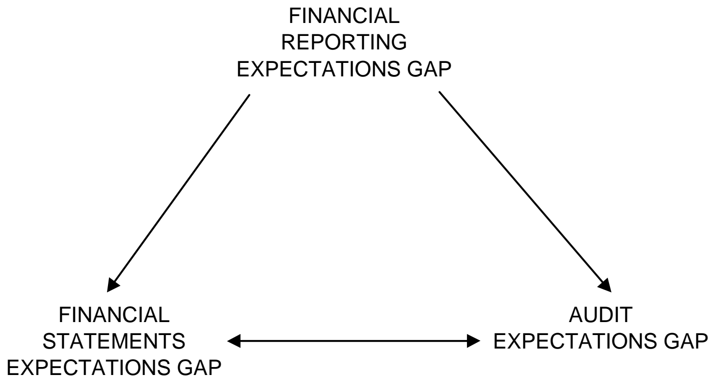

FIGURE 1.1 The financial reporting expectations gap

representations. The development of the phrase 'a true and fair view' will be examined. Interestingly, these auditors were quite critical of the phrase 'a true and fair view'.

Chapter 8 will suggest the possibility of a financial reporting expectations gap, comprising a financial statements expectations gap and an audit expectations gap (Figure 1.1). Much work has been conducted relating to the audit expectations gap, but the notion of a financial statements expectations gap is relatively unexplored. While effort has been put into trying to reduce the audit expectations gap, this may be a futile task if there is a larger expectations gap relating to the financial statements themselves. Chapter 8 goes on to suggest that the imprecise definition of the objective of the financial statements by standard-setters may be contributing to the financial statements expectations gap. It also questions whether the financial statements really reflect 'performance'. After all, the auditors say nothing about economy, efficiency or effectiveness in their audit report. In addition to this, as most readers of the financial statements are very remote from the reporting entity, it is difficult for them to form views on what could have been, or what should have been achieved. Although the financial statements are used as a surrogate performance indicator, it is important that such users are aware of the limitations of such statements.

Having identified the financial reporting expectations gap, Chapter 9 seeks to offer an alternative basis for the construction of a conceptual framework for external corporate reporting, namely, the corporate communication of performance and risk. This would be viewed in terms of corporate governance and would focus on the reporting entity rather than on the myriad of potential users of the financial statements. After the limitations of the financial statements have been recognized, the debate about how to communicate

corporate performance and risk can begin. In recognition that traditional accounting information (historically transaction-based financial data) may no longer be considered the language of business (Elliott Committee, 1997b), auditors are being encouraged to expand their assurance services to encompass these other types of information – much of it non-financial. For internal reporting purposes, management has started to supplement the accounting numbers with other performance indicators (including non-financial indicators), but while the objective of the financial statements is so all-embracing the external demand for such data is likely to be stifled.

CONCLUSION

This chapter has tried to explore the diversity of crucial issues currently facing financial reporting. It must be remembered that the second half of the twentieth century saw a number of subtle changes in the way the financial statements are viewed, but their ramifications have been profound. The focus of financial reporting has moved from providing the financial statements to shareholders, to the provision of general-purpose financial statements to enable users to take decisions and make predictions of future cash flows. Users of the financial statements have been keen to expound their requirements, but

> *if the responses of receivers [users] to accounting stimuli is to be taken as evidence that certain kinds of accounting practices are justified, then we must not overlook the possibility that those responses were conditioned. . . . The receivers are likely to have gained the impression that they ought to react, and have noted that others react, and thereby have become conditioned to react. The fact that Pavlov's dog reacted to the sound of a bell does not provide justification for the existence of the bell. (Sterling, 1970: 453)*

The current emphasis appears to be on assisting almost instantaneous decision making and the prediction of the future possibly at the expense of understanding the past. Capital markets are considered to impound information into a share price as soon as it is available, but it must not be forgotten that markets are comprised of a multitude of human judgements. As with any judgement, its validity depends on the experience, the evidence and understanding of the person who has to form the opinion. Just because the users of the financial statements may want something, at what point is it necessary to say that accountants (and indeed anyone else) cannot provide them with it? Awareness of the limitations of the financial statements is a key starting point

in the quest for alternative/supplementary disclosures. However, this does not mean that accountants should be embarrassed about the limitations of the financial statements – the financial statements do have their uses, it is just that they may not satisfy the needs of some very vocal users.

The advances in information technology now mean that there has been a proliferation in the number of producers and users of accounting data. This 'mass access' is probably accompanied by half-remembered warnings (or even worse, no knowledge) about the limitations of this data. It is important that advances in technology are matched with advances in common sense; however, the vagueness of 'accounting theory' may mean that this 'common sense' is not so common.

DISCUSSION QUESTIONS

1 Given all the issues discussed in this chapter, do you consider that external financial reporting has lost its focus? Prepare an argument to defend the stance you take.

2 Most financial advertisements that appear in newspapers specifically warn that past performance may not necessarily be a guide to future performance. How do you reconcile this with the standard setters' emphasis on enabling users of the financial statements to predict future cash flows?

3 Real-time reporting would presumably result in profits/losses and gains/losses being calculated on a minute-by-minute basis. How useful/realistic do you think this would be?

4 With the rise of the 'knowledge economy', it is likely that companies will have more and more intangible assets that at present are not recognized in the financial statements. What are the implications of this for accountants, companies and those outside the reporting entity?

5 What is the distinction between aggressive earnings management and fraud?

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