Learning Objectives

Upon completing this chapter readers should:

♦ have a broad understanding of the history of the accounting profession and of accounting regulation;
♦ be aware of some of the arguments for and against the existence of accounting regulation;
♦ be aware of some of the theoretical perspectives used to explain the existence of regulation;
♦ be aware of how and why various groups within society try to influence the accounting standard-setting process;
♦ acknowledge that many accounting decisions are based on professional opinions and have an awareness of some of the theories used to explain what influences the accountant to choose one accounting method in preference to another;
♦ be aware of some of the arguments advanced to support a view that the accountant can be considered to be a powerful member of society.

Opening issues

(a) Through such mechanisms as conceptual framework programmes, accounting professions throughout the world promote a view that accounting reports, when prepared properly, will be objective and will faithfully represent the underlying transactions and events of the reporting entity. Is it in the interests of the accounting profession to promote this view of objectivity and neutrality, and if so, why?
Introduction

Financial accounting is a process involving the collection and processing of financial information to assist in the making of various decisions by many parties external to the organization. These parties are diverse and include present and potential investors, lenders, suppliers, employees, customers, governments, the local community, parties performing a review or oversight function, and the media. Financial accounting deals with the provision of information to parties not involved in the day-to-day running of the organization. As there are many parties external to the firm, with potentially vastly different information demands and needs, it is not possible to generate a single report which will satisfy the specific needs of all parties (reports that meet specific information needs are often referred to as special-purpose reports). As such, the process of financial accounting leads to the generation of reports deemed to be general purpose financial reports.

Financial accounting tends to be heavily regulated in most countries, with many accounting standards and other regulations governing how particular transactions and events are to be recognized, measured and disclosed. The reports generated, such as the balance sheet, profit and loss account (or income statement), statement of cash flows, operating and financial review, and supporting notes, are directly impacted by the various accounting regulations in place. When existing accounting regulations change, or new accounting regulations are implemented, this will typically have an impact on the various numbers (such as particular revenues, expenses, assets and liabilities) included in the reports provided to the public.

Ideally, users of financial reports should have a sound working knowledge of the various accounting standards and other regulations because, arguably, without such a knowledge it can be difficult (or perhaps near impossible) to interpret what the reports are actually reflecting. For example, ‘profit’ is the outcome of applying particular accounting rules and conventions, many of which are contained within accounting standards. As these rules change (as they frequently do), the same series of transactions will lead to different measures of ‘profits’ and net assets. Such a situation leads to an obvious question: should readers of financial reports be expected to understand financial accounting? The answer is yes, even though many
users of financial statements (including many company directors and financial analysts) have a very poor working knowledge of accounting.

Throughout the world, various professional accounting bodies have stated specifically that users of financial reports do need to have some level of knowledge of financial accounting if they are to understand financial reports properly. For example, the International Accounting Standards Board’s conceptual framework (IASC, 1989, paragraph 25) states that:

... users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence.²

If we are to review an annual report of a company listed on a stock exchange, we will soon realize just how confusing such a document would be to readers with a limited knowledge of accounting (and, as became clear in the aftermath of the collapse of Enron, many people with formal qualifications in accounting also have trouble interpreting the accounting reports of companies which have more complex financial structures and engage in more complex financial transactions). Unfortunately, many readers of financial statements have tended to consider figures such as ‘profits’ or ‘assets’ as being ‘hard’ objective numbers which are not subject to various professional judgements. Hence, although such users may not understand some of the descriptions of accounting methods used, they may believe that they understand what ‘profits’ and ‘net assets’ mean. As we know, however, the accounting results (or numbers) will be heavily dependent upon the particular accounting methods chosen, as well as upon various professional judgements made. Depending upon who compiles the accounting reports, measures of profits and net assets can vary greatly.³

A review of annual reports will indicate that many companies provide summary ‘highlight’ statements at the beginning of the reports. Often, multi-year summaries are given of such figures as profits, return on assets, earnings per share, dividend yield, and net asset backing per share. By highlighting particular information, management could be deemed to be helping the less accounting-literate readers to focus on the important results. However, a downside of this is that management itself is selecting the information to be highlighted (that is, such disclosures are voluntary) and as a result, a large amount of otherwise important information may be overlooked.

Financial accounting can be contrasted with management accounting. Management accounting focuses on providing information for decision making by parties who work within an organization (that is, for internal as opposed to external users) and it is largely unregulated. While we will find that most countries have a multitude of financial accounting standards which are often given the force of law, the same cannot be said for management accounting. Because management accounting relates to the provision of information for parties within the organization, the view taken is that there is no need to protect their information needs or
rights. It is the information rights of outsiders who are not involved in the day-to-

day management of an entity that must be protected. Because financial reports are

often used as a source of information for parties contemplating transferring

resources to an organization, it is arguably important that certain rules be put in

place to govern how the information should be compiled. That is (adopting a pro-

regulation perspective), to protect the interests of parties external to a firm, some

regulation relating to accounting information is required. We now briefly consider

the history of accounting practice and its associated regulation.4

An overview of the development and regulation of accounting practice

This section examines the development of accounting regulations in jurisdictions

where the primary role of financial accounts has been to aid investment decisions

made by external investors in developed capital markets. As we will see in Chapter 4,

the primary role of financial accounting in many European countries has historically

been different to this capital market based role. However, with increasing globaliz-

ation of business and capital markets, the role of financial accounting by large

companies in all European countries is now primarily focused on the provision of

information to capital markets, and regulations developed over a long period of

time in capital market dominated economies (with large numbers of external share-

holders) now apply to most large European Union (EU) companies.

While the practice of financial accounting can be traced back many hundreds of

years, the regulation of financial accounting in most capital market dominated

economies (such as the USA, UK, Ireland, Australia, Canada) generally commen-

ced in the twentieth century. In part this lack of regulation in the early days

may have been due to the fact that until recent centuries there was a limited

separation between the ownership and management of business entities and, as

such, most systems of accounting were designed to provide information to the

owner/manager. In the last century there was an increase in the degree of separation

between ownership and management in many countries, and with this increased

separation came an increased tendency to regulate accounting disclosures.

Reliance on double entry bookkeeping

Early systems of double entry bookkeeping and accounting, similar to the system

we use today, have been traced back to thirteenth- and fourteenth-century

Northern Italy. One of the earliest surviving descriptions of a system of double

entry accounting is by the Franciscan monk Luca Pacioli as part of his most famous

work entitled Summa de Arithmetica, Geometrica, Proportioni et Proportionalita,

published in Venice in 1494. A review of this work (there are translated versions)

indicates that our current system of double entry accounting is very similar to that

developed many hundreds of years ago. Even in the days of Pacioli there were debits
and credits, with debits going on the left, credits on the right.\(^5\) There were also journals and ledgers. Reflecting on the origins of double entry accounting, Hendriksen and Van Breda (1992, p. 36) state:

Debits, credits, journal entries, ledgers, accounts, trial balances, balance sheets and income statements all date back to the Renaissance. Accounting, therefore, can claim as noble a lineage as many of the liberal arts.\(^6\) Accounting students can take pride in their heritage. Part of this heritage is a rich vocabulary, almost all of which dates back to this period and much of which is fascinating in its origin.

Debits and credits, which as we now know originated a number of centuries ago, have, over the ages, proved to be the bane of many an accounting student. So, did we really need them? Why couldn’t we have simply used positive and negative numbers? For example, if we were to pay wages, why couldn’t we have simply put a positive number under the wages column and a negative number under the cash column? The simple answer to this appears to be that negative numbers were not really used in mathematics until the seventeenth century. Hence, the t-account was devised to solve this problem with increases being on one side, and decreases on the other. But why keep the t-account, now that we accept the existence of negative numbers? Pondering this issue, Hendriksen and Van Breda (1992, p. 51) comment:

Textbook writers still explain how debits are found on the left and credits on the right and teach students the subtraction-by-opposition technique that was made obsolete in arithmetic three centuries ago. Programmers then faithfully seek to reflect these medieval ideas on the modern computer screen.

As we will see in subsequent chapters, there are many criticisms of our financial accounting systems. For example, there is an increasing trend towards the view that financial accounting should reflect the various social and environmental consequences of a reporting entity’s existence. Unfortunately, however, our ‘dated’ double entry system has a general inability to take such consequences into account – but we will cover more of this in later chapters, particularly in Chapter 9.

**Early development of professional bodies**

While accounting and accountants have existed for hundreds of years, it was not until the nineteenth century that accountants within the United Kingdom and the United States banded together to form professional associations. According to Goldberg (1949), a Society of Accountants was formed in Edinburgh in 1854, later to be followed by a number of other bodies, including the Institute of Chartered Accountants in England and Wales (ICAEW), which was established in 1880. According to Mathews and Perera (1996, p. 16), from the early years, the ICAEW was very concerned about the reputation of its members and as a result set conditions for admission, including general education examinations, five years of articles served with a member of the institute, and intermediate and final examinations in a range of subjects.
Within the United States the American Association of Public Accountants was formed in 1887 (Goldberg, 1949). This association went on to form the basis of the American Institute of Certified Public Accountants (AICPA). While members of these bodies were often called upon to perform audits in particular circumstances, and while companies were generally required to prepare accounting reports subject to various company laws and stock exchange requirements, there was a general absence of regulation about what the reports should disclose or how the accounting numbers should be compiled.

**Early codification of accounting rules**

In the early part of the twentieth century there was limited work undertaken to codify particular accounting principles or rules. Basically, accountants used those rules of which they were aware and which they (hopefully) believed were most appropriate to the particular circumstances. There was very limited uniformity between the accounting methods adopted by different organizations, thereby creating obvious comparability problems. Around the 1920s a number of people undertook research that sought to observe practice and to identify commonly accepted accounting conventions. That is, they sought to describe ‘what was’, rather than assuming a normative position with regards to ‘what should be’. By simply describing current practice, the researchers gave themselves limited possibility for actually improving accounting procedures. As Mathews and Perera (1996, p. 20) state:

> This led to a practice-theory-practice cycle and tended to retard the progress of accounting, because there was no value judgement exercised in respect of the practices which were observed. In other words, there was no opportunity to examine critically what was being practised before the next generation of accountants were prepared in the same manner.

Early researchers who provided detailed descriptions of existing conventions of accounting included Paton (1922); Paton and Littleton (1940); Sanders, Hatfield and Moore (1938); and Gilman (1939). These studies described such things as the doctrines of conservatism, concepts of materiality, consistency, the entity assumption, and the matching principle.

A great deal of the early work undertaken to establish particular accounting rules and doctrines was undertaken in the United States. In 1930 the accounting profession within the United States cooperated with the New York Stock Exchange (NYSE) to develop a list of broadly used accounting principles. According to Zeff (1972), this publication is one of the most important documents in the history of accounting regulation and set the foundation for the codification and acceptance of generally accepted accounting principles. The NYSE requested the accounting profession to compile the document as it was concerned that many companies were using a variety of (typically undisclosed) accounting methods.
Development of disclosure regulations

Within the United States it was not until 1934 that specific disclosures of financial information were required by organizations seeking to trade their securities. The Securities Exchange Act of 1934, as administered by the Securities Exchange Commission (SEC), stipulated the disclosure of specific financial information. The SEC was given authority to stipulate accounting principles and reporting practices. However, it allowed the accounting profession to take charge of this activity as long as it could clearly indicate that it would perform such duties diligently. In an effort to convince the SEC that it could identify acceptable accounting practices, the American Institute of Accountants (one of the predecessors of the AICPA) released, in 1938, a study by Sanders, Hatfield and Moore entitled *A Statement of Accounting Principles*.

In 1938 the SEC stated (within Accounting Series Release No. 4) that it would only accept financial statements prepared in accordance with the generally accepted accounting principles of the accounting profession – thereby giving a great deal of power to the profession. In part, ASR No. 4 stated:

> In cases where financial statements filed with the Commission ... are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters are material. In cases where there is a difference of opinion between the Commission and the registrant as to proper principles of accounting to be followed, disclosure will be accepted in lieu of correction of the financial statements themselves, only if the points involved are such that there is substantial authoritative support for the practices followed by the registrant and the position of the Commission has not previously been expressed in rules, regulations, or other releases of the Commission, including the published opinion of its chief accountant.

While the above statement does indicate that the SEC was to allow the accounting profession to determine acceptable practice, many considered that the SEC was also warning the accounting profession that it must take an authoritative lead in developing accounting standards, otherwise the SEC would take over the role (Zeff, 1972). From 1939 the Committee on Accounting Procedure, a committee of the accounting profession, began issuing statements on accounting principles, and between 1938 and 1939 it released 12 Accounting Research Bulletins (Zeff, 1972).

Development by the accounting profession of mandatory accounting standards is a relatively recent phenomenon. In the United Kingdom it was not until 1970, when the Accounting Standards Steering Committee was established (later to become the Accounting Standards Committee and then the Accounting Standards Board), that UK accountants had to conform with professionally developed mandatory accounting standards. Prior to this time the ICAEW had released a series of ‘recommendations’ to members. In the United States, although there had been Accounting Research Bulletins (released by the Committee on Accounting
Procedure, formed in 1938), and Opinions (released by the Accounting Principles Board, formed in 1959), these Bulletins and Opinions were not mandatory. Rather they indicated perceived best practice. There tended to be many corporate departures from these Bulletins and Opinions and as a result, in 1965 a rule (Rule 203 of the AICPA) was introduced that required departures from principles published in APB Opinions to be disclosed in footnotes to financial statements. From 1 July 1973 the APB was replaced by the Financial Accounting Standards Board (FASB), which has subsequently released many accounting standards that are mandatory.

As noted at the beginning of this section, and as will be explored in greater depth in Chapter 4, financial accounting practices (and therefore the regulation of financial accounts) in many European countries was not primarily focused on the provision of information to aid investment decisions by external shareholders in capital markets. Regulation of accounting through professionally developed standards is therefore an even more recent phenomenon in large parts of Europe than it is, for example, in the UK, Ireland or the Netherlands. However, regulation through accounting standards of the consolidated financial statements of all companies whose shares are traded on any stock exchange in the EU became compulsory from 1 January 2005. A further significant change in the accounting regulatory frameworks of many countries occurred following several high profile accounting and audit failures in the USA in 2001 and 2002 (such as Enron and WorldCom). Although, as Unerman and O’Dwyer (2004) point out, these were not the first large scale accounting failures to occur since the inception of regulation through professional accounting standards, they were much larger than previous failures and occurred at a time of sharply falling stock markets. Private investors who were already losing confidence in stock markets due to their financial losses on falling share prices now perceived accounting failures as contributing to even larger losses. In this climate, politicians came under pressure to make accounting regulation more rigorous, and they passed legislation (such as the US Sarbanes-Oxley Act of 2002) to give greater legal force to many existing and new regulations.

The rationale for regulating financial accounting practice

As indicated above, even though financial reports have been in existence for hundreds of years, the regulation of accounting in economies dominated by capital markets (with large numbers of external investors) is a fairly recent phenomenon. Early moves for regulation of accounting were introduced in the United States around the 1930s and followed events such as the Wall Street stock market crash of 1929. Rightly or wrongly it was argued that problems inherent to accounting led to many poor and uninformed investment decisions (Boer, 1994, Ray, 1960), and this
fuelled the public desire for information generated by companies to be subject to
greater regulation.

In most countries with developed capital markets and large numbers of external
investors, there are a multitude of accounting regulations covering a broad cross-
section of issues – but do we really need all this regulation? As we will see in the next
chapter, there are two broad schools of thought on this issue. There are parties who
argue that regulation is necessary, with reasons including:

- 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 capital
  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 unregulated disclosures;
- those who demand information can often do so due to power over scarce
  resources. Parties with limited power (limited resources) will generally be unable
  to secure information about an organization, even though that organization may
  impact on their lives;
- investors need protection from fraudulent organizations that may produce mis-
  leading information, which due to information asymmetries, cannot be known
  to be fraudulent when used (such as apparently occurred at WorldCom in the
  USA and Parmalat in Italy);
- regulation leads to uniform methods being adopted by different entities, thus
  enhancing comparability.

Others argue that regulation is not necessary, particularly to the extent that it
currently exists. Some of the reasons cited include:

- accounting information is like any other good, and people (financial statement
  users) will be prepared to pay for it to the extent that it has use. This will lead to
  an optimal supply of information by entities;\(^{10,11}\)
- capital markets require information, and any organization that fails to provide
  information will be punished by the market – an absence of information will be
  deemed to imply bad news;\(^{12}\)
- because users of financial information typically do not bear its cost of produc-
  tion, regulation will lead to oversupply of information (at a cost to the produc-
  ing firms) as users will tend to overstate the need for the information;
- regulation typically restricts the accounting methods that may be used. This
  means that some organizations will be prohibited from using accounting
  methods which they believe best reflect their particular performance and
  position. This is considered to impact on the efficiency with which the firm can
  inform the markets about its operations.
When regulation is introduced, there are various theories available to describe who benefits from such regulation. There is the public interest theory of regulation which proposes that regulation be introduced to protect the public. This protection may be required as a result of inefficient markets. Public interest theory assumes that the regulatory body (usually government) is a neutral arbiter of the ‘public interest’ and does not let its own self-interest impact on its rule-making processes. According to Scott (2003, p. 448), following public interest theory, the regulator ‘does its best to regulate so as to maximize social welfare. Consequently, regulation is thought of as a trade-off between the costs of regulation and its social benefits in the form of improved operation of markets’.

A contrary perspective of regulation is provided by capture theory which argues that although regulation is often introduced to protect the public, the regulatory mechanisms are often subsequently controlled (captured) so as to protect the interests of particular self-interested groups within society, typically those whose activities are most affected by the regulation. That is, the ‘regulated’ tend to capture the ‘regulator’. Posner (1974, p. 342) argues that ‘the original purposes of the regulatory program are later thwarted through the efforts of the interest group’. Empirical evidence of a regulator making individual decisions which favour the groups that it regulates is not sufficient to demonstrate regulatory capture (as each of these decisions might be regarded as the most appropriate in the circumstances). Rather, most of the regulator’s whole programme of regulation needs to work in the interests of the regulated, and usually against the interests of those who the regulator is intended to protect. This implies that accounting regulations can have a different impact on different people or groups, and there is evidence (discussed in the next chapter) showing that specific accounting regulations do have social and/or economic consequences which vary between different groups.

Both public interest theories and capture theories of regulation assert that initially regulation is put in place to protect the public (capture theory simply asserts that the regulated will then subsequently attempt to control the regulatory process). Another view, which is often referred to as private interest theory (or economic interest group theory), is proposed by researchers such as Stigler (1971) and Peltzman (1976). This theory relaxes the assumption that regulations are initially put in place to protect the public interest, as well as the assumption that government regulators are neutral arbiters not driven by self-interest. Stigler (1971) proposes that governments are made up of individuals who are self-interested and will introduce regulations more likely to lead to their re-election. In deciding upon particular regulation they will consider the impacts upon key voters, as well as on election campaign finances. Individuals with an interest in particular legislation are deemed more likely to get their preferred legislation if they can form themselves into large organized groups with strong cohesive voting power. These theories of
regulation (public interest theory, capture theory and private interest theory), as well as others, are further considered in Chapter 3.

If we are to accept the need for accounting regulation, a further issue to consider is who should be responsible for the regulation – should it be in the hands of the private sector (such as the accounting profession), or in the hands of government? Can private sector regulators be expected to put in place regulations that are always in the public interest, or will they seek to put in place rules that favour their own constituency? Advocates of private sector accounting standard-setting would argue that the accounting profession is best able to develop accounting standards because of its superior knowledge of accounting, and because of the greater likelihood that its rules and regulations would be accepted by the business community. Proponents of public sector accounting standard-setting argue that government has greater enforcement powers, hence the rules of government are more likely to be followed. It might also be less responsive to pressures exerted by business, and more likely to consider overall public interest.

What we demonstrate in subsequent chapters is that the regulation of accounting (or indeed an absence of regulation) can have many economic and social consequences. As such, the accounting standard-setting process is typically considered to be a very political process, with various interested parties lobbying the standard-setters.

The role of professional judgement in financial accounting

As we know from studying accounting, the process involved in generating accounts depends upon many professional judgements. While the accounting treatment of many transactions and events is regulated, a great deal of accounting treatment pertaining to other transactions and events is unregulated. Even when particular regulations are in place, for example, that buildings must be depreciated, there is still scope to select the useful life of the building and the residual value. Many such judgements must be made – should an item be capitalized or expensed? This in turn will depend upon crucial assessments as to whether the expenditure is likely to generate future economic benefits.

At the core of the accounting process is an expectation that accountants should be objective and free from bias when performing their duties. The information being generated should represent faithfully the underlying transactions and events and it should be neutral and complete (IASC, 1989, paragraphs 33, 36 and 38). However, can we really accept that accounting can be ‘neutral’ or objective? Throughout the world, several national accounting standard-setters have explicitly considered the economic and social implications of possible accounting standards prior to their introduction (the consideration of economic and social consequences
is referred to in some countries’ conceptual framework projects). In these countries, if the economic or social implications of a particular accounting standard have been deemed to be significantly negative, then it is likely that the introduction of the standard would have been abandoned – even though the particular standard may have been deemed to more accurately reflect particular transactions or events. While it is difficult to criticize a process that considers potential impacts on others, it is nevertheless difficult to accept that accounting standards are neutral or unbiased. In a sense the acceptance of the need to consider economic and social consequences as part of the standard-setting process has created a dilemma for standard-setters. According to Zeff (1978, p. 62):

The board (FASB) is thus faced with a dilemma which requires a delicate balancing of accounting and non-accounting variables. Although its decisions should rest – and be seen to rest – chiefly on accounting considerations, it must also study – and be seen to study – the possible adverse economic and social consequences of its proposed actions ... What is abundantly clear is that we have entered an era in which economic and social consequences may no longer be ignored as a substantive issue in the setting of accounting standards. The profession must respond to the changing tenor of the times while continuing to perform its essential role in the areas in which it possesses undoubted expertise.

However, this willingness to take into account the possible wider social and economic consequences in developing accounting standards has reduced in several countries in recent years. For example, in the UK in 2001 and 2002, many large companies blamed (possibly unfairly) the rules in a controversial new accounting standard on pension costs for their decisions to withdraw elements of their pension schemes from many employees. This can be considered to have been a significant negative social consequence from the new accounting standard for these employees, but the UK accounting regulator refused to change the accounting standard (despite considerable political pressure).

In Chapters 7 and 8 we consider various theoretical perspectives proposed as explanations for why particular accounting methods may be implemented by a reporting entity (remember, the accounting treatment of many transactions and events is not subject to accounting standards). Consistent with a perspective of objectivity is a view that organizations are best served by selecting accounting methods that best reflect their underlying performance. This is referred to as an ‘efficiency perspective’ (derived from Positive Accounting Theory). The efficiency perspective asserts that different organizational characteristics explain why different firms adopt different accounting methods (Jensen and Meckling, 1976). For example, firms that have different patterns of use in relation to a particular type of asset will be predicted to adopt different amortization policies. Advocates of the efficiency perspective argue that firms should be allowed to choose those
accounting methods that best reflect their performance, and that accounting regulations that restrict the set of available accounting techniques will be costly. For example, if a new accounting standard is released that bans a particular accounting method being used by a reporting entity, then this will lead to inefficiencies as the resulting financial statements may no longer provide the best reflection of the performance of the organization. It would be argued that management is best able to select which accounting methods are appropriate in given circumstances, and government or other bodies should not intervene in the standard-setting process. This perspective, however, does not consider that some financial statement preparers may be less than objective (that is, like Enron, WorldCom or Parmalat, they may be creative) when preparing the financial reports. The efficiency perspective also dismisses the comparability benefits that may arise if standard-setters reduce the available set of accounting methods.

An alternative perspective to explain why particular accounting methods are selected (and which is also derived from Positive Accounting Theory) is the 'opportunistic perspective'. This perspective does not assume that those responsible for selecting accounting methods will be objective. Rather, it assumes that they will be driven by self-interest (Watts and Zimmerman, 1978). This perspective provides an explanation of the practice of creative accounting, which is defined as an approach to accounting wherein objectivity is not employed, but rather, refers to a situation where those responsible for the preparation of accounts select accounting methods that provide the result desired by the preparers. As an example, an organization might, like Enron, opportunistically elect to structure certain transactions in a manner designed to remove specific assets and related liabilities from its balance sheet (a technique known as off balance sheet funding) not because these assets and liabilities do not ‘belong’ to the organization, but perhaps because this off balance sheet funding has the effect of reducing the reported debt to equity (capital gearing) ratio at a time when the organization is close to breaching particular accounting-based agreements negotiated with external parties, such as loan agreements which have a stipulated minimum allowable debt to equity ratio, below which particular assets of the reporting entity may be seized.

Apart from the efficiency and opportunistic perspectives, there are a number of other theoretical perspectives proposed to explain why an entity may select particular accounting and disclosure policies (other perspectives include legitimacy theory, political economy theory and stakeholder theory). Chapter 8 further explores the alternative perspectives. However, what is being emphasized at this point is that, although there is much accounting regulation in place (and there are various theories to explain the existence of regulation), there are also many accounting decisions that are unregulated (giving rise to various theories to explain the choice of particular accounting methods from the set of available alternatives).
How powerful is the accountant?

Accountants are often the butt of many a cruel joke. They are often portrayed as small, weak individuals with poor social skills. For example, consider the depictions of accountants in various movies and television programmes. In the (in)famous Monty Python ‘Lion Tamer’ sketch, in which John Cleese is cast as a recruitment consultant who interviews Michael Palin (who plays Mr Anchovy the accountant and aspiring lion tamer), Cleese describes the accountant as:

An extremely dull fellow, unimaginative, timid, lacking in initiative, spineless, easily dominated ... Whereas in most professions these would be considerable drawbacks, in accountancy they are a positive boon.\(^\text{15}\)

Most of us would also probably remember such characters as Louis Tully, the ‘nerd’ accountant in _Ghostbusters_ and Leo Getz the bumbling accountant in _Lethal Weapon 2_ and _3_. These are only two of many poor depictions that movies make of accountants. While accountants may be the subject of such (poorly informed and unpleasant) depictions and taunts, we can rest in the knowledge that we accountants are indeed very powerful individuals. The assertion that accountants are powerful (which is obviously flattering to students of accounting) is based on a number of perspectives, as follows:

- The output of the accounting process (for example, _profits_ or _net asset backing per share_) impacts on many decisions such as whether to invest in or lend funds to an entity, whether to lobby for increased wages based on profitability, whether to place an entity into technical default for failure to comply with previously agreed accounting-based restrictions, whether to lobby government for intervention because of excessive _profits_, and so on. That is, many transfers of funds (and therefore wealth) arise as a result of reports generated by accountants through the accounting process. Because accounting is heavily reliant on professional judgement, the judgement of the accountant can directly impact on various parties’ wealth.

- There is also a perspective that accountants, in providing objective information to interested parties, can in a sense provide or transfer to them a source of ‘power’ to drive changes to corporations’ behaviour. As Gray (1992, p. 404) states:

  ... power can be exercised in some degree by all ... external parties. For that power to be exercised there is a basic need for information (as an essential element of the participatory democratic process ...) and this information will be an extension of that currently available. That is, the widest possible range of participants must be emancipated and enabled through the manifestation of existing but unfulfilled rights to information.

- By emphasizing particular performance attributes (such as _profits_), accountants can tend to give legitimacy to organizations that otherwise may not be deemed to be legitimate.
Further reflecting on the above points, we can consider the work of Hines (1988, 1991). Hines (1991, p. 313) stresses a perspective that ‘financial accounting practices are implicated in the construction and reproduction of the social world’. What she is arguing is that by emphasizing measures such as profits (which ignores many negative social and environmental impacts) accounting can cause people to support organizations that may not otherwise be supported. By holding profitability out as some ideal in terms of performance, profitable companies are considered to be good companies.

Consider Exhibit 2.1. The newspaper report emphasizes the profits (and cost reduction measures) of British American Tobacco (BAT). If underlying profits increase, this is typically portrayed as a sign of sound management. The earning of profits tends to be seen as consistent with a notion of legitimacy – profits are reported and emphasized as some form of objective measure of performance. But as we know, and what the media typically neglects to note, is that the measure of profits really depends on the assumptions and judgements made by the particular team of accountants involved. As can be seen from Exhibit 2.1, no mention is made of the accounting methods employed by BAT. This is typical of media coverage given to corporate performance, with accounting results (for example, profits) being apparently promoted as hard, objective calculations. Financial accounting can engender such views because it is promoted (through such media as conceptual frameworks) as being objective and reliable and having the capacity to accurately reflect underlying facts. As Hines (1991, p. 315) states in relation to conceptual framework projects:

> It appears that the ontological assumption underpinning the CF is that the relationship between financial accounting and economic reality is a unidirectional, reflecting or faithfully reproducing relationship: economic reality exists objectively, inter-subjectively, concretely and independently of financial accounting practices; financial accounting reflects, mirrors, represents or measures this pre-existent reality.

What also should be appreciated is that the measures of profit calculated for BAT (and other organizations) ignore many social and environmental externalities caused by the reporting entity. In the case of a cigarette manufacturer such as BAT there is scientific evidence that their product causes major adverse social (and related economic) consequences. Accounting, however, ignores these externalities. Furthermore, the factory closures mentioned in the newspaper report were portrayed in the (positive) terms of cost savings, ignoring the negative social impact (externalities) of the closures on the workers employed in these factories or the communities where the factories were located.

A counter view to the above perspective (that accounting is objective and provides an accurate reflection of a pre-existent reality) is the view adopted by Hines that accountants can, in a sense, create different realities, depending upon the particular
BAT takes £50m China write-down

Lisa Urquhart

British American Tobacco has taken a £50m write-down on the money it spent trying to get agreement to build a factory in China.

The group is in a stand-off with the Chinese state tobacco monopoly over whether it has agreement to build a factory.

Paul Adams, chief executive, said the decision did not reduce BAT’s determination to break into the world’s biggest cigarette market. ‘We continue to have our discussions with the Chinese government and we continue to make slow progress.’

BAT also raised the prospect of factory closures across its 65 sites worldwide to reduce costs. Supply-chain savings have reached £120m over the last two years as the group has closed factories and moved production.

Analysts also welcomed the news that the group had stepped up its overhead cost saving targets from £200m to £320m by 2007 after finding itself ahead of schedule.

The emphasis on cost savings helped Jan du Plessis, chairman, to predict future earnings per share growth in high single figures. Underlying earnings per share rose 10 per cent in 2004, ahead of expectations.

But he once again ruled out a large acquisition to aid growth. ‘We are comfortable that our strategy can deliver organic growth, we don’t need to do any large acquisitions to add growth,’ he said. There has long been speculation that BAT might bid for rival Gallaher.

The group reported 2004 pre-tax profit up 20 per cent to £1.87bn. Underlying operating profit rose 2 per cent to £2.83bn, in line with forecasts.

Group volumes, including make-your-own cigarettes, increased 8 per cent to £853bn cigarettes in the year, helped by the merger of its US business with RJ Reynolds.

The price war and duty increases continued to be felt in Canada, where profit from Imperial Tobacco Canada fell by £122m, or 36 per cent, to £342m. Despite some recovery in prices, the group predicted further profit and volume falls in Canada for 2005.

The contribution from BAT’s €2.3bn (£1.6bn) purchase of Ente Tabacchi Italiani went some way to offset the Canadian performance as European profit rose by £190m to £726m.

The proposed final dividend of 29.2p (27p) gives a total of 41.9p (38.8p) on earnings per share that almost doubled from 26.93p to 52.2p. This was helped by a share buy-back. BAT promised to pay half its future earnings in dividends.

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judgements taken, the accounting standards available, and so on. That is, accounting does not objectively reflect a particular reality – it creates it. This view is also supported by Handel (1982, p. 36) who states:

Things may exist independently of our accounts, but they have no human existence until they become accountable. Things may not exist, but they may take on human significance by becoming accountable ... Accounts define reality and at the same time they are that reality ... . The processes by which accounts are offered and accepted are the fundamental social process ... . Accounts do not more or less accurately describe things. Instead they establish what is accountable in the setting in which they occur. Whether they are accurate or inaccurate by some other standards, accounts define reality for a situation in the sense that people act on the basis of what is accountable in the situation of their action. The account provides a basis for action, a definition of what is real, and it is acted on so long as it remains accountable.

While one team of accountants may make various accounting assumptions and judgements which lead to a profit being reported, it is possible that another team of accountants may make different assumptions and judgements which lead to the same organization (with the same transactions and events) reporting a loss. Recording a loss may generate many negative reactions from various stakeholder groups (for example, from shareholders, the media and analysts) and may cause real negative cash flow consequences for the reporting entity. Hines (1991, p. 20) further reflects on the power of the accounting profession. She states:

If, say, auditors qualify their report with respect to the going-concern assumption, and/or insist that a corporation’s financial statements be prepared on the basis of liquidation values, this in itself may precipitate the failure of a company which may otherwise have traded out of its difficulties.

Another point to be made (which is related to the above point), and one which we consider further in Chapter 3, is that few, if any, accounting standards are introduced without some form of economic and social impact (which as we know from previous discussion in this chapter is considered by many accounting standard-setters). As an example, we can consider the various arguments that were raised over the implementation of International Accounting Standard (IAS) 39 (Financial Instruments: Recognition and Measurement) by several EU countries. Many European banks argued that implementation of IAS 39 would require them to value certain financial assets and liabilities in a manner which would not reflect the underlying economic reality of many financial transactions, and this would result in unrepresentative and highly volatile profit or loss figures and substantially weakened balance sheets. It was further argued that these weakened balance sheets and highly volatile reported profits would impact on market perceptions of banks’ creditworthiness, thus increasing their cost of capital. Banks in some European countries successfully lobbied their own governments to actively support the banks in seeking to change certain requirements of IAS 39. As we will see in Chapter 4, as
part of the EU regulatory process the EU established the Accounting Regulatory Committee (ARC) whose task is to scrutinize all international accounting standards and recommend whether they should be enforced in the EU. Successful lobbying by banks in Italy, Spain, Belgium and France led to these countries’ members of the ARC voting against EU adoption of IAS 39 in July 2004, apparently because of its potential negative economic impact.

Because of these wider social and economic impacts, perspectives of accounting as being neutral in its effects are now widely dismissed (Zeff, 1978). Many national standard-setting bodies throughout the world explicitly state in their various documents (which often form part of their respective conceptual frameworks) that economic and social implications of particular pronouncements must be considered prior to the introduction of new accounting rules. As Zeff (1978, p. 60) states:

> The issue of economic consequences has, therefore, changed from one having only procedural implications for the standard-setting process to one which is now firmly a part of the standard-setters’ substantive policy framework.

The IASB, which has now effectively taken over the accounting standard-setting process in many countries (including all members of the EU), does not have such a formal requirement to consider the broader social and economic implications of their accounting rules. However, members of both the IASB and its supervisory body (the International Accounting Standards Committee Foundation) must be aware that, in practice, if they develop too many accounting standards which have widespread negative social and/or economic impacts in many nations, the governments of these nations are likely to reduce or withdraw their support for continued use of International Financial Reporting Standards in their nations.

Hence we are left with a view that while the notion of objectivity and neutrality is promoted within various conceptual frameworks (perhaps, as Hines suggests, as a means of constructing a perceived legitimacy for the accounting profession), various factors such as the possible economic and social implications, and the potential influences of management self-interest (culminating in some form of creative accounting) can lead us to question such claims of objectivity. This chapter has also promoted a view that accountants do have quite a degree of power – many decisions with real economic and social implications are made on the basis of accounting information. Whether accounting information is like any other good that can be freely traded in the marketplace, or whether it should be subject to regulation, is an issue that we further investigate in the next chapter.
In this chapter we explored how the output of the financial accounting process is used in many different decisions by parties both within, and outside, an organization. Because the financial accounting process provides information to parties external to the organization who otherwise would not have information, and because this information is often used as the basis for many decisions, it is generally accepted that it is necessary to regulate the practice of financial accounting.

Financial accounting practices are heavily regulated. However, in countries dominated by strong capital markets (with large numbers of external investors), the history of financial accounting regulation is relatively recent and there was a general absence of such regulation prior to the twentieth century. In the early parts of the twentieth century, accounting research often involved documenting commonly used accounting practices. This research led to the development and acceptance of broad principles of accounting that all accountants were expected to follow. Over time, broad principles gave way to the development of specific accounting standards. Accounting standards began to be released by various accounting professional bodies throughout the world around the 1970s and standard-setting activity has tended to increase since then. Financial accounting practices throughout the world today are generally regulated by a large number of accounting standards.

The act of regulating accounting practices through the continual release of new and revised accounting standards has led to various arguments for and against regulation. The arguments range from the belief that there is no need to regulate accounting practices (the ‘free-market’ approach) to a view that regulation is necessary to protect the interests of those parties with a stake in a reporting entity. Arguments against regulation often rely upon the view that the output of the financial accounting system should be treated like any other good, and if the market is left to operate freely, optimal amounts of accounting information will be produced. Introducing regulation leads to an oversupply of accounting information and can cause organizations to use accounting methods that do not efficiently reflect their actual operations, financial position, and financial performance. As we see in subsequent chapters, such ‘free-market’ arguments are challenged by many people.

This chapter has also briefly considered various theories about who is likely to benefit from regulation once it is introduced (Chapter 3 extends much of this discussion). We considered public interest theory which proposes that regulation is introduced to protect the public and when putting regulation in place, regulators seek to maximize the overall welfare of the community (which

Chapter summary

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This chapter has also briefly considered various theories about who is likely to benefit from regulation once it is introduced (Chapter 3 extends much of this discussion). We considered public interest theory which proposes that regulation is introduced to protect the public and when putting regulation in place, regulators seek to maximize the overall welfare of the community (which
obviously requires trade-offs of particular costs and benefits). Another theory that we considered was capture theory which proposes that while regulation might initially be introduced for the public’s benefit, ultimately the group that is regulated will gain control of the regulation process. That is, they will eventually ‘capture’ the regulatory process. We also considered private interest theories of regulation, which propose that the regulators introduce regulation that best serves the regulators’ own private interests. That is, regulators are motivated not by the public interest, but by their own self-interest. For example, politicians will introduce regulation likely to generate enough support to ensure their re-election.

We also considered issues associated with the ‘power’ of accountants. Arguments were advanced to support a view that accountants hold a very powerful role within society (which stands in contrast to how they are often portrayed in the media). Accountants provide information that is used in many decisions and they are able to highlight or downplay particular facets of an organization’s performance.

Questions

2.1 Do you consider that users of financial reports should have a sound working knowledge of the various accounting standards in use? Explain your answer.

2.2 Do you believe that the media portray accounting numbers, such as profits, as some sort of ‘hard’ and objective performance indicator? Why do you think they might do this, and if they do, what are some of the implications that might arise as a result of this approach?

2.3 Briefly outline some arguments in favour of regulating the practice of financial accounting.

2.4 Briefly outline some arguments in favour of eliminating the regulation pertaining to financial accounting.

2.5 As this chapter indicates, Stigler (1971) proposes a theory (private interest theory) in which it is proposed that regulatory bodies (including accounting standard-setters) are made up of individuals who are self-interested, and these individuals will introduce regulation that best serves their own self-interest. Under this perspective, the view that regulators act in the public interest is rejected. From your experience, do you think that this is an acceptable assumption? Assuming that you reject this central assumption, would this have implications for whether you would be prepared to accept any predictions generated by the private interest theory?
2.6 Because accounting standard-setters throughout the world typically consider the potential economic and social consequences of potential accounting standards when developing accounting standards, it has been argued that reports developed in accordance with the accounting standards cannot be considered neutral or unbiased. Do you agree with this perspective? Is this perspective consistent with the qualitative attributes typically promoted in accounting conceptual framework projects?

2.7 Hines (1991) promotes a view that it is in the interest of the accounting profession to publicly promote a view that the information they generate is ‘objective’. Why do you think this is the case?

2.8 Solomons (1978, p. 69) quotes the American Accounting Association: ‘Every policy choice represents a trade-off among differing individual preferences, and possibly among alternative consequences, regardless of whether the policy-makers see it that way or not. In this sense, accounting policy choices can never be neutral. There is someone who is granted his preference, and someone who is not.’

Required: Evaluate the above statement.

2.9 While it is difficult to criticize a process that considers potential impacts on others, at the same time it is difficult to accept that accounting standards are neutral or unbiased.

Required: Evaluate the above statement.

2.10 Hines (1991, p. 313) stresses a view that ‘financial accounting practices are implicated in the construction and reproduction of the social world’.

Required: What does Hines mean in the above statement? Do you agree or disagree with her, and why?

2.11 Why might accountants be construed as being powerful individuals?

Notes

1 In its Preface to International Financial Reporting Standards (IASB, 2002, paragraph 10), The International Accounting Standards Board defines ‘general purpose financial statements’ as reports ‘directed towards the common information needs of a wide range of users’.

2 Within the United States conceptual framework project, reference is made to the ‘informed reader’ who should have sufficient knowledge of accounting to be able to appropriately interpret financial statements compiled in accordance with generally accepted accounting principles.

3 Yet all the various financial statements may be deemed to be true and fair – which implies that accountants are able to provide different versions of the truth.

4 Although we are focusing on financial accounting in this text, a similar argument can be made in favour of the regulation of social and environmental reporting. Corporations generate many social and environmental impacts which can affect a variety of stakeholders. Such stakeholders arguably have a right to know about the social and environmental implications of an organization’s operations. Such information
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could then provide the basis for decisions about whether the stakeholders will support
the organization’s operations.

5 According to Hendriksen and Van Breda (1992, p. 36), our use of the word debit can
be traced back to the word *debere* (which is shortened to *dr*). This is the Latin word for
an obligation, and can be interpreted as meaning *to owe*. The word credit (abbrevi-
ated to *cr*) can be linked to the Latin word *credere* which means to believe or trust in
someone.

6 Hatfield (1924) points out that Luca Pacioli (who was a prominent academic of his day)
was a close friend of Leonardo da Vinci, and that da Vinci was one of the first people to
buy a copy of *Summa de Arithmetica* and drew the illustrations for one of Pacioli’s
later books.

7 For example, within the United Kingdom the Joint Stock Companies Act 1844
required that companies produce a balance sheet and an auditor’s report thereon for
distribution to shareholders before its annual meeting. This requirement was
removed in a 1862 Act, but reinstated in a 1900 Act. In 1929 a requirement to produce
a profit and loss account was introduced.

8 In 1900 the New York Stock Exchange
required companies applying for listing to
prepare financial statements showing the
results of their operations as well as details
about their financial position. In 1926 the
exchange further required that all listed
companies provide their shareholders with
an annual financial report in advance of the
companies’ annual general meetings. The
report did not have to be audited.

9 Five of the identified principles subsequently
formed the basis of Chapter 1 of Accounting
Research Bulletin No. 43, as issued by the
Committee on Accounting Procedure.

10 Advocates of a regulated approach would
argue, however, that accounting informa-
tion is a public good and, as a result, many
individuals will obtain the information for
free (this is often referred to as the ‘free-
rider’ problem). Once this occurs, reliance
on market-mechanism arguments tends to
be flawed and the usual pricing mechanisms
of a market cannot be expected to operate
(Cooper and Keim, 1983).

11 This ‘free-market’ perspective is adopted by
researchers who work within the agency
theory paradigm. This paradigm is discussed
in Chapter 7.

12 Accepting this perspective, and consistent
with Akerlof (1970), companies that fail to
produce necessary information, particularly
if the information is being produced by
other entities, will be viewed as ‘lemons’, and
these ‘lemons’ will find it more costly to
attract funds than other (‘non-lemon’) entities.

13 In some countries, accounting regulation is
in the hands of both private sector and
public sector entities. As an example, within
the EU, accounting regulations are de-
veloped by the International Accounting
Standards Board (private sector) but have to
be endorsed by the Accounting Regulatory
Committee (public sector) before they are
enforced for EU companies. In the United
States, both the Financial Accounting
Standards Board (private sector) and the
SEC (public sector) have released accounting
standards.

14 According to Hines (1991, p. 330) it is in the
accounting profession’s interest to publicly
promote a perspective of objectivity. As she
states, ‘the very talk, predicated on an
assumption of an objective world to which
accountants have privileged access via their
“measurement expertise”, serves to construct
a perceived legitimacy for the profession’s
power and autonomy’.

15 Smith and Briggs (1999) provide a more
thorough overview of how accountants have
been portrayed in movies and on television.

16 Authors such as Molotch and Boden (1985)
provide a view that a form of social power is
attributed to those people and professions
able to ‘trade on the objectivity assumption’
(p. 281).
References


