FINANCIAL ACCOUNTING THEORY
Craig Deegan

CHAPTER 2

The financial reporting environment

Slides written by Craig Deegan

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PPTs to accompany Deegan, *Financial Accounting Theory* 4e

Learning objectives

2.1 Have a broad understanding of the history of the accounting profession and of accounting regulation.

2.2 Be aware of some of the arguments for and against the existence of accounting regulation.

2.3 Be aware of some of the theoretical perspectives used to explain the existence of regulation.

2.4 Be aware of how and why various groups within society try to influence the accounting standard-setting process.

2.5 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.

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Learning objectives (cont.)

2.6 Be aware of some of the arguments advanced to support a view that the accountant can be considered to be a very powerful member of society.

2.7 Be aware of some assumptions made by accounting standard-setters (in regards to such issues as report readers' knowledge and information needs), and how such assumptions influence the development of accounting regulation.

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Financial accounting defined

- A process involving the collection and processing of information of a financial nature for the purpose of assisting various decisions to be made by parties **external** to the organisation
- Can be contrasted with management accounting which relates to the provision of information to people within the organisation
- With the above definitions in mind, can we explain why financial accounting is heavily regulated but management accounting is not?

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General purpose financial reporting

- Medium and large organisations will typically have diverse users of financial reports who have different information needs
- In the presence of many users it is not generally possible to generate reports to meet individual needs
- This leads to the generation of 'general purpose financial reports' – reports that are governed by accounting standards and conceptual frameworks

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General purpose financial reporting

- The objective of general purpose financial reporting, according to the *IASB Conceptual Framework* is:
  - *to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.*
- If we disagree with the above objective, then we will tend to disagree with the contents of the *Conceptual Framework*
  - do we disagree with elements of the above objective?

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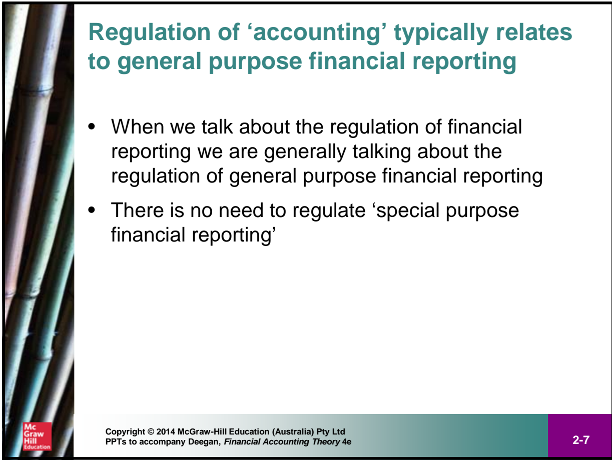
Regulation of 'accounting' typically relates to general purpose financial reporting
• When we talk about the regulation of financial reporting we are generally talking about the regulation of general purpose financial reporting
• There is no need to regulate 'special purpose financial reporting'
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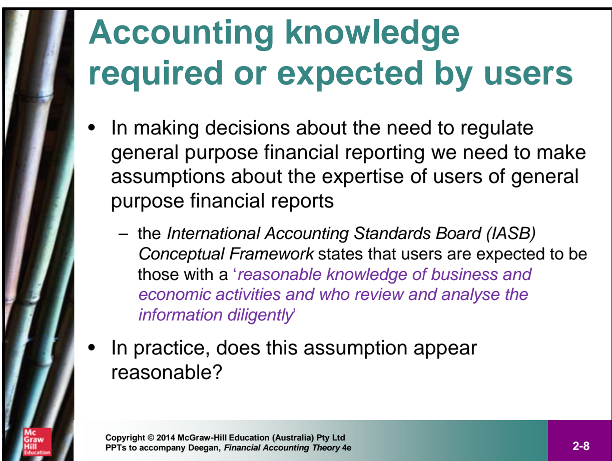
Accounting knowledge required or expected by users
• In making decisions about the need to regulate general purpose financial reporting we need to make assumptions about the expertise of users of general purpose financial reports
– the International Accounting Standards Board (IASB) Conceptual Framework states that users are expected to be those with a 'reasonable knowledge of business and economic activities and who review and analyse the information diligently'
• In practice, does this assumption appear reasonable?
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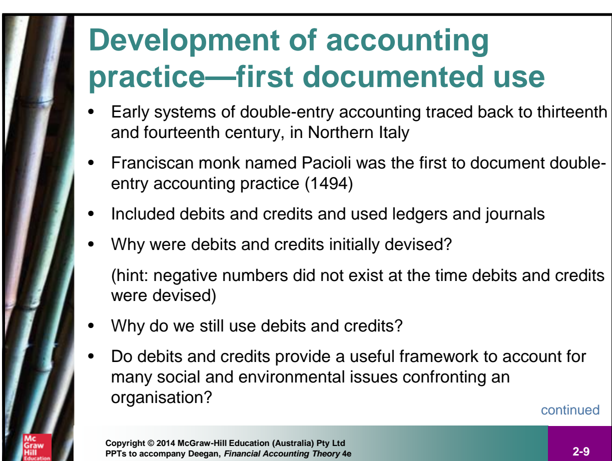
Development of accounting practice—first documented use
• Early systems of double-entry accounting traced back to thirteenth and fourteenth century, in Northern Italy
• Franciscan monk named Pacioli was the first to document double-entry accounting practice (1494)
• Included debits and credits and used ledgers and journals
• Why were debits and credits initially devised?
(hint: negative numbers did not exist at the time debits and credits were devised)
• Why do we still use debits and credits?
• Do debits and credits provide a useful framework to account for many social and environmental issues confronting an organisation?
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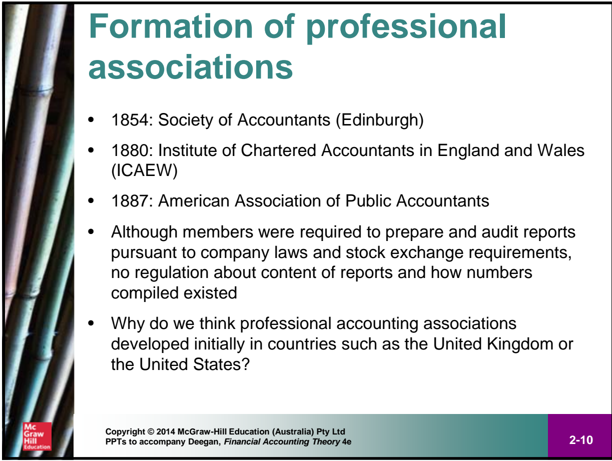
Formation of professional associations
1854: Society of Accountants (Edinburgh)
1880: Institute of Chartered Accountants in England and Wales (ICAEW)
1887: American Association of Public Accountants
Although members were required to prepare and audit reports pursuant to company laws and stock exchange requirements, no regulation about content of reports and how numbers compiled existed
Why do we think professional accounting associations developed initially in countries such as the United Kingdom or the United States?
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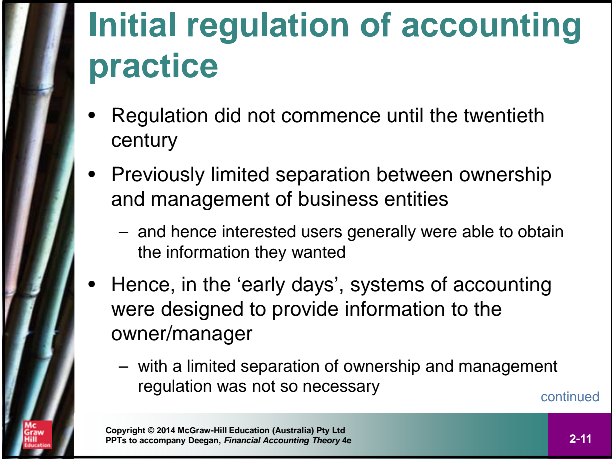
Initial regulation of accounting practice
Regulation did not commence until the twentieth century
Previously limited separation between ownership and management of business entities
– and hence interested users generally were able to obtain the information they wanted
Hence, in the 'early days', systems of accounting were designed to provide information to the owner/manager
– with a limited separation of ownership and management regulation was not so necessary
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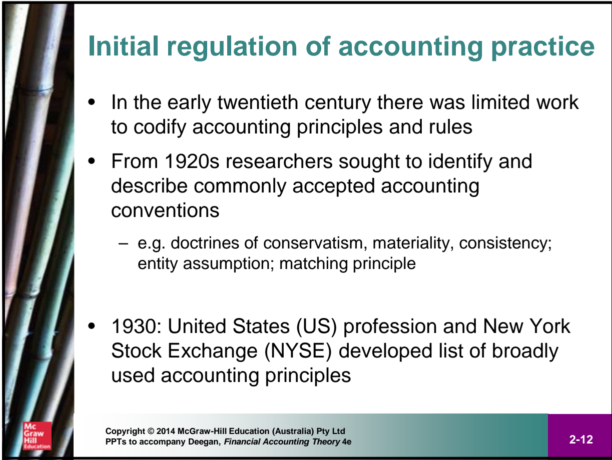
Initial regulation of accounting practice
In the early twentieth century there was limited work to codify accounting principles and rules
From 1920s researchers sought to identify and describe commonly accepted accounting conventions
– e.g. doctrines of conservatism, materiality, consistency; entity assumption; matching principle
1930: United States (US) profession and New York Stock Exchange (NYSE) developed list of broadly used accounting principles
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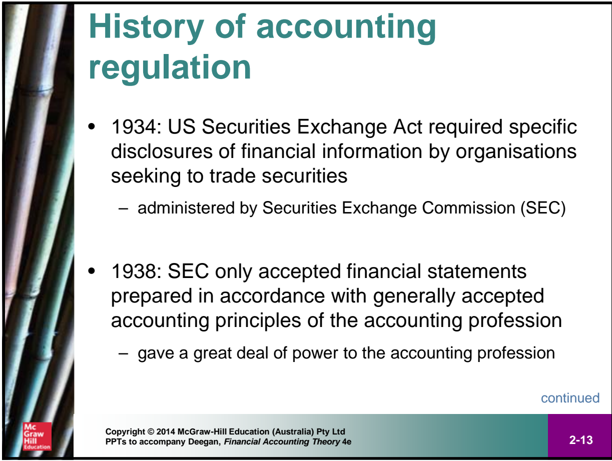
History of accounting regulation
• 1934: US Securities Exchange Act required specific disclosures of financial information by organisations seeking to trade securities
– administered by Securities Exchange Commission (SEC)
• 1938: SEC only accepted financial statements prepared in accordance with generally accepted accounting principles of the accounting profession
– gave a great deal of power to the accounting profession
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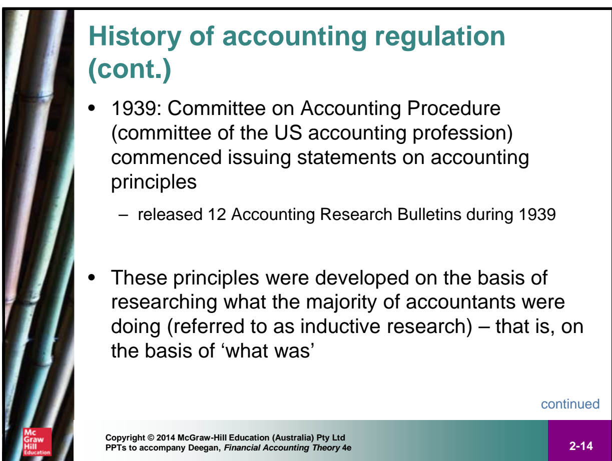
History of accounting regulation (cont.)
• 1939: Committee on Accounting Procedure (committee of the US accounting profession) commenced issuing statements on accounting principles
– released 12 Accounting Research Bulletins during 1939
• These principles were developed on the basis of researching what the majority of accountants were doing (referred to as inductive research) – that is, on the basis of 'what was'
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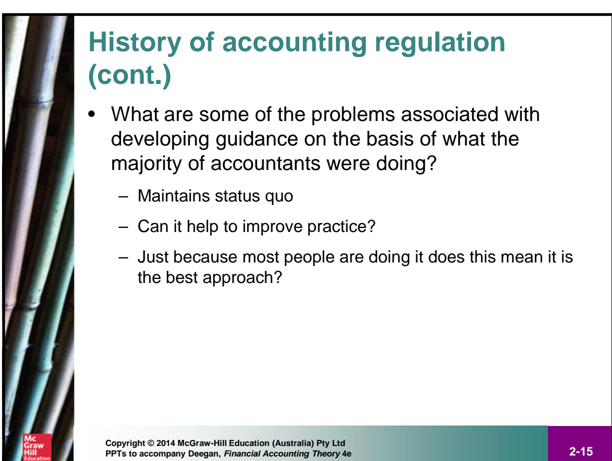
History of accounting regulation (cont.)
• What are some of the problems associated with developing guidance on the basis of what the majority of accountants were doing?
– Maintains status quo
– Can it help to improve practice?
– Just because most people are doing it does this mean it is the best approach?
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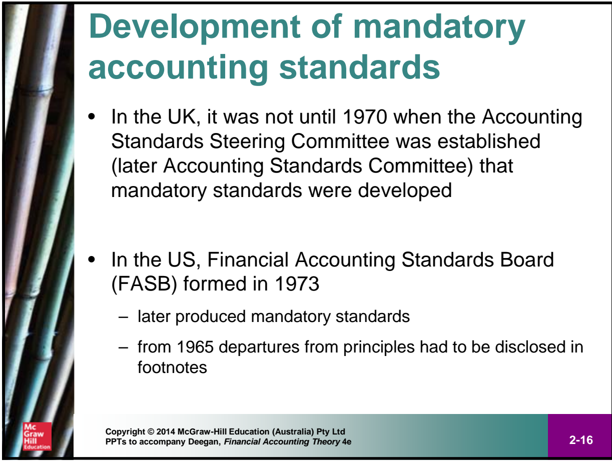

Development of mandatory accounting standards
• In the UK, it was not until 1970 when the Accounting Standards Steering Committee was established (later Accounting Standards Committee) that mandatory standards were developed
• In the US, Financial Accounting Standards Board (FASB) formed in 1973
– later produced mandatory standards
– from 1965 departures from principles had to be disclosed in footnotes
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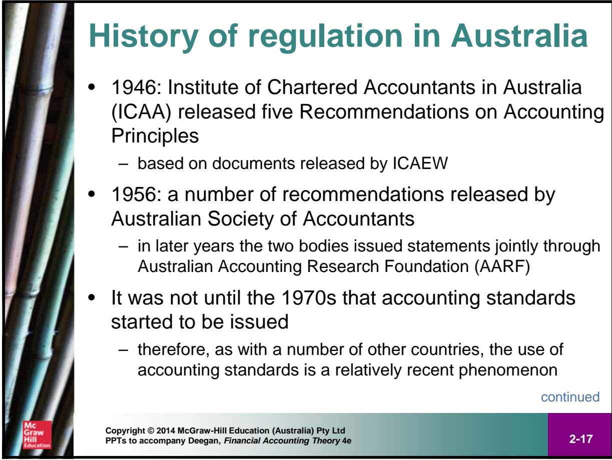

History of regulation in Australia
• 1946: Institute of Chartered Accountants in Australia (ICAA) released five Recommendations on Accounting Principles
– based on documents released by ICAEW
• 1956: a number of recommendations released by Australian Society of Accountants
– in later years the two bodies issued statements jointly through Australian Accounting Research Foundation (AARF)
• It was not until the 1970s that accounting standards started to be issued
– therefore, as with a number of other countries, the use of accounting standards is a relatively recent phenomenon
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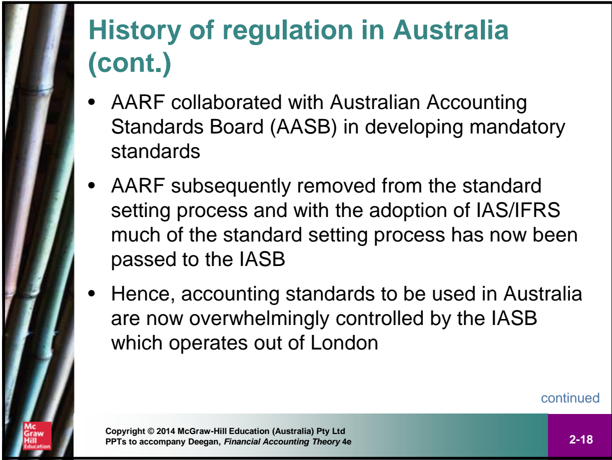

History of regulation in Australia (cont.)
• AARF collaborated with Australian Accounting Standards Board (AASB) in developing mandatory standards
• AARF subsequently removed from the standard setting process and with the adoption of IAS/IFRS much of the standard setting process has now been passed to the IASB
• Hence, accounting standards to be used in Australia are now overwhelmingly controlled by the IASB which operates out of London
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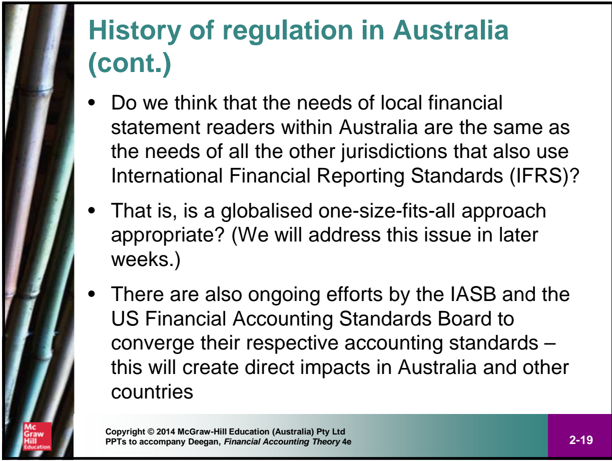
History of regulation in Australia (cont.)
• Do we think that the needs of local financial statement readers within Australia are the same as the needs of all the other jurisdictions that also use International Financial Reporting Standards (IFRS)?
• That is, is a globalised one-size-fits-all approach appropriate? (We will address this issue in later weeks.)
• There are also ongoing efforts by the IASB and the US Financial Accounting Standards Board to converge their respective accounting standards – this will create direct impacts in Australia and other countries
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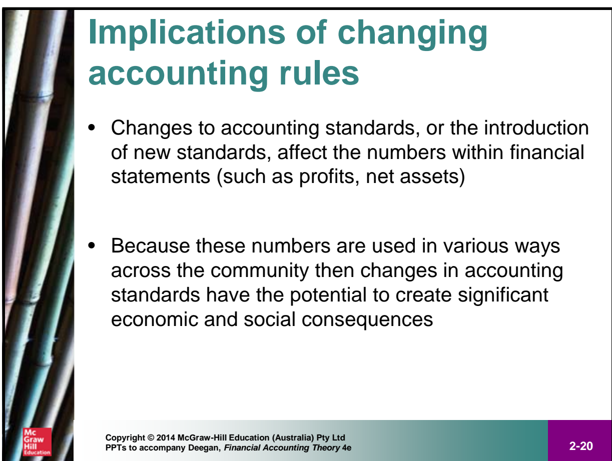
Implications of changing accounting rules
• Changes to accounting standards, or the introduction of new standards, affect the numbers within financial statements (such as profits, net assets)
• Because these numbers are used in various ways across the community then changes in accounting standards have the potential to create significant economic and social consequences
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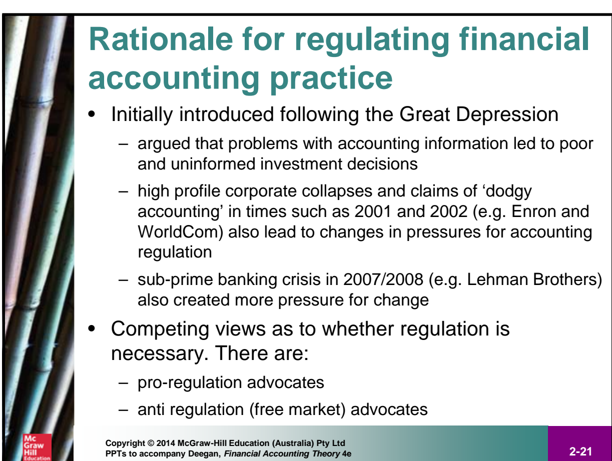
Rationale for regulating financial accounting practice
• Initially introduced following the Great Depression
– argued that problems with accounting information led to poor and uninformed investment decisions
– high profile corporate collapses and claims of 'dodgy accounting' in times such as 2001 and 2002 (e.g. Enron and WorldCom) also lead to changes in pressures for accounting regulation
– sub-prime banking crisis in 2007/2008 (e.g. Lehman Brothers) also created more pressure for change
• Competing views as to whether regulation is necessary. There are:
– pro-regulation advocates
– anti regulation (free market) advocates
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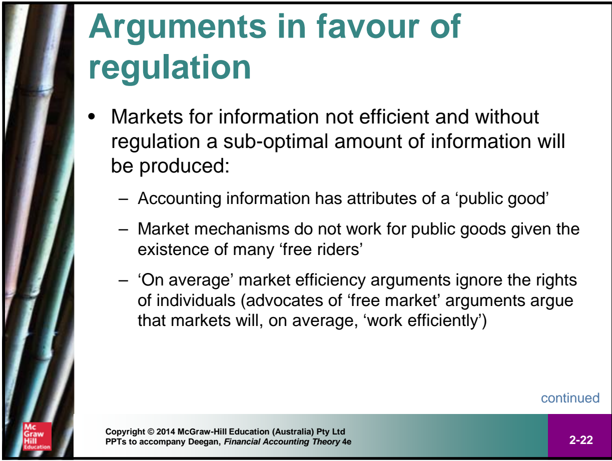
Arguments in favour of regulation
• Markets for information not efficient and without regulation a sub-optimal amount of information will be produced:
– Accounting information has attributes of a 'public good'
– Market mechanisms do not work for public goods given the existence of many 'free riders'
– 'On average' market efficiency arguments ignore the rights of individuals (advocates of 'free market' arguments argue that markets will, on average, 'work efficiently')
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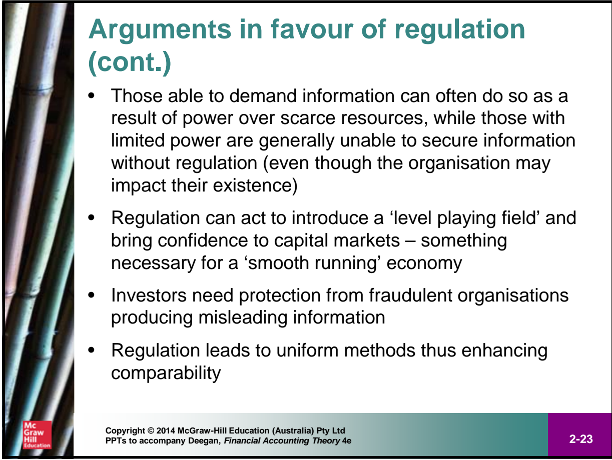
Arguments in favour of regulation (cont.)
• Those able to demand information can often do so as a result of power over scarce resources, while those with limited power are generally unable to secure information without regulation (even though the organisation may impact their existence)
• Regulation can act to introduce a 'level playing field' and bring confidence to capital markets – something necessary for a 'smooth running' economy
• Investors need protection from fraudulent organisations producing misleading information
• Regulation leads to uniform methods thus enhancing comparability
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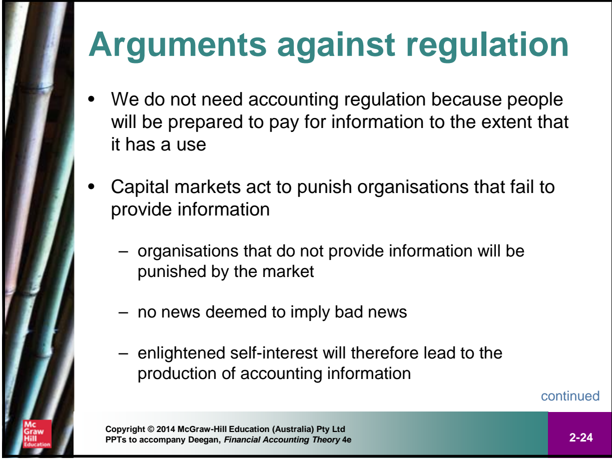
Arguments against regulation
• We do not need accounting regulation because people will be prepared to pay for information to the extent that it has a use
• Capital markets act to punish organisations that fail to provide information
– organisations that do not provide information will be punished by the market
– no news deemed to imply bad news
– enlightened self-interest will therefore lead to the production of accounting information
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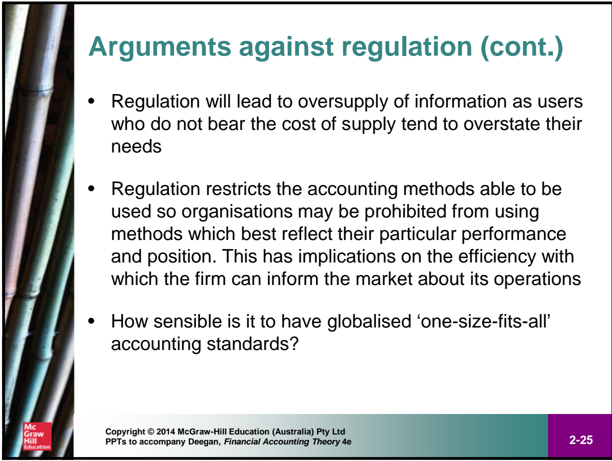
Arguments against regulation (cont.)
• Regulation will lead to oversupply of information as users who do not bear the cost of supply tend to overstate their needs
• Regulation restricts the accounting methods able to be used so organisations may be prohibited from using methods which best reflect their particular performance and position. This has implications on the efficiency with which the firm can inform the market about its operations
• How sensible is it to have globalised 'one-size-fits-all' accounting standards?
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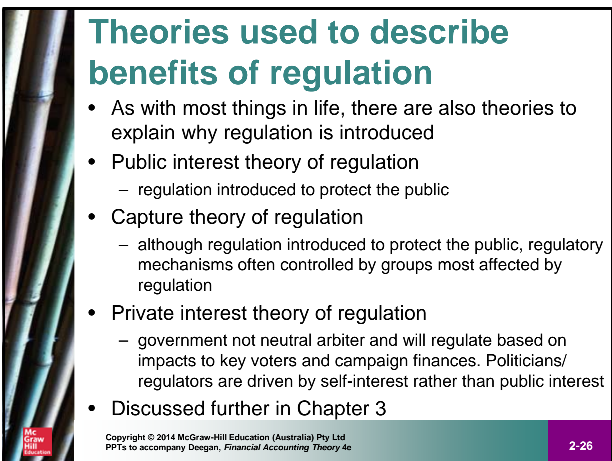
Theories used to describe benefits of regulation
• As with most things in life, there are also theories to explain why regulation is introduced
• Public interest theory of regulation
– regulation introduced to protect the public
• Capture theory of regulation
– although regulation introduced to protect the public, regulatory mechanisms often controlled by groups most affected by regulation
• Private interest theory of regulation
– government not neutral arbiter and will regulate based on impacts to key voters and campaign finances. Politicians/ regulators are driven by self-interest rather than public interest
• Discussed further in Chapter 3
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Private versus public sector regulation
• Private sector regulation
– accounting profession best able to develop accounting standards because of expertise and greater likelihood rules will be accepted by business
• Public sector regulation
– government has greater enforcement powers, hence rules more likely to be followed, may be less responsive to pressure from business and more likely to consider public interest
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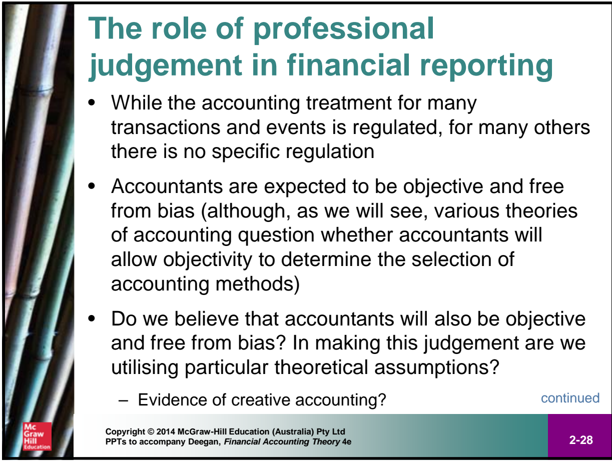
The role of professional judgement in financial reporting
• While the accounting treatment for many transactions and events is regulated, for many others there is no specific regulation
• Accountants are expected to be objective and free from bias (although, as we will see, various theories of accounting question whether accountants will allow objectivity to determine the selection of accounting methods)
• Do we believe that accountants will also be objective and free from bias? In making this judgement are we utilising particular theoretical assumptions?
– Evidence of creative accounting?
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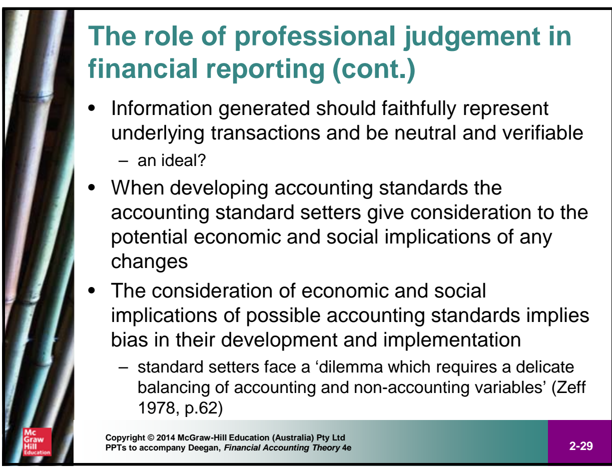
The role of professional judgement in financial reporting (cont.)
• Information generated should faithfully represent underlying transactions and be neutral and verifiable
– an ideal?
• When developing accounting standards the accounting standard setters give consideration to the potential economic and social implications of any changes
• The consideration of economic and social implications of possible accounting standards implies bias in their development and implementation
– standard setters face a 'dilemma which requires a delicate balancing of accounting and non-accounting variables' (Zeff 1978, p.62)
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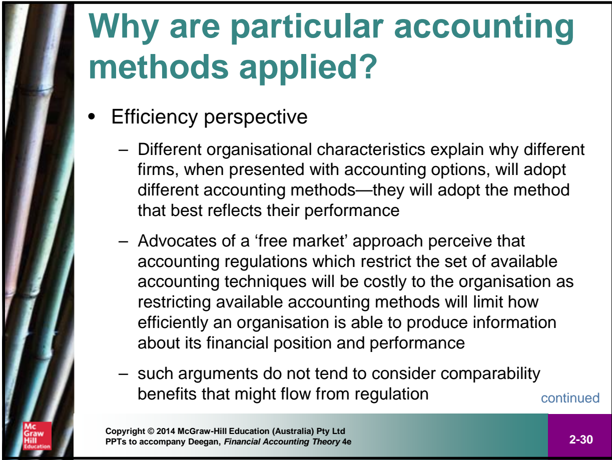
Why are particular accounting methods applied?
• Efficiency perspective
– Different organisational characteristics explain why different firms, when presented with accounting options, will adopt different accounting methods—they will adopt the method that best reflects their performance
– Advocates of a 'free market' approach perceive that accounting regulations which restrict the set of available accounting techniques will be costly to the organisation as restricting available accounting methods will limit how efficiently an organisation is able to produce information about its financial position and performance
– such arguments do not tend to consider comparability benefits that might flow from regulation
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Why are particular accounting methods applied? (cont.)

- Opportunistic perspective
  - assumes that selection of an accounting method is driven by self-interest
  - would question the view that accountants (and other individuals) would be objective
  - accounting methods which provide the desired results for preparers are selected
- Refer to Chapter 7 for a discussion of these perspectives
- Chapter 8 addresses other theoretical perspectives

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The power of accountants

- Accountants are often depicted as boring individuals with limited influence on others…do we agree?
- An alternative perspective is that accountants are among the MOST POWERFUL members of society
  - and we must use our powers wisely
- Output of the accounting process impacts many decisions about wealth transfers so the judgement of accountants affect various parties' wealth
- Accountants can give legitimacy to organisations which may not otherwise be deemed legitimate (e.g. emphasising profits)

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The power of accountants (cont.)

- When accounting standard setters – such as the IASB or FASB – create new rules, this can create real economic and social consequences.
- The provision of accounting information leads to power for those who receive the information – allows them to make informed decisions
- Profit measures ignore many social and environmental externalities caused by the reporting entity
  - for example, accounting has traditionally ignored the 'social costs' associated with carbon emissions and associated climate change
  - the accountant has therefore contributed to climate change?

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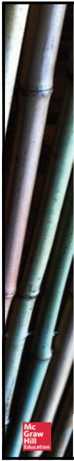

The power of accountants (cont.)

- Accounting does not objectively reflect a particular reality—it creates it.
  - accountants can 'create reality'
  - for example, if the accounting profession develops rules that omit any consideration of various social and environmental impacts then any related social and environmental expenses will not be recorded and reported and therefore will not be brought to the attention of financial statement readers
  - conversely, if accounting placed a cost on environmental degradation then this would reduce profits (and subsequent dividend payments), the likely consequence of which would be pressure on the entity from financial stakeholders to reduce the expenses (and hence, the environmental degradation)
  - in this regard, what might be the impacts of current efforts to place a cost on carbon emissions?

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