FINANCIAL STATEMENTS AND ECONOMIC REALITY : UNDERPINNING THE TANNER DOUBTS

by

GEORGE HAMPTON
Senior Lecturer, Department of Accountancy and Law, Mitchell College of Advanced Education

This article was written in response to a question posed in a paper by Mr. R.J. Tanner in the April 1981 issue of the Journal, 'Can Shareholders Rely on Reports Prepared by Accountants and Auditors?'

The author of this article, an academic who has worked as a public accountant and secretary of a listed company, enumerates reasons which support a negative answer to Mr. Tanner's question. He believes that a solution to the problems giving rise to this negative answer and continued criticisms of financial statements and the accountancy profession, is long overdue. The solution offered requires financial statements to reflect economic reality.

Criticisms of the accountancy profession and warnings about the consequences of failure to rectify the causes of those criticisms, are not new. The critics include company investigators, accounting authors, the judiciary, politicians, the financial press and stockbrokers. The criticisms are quite numerous. In general terms they relate to the way in which the profession goes about its business and the financial statements which its members prepare and audit.

This article takes up recent criticisms raised in JASSA[1] by a director of the Australian Shareholders' Association Ltd., in a paper entitled 'Can Shareholders Rely on Reports Prepared by Accountants and Auditors?' The question involves the credibility of the accountancy profession and the reliability of financial statements. It deserves an answer.

At the outset it should be acknowledged that the accountancy profession in many countries has taken steps in an endeavour to remedy the causes of criticisms. However, that there are continuing criticisms cannot be denied. The question is whether those criticisms are well founded, and if so, what can sensibly be done about rectifying the problems giving rise to the criticisms. The persistence of criticisms despite the efforts of the profession indicates that solutions to those problems are not readily apparent, or if they are, they are not acceptable.

As a starting point in the examination of the above question, the shareholders' need for information communicated by way of financial statements is considered.

The Need for Information

The problem which shareholders and others face, is that they cannot themselves make observations which will provide them with all of the information they need or desire about a particular company. Instead they rely on observations which others make and reports of those observations which are communicated in the form of information.

Circumstances and the law place shareholders in a position where in many respects they are forced to rely on financial statements for the financial information they require. However, shareholders will continue to rely on directors, accountants, auditors and financial statements only where the information provided proves to be reliable. Where personal observations lead shareholders to doubt and dispute this reliability the consequences mentioned by Tanner and other authors follow – the accounting profession is held in low regard, the integrity of directors is under suspicion, accounting standards are blamed and auditors come under attack.

Shareholders could be forgiven for assuming that they and their advisers could and should be able to rely on financial statements when making decisions about whether to sell or hold or buy or not buy shares in a company. Whether they can is the matter being examined. But firstly it is necessary to recognise that there is some confusion about the meaning of reliability, and hence about the type of reliability that one could reasonably expect to be associated with financial statements.

Reliability

The importance of reliability is recognised in the American Financial Accounting Standards Board's (FASB) "Statement of Financial Accounting Concepts No. 2 – Qualitative Characteristics of Accounting Information", issued in 1980. This is the second of a series of statements intended to establish the objectives of financial reporting and the concepts upon which financial accounting and reporting will be based.

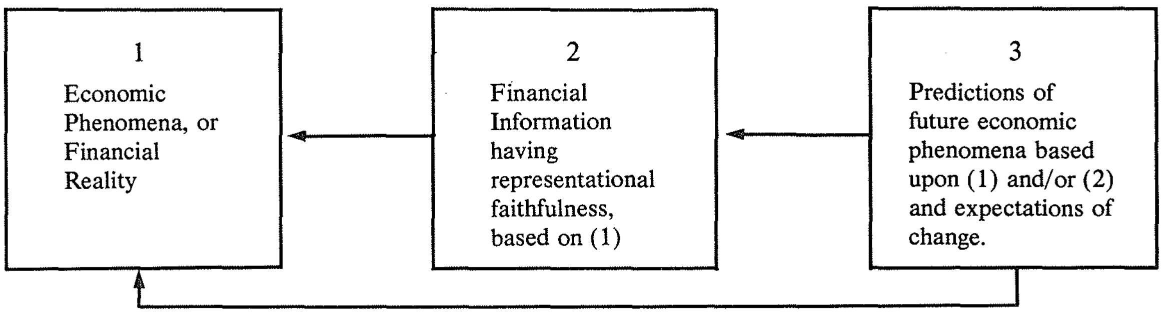
Reliability is one of the primary decision-specific qualities identified by the FASB. Two different concepts are recognised:

(a) Representational faithfulness. Information is said to be reliable when it has representational faithfulness or 'correspondence or agreement between a measure or description and the phenomenon it purports to represent'.[2]

(b) Predictive effectiveness. 'Prediction' in ordinary usage includes any single statement about some future event as contrasted with its use in science as an argument. Both scientific explanation and prediction are considered to be conclusions based upon premises relating to some event.[3]

The FASB Statement illustrates the concepts by reference to drugs. If a drug can be relied upon to cure a condition for which it was developed it has reliability in terms of effectiveness, or doing what it is expected to do, or predictive ability.[4] If it complies with the formula shown on the label it has representational faithfulness.

The relationship and difference between the two concepts of reliability in respect to financial reporting may be depicted as follows:



When the financial information adequately represents the economic phenomena for the purpose at hand, there is reliability in the sense of representational faithfulness. Reliability in the second sense refers to the extent to which predictions come to pass, that is, it relates to future economic phenomena.

There are many statements in the accounting literature which recognise the shareholders' interest in the future, particularly in forecasting the level and timing of their future cash flows from dividends and the sale, redemption and maturity of securities. But it is important to recognise that while some persons may use accounting information as an aid to prediction, accountants have consistently emphasised that their role in the preparation of accounting reports for external users does not include prediction.[5] When the Institute of Chartered Accountants in Australia issued Miscellaneous Technical Statement F7 'Reports on Profit Forecasts' in 1975, it emphasised that 'profit forecasts . . . are not capable of confirmation and verification by reporting accountants in the same way as financial statements which present the final results of completed accounting periods and there is no question of their being "audited"'.[6]

Since audited financial statements relate to completed accounting periods, there is no claim to reliability in the sense of predictive ability. Those statements are designed to report the financial results for a past period and the financial position at the end of that period, as required by section 162 of the Companies Act.

Accountants and auditors are acting in a different capacity when they are involved with profit forecasts which of necessity are based upon assumptions which may well prove to be false. Hence the difference between audited financial statements and profit forecasts appearing in prospectuses must be recognised. The reliability of the former relates, one could reasonably expect, to representational faithfulness. The reliability of the latter depends upon the closeness of the predicted value to the actual future value, and should be based on some predictive model. The reliability of a predictive statement should be assessed at the time when it is made by reference to the amount of support which the premises for that prediction furnish for the prediction, and the support once can muster for the premises. In practice this invariably means that reference will be made to the symbolic representation of past phenomena, including financial statements.

The concept of reliability adopted in the FASB Statement is based on representational faithfulness. This concept is used to assess the reliability of financial statements.

Reasons for Doubting Representational Faithfulness

There are a number of reasons for believing that historic cost-based financial statements fail to satisfy shareholders' needs for a reliable representation of economic phenomena.(7)

(a) Some of the assumptions upon which the system of financial accounting is based are not acceptable.

One of the fundamental assumptions upon which historic cost-based accounting rests is that the dollar is a stable unit of measurement.

This assumption is unrealistic.

The profession has acknowledged the weaknesses of traditional financial statements(8) based upon this assumption and in countries such as Australia considerable resources were devoted to the rectification of this problem during the 1970s. To date no accounting standard dealing with this matter has been issued in Australia. The proposed solution, current cost accounting, is not evaluated here; sufficient to say that at the present the problem persists.

However the criticisms embrace more than just the assumption of a stable unit of measurement. Edwards and Bell(9) concluded two decades ago that the assumptions upon which conventional accounting rest, in particular the money, realisation and fiscal-period conventions, would lead to complete, truthful and unambiguous financial statements only in a situation akin to the stationary state, where tastes, techniques and resources remain constant through time. The stationary state does not exist, except in imagination.

As a result financial statements based upon these assumptions cannot be relied upon to faithfully portray phenomena in a dynamic economy.

(b) There is a wide choice of accounting principles, bases and methods available to companies when preparing and presenting financial statements.

In order to have representational faithfulness, identical items (such as assets) need to be reported in identical ways in the financial statements of different companies, and an individual company cannot have a variety of reporting options available to it. Unfortunately this is not the case.

There is no doubt that directors, accountants, and auditors can, within the constraints (such as they are) imposed by accounting standards, generally accepted accounting principles and the requirements of the Companies Act that accounts show a true and fair view, arrive at different figures for financial results over a period of time and financial position for a particular company at a point of time.

In the Brins Australia Ltd. case the investigators report identified six main differences between the profit figure of $81,247 which the company notified to the Sydney Stock Exchange for the period ended December 31, 1970 and the draft accounts prepared by the company's auditors, disclosing a loss of $1,646,680. As a result 24 informations were laid against the managing director and chairman of directors of the company. It is not surprising, given 'the inescapable conclusion that there are as many "true and fair" views as there are viewers'(10) that the magistrate dismissed all informations. The magistrate's view on the reliability of the financial statements prepared by the auditors is relevant here:

> This difficulty (of reconciling accounting figures with economic events) seems to me to provide strong support for the view that even if it were accepted that the accounts of the auditors may have been true and fair from an accounting point of view, the accounts did not present an accurate picture of the financial position of Brins as at 31st December 1970.(11)

The FASB(12) has recognised the credibility gap problem associated with choice of different reporting methods. 'The public is naturally skeptical about the reliability of financial reporting if two enterprises account differently for the same economic phenomena'. But until steps are taken to eliminate reporting options, thousands of different methods(13) are available and can be used to achieve a variety of ends.

(c) Figures which appear in financial statements are determined by convention or decree(14) rather than by reference to real world phenomena. The classical example here is depreciation.

In traditional accounting the depreciation expense and the depreciated amount of the asset are based upon an allocation process. The process involves the determination of the historic cost of the depreciable asset, an estimate of its useful life and ultimate disposal amount, and the selection of a specific method for calculating depreciation. The last three of these four stages in the process are not, and cannot be, determined by reference to past phenomena. In other words there is no attempt at representational faithfulness as the term is used here. The estimate of the useful life of the asset and its disposal amount are predictions, rather than being representations of phenomena, things which have occurred or exist.

The depreciation calculation cannot be defended on the basis that it is an approximation. Any attempt to defend it on this basis should immediately prompt the question, 'an approximation of what?' There is nothing in the external world which depreciation allocations endeavour to approximate.

(d) The precise nature of the 'things' measured in accounting has not been determined.

The topic of measurement is not presently covered by any statement issued by the Australian accountancy profession. The FASB has foreshadowed the publication of a statement dealing with measurement as part of its planned series of publications dealing with the conceptual framework.

In accounting use is made of numbers, not in an abstract sense whereby they are unrelated to the 'real' world, but in order to convey quantitative information about empirical relations, in such a way as to facilitate choice. At least this is what one would expect if financial statements are to have representational faithfulness.

An important point emerges here. Unless the users of measurements are told which of the numerical relations in the numerical relations system apply to the objects or properties of objects, events or states measured, they could be led to infer relations which do not hold among the empirical phenomena. Many relationships are known to exist among numerals, and shareholders face the problem of determining which of those relationships apply to the numbers used in accounting. For instance, is it safe to assume that a figure of $2x shown on a balance sheet is meant to represent twice the amount (in any sense) of $x shown for another item on the same balance sheet? It isn't.

Under the present system of accounting it would seem that not one but a number of properties are 'measured' or valued or calculated, and further that these properties have not been clearly spelt out. In other words accountants have only 'hazy notions'[15] of the 'things' measured.

The different properties 'measured' are shown in terms of dollars. But invariably the dollars do not all have the same significance. As a result aggregated financial statements can be criticised because they add and subtract 'measures' of properties of a different type.

In accounting, as in other disciplines, measurement is an activity which needs to be guided by a theory. Measurement without the guidance of a theory has been described as 'aimless wandering'.[16]

(e) There is no adequate theory or conceptual framework to explain what phenomena accounting figures measure or what those figures mean, and hence which enables shareholders and other users to determine what meaning may be legitimately derived from those figures.

In 1955 Chambers[17] observed:

> 'It is 25 years since Professor J.B. Canning wrote: "The accountants have no complete philosophical system of thought about income nor is there any evidence that they have ever felt the need for one". Even today this statement is true. In fact, accountants do not appear to have any complete system of thought about accounting – and this might well be considered a more fundamental lack.'

There is still no complete philosophical system of thought about accounting as practised today. This absence could be considered the most important unresolved problem facing the accountancy profession. The American Institute of Certified Public Accountants has been working on a solution. Its conceptual framework project is designed to fit together the different facets of financial accounting and reporting to form a cohesive and operable whole. In Australia the matter has not yet reached the stage where any statement or exposure draft has been issued.

The consequence of all this is that, in general, shareholders do not understand what accounting figures mean and in particular they do not understand what profit means. They could not be expected to understand the technical aspects of financial statements, and those statements are becoming more and more obscured by technical disclosures – all done with apparent precision.

The problem does not end there. It extends to financial advisers who could be expected to have an understanding of the technical aspects of accounting, and this is the more damaging criticism.

Given that:

(a) Assumptions upon which the system of financial accounting rests are unacceptable;
(b) There is a wide choice of accounting policies so that identical items may be reported in different ways in financial statements;
(c) Some figures which appear in financial statements are determined by convention rather than by reference to real world phenomena;
(d) There is no specification of the precise nature of the 'things' measured in accounting; and
(e) There is no adequate explanation of what meaning one may attach to financial statements,

even accountants who prepare the financial statements cannot always explain them in terms of representations of economic phenomena or reality. Those statements cannot be relied upon to have representational faithfulness.

An Explanation for the Situation

While there are good reasons for believing that shareholders cannot rely upon reports prepared by accountants and auditors as faithful representations of economic phenomena, the reason why they are not is another question. That question is addressed briefly.

It must be recognised that while accountants and auditors are involved in the preparation and audit of financial statements, it is the responsibility of the directors to 'cause to be made out' and laid before the company at each annual general meeting a profit and loss account and a balance sheet[18] which give a true and fair view. Those financial statements are the responsibility of the directors.[19] Provided the directors choose from the acceptable alternative accounting policies available, an auditor has no reason to qualify the audit report. And representational faithfulness is not assured. The only way to arrive at a situation where there is representational faithfulness, is to change the rules. On the basis of past experience this may not be easy, and the blame does not rest entirely upon the accountancy profession.

While the critics and criticisms of accounting are many, sensible, comprehensive suggestions of what can be done to rectify short-comings, are few. Most of the suggestions simply add to the patch-work nature of the system already in operation, and their implementation would only multiply disclosures, and perhaps add to the confusion of what accounting is about.

No doubt the accountancy profession has contributed to the confusion. As one corporate financial executive said 'Over the years the accounting profession has projected an image of verifying and certifying financial statements to an exactness that probably does not exist, and this in turn has caused the public to have an expectation for accounting performance that cannot be fulfilled'.[20] Nevertheless it is reasonable to expect representational faithfulness.

The profession may have difficulty in rectifying the cause of the criticism, for a number of reasons. In the first place there is not discernible, wide-spread agreement among the critics about what should be done. Accountants cannot produce financial statements which have representational faithfulness while at the same time endeavouring to be 'all things to all men'.[21] Yet if they are not there is the fear of alienating some, and the profession functions on the basis of general acceptance. Those whose suggestions are not accepted are likely to feel offended, and to refuse to adopt changes in accounting standards where those changes do not satisfy their purposes or coincide with their ideas[22].

The consequence of the continuation of this sort of situation is compromise, a wide choice of accounting policies, ad-hocracy and uncertainty about the role of financial statements.

Conclusion

There is no reason to doubt that shareholders are interested in and need reliable reports about past progress and the current financial position of the company in which they hold shares. Whether reports received by them are reliable is another matter.

Unfortunately there is nothing new about the doubts implicit in the question 'Can Shareholders Rely on Reports Prepared by Accountants and Auditors?' The evidence provided by Tanner leads one to make a negative response. The reasons enumerated in this article reinforce the conclusion that shareholders cannot confidently trust financial statements, as presently prepared by accountants, to be representations of economic reality. And invariably they would not have access to information which would enable them to ascertain how close some of the important financial statement figures were to economic reality. The term 'mushroom treatment' is appropriate.

Accounting data which enables past decisions to be evaluated and which provides a sound basis for preparing and evaluating future plans needs to be reliable in the sense of having representational faithfulness. Until such time as the accountancy profession, with the support of interested parties, takes steps to ensure that financial statements have this characteristic, criticisms of both the profession and the financial statements which members of the profession prepare and audit, can be expected to continue.

In the mean time a warning is appropriate. Shareholders, their advisers and financial analysts should know that there are potential dangers associated with the use of figures in financial statements in a way which is inconsistent with their intended use, and that use does not necessarily include representational faithfulness.