ACCOUNTING EDUCATION AND THE CORPORATE REPORTING FUNCTION

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GRAHAMSTOWN
RHODES UNIVERSITY
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AND
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called "accounting". This is not necessarily directed towards the qualifying of practitioners; rather, it is based on the proposition that the knowledge of the discipline has a virtue or value of more general application than soley the vocational practice of accounting. This approach may be regarded as education <u>in</u> accounting, or the "discipline" approach.

Although there are many aspects in which the two approaches overlap and are interconnected, they are different in objective and this will affect the content of the courses being offered. Education <u>in</u> accouting may be availed of by many people with neither the desire nor the intention to become professional accountants, and many of these people may be found in all sorts of vocations and activities as well as in business or government.

One of the dilemmas facing the academic in deciding on one of these objectives is that, if the professional approach is adopted, the courses may be dominated too greatly by the requirements laid down for admission by the professional body, to the detriment of the broader approach possible on the discipline basis. However, if the discipline approach is used, the courses may be diffused or diversified or even concentrated in directions which professional accountants may regard as ineffective in, or irrelevant to, the environment of conventional accounting practice and/or knowledge; that is, the coverage may be regarded by practitioners as divorced from reality and not very useful in practice.

Ideally, accounting courses should be developed so as to achieve some sort of balance between these two approaches, in the hope that the pursuit of both objectives can be carried out simultaneously. In my opinion, this compromise approach is not being achieved successfully in South African universities. Institutional pressures have forced local academics to adopt an almost purely professional approach.

The practice of completing the academic qualifications required to become eligible to write the qualifying examination, set by the Public Accountants' and Auditors' Board, on a full-time basis, is growing in South Africa. The Profession encourages potential accountants to adopt this approach. There are very substantial benefits to be gained by all. Students have more time to concentrate on their studies in a university environment without partners and managers breathing down their necks to meet numerous audit deadlines. Students, it is argued, have more time to study the subject matter in depth, participate in discussions with their lecturers and peers, and, most importantly, to read widely on accountancy matters. These are luxuries which part-time students only dream of!

Audit firms, too, look upon this approach favourably. To put it bluntly, it enables them to place more pressure on their audit clerks, and they can expect to get their money's worth from their staff, without continually having to worry about their clerks having to attend lectures and tests, as well as the annual problems of study leave and examinations. Add to this the pressure of overtime work to meet certain deadlines, and it is clear that part-time study can create many headaches for firms in planning their audit engagements.

For academic accountants, too, there are advantages. There is more time to widen the courses in line with the discipline approach - where a lecturer refers students to certain references, they can be expected to follow these up eagerly, and broaden their accounting knowledge accordingly - or so it is said.

Where, then, lies the problem?

Put shortly, as I see it, the difficulty lies in the fact that the student is expected to graduate from the university capable of passing the professional examination. The success or failure of an accounting department, in the eyes of most members of the profession, is guaged by the pass rate which its students achieve in the qualifying examination, written only a few months after the students have graduated. In my view, practising accountants are not bearing their share of the responsibility in this qualifying process - this responsibility is offloaded almost entirely onto the shoulders of accounting academics.

In recent years there has, undoubtedly, been an explosion in the body of knowledge related to accounting (including computerised accounting applications), auditing, taxation and other such fields. In particular, the rapidly growing number of accounting and auditing standards published by the professional bodies, as well as the annual increase in the number of complexities relating to taxation all have to be dealt with in detail in the university before the student graduates and is allowed to write the qualifying examination.

This narrow, technical-type approach being forced onto university departments of accounting has had many harmful effects on the profession as a whole. Michael O Alexander, Director of Research and Technical Activities of the Financial Accounting Standards Board, the standard-setting body in the United States, is equally concerned with this problem. "Students in accounting", he says, "are having to specialize in learning rules rather than learning to think about the underlying theory, reasoning, and objective ... The costs over the future could be monumental, particularly if young people who like to use their minds and creative instincts find an alternative to accounting."[1]

There are two matters arising from this which I find particularly disturbing: one is that too many accounting academics do not seem to regard this narrowing in accounting education as a problem, and, I suppose, they can hardly be blamed, having themselves been subjected to this purely professional approach, which, it appears, has had the effect of creating in their minds an in-built bias against the so called "woolly, theorectical" approach of the discipline objective. The other disturbing point is that it appears that the profession at large is not far-sighted enough to realise that this purely professional approach to accounting education is not in the best long-term interests of the profession itself. Is it at all surprising, then, that there is so little research being undertaken by accountants, and particularly academic accountants, in South Africa?

It is not the responsibility of the university to prepare its students soley for the tasks they will perform in their first few years as graduates. The university owes it to its students to confront them with broader and less immediate issues, so that they may acquire the ability to contribute to and cope with change within their professions. There can be no question that accounting, and more particularly, corporate financial reporting is destined for significant change in the not too distant future, and it appears that accountants world-wide are having more than a little difficulty in coping with the change demanded of them by society.

Corporate financial reporting has come under increasing criticism in recent years for failing to bring about changes aimed at increasing the usefulness of company financial statements. A major concern is the continued use of the historical cost basis of accounting, as modified over the years, which, it is claimed, does not adequately serve the needs of either preparers or users of financial statements.

The modern concepts of accounting and corporate reporting developed as a result of the growth of business enterprises into corporations which became too large to be managed by their shareholders. One of the major responsibilities of the managers or directors in the early years was to report to the owners or shareholders on their stewardship of a company's assets. This was done by preparing and presenting a balance sheet to the shareholders which, naturally, led to the demand for the services of an independent auditor. At this early stage, the primary concern of the accountability concept was seen to be honesty and regularity in the financial affairs of the company. The historical cost concept and its related principles were born out of this stewardship function.

Time moved on, however, and the stewardship function, while remaining an important element of corporate accountability, has been overtaken in importance by shareholders' and other users' expectations of profitability and management performance. This led to the emergence of the income statement as the major vehicle of company reporting. This change in emphasis, from the balance sheet to the income statement, was not a happy one for the profession. The emphasis on profitability led to the problem of the allocation of costs over different periods in the determination of profit for any given period. Attention was focussed on the bases of calculation of profit and the comparison of profitability ratios of different companies. Different accounting methods being used in practice dealing with apparently similar transactions or events were highlighted, and accountants seldom got away unscathed when it came to events such as the Great Crash of 1929 or, indeed, any company failures that occurred over the years.

More recently, accountants have been criticized for failing to disclose the effects of changing prices on profit and asset values, and, thereby, failing to report the "real" profit or net worth of a company, so as to assist investors in their decision making.

Much work has been done by the profession in producing accounting and auditing standards in an attempt to overcome these problems and to modify and adapt the historical cost system so as to present, in the financial statements, a fairer picture of economic reality. Fixed assets, for example, are increasingly being revalued, rather than being disclosed at cost.

The Sandilands Committee, set up by the British Government in 1974 to consider whether, and if so, how, company financial statements should allow for changes in costs and prices, came to the conclusion that:

> "taken as a whole these modifications and adaptations have made present-day accounting conventions more complex and less standardised than many would consider desirable. They have strained historic cost accounting principles to breaking point, reduced its objectivity, and have still failed to produce a satisfactory answer. It is clear that more comprehensive proposals for dealing with the problem need to be considered."[2]

This reminds me of the story of a student of a well known university who applied for a position in an auditing firm. The staff partner of the firm was reviewing the application form and noted the student's excellent credentials. He was somewhat puzzled, however, by the student's vital statistics - his height was shown as sixteen inches and his weight as four pounds. As he sat waiting for the student to enter his office, he mused about some of the interesting assignments in which such an auditor might prove useful. He was rather surprised when a strapping young two hundred pounder (ninety-one kilogrammer, somehow, doesn't sound right!) walked in.

Having discussed with him his qualifications and other such matters, the student was asked to explain the peculiarity in his vital statistics. He said that he had been educated at a very good university and he understood that generally accepted accounting practice required the presentation of all data at cost less depreciation. Interpolating this requirement to his own vital statistics, he had shown his height and weight at two-thirds of his height and weight at birth, because he felt that at age twenty-three he was about one-third depreciated!

One cannot, of course, accuse the student of supplying false information. There must, however, be at least some doubt regarding the usefulness of the information!

Marvin L Stone, in his article "'Tis the Age of Aquarius - Even for Accounting"[3] refers to a research study conducted by a Masters candidate at the University of Denver in which businessmen and investors were asked about the extent to which they based their decisions on financial statements. He was somewhat shocked to learn that practically no-one paid any attention to financial statements, which made him conclude that generally accepted accounting principles seemed to produce generally ignored financial statements.

Stone continues:

> "This is not to say that accountants are not trying to improve their product. Certainly we are not standing still nor ignoring modern technology. Not at all. We are striving diligently to invest all of this useless data, which no-one wants or uses, with increasing degrees of precision. Computers permit the production of useless data much faster; we are constantly improving accounting terminology so that this useless data will be more understandable; and, of course, we are improving our audit techniques tremendously so that we can make this useless data more credible."[4]

These kinds of statements or conclusions are, perhaps, exaggerated, but the intention is, at least partly, to shock the profession into realising that the historical cost method and its related principles which we defend and cling to so vigorously, have serious weaknesses which cannot be overcome simply by cosmetic changes.

Littleton reminds us, however, that we should be careful to give our nineteenth century predecessors the credit due to them, and not to take them to task because their practices do not meet our needs today. We would do better to try to improve our understanding of our present needs, so that we can devise means of meeting them, and will no longer have to make do with inherited practices, some of which have outlived their usefulness.[5]

Frank S Capon, former President of the Canadian Institute of Chartered Accountants, believes that accountants are too often wedded to their own traditional concepts on the grounds that they are generally accepted. "It is easy to think up reasons against change", he says, "particularly when the new systems are more familiar to others. But this insistence on adherence to tradition at all costs is not a viable option for accounting, unless we decide that our role is to be limited to the bookkeeping function of recording past transactions."[6]

Much reseach is in progress at present, particularly in the United States, Canada, Britain and, to a lesser extent, Australia, into alternative approaches to corporate reporting. A major problem which emerged early on is the realisation that accounting lacks an underlying, fundamental objective, or "conceptual framework" as it has become known. Without such a framework that is generally accepted by the profession and the users of financial statements, a meaningful basis of measuring profit and asset values is not possible. If financial statements are to be more useful to all user groups we must decide what it is we are trying to measure.

The absence of such a conceptual framework seriously hampers the ability of accountants to choose between alternative accounting practices. How can one decide whether any principle or practice is an improvement on another without judging it against a clearly defined objective? Most preparers of financial statements would probably agree that their major responsibility revolves around giving the shareholders a fair account of their stewardship, as well as supplying these shareholders and other user groups who have a legitimate interest in the affairs of the company, with a realistic economic picture of the enterprise.

The major problem in this regard is that there are nearly as many definitions of profit and economic reality as there are user groups. Two major research projects which are playing a significant part in attempts by the profession to resolve these deficiencies in the corporate reporting function are the conceptual framework project of the Financial Accounting Standards Board (FASB) in the United States, and a research study conducted by the Canadian Institute of Chartered Accountants (CICA) and published, in 1980, under the title "Corporate Reporting : Its Future Evolution".

The FASB project, which commenced in 1973, is a long-term, ambititious effort aimed at establishing a so called "constitution" for accounting - a coherent system of interrelated objectives and fundamentals that is expected to lead to consistent standards, and that prescribes the nature, function and limits of financial accounting and reporting. In attempting to solve these underlying problems facing accountants in measuring profit and asset values, the FASB has so far published numerous discussion memoranda, held public hearings on all the stages so far undertaken, and received a tremendous response from the profession and other groups in the United States. Numerous statements of concepts have already emerged, and, although it is proving a difficult task to formulate such a conceptual framework which meets with the approval of all parties, the FASB must be commended in finally addressing this most difficult accounting problem.

The Canadian study, in its belief that the FASB project is attempting to formulate a single basis for measuring profit and asset values, states that the FASB approach is not suitable for Canada in that it is too dependent on normative solutions and too narrow in its scope. It emphasizes that the problems of economic reality cannot be pinned down by adopting a normative or authoritarian approach that provides definitions that everyone is expected to accept, however useless the measurements derived may turn out to be. A conceptual framework that involves the imposition of standards based on an intellectual process that is inappropriate to accounting, is regarded as unlikely to succeed. The Canadian study, therefore, believes that a conceptual framework that is going to be regarded as appropriate, is one that is based on utilitarianism rather than authoritarianism.

As Professor Edward Stamp, Director of the International Centre for Research in Accounting in the University of Lancaster, who drafted the Canadian research study, puts it:

> "Any conceptual approach towards the analysis of accounting standardisation problems must have this concern with the needs of users, as well as being structured and logical in its approach. Unlike the natural sciences, where the laws are embedded in the natural environment, so that we can discover them but not make them, and unlike formal disciplines such as logic (where analysis is not required to have any empirical referents to be valid), accounting standards are man-made efforts to control a man-made

environment, and they must be flexible enough to adapt to changes in this environment. A deductive conceptual framework, in which prescriptions about the form and content of financial statements are derived from rigid axioms and definitions, owes its deceptive allure to the notion that accounting is (or should be) developed like a natural science or, alternatively, as a formal discipline."[7]

In contrast to this, an evolutionary or jurisprudential approach entails the assessment of accounting innovations to determine whether or not they will adequately serve the needs of users.

It is interesting to note this difference in approach between the FASB project and the Canadian study. The FASB's stated primary concern is with the needs of investors and creditors. The Canadian report regards it as appropriate to acknowledge the interests of a wider group of users. There are major differences between the environments of the United States and Canada. As the Canadian study points out:

"Within the United States, the West was won with the gun. More orderly means were used in Canada, and Canadians still tend to take a less adversary approach towards the solution of their problems than is the custom in the United States."[8]

While such differences do not mean that accounting standards developed in one country must be different in kind from those issued in another country, it may well mean that a different approach towards the setting of accounting standards is required. This will have to be borne in mind too by the South African profession when due consideration is given to the adoption of such a conceptual framework.

The Canadian report contends that a jurisprudential approach should be adopted in the setting of accounting standards. This approach recognises that the standard setting body should operate within a quasi-constitutional framework, which will enable it to ensure that evolutionary, rather than revolutionary changes occur. It may then be possible to reverse one of the most disquieting trends of recent years, namely, the trend towards the development of books of rules that attempt to define and cover, in great detail, every conceivable problem the standard setting body can think of. The need identified in this study is for a system that provides precedents and an appeal procedure - two features that are an integral part of the legal system - without constructing a straitjacket of rules and definitions that diminishes flexibility and inhibits progress.

Central to the Canadian proposals is the adoption of a set of criteria which should be used by the standard setters, preparers of financial statements, and other interested parties to:

- . judge the quality of accounting standards;
- . choose between possible alternative standards on any given subject; and
- . assess the usefulness of published company reports to the user groups.

The research study specifies twenty such criteria, the most important of which are relevance to user needs, objectivity, verifiability, materiality, substance over form, cost-benefit effectiveness, completeness, timeliness and comparability.

The broad, flexible and evolutionary approach recommended by the Canadian report will clearly suit preparers of financial statements such as Ian Tegner, who believes that:

> "Once the conceptual framework has been developed and the objectives clearly defined, they must not be allowed to be emasculated by being placed in the strait-jacket of standards of the type we have now. We should instead have supporting guidelines to provide assistance to preparers where necessary, but, within that framework and directed at those objectives, we must allow well managed companies to apply the accounting treatment which is most appropriate to their own individual circumstances. The onus of protecting the shareholder and other users against misrepresentation is then placed firmly where it belongs - on the auditor."[9]

Uniformity and comparability are, clearly, two criteria that are furthermost from the minds of accountants and users who think along these lines. Whilst I share Tegner's views to the extent that these two criteria should not be strived for at any cost, they are characteristics which many user groups regard as being of the utmost importance. Often, however, uniformity, comparability, as well as objectivity can only be achieved at the expense of some other more favourable qualitative characteristic, usually relevance. In such cases a trade-off is essential in favour of relevance to user needs.

The FASB project is attempting to formulate its conceptual framework by re-examining the very foundations of financial accounting and corporate reporting. Having formulated the major objective of corporate financial reporting, namely decision usefulness, having examined in detail the criteria or qualitative characteristics which make financial information useful, and having defined the elements that are decision useful, the difficult stages have yet to be finalised. These stages are concerned primarily with the problems of recognition and measurement, or, put in another way, with the establishment of a generally accepted definition of profit and the selection of a basis of asset valuation.

Some of the questions which are being dealt with at present and which, not surprisingly, are proving very difficult to finalise are the following:

1. Firstly, should profit be regarded as resulting from a matching of costs against revenues, or should it be thought of as a change in the value of the net assets of an enterprise during the period in question, after allowing for introductions and withdrawals of capital?

   The use of either method can be made to hinge upon rigorous definitions of net assets, revenues and expenses. The "change in net assets" approach has the advantage of simplicity, generally does not distinguish between "realised" and "unrealised" profits, and is certainly relevant to the needs of those users of financial statements whose prime concern is the creation of wealth. The "matching" approach, on the other hand, is more natural to those users who are concerned with the measurement of performance, generally distinguishes between operating and extra-ordinary profits, and, currently, does not include unrealised profits in the statement of income.

The real point is that the issue cannot be settled in abstract terms without reference to the needs of users.

Also relevant to users' needs is the choice of either the proprietary or the entity concept. The former looks at the financial affairs of a company through the eyes of its owners, that is, the shareholders. The entity concept, on the other hand, views the company as an entity separate from the shareholders, who are regarded in the same manner as any other stakeholders or creditors who have claims against the company. The selection of one of these concepts can have a material affect on the profit calculation, particularly when viewed in relation to the selection of a capital maintenance concept. This is important where a change from the traditional historical cost basis of accounting to a current value based system is contemplated.

In his discussion of a definition of profit, Sir John Hicks states, " ... it would seem that we ought to define a man's income as the maximum value which he can consume during a week and still expect to be as well off at the end of the week as he was at the beginning". This is translated, in the Sandilands Report, into an analogous definition for a company - maintaining well-offness is treated as equivalent to maintaining capital intact. In other words, a profit is earned only after the capital of the company has been maintained. The question that has not yet been settled satisfactorily, however, is whether profit should be regarded as having been earned after the preservation of financial or physical capital. While this decision will not alter the total of the shareholders' funds, it can affect the individual figures reported for capital and profit.

The maintenance of financial capital is linked with the proprietary concept and is, generally speaking, the method preferred by accountants in the United States and Canada. The maintenance of physical capital is linked with the entity concept and expresses, in monetary terms, the results of assuming that profit can be measured only after the capacity of the enterprise to continue, at its current level of operations, has been maintained. This method is favoured by the profession in the

Netherlands. Clearly, it is not possible to make an arbitrary choice that will be appropriate for all users.

3. Another question of vital importance is the selection of a basis of valuation of assets. Many different methods have been suggested in recent years as being the most appropriate method. These include

   - the current (or general) purchasing power method;
   - the replacement cost method;
   - the present value method;
   - the current cost method; and
   - the continuously contemporary accounting (or exit value) method.

   Again, each of these methods may be appropriate depending on the circumstances prevailing and, particularly, on the users' needs.

   These different bases of profit calculation and asset valuation raise the important question of whether one set of "general purpose" financial statements can possibly be expected to satisfy the needs of all the different user groups. Many eminent accountants have answered this question in the negative, and this raises the possibility of the preparation of multi-columned financial statements, each column depicting the results using a different basis. This would have the advantage of supplying various user groups with information which may be of particular interest to their own needs. The major disadvantages appear to be the cost of acquiring and auditing the additional information and the possibility that the multitude of profit figures and asset values may lead to distrust of the accounting and audit functions on the part of many users.

One of the underlying objectives of accountants proposing a change to a current value basis of accounting is to attempt to depict economic reality more accurately, and, thereby, to make financial statements more relevant to user needs. The term <u>economic reality</u> on its own could provide an interesting topic for a lecture or a seminar, but I wish to emphasize merely two points in this regard:

1. Firstly, the user should not be misled - financial statements aimed at depicting economic reality are not going to make his decisions for him - the user must either be educated to make his own decisions or, alternatively, seek expert advice. It is a fallacy that financial statements are, or ought to be, prepared so as to be readily understood by the man in the street. Business enterprises are becoming increasingly complex and attempts to oversimplify such financial issues could well result in financial statements becoming meaningless, or even worse still, misleading.

2. The other point I wish to make with regard to economic reality is that it should be recognised that even a fully fledged current value balance sheet will not measure the current worth of an enterprise. To suggest otherwise is to argue that it is possible to produce a balance sheet on which the figure for shareholders' funds represents the price which any willing buyer or seller would be prepared to pay or accept in return for all the issued shares of the company. Such a value is not uniquely determinable. Goodwill, in particular, is often a major asset of a business enterprise. The problems associated with the measuring and accounting for goodwill are extremely complex, and it is not surprising that none of the proposed systems of current value accounting contains any prescriptions in this regard.

Of all the bases of asset valuation, the historical cost method is the one that is generally considered to be the most objective in that it relies for its measurements on the amounts of cash actually paid out. The other bases (with the exception of the current purchasing power method) entail estimating what might occur if the assets were to be replaced or disposed of. Accountants often argue that such estimates will make the auditor's task of verifying such values well-nigh impossible, and that this will substantially reduce the objectivity of the reported results. It must, however, be borne in mind that even the historical cost method entails the making of subjective estimates, such as the useful lives of assets, the collectability of outstanding receivables, the likely future benefit to be derived from research and development expenditure, and so on. Even this method of accounting is, therefore, not as objective as many accountants would like to believe.

Objectivity is, of course, a highly desirable quality. It should, however, be looked at not in isolation, but in relation to at least two other qualities, namely realism and relevance to user needs. It is possible, and perhaps even probable, that users will be willing to opt for greater realism and relevance at the expense of objectivity.

Accountants have been accused of clinging to the historical cost system so as to make their auditing task of verification as straightforward as possible. This is understandable when one considers the risks with which auditors have to contend when reporting on the financial statements of companies. A compromise arrangement may be possible whereby auditors may be able to offer a lesser degree of assurance on current value information as compared with the higher level of assurance associated with the more objective information dealt with in the historical cost financial statements.

Accounting, it should be remembered, is not an end in itself. It should provide the means whereby people's needs for information to make investment and other decisions, can be met. If accountants are not to lose much of the credibility which they have built up over many decades, they will have to think more seriously about satisfying these needs of the users of their product.

In conclusion, Mr Pro-Vice-Chancellor, I wish to make the following points:

1. South African accountants, and particularly academic accountants, as well as our accounting students, should become involved to a greater extent in the search for answers to the fundamental problems currently facing the profession. One could argue that the universities and accounting academics are to blame here in that they do not concentrate sufficiently on the underlying theorectical issues in accounting. In my opinion, however, the qualifying process should be amended so as to place a greater responsibility on the practising arm of the profession, particularly with regard to current techniques used in practice, the technicalities contained in professional accounting and auditing statements, and other such matters.

   I think here, for example, of the Australian method of qualifying as a Chartered Accountant, whereby students, after graduating, and during their period of articles, participate in what is known as the "professional year", managed entirely by practising accountants. During this year the prospective accountants are brought up to date on such technical matters as I have referred to earlier, and are generally prepared for their final qualifying examination. This enables the university accounting academics to concentrate more on the discipline approach to accounting education.

2. Following on from this first point, it has become clear to me in recent years that there exists an urgent need for accounting courses in South Africa to be designed in such a manner as to present our students, and particularly the more gifted ones, with conceptual challenges of the type I have barely touched on tonight. This restructuring is necessary, not only to satisfy the needs of our students, but also to further the long-term interests of the profession itself.

3. Finally, Sir, I wish to assure you that the staff of the Accounting Department at Rhodes University are aware of these institutional problems, but are committed to a programme which attempts, as far as possible, to strike a balance between the "professional" and "discipline" approaches to accounting education.

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