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A Framework for Developing The Objectives of Financial Statements

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Introduction

This paper is intended to provide a framework for developing the objectives of financial statements. It does not deal with what the objectives should be since this is to be discussed and decided by the Study Group on the Objectives of Financial Statements. However, in explaining the framework for developing such objectives, some examples of objectives that the Study Group may consider adopting are stated. It should be emphasized that these examples are used to clarify the nature of the framework and are not necessarily objectives which the authors think the Study Group should adopt.

In discussing the objectives of financial statements, it is important to understand the level of objectives at issue. There are many objectives that may be arranged in a hierarchy of means-ends relationships. Unless the level of objectives at issue is known, arguments can be confusing.

One way to focus attention on the level of objectives is to label a few important layers, using convenient names. Therefore the following hierarchy of levels of objectives is used for discussion purposes:

1. Fundamental objectives
2. Constitutional objectives
3. Operational objectives
4. Prescriptive objectives

Fundamental Objectives

Fundamental objectives are at the top of the hierarchy and are essentially non-operational. Everyone agrees that they are the ultimate objectives of financial statements, but they are so remote from questions on accounting principles and procedures that they do not necessarily provide any criteria or guidelines to the questions. Accountability is an example of a fundamental objective.

The American economy is based on a network of *accountability* relationships. The separation of ownership and management of economic resources has created the basic need for accountability. But in our modern economy, accountability is not limited to the relationship between management and owners. Within the management hierarchy, a subordinate is considered to be accountable to his supervisor for the management of resources entrusted to him. Externally, the firm is accountable not only to its shareholders but also to its creditors and governments at all levels. The recent emphasis on the quality of the environment (clean air, water) has added the public to the list of parties to whom a firm is accountable.

Accountability normally refers to the past activities of an entity. However, in some cases an entity is accountable for its plans of future activities as observed in governmental budgets. In either case, accountability requires the recording and reporting of the entity's activities and their consequences. Acceptance of such a report by the party to whom the entity is accountable normally constitutes a discharge of the accountability for activities covered by the report.

Accounting records and financial statements have been developed primarily to satisfy such an objective. Although accounting records and financial statements are used for other purposes, the objective of providing the means for establishing accountability may be considered as a fundamental objective of financial statements.

Implicit in this objective is the need to derive performance measures since the objectives of accountability include the entity's performance with respect to its goals. In the free enterprise system, one of the central goals of an entity is achieving a certain level of profits. Therefore, it follows that an important objective of financial statements is to report on this achievement.

The concept of profit is not an easy one to define and quantify. In fact, it is almost as difficult to quantify as are many goals of society such as freedom, security, or economic prosperity. Economists have proposed various concepts of profit at an abstract level. Accountants, however, have had to devise operational ways of measuring profit and, furthermore, accountants have had to do it with a reasonable degree of objectivity because subjective measures cannot stand the legal and organizational pressure involved in accountability. Considering the magnitude of difficulty involved in developing a suitable profit measure, accountants have been quite successful in developing and maintaining a system of profit measurement, although the need for improvement has always existed and will always exist.

Now accountants are under attack because some groups have suddenly discovered that elements of arbitrariness exist in the measurement of profit. To some extent this is true of any performance measure. For example, there is no reason why a touchdown in football counts six points while a field goal counts only three points. A team with a good kicker may argue for more points for field goals. But what makes such arbitrary factors legitimate is the agreement among the interested parties. In the case of profit measurement, there is an explicit or implicit agreement among the interested parties to delegate the function of profit measurement to accountants. Therefore, the mere existence of arbitrariness should not be cause for discarding a system that has been developed and maintained over many decades.

However, it is also true that innovations in management and technology may call for new methods of profit measurement. In addition, new information such as the reporting of management plans or management's profit forecasts may be desirable to include in financial statements.

In summary, at least one of the fundamental objectives of financial statements may be stated as the need to communicate information on the discharge of accountability of an entity to parties to whom the entity is accountable. Although the contents of financial statements may change over time, this fundamental objective of financial statements seems to be invariant.

Constitutional Objectives

The next level of objectives is referred to as constitutional objectives in this discussion. Constitutional objectives are of a more operational nature than fundamental objectives. The determination of whether major questions are in line with the overall policy of the accounting profession (whether they are "constitutional" or "unconstitutional") can be made by comparing such questions with the constitutional objectives. For instance, the judgment that "financial statements should not contain information that might unduly impair the competitive advantage of the firm" might be a constitutional objective. Thus, particular pieces of information in financial statements may be included or excluded according to their effects on the competitive advantage of the firm. On the basis of these judgments, precedents will be established. However, constitutional objectives are themselves not operational; they should be viewed as criteria for evaluating the policy decisions of the profession. The constitutional objectives may be structured in various ways.

One such way is this. 'The fundamental objectives of financial statements are stated first. Then, the constitutional objectives are developed logically from the fundamental objectives in order to provide guidelines on important issues.

1. What are the bases for accountability?
2. To what extent does each of the interested parties (shareholders, creditors, public in general) have the right to know about the activities of an entity and the consequences of such activities?
3. To what extent does an entity have the right to withhold information concerning its activities and their consequences?
4. At what level of detail should information be disclosed?
5. At what level of reliability should information be disclosed?
6. When should particular pieces of information be disclosed?
7. What should the responsibility of auditors be?
8. What organizational units should be authorized to define and maintain the operational objectives of financial statements?

Thus constitutional statements covering questions 2 through 8 would need to be developed on the basis of the need for accounting to satisfy the fundamental objective of accountability.

Operational Objectives

Operational objectives deal directly with the criteria or guidelines for selecting alternatives in financial accounting. They are operational in the sense that many practical problems in selecting alternatives can be solved by referring to the objectives.

The problems in selecting alternatives in financial accounting and reporting may be classified according to the following four categories:

1. Information content
2. Information processing
3. Information control
4. Information dissemination

Information content deals with the kinds of information that ought to be provided in financial statements. Currently there are many such questions. Should budgets for the next few years be included? Should information on outstanding orders be shown? Should commitments be described, and if so, in how much detail? Should current values of assets be disclosed? Should information on human resources—age, experience, dollar value—be included? Among the seven qualitative objectives discussed in APB Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," relevance and completeness may be considered as dealing with the information content of financial statements.

The second category, information processing, is concerned with the way a given set of information should be generated. One possibility is to require all transactions to be recorded accurately in accounting ledgers based on the accepted bookkeeping principles. Another approach is to allow the use of statistical sampling to generate desired information without a 100 per cent transaction record. Still another possibility is to generate information on past events based on retrospective estimates using various source documents and other evidence instead of recording transactions as they occur. Perhaps the most liberal approach in information processing is to allow information to be generated on the basis of a purely subjective estimate of a single person. Among the seven objectives in APB Statement No. 4, perhaps neutrality and comparability may be regarded as dealing with information processing.

The third category, information control, deals with the reliability of information. The firm may disclose any information it desires in its annual report. But information in financial statements is considered to be more reliable than other forms because a firm of CPAs has verified sources of the information and expressed its opinion as to fairness. To what extent should reliability be emphasized? Do CPAs have the required capability to test the reliability of information? Costwise, is it reasonable to expect a high degree of reliability? To what extent should reliability be traded for relevance and timeliness? These are the questions that can arise in information control. Obviously, verifiability, which is one of the seven objectives in APB Statement No. 4, is related to this category.

There is another aspect that ought to be discussed in this category. In addition to controlling information and its quality, financial accounting has the objective of controlling resources. An accounting for all actual resource flows must be made because, under current accounting practices, all resource flows must be recorded. If there is any question on a particular resource flow, accounting records provide a basis for further checking. Thus, a question may be raised as to whether the objectives of financial accounting include contributing to such resource control or whether the objectives should be limited to the purely reporting aspect of financial accounting.

The last category, information dissemination, deals with the question of how financial information should be disseminated among interested parties. Understandability and timeliness, among the seven objectives of the Statement, are related to the method of dissemination. However, there seems to be a wide variety of questions that need to be answered with respect to the method of dissemination to be used in future financial accounting. For example, if particular information to be disseminated is likely to change the investors' evaluation of the firm significantly, CPAs must develop a method of dissemination that is not unfair to some groups. The notion of equitable dissemination must be established. Understandability raises an issue of whether CPAs should limit their role to reporting facts with the minimum amount of interpretation, as newspaper reporters do, or whether they should provide their interpretation of the financial statements of the firm to the maximum extent possible.

In summary, content, processing, control, and dissemination are the four essential problems that arise in defining the future states of financial statements. Therefore, the operational objectives of financial statements must be capable of providing criteria or guidelines to answer these questions.

Prescriptive Objectives

Prescriptive objectives are not criteria for selecting alternatives in financial accounting. They are dicta used to indicate which alternatives should be selected. The establishment of such a set of objectives is the most direct way of solving the accounting objectives problem. "Assets should be valued on the basis of current replacement cost." "Budgets for the forthcoming period should be disclosed," are examples of prescriptive objectives. They are the policies adopted by the profession. Prescriptive objectives are more or less like opinions of an Accounting Principles Board or a Financial Accounting Standards Board designed to settle specific issues on policies and procedures.

Conclusions

Although there are many layers of objectives that may be considered, the above four layers should be sufficient for discussion purposes. It may be noted that the layers are formed in terms of goal-subgoal or means-ends relationships (e.g., constitutional objectives are the means to achieve the fundamental objectives), but their time horizons are quite different. Fundamental objectives may be applicable for a few centuries, constitutional objectives for a few decades, operational objectives for ten or 20 years and prescriptive objectives for several years.

It is significant that the accounting profession in the United States has realized the need to reevaluate the objectives of accounting and has decided to make an extensive study to improve their contribution to the economy. Despite its conservative nature, there have been many changes in the accounting profession, and there will be many more in the near future. It is important, therefore, in guiding such changes to firmly understand the directions in which the profession should move. The attempt to identify and establish objectives of financial statements is aimed precisely at the goal of providing directions for the profession to develop itself in the future.