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Purpose and Need for Objectives

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The Need for Objectives of Financial Statements

The definite need for explicitly stated objectives of financial statements has been inferred again by the appointment of the Study Group on the Objectives of Financial Statements by the American Institute of Certified Public Accountants. By implication, the following question deserves summary analysis: Why should objectives of accounting and accounting's basic output, financial statements, be rigorously defined and explicitly communicated in the absence of similar statements of objectives by many other areas of trade and professional endeavor? Consider, for example, the cobbler whose services are limited exclusively to the repair of shoes. It is generally agreed that there exists a one-to-one relationship between the cobbler and *each* individual customer in relation to services rendered, i.e., no third parties are involved. The objective of the cobbler is thus a *private* one of satisfying a specific customer who directly requests, and pays for, the shoe repair services.

The relationship described above, which can easily be extended to professions such as law or medicine, can be compared and contrasted with the rendering of services by the certified public accountant. Accounting services are commissioned by specific customers or clients. However, there is more involved in this particular relationship. Financial statements of publicly held corporations are produced by client companies but are not intended to primarily benefit these companies or its management. The primary purpose of financial statements is to serve the needs of various third parties. These third parties, such as existing or potential stockholders, creditors, suppliers, or employees, have diverse needs and do not directly employ the preparers or attestors of financial statements. In most instances these third parties also cannot directly nor effectively communicate their needs, desires, or requests to preparers or attestors of financial statements.

Financial statements are responsive, and accountants are responsible, to third parties who rely on information contained in financial statements. To satisfactorily discharge this responsibility and to establish the responsiveness of financial statements to users' needs, it is necessary that there be an explicit statement of objectives of the accounting profession, a statement that is not necessary for other trades or professions in which responsibility does not extend beyond the individual direct customer or client level.

It is most important for objectives of financial statements to be stated explicitly to provide for effective evaluation and evolution of financial accounting standards, and to respond to the challenges posed by public criticism of the financial accounting process. Stated objectives should set forth the function of financial statements and provide an overall framework for determining financial accounting principles or standards. The objectives should also facilitate the determination of implementation techniques and formats.

Objectives and Financial Accounting Standards

Financial accounting principles or standards indicate

> . . . which economic resources and obligations should be recorded as assets and liabilities by financial accounting, which changes in assets and liabilities should be recorded, when these changes should be recorded, how the assets and liabilities and changes in them should be measured, what information should be disclosed and how it should be disclosed, and which financial statements should be prepared.[1]

They are guides to be followed in the preparation of financial statements.

Objectives of financial statements, on the other hand, are the functions that financial statements are designed to serve, the policies to which financial statements should conform, and the qualities financial statements should have to serve their functions and conform to established policies.

Financial accounting standards, which represent specific choices for preparation of financial statements, should be selected to promote the objectives of financial statements. "Financial accounting and reporting . . . must rest on . . . standards designed to achieve what are perceived to be the desired objectives of financial accounting and reporting."[2] Agreeing on the objectives and stating them explicitly is indispensable to that process. Ideally, the objectives should be identified, and then methods of implementing the objectives should be selected as financial accounting standards.

Stating objectives facilitates the following activities:

1. Evaluation of present financial accounting standards.
2. Adoption of proposed financial accounting standards.
3. Evolution of financial accounting standards to respond to changes in objectives or in implementation technology.

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[1] APB Statement No. 4, *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises* (New York: American Institute of Certified Public Accountants, 1970), Paragraph 137.

[2] Study on Establishment of Accounting Principles, *Establishing Financial Accounting Standards* (New York: American Institute of Certified Public Accountants, 1972), p. 19.

Evaluating Present Financial Accounting Standards

Present financial accounting standards can be effectively evaluated only if the objectives which they are supposed to fulfill have been specified first. Without stated objectives, present financial accounting standards can only be evaluated against inconclusive criteria, such as the number of enterprises that follow the standards or whether the standards conform to traditional ideas. It is, however, impossible to determine whether a given standard is accomplishing the intended goal if that goal is not known or stated. "Articulation of social goals is important for ascertaining whether they are being reached and even for reaching them. It is improbable, to say the least, that any goals can be reached by chance."[3]

If a financial accounting standard were adopted, for example, which specified a single method of depreciation as the only acceptable method, conformity of accounting practice to that standard could be determined. Whether the method was accomplishing the implicit objective which led to the adoption of the standard, however, could not be determined in the absence of an explicitly stated objective. Furthermore, whether practices such as changing estimates of depreciable lives have subverted the implied objective from which the standard was developed also could not be determined. Whether or not practices subverted the intended objective could only be determined if the objective has been previously specified.

Adoption of Proposed Financial Accounting Standards

Specifying objectives is necessary to reach agreement on sound changes in financial accounting standards or the adoption of new accounting standards. How can an analysis of proposed changes in standards proceed in a logical or rational manner unless the objectives to be served by these standards are explicitly stated and agreed to? If objectives are not explicitly stated, it is difficult to establish whether disagreement results because of differences in implied objectives of financial statements or because of differing conclusions concerning the efficacy of the proposed standards in achieving agreed-to objectives. The explicit statement of objectives allows for a more structured investigation of proposed standards and should facilitate resolution of conflicting positions. Disagreement may remain but would be confined to questions such as those concerning the efficiency of proposed standards in achieving objectives or the resolution of conflicts between objectives.

Responding to Changes in User Needs or Technology

Financial accounting standards at any time may be the best available means to achieve the objectives of financial statements, given existing needs and the implementation technology available. Both needs and technology may later change however. Stating the objectives of financial statements

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[3] Nestor E. Terleckyj, "Measuring Progress Towards Social Goals: Some Possibilities at National and Local Levels," *Management Science,* August 1970, p. B-765.

and the available implementation technology permits systematic re-examination of financial accounting standards in the light of changed circumstances. In the absence of stated objectives and without consideration of changes in implementation technology, financial accounting standards may become dogma, appearing as ends in themselves rather than as the pragmatic means aimed at accomplishing objectives. Enveloped in tradition, the original justification for the standard is forgotten and the standard becomes impervious to change.

Conservatism is an example of a financial accounting standard that originally might have been a sound response to proper objectives. Since the objectives that the standard of conservatism was intended to accomplish were never made explicit, however, conservatism has achieved the status of an end and, as such, defies and hinders re-examination and revision. The following speculative analysis may be plausible: If the primary audience for financial statements originally were credit grantors, then conservatism may have evolved in response to an objective to provide useful information to credit grantors. Credit grantors must make decisions as to whether to grant loans. In making a loan, the credit grantor receives the benefit of interest payments but risks the principal of the loan. Since principal is almost always larger than interest, the lender has more to lose by making a bad loan (in which he loses the principal) than by not making a good loan (in which he foregoes the interest he could have earned). He therefore needs information that will minimize his chances of making a bad loan, even at the cost of not making loans that could and should have been made. Conservative accounting information may have resulted because of creditors' preference for information that would minimize the probability of making a "bad" loan.

Since the audience for financial statements has shifted to a large degree from creditors to investors, the standard of conservatism may no longer be responsive to users' needs. Investors have as much to lose by not making a good investment as from making a bad investment. In fact, they have more to lose from not making a good investment since market appreciation is unbounded, whereas market loss is limited to the price paid for the security.

It was never stated that conservatism was a standard intended to be responsive to creditor needs or any other objective. Instead we inherited a dogma, and no vehicle for modifying this standard is available to respond to a changed audience of users. Conservatism may, of course, have evolved in response to different influences. In any event, since the objectives originally to be served by the standard of conservatism were not identified or are now lost, no methods are available to determine if the objectives originally justifying the standard are viable or obsolete.

Another example may clarify this point. One of the most vexing problems confronting the accounting profession in the past decade has been the problem of leases or, more generally, of executory contracts essentially unperformed by both parties. Since the early twentieth century, accountants have accepted with little questioning the dogma that executory contracts essentially unperformed by both sides shall not be recorded. They have not seriously questioned why this practice was adopted or what ends it was meant to serve. It is entirely possible that when this practice was adopted in the early twentieth century it represented a proper response to a valid objective: Information should only be reported in financial statements if the benefit of that information exceeds the cost of reporting it.

In the early twentieth century most executory contracts were of short duration and essentially recurring. A typical example might be a one-year lease. Obviously any payments demanded by the lease contract were recorded as they occurred. Similarly, the utilization of lease facilities and the incurrence of any liability as a result were also recorded. Thus the question concerning leases at that point of time was not whether they should be recorded by the accounting process but rather how often. Payments under the lease were recorded, and utilization of lease facilities was recorded. The questions of whether the signing of the lease or the entering into the agreement should also be recorded became appropriate matters for consideration. Since under the conditions stated all three of these events were likely to happen within one year, the legitimate question could be raised whether the costs of recording the lease agreement as well as the payment and utilization of lease facilities were justified by the informational benefits of reporting such agreements. Very likely, a proper response would have been that there was little informational benefit to be gained by reporting the signing of the lease under such circumstances. However, no reasoning leading to the adoption of the standard was given and it was never specified what objective was meant to be served by the practice of not recording executory contracts essentially unperformed. Thus, as the nature of executory contracts changed from essentially short-term recurring contracts to long-term leases or long-term employment contracts, it was impossible to determine whether such changed circumstances should result in changed practices. Obviously, if the objective that led to the adoption of the rule that executory contracts essentially unperformed shall not be recorded was related to informational benefits and costs, then that relationship is drastically altered when the contract is a fifty-year lease rather than a one-year recurring agreement.

Response to Challenges and Criticism

Stating objectives of financial statements is necessary not only to evaluate and change financial accounting standards but also to preserve those standards that facilitate the achievement of proper objectives. Without stating objectives explicitly, proper standards cannot be effectively defended against challenges. Stating objectives of financial statements would strengthen the accounting profession's position for establishing financial accounting standards in the private sector. Demonstrating that the objectives of financial statements legitimately differ from objectives of fiscal or tax policy would provide a sound rationale for financial accounting standards that differ to some extent from rules of tax accounting, for example. Demonstrating that financial accounting standards represent appropriate and feasible implementation of stated and desirable objectives of financial statements would reduce opportunities for political interference in financial statement construction.

Court decisions have recently held that conformity with generally accepted accounting principles or standards is not necessarily a valid defense to a challenge against financial statements. The courts themselves have implicitly established objectives of financial statements and have determined whether given financial statements under challenge adequately meet the objectives. If the accounting profession agreed to and stated the objectives of financial statements and demonstrated that financial accounting standards serve those objectives, it could more easily justify the position that conformity with financial accounting standards should be the criterion to judge financial statements. In other words, the profession can then legitimately argue that principles and standards are generally accepted because they are proper and right rather than that they are right and proper because they are generally accepted.

The public has criticized the accounting profession for not being a positive force in the public sector. Stating objectives of financial statements clearly and establishing financial accounting standards that are responsive to objectives seem the best way to meet that criticism. The accounting profession could then be identified and evaluated in terms of the appropriateness of visible goals and its effectiveness in achieving these.