

QUALITATIVE CHARACTERISTICS OF BUSINESS REPORTING: A HISTORICAL PERSPECTIVE

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Abstract

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This paper aims to provide a historical review of several leading documents in relation to the objectives of financial statements. Four main documents were discussed, analyzed and compared, using the content analysis approach. These documents are The Trueblood Report (1973), The Corporate Report (1976), Making Corporate Reports Valuable (McMonnies, 1988), and Guidelines for Financial Reporting Standards (Solomons, 1989). These documents were selected because they have been described as milestones in addressing qualitative characteristics of financial and business reporting. The historical review showed that the basic objective of financial statements is concerned with providing useful information for economic decision-making. In addition, it emphasized that information is useful when: 1) it shows the economic reality of the financial statements (i.e., balance sheet, income statement, and cash flow statement); and 2) it is relevant and reliable to users.

Keywords: Trueblood Report, Corporate Report, MCRV, Solomons, Relevance and Reliability, Economic Reality

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1. INTRODUCTION

Developments in business reporting have been given considerable attention for some time by the accounting profession in various countries. In spite of the massive investment of time and resources in recent years, improvements are still in progress to achieve significant contribution in present-day business reporting. The failure to achieve progressive achievements is attributable in large part to the absence of the objectives of financial statements (Flegm, 2006). Major different attempts toward the formulation of objectives of financial statements have been made by the US and UK accounting professions. In the US, the importance

of the development of financial statement objectives was first expressed by the Study Group (Cramer & Sorter, 1973) on the objectives of financial statements and emphasized by the FASB to develop a conceptual framework or constitution. In the UK, the importance of these objectives was highlighted by the publication of the Corporate Report (1976) by the Institute of Chartered Accountants in England and Wales (ICAEW). The publication of Making Corporate Reports Valuable (McMonnies, 1988) and the Guidelines for Financial Reporting Standards (Solomons, 1989) were produced to further shape the future development of accounting standards. These four publications represent leading documents in formulating the objectives of financial statements.

Resolving conflicts of interest that exist in the information market and the objectives of financial statements must be considered as initial steps toward the development of business and accounting theories. In order to specify the objectives of financial statements, it is important first to specify the users of the statements. Users and objectives of financial statements are usually addressed together in the literature because they are interrelated. Mbobo and Ekpo (2016) addressed the qualitative characteristics of financial reporting and operational and how they can be operationalized. They examined the perception of Nigerian accountants on the use of qualitative characteristics in the measurement of financial reporting quality. Mbobo and Ekpo (2016) found that qualitative characteristics, such as faithful representation and relevance, would have greater potential to enhance the quality of financial reporting.

The purpose of this paper is to provide a comprehensive review of four leading documents with respect to the objectives of financial statements, published between 1973 and 1989. The paper analyses and compares these different documents to address the fundamental assumptions underlying the objectives of financial statements. The content analysis approach was adopted in this study. Content analysis can, sometimes, be subject to personal judgment and thus bias. But in terms of studying historical data, its main advantage is objectivity, in addition to its ability to provide unobtrusive evidence of historical trends (e.g., Aronoff, 1975; West, 2007). Content analysis was, therefore, considered preferable to this study, given its analytical and comparative nature of historical documents.

2. TRUEBLOOD REPORT: AN OVERVIEW

In April 1971, the AICPA Board of Directors announced the establishment of a Study Group, formally known as the "Trueblood Committee" to address the growing concerns about present-day corporate financial reporting. The Trueblood Committee was established on the grounds that the conceptual accounting framework was urgently needed. The committee was basically charged with the development of the objectives of financial statements along with determining users and uses of financial statements; the extent to which accounting can provide such information; and determining the conceptual framework needed to provide this necessary information.

The Study Group represented a major attempt towards the development of objectives of financial statements and recommended continuous efforts to update accounting standards. The Trueblood Committee was composed of nine members, representing the academic world, the accounting profession, the industry, and the Financial Analysts Federation. A team of academicians, practitioners, and consultants served as advisers. The committee conducted meetings and interviews to assess the informational needs of various interested groups from all sectors (i.e., business, non-profit, and public organizations). Relevant literature in accounting, economic, and finance provided the basic conceptual foundation. On the basis of the empirical and conceptual data gathered, the study group issued

two reports. In 1973, the first and most important report was issued and called the "Report of the Study Group on the Objectives of Financial Statements". This report stated the objectives of financial statements and later recommended objectives representing the basis for the Statement of Financial Accounting Concepts No. 1. In 1974, the second report "Wheatman Report" was issued. It included a selection of articles by the team of advisers that the study group considered when forming the objectives in the "Trueblood Committee" report.

According to Bloom (1996), the committee made several principal recommendations, one of which was to address the issue of accounting for goodwill. Shahwan (2004) concluded that goodwill asset was to be capitalized but not amortized as there was an inconsistent association between equity market values and write-offs of goodwill.

3. THE CORPORATE REPORT: AN OVERVIEW

In the early 70s, the ICAEW was concerned about corporate financial reporting and annual financial reports. In 1974, ICAEW assigned to its Accounting Standards Committee to set up a working party to re-examine the scope and aims of published financial reports in the light of the needs and conditions. In July 1976, the working party report was published and it represented the effort of an eleven-member party, working within the following frame of reference:

- They should consider the most suitable means of measuring and reporting the economic position, performance, and prospects of undertakings for the purpose and persons identified above.
- Their purpose was to re-examine the scope and aims of published financial reports in the light of modern needs and conditions.
- They should be concerned with the public accountability of economic entities of all kinds, but especially of business enterprises.
- They should seek to establish a set of working concepts as a basis for financial reporting. Their aim was to identify the persons or group for whom published financial reports should be proposed, and the information appropriate to their interests.

The working party report was presented as a discussion paper intended as a first step toward a major review of users, purpose, and methods of modern reporting in the UK.

The basic philosophy and starting point of the corporate report is that financial statements should be appropriate to their expected use by potential users. In other words, financial statements should attempt to satisfy the informational need of their users. So, we can conclude here that the Corporate Report adopted a user decision-oriented approach of accounting, as noted earlier in the previous section. The report firstly summarizes its own conclusion as to the fundamental objective of published accounts. As stated in the Corporate Report that "in our view the fundamental objective of corporate reports is to communicate economic measurements of and information about the resources and performance of the reporting entity useful to those having a reasonable right to such information"(p. 1).

The report assigns responsibility for reporting to the “economic entity” having an impact on society through its activities. It suggests seven desirable characteristics that corporate reports should possess if they are to meet the fundamental objectives of annual reports established by the basic philosophy. Corporate reports must be relevant, understandable, reliable, complete, objective, timely, and comparable. The Corporate Report argued that current reporting practices did not fully meet the needs of the various users of accounts and recommended that all significant economic entities should publish the following additional statements: A Statement of Value Added; An Employment Report; A Statement of Money Exchange with Government; A Statement of Transactions in Foreign Currencies; A Statement of Future Prospects; and A Statement of Corporate Objectives. Finally, after assessing six measurement bases (historical cost, purchasing power, replacement cost, net realizable value, value to the firm, and net present value) against three criteria (theoretical acceptability, utility, and practicality), the report rejected the use of historical cost in favor of current values accompanied by the use of general index adjustment.

In comparison, the information provided by financial statements should attempt to satisfy users’ needs as per the Trueblood Report and the Corporate Report. Both documents recommend that users’ are in need of information provided by the income statement. The Trueblood Report is a descriptive study concerned with the objectives of financial statements and considered society as a specific user of accounting information. This is unfeasible since the inclusion of society as a user would have opened a “can of worms” that we are not presently capable of handling operationally, except at a very elementary level. Whereas, the Corporate Report is a study concerned with the fundamental aims of published financial reports and the means by which these aims can be achieved. It was intended to be the starting point of a major review of the users, purposes, and methods of modern financial reporting.

In conclusion, a comparison of the Corporate Report and the Trueblood Report as per their major findings and recommendations can not be made without considering the different economic and political environments in the UK and the US. In general, both documents adopted a user-oriented approach to satisfy user needs. Accordingly, it can be concluded that both reports suggested the same overall objectives of financial statements. The Corporate Report provided a more fundamental consideration of the purposes of financial reporting and was potentially more far-reaching in its conclusions than was any other document issued by the ASC.

4. MAKING CORPORATE REPORTS VALUABLE — MCRV

In 1986, a Research Committee by the Institute of Chartered Accountants of Scotland (ICAS) conducted a study, which, over two years of discussions, resulted in the production of a report called “Making Corporate Reports Valuable” (MCRV). In 1988, MCRV was published in an attempt to enhance corporate performance and accountability. The major motive

behind MCRV was the concern about the unsatisfactory status of present-day financial reports and the need to improve corporate financial reporting.

The major part of the MCRV report was devoted to the objectives of financial reporting. Three major objectives of financial reporting, as presented by the report, were that accounts should show “economic reality”, accounts should show “true and fair view”, and accounts should be useful for decision-making purposes. Frezatti, de Aguiar, and Rezende (2006) stated that the qualitative characteristics of accounting information contribute to user satisfaction and ultimately to the decision-making process. The economic reality was interpreted by ICAS Research Committee as “what really happens expressed in financial terms” (McMonnies, 1988, p. 107). The meaning of “a true and fair view” is obviously of crucial importance. Francis and Schipper (1999) stated that “it means whatever the accounting profession currently thinks it means”. In MCRV’s point of view, a true and fair view implies actions necessary to give a proper impression of the financial results position of a business. It would appear that disclosure requirements and accounting standards are, in practical terms, the main ingredients of a true and fair view. The source of the third objective appears to date back to the Trueblood Report. As per MCRV, the basic objective suggested linking accounting to decision-making, i.e., “An efficient market requires the communication of useful information from management to investors” (McMonnies, 1988, 1).

A question that imposed itself is whether present-day financial statements satisfy the meaning of these definitions. The profit and loss account and the balance sheet are two main statements of present-day financial reporting. The profit and loss account shows the net results of company operations, in terms of profit or loss, during the financial period. The profit figure resulted from the profit and loss account is regarded as meaningless by MCRV for many reasons. For instance, the depreciation expense figure reported in the profit and loss account may be incorrect in the sense that it may be overstated or understated charged to accounts. So, it can be argued that present-day financial statements are based on the reality of a company’s progress and position, and in order to get a meaningful picture, we have to take apart the figures and adjust them by our estimates.

The balance sheet is a financial statement that shows the financial position of the company at a specific point in time, with the limitation of historical cost accounting. It is agreed by MCRV that the historical nature of the balance sheet and accrual adjustments prevent the balance sheet from being proper statements of financial position. The balance sheet reports assets allocated at depreciated historical cost, at amounts representing current valuations, and at the results of revaluations of earlier periods (sometimes depreciated and sometimes not). So, it can be argued that there is no consistency in valuation practice because the balance sheet is concerned with matching and not valuation. The total sum of the assets is meaningless, and combining it with the liabilities to show the company’s financial position does not, in practice, achieve anything worthwhile.

MCRV report suggested an entirely new information package for accounting statements, which included four accounting statements and a set of future-oriented statements. The new package can be useful for both management and external users (i.e., investors) as it represents the main thrust of MCRV. Four accounting statements were suggested to replace the existing ones and these statements were the current value balance sheet, the operation statement, the statement of changes on financial wealth, and the statement of distributions which would include an adjustment for general inflation. In regard to the set of future-oriented statements, it should be developed, as proposed by MCRV, to include statements of objectives, plans, and projected cash flows.

Fundamental changes, in some financial systems, such as the tax law and company law, were required to be changed in order to imply MCRV proposals in financial reporting as MCRV proposals were considered as a long-term improvement of financial reporting. In addition, MCRV addressed the deficiencies associated with present-day financial reporting and pointed out the following recommendations:

- In order to show a “true and fair” view or to portray the economic reality, economic substance should prevail over legal form in accounts.
- All assets and liabilities should be recorded using net realizable value as to apply mainly additively and comparability.
- The disclosure requirement for potential liabilities, expectations, and future financial plans or gains.
- Based on the grounds that wealth is broader than profit, accounts should reveal changes in financial wealth including unrealized gains or losses.

Present-day accounts require to be improved and the above four recommendations represent short-term improvements to accounts. Such improvements also require the inclusion in all cooperate reports of a statement of objectives; regular revaluation of fixed assets; improved segmental reporting; market capitalization comparisons; information about current trading and future prospects; greater use of audit committees and more informative audit reports; and realized and unrealized source of the gain statement.

5. GUIDELINES FOR FINANCIAL REPORTING: AN OVERVIEW

A major part of Solomons’s report was about the objectives of financial reporting. The motive behind Solomon’s report was to furnish the basis for a conceptual framework of financial reporting. According to his report, entities were classified as private profit-seeking entities, private non-profit entities, and public sector entities. As users’ needs of financial statements may vary from one entity to another, Solomons’s report was much focused on private profit-seeking entities, and it was a complete reformulation of GAAP for these entities. Recently, a case study, conducted by Hawkins and Cohen (2001), discussed the conceptual framework for financial reporting as set by the Financial Accounting Standards Board, along with the objectives of financial statements.

Solomons covered the issue of the objectives of financial reporting and addressed the relevant issues of profitability, viability, representational faithfulness, and comparability as fundamental assumptions of financial reporting.

The objectives of profitability and viability are considered as the central economic characteristics to be represented in the financial statements. They are interrelated elements of performance in the sense that enterprises must be profitable and viable. Profitable enterprises are not necessarily viable. As losses may incur in the short run, enterprises must be profitable over the long run. The viability of enterprises requires profitability and liquidity. The enterprise’s viability represents the ability to generate cash flows at amounts and times that meet enterprises’ commitments.

Solomons report addressed representational faithfulness as a fundamental objective of financial reporting. According to his report, reliability is the main component of representational faithfulness. According to Yang, Rohrbach, and Chen (2005), reliability appears to decline by the voluntary nature of provisions and by the effects of opportunism in some other cases. Solomons pointed out that accounting information is reliable if its user has a reasonable assurance that it faithfully represents what it purports to represent. It is the most critical element of reliability which concerns the correspondence between an event it purports to represent and the economic object to measure. The events are the changes in the enterprise’s value in regard to revenue, expense, gains and losses, and the economic objects are assets and liabilities. Miller and Bahnson (2007b) argued that verifiability is necessary for reliability, but not sufficient. Reliability also demands neutrality which is the absence of bias. Traditional conservatism is not neutral and produces unreliable financial statements. As Miller and Bahnson commented, there is nothing virtuous about reporting. Only part of the whole truth can create the desired message (Miller & Bahnson, 2007a).

Another issue of interest is to examine whether the representational faithfulness of financial reporting, as stated by Solomons, leads to the same true and fair view of financial statements. Solomons’s report said “Faithful representation requires something more. Where there is any discretion about how relevant phenomena are to be quantified, perhaps because of the presence of uncertainty, faithful representation requires the depiction of uncertainty” (p. 1). The question here is whether differences exist between representational faithfulness and true and fair view of accounts. The following example clarifies this issue. Assume that the balance sheet of a firm has reported accounts receivables of \$15,000. To accounts for reliability, the financial statements should account for the doubtful debts and the collectability of receivables. To test for the true and fair view, the accounts have to prove the existence of customers’ accounts as audited using the sample auditing techniques. So, the concern is about the uncertainty involved in the collectability of account receivables reported in the financial statements.

Financial statements can be subject to comparability with similar firms and even over periods of time for the same firm. Solomons report defined comparability as “to make like things look

alike". It seems that achieving comparability is often elusive because it means to have like things reported alike, while unlike things may be reported differently. Apparently, it is a concept that applies to users of financial statements.

The MCRV and Solomons addressed the objectives of financial statements and indicated the importance of its development. Both documents agreed on some issues and disagreed on others. The comparison below analyzes the issues of similarities and differences between both documents.

The MCRV and Solomons are similar in terms of emphasizing that accounting data should be relevant to users' needs. Both documents concluded that the accounts should attempt to portray economic reality. Both documents also stressed more on the balance sheet than on the profit and loss account. First, the MCRV and Solomons emphasized the importance or relevance of accounting data to the needs of user groups. To be relevant, information must be logically related to a given decision (Holthausen & Watts, 2001). Both documents pointed out that, to be relevant to user groups, accounting information must be capable of making a difference in a decision by helping user groups to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations. Information is relevant to a decision if it can reduce the uncertainty about the variables in the decision process. Information about past activities aids in the prediction of the outcome of related future activities. An example given by Solomons was interim earning reports, which provided both feedback on past performance and a basis for prediction before the year-end. Therefore, relevant information must have predictive value and/or feedback value. Usually, both are supplied simultaneously, because knowledge about the consequence of actions taken will improve the decision maker's ability to predict the results of similar future actions. Timeliness is also a component or an ingredient of relevance. If the information is not available at the time a decision needs to be made, it lacks relevance. The idea of timeliness is to make information available for decision-makers before it loses its capability to influence a decision.

The second point that both documents agreed on is that both concluded that accounts should attempt to portray economic reality. "Economic reality" is a complicated subject and can be subjective. Both publications were considered to be major attempts towards the drive for economic reality. That drive was the basic reason behind the change from cash to accrual accounting (for example, pensions, 2004), from complete contract to the percentage of completion recording of contract, and from a pooling of interests to purchase corporate acquisition. A reference should be made here to the Trueblood report as it provided a thrust in this drive towards portraying economic reality by pointing out that users of financial statements seek information concerning the cash consequences of their economic decisions. The Trueblood Report went on to state that earning power indicated the ability of an enterprise to generate cash in the future and hence; "An objective of financial statements is to provide users with information for predicting and evaluating enterprise earning power" (Solomons, 1989, 1).

Both documents suggested that the drive towards portraying economic reality — or as Trueblood put it, future cash generation ability — must obviously be considered in the adoption of accounting policies. In addition to the objective similarities, MCRV and Solomons had their origins in discussions and research committees rather than standards committees, even though MCRV was an example of teamwork, while Solomons presented his individual view. Both documents were critical to the current state of corporate reporting in the UK, and they represent the first step toward a reassessment of the nature of financial reporting. They make some recommendations for present-day financial statement deficiencies, as was seen at the beginning of this section. Finally, both documents emphasized the balance sheet rather than the profit and loss account. This approach does not mean that the balance sheet is more important than is profit and loss account, but what they really mean is that in order to measure the income we have to examine balance sheet changes. So, it can be argued that both documents adopted an articulated approach in relating the balance sheet to profit and loss account.

Both documents appeared to disagree on several issues, including the central statements, the basis for valuation, and specific topics such as goodwill treatment. With respect to the issue of central statements, MCRV reviewed the existing financial statements and concluded a need to suggest a new ideal type of financial statements. The suggested ideal solution was to propose a new "financial package" that would replace the current ones. Solomons document was in favor of the traditional accounting approach in the sense that the balance sheet and profit and loss account were assumed to be central statements. In regard to the basis for valuation, MCRV emphasized the use of net realizable value as a basis for valuation. Net realizable value (NRV) is based on the current selling process. Solomons argued that the current cost accounting would need to be appraised as the basis for valuation. In that, it preferred that system of "value to the business" which is similar to current cost accounting.

Another issue of difference was to account for goodwill. MCRV suggested capitalizing goodwill and amortizing it over its expected useful life. The issue became as to how the expected useful life of goodwill asset would be estimated. This problem was not an issue in Solomons document. On the contrary, Solomons argued that goodwill had no room in the main financial statements and suggested that purchased and non-purchased goodwill is treated consistently in accounts.

However, MCRV and Solomons moved away from the Trueblood Report and the Corporate Report. In that, their proposals were based on different fundamental assumptions. The MCRV and Solomons emphasized the importance or relevance of accounting data to the needs of the users, and both advocated a comprehensive income statement (incorporating all gains, including appreciation in asset values) with a financial capital maintenance concept. On the other hand, one of the main important fundamental characteristics of the MCRV proposal was that management information needs were not fundamentally different from those of users of external reporting. The only difference

between the package which management would use and the package which would be communicated externally would be a reduced amount of information to external users in circumstances where the reduction would be beneficial to users such as investors. Furthermore, MCRV proposals preferred current and future information rather than past information in the sense that the present information can show the economic reality of the situation, including the right picture about the enterprise. The future information is more relevant to the users rather than past information for the purpose of making economic decisions.

MCRV and Solomons's proposals stressed the same basic objective of financial statements which maintained that financial statements should provide useful information for making economic decisions. However, the statements which represent useful information were different under these reports. MCRV and Solomons believed that accounting information can be useful when it shows or portrays economic reality and is relevant to the needs of the users. MCRV and Solomons proposed a general view of objectives. To meet these objectives, users should be identified first in order to disclose relevant data according to their needs. Accordingly, it can be concluded that, if both views are to be reconciled, accounting information is useful when it shows the economic reality of the financial position, performance, financial adaptability, and accountability of the enterprise.

6. CONCLUSION

In view of the comparison and analysis above, it can be concluded that the four documents emphasized the usefulness of accounting for decision-making purposes. This leads to an inference that accounts should essentially portray economic reality. The main objectives of these documents are to help financial report users make decisions about efficient allocation of scarce economic resources, and provide a mechanism that assists managers of reporting entities to discharge their accountability obligations for resources entrusted to them. Those two objectives are commonly referred to as "decision-usefulness" (Frezatti et al., 2006) and the "stewardship" functions of financial reports. In common, the qualitative characteristics that have been outlined to make financial statements information useful are relevance and reliability. With respect to relevance, information is relevant when it influences the decision-making needs of users. It relates to the predictive value and confirmatory value of accounting information. Relevant information helps users form expectations about the outcomes of past, present, and future events as well as confirm or correct past evaluations (Miller & Bahnson, 2007b). In relation to reliability, the quality of reliability includes faithful representation; substance over form; neutrality; prudence; and completeness. This quality is the correspondence or agreement between a measure and the phenomena it purports to represent (Miller & Bahnson, 2007b).

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