

CHAPTER 1

Introduction and problem statement

1.1 Introduction

The traditional formal communication vehicle between a publicly listed entity and its interested constituencies is the corporate annual report (CAR). This issue will be further tested in the questionnaire for preparers (chapter 9) as follows: (Statement 28: *The corporate annual report is the primary communication channel of a company*). The corporate annual reports (CARs) of entities in South Africa have undergone significant change and are still in a process of transition; this is a worldwide trend. CARs are the playing fields on which business information, through the use of “accounting of the mind” practices, appears above the surface. Accounting of the mind practices represent the practices of human beings when making decisions about the control, conversion and allocation of resources. These practices come about through the recording of transactions and past experiences in human memory and are manifested in the form of habits for example (Gouws, 2006). “Accounting of the mind practices” is therefore a broader concept than “accounting practices”, which merely capture entity information. Accounting of the mind practices produce either discretionary disclosures through discretionary accounting practices, or statutory financial disclosures through accounting practices that have become generally accepted accounting principles. A list of accounting practices would consist of the following: observation or discovering, identifying (choice), recognising, classifying, measuring, recording, summarising, analysing, interpreting and reporting of accounting information.

Nowadays CARs are carrying more and more information (which reflects change) and the intention is to present this in such a way that it satisfies the relevant economic needs of various stakeholders. The accounting literature indicates the need for new approaches to and outlooks on the broader topic of financial reporting (Wolk, Tearney & Dodd, 2000:157). This research will investigate the changing appearance of CARs as a whole from a systems perspective.

1.2 A visual overview of the thesis

Chapter 1 Introduction and problem statement	Chapter 2 CARs in context	Chapter 3 The subprocesses responsible for CARs
Chapter 4 Quality issues In CARs	Chapter 5 The business communication potential of CARs	Chapter 6 Decision- usefulness
Chapter 7 Research methodology	Chapter 8 Research results: content analyses	Chapter 9 Research results: questionnaire for preparers
Chapter 10 Research results: questionnaire for users	Chapter 11 Research results: questionnaire for designers	Chapter 12 Conclusions and recommendations

This chapter will cover the problem statement and the importance of the study, the hypothesis of the study, the research objectives and scope, the research methodology, role players that can benefit from the study, a list of definitions used, a list of abbreviations and acronyms used and a demarcation of the chapters of the thesis.

1.3 Problem statement and the importance of the study

From a systems perspective, the changing appearance of CARs over the years has received little attention from researchers generally. Hopwood (1996:55) contends that the CAR is a largely unresearched document. Stanton and Stanton (2002:478) contend that “[e]xplanation of the changing structure and content of annual reports remains divided, largely because of the differing perspectives of researchers...”.

In order to provide a possible solution, this research views CARs as a whole from a systems perspective because “... the more we study the major problems of our time, the more we come to realize that they cannot be understood in isolation. They are systemic problems, which mean that they are interconnected and interdependent” (Capra, 1996:3).

The research problem follows from the fact that generally accepted accounting practices that generate statutory disclosures are seen mainly in isolation and that contextual accounting practices that generate contextual disclosures are deemed to be of less importance. In order to obtain a complete picture of an entity, the generally accepted accounting practices that generate statutory disclosures should not be seen in isolation, but should be studied together with the contextual accounting practices that generate contextual disclosures. CARs are therefore researched by reviewing the whole inclusive process as a system. Because stakeholders interact freely with their environment it is assumed that a CAR is the product of an open system and that CARs can be understood by studying their external environment, internal environment and interrelationships.

CARs are the product of information-processing systems and it will be shown that one system, which also contextualises CARs, is responsible for generating discretionary disclosures, while another system is responsible for generating statutory disclosures. An understanding of the real meaning of the statutory information contained in CARs can only be achieved when the statutory information is supplemented with contextual information.

The research problem addresses the lack of understanding of the interrelated information-processing systems of which CARs are the product, which results in the underutilisation of CARs' creative and innovative potential.

In this study the research questions are as follows:

- Do the CARs generated by the information-processing systems reflect the disclosure of information, captured and screened by accounting practices, that rests on a firm foundation supporting a logical body of practice (Herrick, 1944:49)? This issue will be tested in the questionnaire to be distributed to preparers of CARs (chapter 9) as statement 5: *Accounting practices that capture and screen information, generate the statutory and discretionary disclosures in CARs.*
- Can CARs be visualised as a product of information-processing systems, representing an interaction between entities and stakeholders to generate and share information that is constantly escalating and being presented in different formats? This question will be tested as statement 7 to be included in the questionnaire for preparers (chapter 9). (Statement 7: *CARs can be visualised as the product of information systems, representing an interaction between the entity and stakeholders to generate and share information*) and in the questionnaire for users (chapter 10) as Statement 1 (*Information in CARs is constantly escalating and presented in different formats*).
- Has the business information created by accounting practices the potential to become discretionary or statutory information in CARs? This issue will be covered by a statement to be included in a questionnaire for preparers of CARs (see chapter 9) (Statement 11: *Business information created by accounting practices has the potential to become discretionary or statutory information in CARs*).

- Is there a relationship between the information-processing system that generates the statutory disclosures in CARs and the information-processing system that generates the discretionary disclosures in CARs, which also contextualise CARs? This issue will be further explored in the questionnaire for preparers (chapter 9) (Statement 8: *The interdependency of interrelated systems, that is, the system that generates statutory disclosures and the system that generates discretionary disclosures in CARs, results in the disclosure of balanced information in CARs*).
- Does the discretionary financial information reported in CARs, if proven useful over time, have the potential of being accepted as statutory information governed by generally accepted accounting principles? This question will be included in the questionnaire for preparers (chapter 9) (Statement 12: *The discretionary information reported in CARs, if proven useful over time, has the potential of being accepted and disclosed as statutory information*).
- Is the mandatory financial information system (MFIS) that generates statutory disclosures in CARs a semi-open system? This issue will be explored in the literature review to be undertaken in chapters 1 to 6.
- Should CARs also provide other competitive financial information (e.g. an analyst's report)? This issue will be addressed in the questionnaire for preparers (chapter 9) as follows: Statement 20: *An independent analyst's report should be part of CARs*. It will also be included in the questionnaire for users (chapter 10) as statement 10.
- Do CARs provide enough information for users on the benefits they hold for users' future decision making? This question will also be explored in the questionnaire for preparers (chapter 9) as follows: Statement 32: *CARs provide users with enough information about future benefits for their decision making*.

- Is one of the objectives of CARs to enable users to predict the entity's future prospects? This issue will be addressed in the questionnaire to preparers (chapter 9) as follows: Statement 33: *The CARs objective is to enable users to predict the future prospects of the entity.*
- Do the systems that generate disclosures in CARs allow for feedback from users? This aspect will be covered in the questionnaire for users (chapter 10) as follows: Statement 26: *CARs should provide an observable feedback section for users.*
- Has CARs' potential in the education of accountants been recognised? This aspect will be tested in the questionnaire for users (academics) (chapter 10) as follows: Statement 29a: *The curriculum for accounting students makes adequate provision for the study of and research into corporate annual reports in respect of the statutory section;* and Statement 29b: *The curriculum for accounting students makes adequate provision for the study of and research into corporate annual reports in respect of the discretionary/voluntary section.*
- Should business information contained in CARs that is not useful or comprehensible be discarded or replaced? This question will be included in the questionnaire for preparers (chapter 9) as Statement 21: *The business information in CARs that is not useful or comprehensible must be discarded or replaced*) and also in the questionnaire for users (chapter 10) as Statement 27.
- What new dimensions can be added to CARs? This issue will be covered in the literature review in chapters 1 to 6 and in chapter 12.
It may be possible to find answers to these questions if all the processes that encompass the generation of information disclosed in CARs are viewed from a systems perspective.

1.4 Hypothesis of the study

The hypothesis of this study is that CARs are the information products of accounting practices in transition. The word “transition” means “change-over, conversion, development, evolution, metamorphosis, shift” (Collins 1985). It encompasses movement and change.

1.5 Research objectives and scope

In order to address the research problem in an organised and systematic manner, the following research objectives have been formulated:

Firstly, important aspects of the history of reporting will be examined. Secondly, the systems that generate the information in CARs will be explored as a whole in order to discover their essence and attributes. Thirdly, the attributes of information from two different paradigms will be investigated. This will be followed by, fourthly, an exploration of the subprocesses that influence reporting in order to produce a better understanding of the type of information to be disclosed in CARs. For instance, the users’ need to use information in such a way that it is useful for creating the meaning necessary for decision making could influence the accounting practices used in the generation of information. Fifthly, an investigation into the quality of the information used in CARs will be undertaken to discover what types of information need to be disclosed in CARs in order to reduce users’ business risks. Finally, the communication potential of CARs will be identified in order to discover ways to bridge the communication gap between the preparers and users of CARs. The research objectives will include an examination of the attributes of decision-useful information in order to identify the types of information that should be presented in CARs so as to reduce the risks that stakeholders are faced with. From the literature study above, statements will be formulated to be included in research questionnaires for distribution to preparers, users and designers of CARs.

In conclusion, suggestions will be made for improving CARs as a tool to assist users in their decision-making needs, and the learning opportunities that the study of CARs offers students will be discussed.

The study views CARs as a whole and excludes a study of the transition of specific accounting practices. This research investigates holistically the changing appearance of CARs, driven by accounting practices in transition, from a systems perspective.

1.6 Research methodology

1.6.1 Introduction

In this research, systems theory will be used to interpret the relationships between the systems that generate disclosures in CARs. Systems can be either open systems or closed systems, depending on the nature of their relationship with their environment. Open systems interact with the environment to obtain new energy from it. This new energy encompasses new ideas, innovation and creativity generated by feedback. On the other hand, closed systems have no interaction with their environment, and deteriorate as a result of lack of feedback from the environment and outside stakeholders (Schoonraad, 2004:90). From an accounting point of view, systems that for instance take feedback from users into account would qualify as open systems.

Innovation usually takes place when humans are faced with discomfort and imbalances (disequilibrium). The term “equilibrium” occupies a central position in the new science, that is, the paradigm of nonlinear thinking, where relationships, connections and context play a major role and where events and transactions are generally unpredictable (Capra, 1996:122). Emery (1981:74) maintains that systems “contain sets of vectors and processes which prevent the attainment of equilibrium”. If a system attains equilibrium then the system stagnates and dies. Wheatley (1999:77) declares that “[e]verything alive is an open system that engages with its environment and continues to grow and evolve”.

From a systems perspective CARs, which are driven by uncertainty, may be perceived as the information product of interrelated systems, for example the discretionary information system (DIS) and the mandatory information system (MFIS). This issue will be further explored in the questionnaire for preparers (chapter 9) as Statement 8: *The interdependency of interrelated systems, that is, the system that generates statutory disclosures and the system that generates discretionary disclosures in CARs, results in the disclosure of balanced information in CARs.*

In this interrelationship between the DIS and the MFIS, the DIS is involved with the disclosure of discretionary information, which forms the context in which to understand the mandatory information disclosed by the MFIS. The boundaries of these systems (areas of activity) sometimes overlap, but this overlapping should not be cause for alarm or dispute (Goldburg, 2001:14, 15), as both the systems are responsible for disclosing relevant information expressly for the purpose of minimising stakeholder risks. As an open system, entities' CAR documents are the output of the interrelationship of the systems that generate the information disclosed in CARs. The interrelationship of the two systems will be tested in the questionnaire for preparers as statement 10 in chapter 9. (Statement 10: *There is an interrelationship between these systems.*) The discretionary information disclosed in CARs, as generated by the DIS, if proven useful over time, has the potential of being accepted as statutory information governed by generally accepted accounting principles (the MFIS). When studying the history of CARs in terms of its growth and relationships it is evident that it is an open system (refer chapter 2).

Generally accepted accounting practice (GAAP) is accommodated for in the International Accounting Standards Board's (IASB) Framework, International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs). The South African GAAP statements are in all respects the same as the IASB Framework, the IASs and IFRSs. The accounting standards that are complied with in South Africa are therefore the accounting standards that are complied with in the United Kingdom. For this reason reference was made to the IASB and not to SAICA. SAICA is also not in possession of any literature and research regarding corporate annual reports.

The research methodology for this study (also see chapter 7) encompasses the following:

- Firstly, using a transdisciplinary approach, a critical literature review will be undertaken to obtain all the dimensions of CARs and the processes involved in generating them. This is necessary for an understanding of the systems that drive the types of disclosure contained in CARs. The review of the literature (refer to chapters 1 to 6) will be used to develop statements that will be included in the questionnaires to be distributed to preparer respondents (refer to chapter 9), user respondents (refer to chapter 10) and designer respondents (refer to chapter 11).
- Secondly, an analytical content analysis will be undertaken to discover the extent to which disclosures in CARs have escalated (refer to chapter 8).
- Thirdly, empirical questionnaires will be developed, making use of the findings of the literature review (chapters 1 to 6), and distributed to applicable respondents (refer to chapters 9, 10 and 11).
- The research is further complemented by the researcher's personal experience in the field of CARs preparation, initially as an accountant and subsequently as an educator and trainer of chartered accountants.

1.7 Who could benefit from the study?

This study will contribute to the body of accountability theory, to the knowledge of preparers, users and designers of CARs documents and to students, standard setters and auditors. It will reconcile the differences between advocates for the disclosure of statutory information and advocates for the disclosure of discretionary information, as the study will

show that there is an interrelationship between the systems that generate information in CARs.

1.8 List of definitions used

The accounting literature contains standard definitions for accounting terms. Some of these terms have been adapted and new ones developed for the context of this thesis. For the purposes of this study, the terms below are defined in the following way:

- **Accountability.**

Accountability is defined as the objective of financial reporting that reflects an agency relationship between managers, who are accountable to absentee owners, and stakeholders in terms of how they have used the economic resources entrusted to them (Kam, 1990:48, 159). The statutory section of corporate annual reports (CARs) reflects that relationship.

- **“Accounting of the mind” practices**

“Accounting of the mind” practices represent the practices of humans (the grassroots practices) that assist them when making decisions about the control, conversion and allocation of resources. They entail the recording of transactions and past experiences in the human memory, for example in the form of habits (Gouws, 2006). (Also refer to chapter 4.) They are the original accounting practices that are further refined and constructed into the accounting practices that generate disclosures in CARs.

- **Accounting practices**

Accounting practices are constructed from “accounting of the mind” practices and are used, as Staubus (1995:95) contends, as the generators of accounting information. Accounting practices stem from prevalent industry practices (Belkaoui, 2004:57) and include observing, discovering, identifying or recognising, classifying, measuring, recording, summarising, analysing, interpreting and reporting. They encompass all the practices and procedures used in the accounting value chain.

- **Accounting praxes – a possible new terminology**

Accounting praxes entail exalted, established and accepted accounting practices used in the process of reporting. However, for the purposes of this study it is assumed that generally accepted accounting principles have the same meaning as accounting praxes.

- **Business communication**

Business communication refers to the establishment and maintenance of mutually beneficial relationships between an entity and its relevant stakeholders through the exchange of information *inter alia* through the feedback that is needed to facilitate optimal decisions on the allocation of scarce resources.

- **Decision usefulness**

Decision usefulness is defined as an objective of financial reporting that has moved away from the traditional narrow goal of stewardship to a much wider role of providing heterogeneous users with information for decision-making purposes. It encompasses the accountability objective (Gouws, 1997:66, 68), and the information in CARs incorporates this objective.

- **Discretionary information system (DIS)**

A DIS is the system that uses discretionary accounting practices to generate discretionary disclosures and initiatives in CARs. This then forms the context in which to understand the mandatory financial information presented in CARs. These discretionary disclosures (Einhorn, 2005:594) are more flexible and relevant than the statutory disclosures generated by the MFIS and are not necessarily uniform. They include intellectual capital management, executive remuneration, human rights, occupational health and safety and human capital practices, innovation, research and development, customer satisfaction, climate change, corporate governance, consumer and public health, reputation risk, and the environmental and social impacts of corporate activity, operating and financial reviews, external threats, exposure risk, corporate responsiveness and impact on value (OECD, 2006:21).

- **Discretionary accounting practices**

Discretionary accounting practices screen the information captured by accounting practices and then disclose it as discretionary information in CARs.

- **Full disclosure**

Full disclosure is defined as the disclosures in CARs generated by the MFIS (the statutory disclosures) and the DIS (the discretionary/contextual disclosures), as well as disclosures to enable/empower users with “limited authority, ability, or resources” (Objective no. 2 in AICPA, 1973) (Wolk *et al.*, 2000:184).

- **Generally accepted accounting practice (GAAP)**

In the US, GAAP stands for generally accepted accounting principles, while in South Africa it refers to generally accepted accounting practice. This implies that these terminologies describe very similar conditions. The term “general acceptance” however remains a source of confusion, especially in a new situation (Belkaoui, 2004:45), as a more recent accounting practice that is preferred above an older established practice may not have the status of that of a generally accepted accounting practice. The new practice must first be accepted as a new standard before it achieves the same status as a principle. Accounting principles are derived from the observation of good accounting practices (Paton & Littleton, 1940). Many accounting concepts have influenced accounting rules, which evolve from practical operating necessities including income tax laws (Wolk *et al.*, 2000:136).

According to Grady (1965:407), principles or standards are postulates derived from experiences and reason that have proven useful. Principles are postulates that have been successful in practice (Wolk *et al.*, 2000:141). Generally accepted accounting principles are rooted in experience, reason, custom, usage and practical necessity. They encompass the conventions, rules and procedures necessary to define accepted accounting practice at a particular time (AICPA, 1970 in Wolk *et al.*, 2000:141). GAAP governs the mandatory information to be disclosed in CARs. GAAP is accommodated for in the IASB Framework, International Accounting Standards (IASs) and International

Financial Reporting Standards (IFRSs). The South African GAAP statements are in all respects the same as the IASB Framework, the IASs and IFRSs. The accounting standards that are complied with in South Africa are therefore the accounting standards that are complied with in the United Kingdom.

- **Internet financial reporting (IFR)**

Internet financial reporting (IFR) improves users' access to information by providing information that meets their specific needs, allowing nonsequential access to information through the use of hyperlinks, and interactive and search facilities, and allowing the opportunity to provide more extensive, in-depth, flexible and timely information than is available in CARs (Laswad, Oyelere & Fisher, 2000:41). IFR is therefore an additional source of financial information on entities.

- **Mandatory financial information system (MFIS)**

The mandatory financial information system (MFIS) is an information processing system that generates the mandatory information, governed by GAAP and the Companies Act, disclosed in CARs. The purpose of rule-making bodies with regard to mandatory information is to promote uniformity by limiting the alternatives to GAAP.

- **Preparers of corporate annual reports (CARs)**

The preparers of corporate annual reports (CARs) are those role players entrusted with the preparation of the CAR document. They use accounting practices, that is, generally accepted accounting principles, including the requirements of the Companies Act and JSE regulations, for the disclosures contained in the statutory section of CARs; and discretionary accounting practices for the disclosures contained in the discretionary section of CARs.

- **Stakeholders**

Stakeholders are defined as groups or individuals who can affect or who are affected by the achievement of an entity's objectives. They use the disclosures of CARs to reduce risk and uncertainty and to maximise opportunities for making decisions on the control, conversion and allocation of scarce resources.

- **Systems**

Capra (1996:29) states that, in systems theory, the properties of the parts can be understood only in terms of the organisation of the whole. The evolution of disclosures in CARs can only be understood if a study is undertaken within the context of the two systems, that is, the information-processing systems (the MFIS and the DIS) responsible for generating the disclosures in CARs. This study investigates CARs from a systems perspective.

- **The new science**

The new science of the twenty-first century is situated in the paradigm of nonlinear thinking, where relationships, connections and context play a major role and where events and transactions are generally unpredictable (Capra, 1996:122). The essential properties of the system are those properties of the whole that none of the parts possess (Wheatley, 1999:10). These properties originate in the interactions and relationships between the parts (Capra, 1996:29). The systems that generate the information reported in CARs can only be understood in the context of the larger whole.

- **The old science**

The old science is involved with the paradigm of linear thinking, classification and boundaries that developed in the seventeenth century. It represents the belief that in every complex system the behaviour of the whole can be understood entirely from the properties of its parts (Wheatley, 1999:29). In terms of this model, CARs can therefore only be understood by studying the disclosures in CARs separately.

1.9 List of abbreviations and acronyms used

Abbreviations and acronyms used in this study include:

AICPA	American Institute of Certified Public Accountants
APB	Accounting Principles Board
CAR	Corporate annual report
CARs	Corporate annual reports
DIS	Discretionary information system

EPS	Earnings per share
EVA	Economic value added
FASB	Financial Accounting Standards Board
GAAP	Generally accepted accounting principles
GRI	Global Reporting Initiative
IASB	International Accounting Standards Board
IASs	International accounting standards
IFR	Internet financial reporting
IFRSs	International financial reporting standards
MFIS	Mandatory financial information system
OFR	Operating and financial review
SAC	Standards Advisory Council
SEC	Securities and Exchange Commission

1.10 Demarcation of chapters

CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

This chapter will make the research problem known to the reader. The research problem is that a lack of understanding of the interdependency of interrelated systems that drive the reporting of information in CARs, for example the system responsible for generating statutory disclosures and the system responsible for generating discretionary disclosures, which also form the context of CARs, results in the underutilisation of CARs' creative and innovative potential.

CHAPTER 2

CARs IN CONTEXT

This chapter explores the features that form the context for CARs. Firstly, important aspects of the history and development of CARs will be presented to link the past with the present and to produce insights for shaping the CARs development process.

This will be followed by an interpretation of the two systems that drive CARs. The perception is that CARs, which are driven by several reporting processes, are the information products of interrelated reporting systems, for example the statutory disclosures and the discretionary disclosures.

In addition, an investigation into the attributes of the information disclosed in CARs will be undertaken according to two different paradigms.

CHAPTER 3

THE SUBSYSTEMS RESPONSIBLE FOR CARs

In this chapter the subsystems responsible for CARs will be explored. The objective of this chapter is to produce insights for understanding the type of information that needs to be disclosed in CARs.

The chapter investigates the following four subsystems:

- users' needs and uncertainty
- systems
- innovation
- reporting in CARs

CHAPTER 4

QUALITY ISSUES IN CARs

The quality features of corporate financial reporting will be investigated and their importance for CARs will be considered.

CHAPTER 5

THE BUSINESS COMMUNICATION POTENTIAL OF CARs

In this chapter the business communication potential of CARs will be explored in order to discover ways to bridge the gap between the preparers and users of CARs.

CHAPTER 6

DECISION-USEFUL INFORMATION

In this chapter it will be shown that the users' need for decision-useful information is the primary driving force that determines the types of ultimate disclosure in CARs.

In this chapter, users' interpretation processes will be explored and it will be shown that the main objective of the interpretation processes is to discover meaning. It will be demonstrated that the users' need to interpret financial information is without doubt the *raison d'être* for disclosures in CARs. Users have to play an active role in extracting the information they need. The investigation of information and perception indicates that users of CAR information should mentally construct a whole in order not to lose any information, and should only move to the parts if the interrelationship between the whole and the parts gives rise to enhanced meaning.

In order for CARs to be an instrument in decision making, it is necessary to disclose information about the various inputs and processes of the business information and not just supply information on the outputs. From the investigation it is also clear that predictive information will assist users in predicting the future prospects of entities. Users should in turn be able to give feedback.

CHAPTER 7

RESEARCH METHODOLOGY

This chapter introduces the empirical component of the study. It describes the analytical content analysis as well as the empirical questionnaires that will be developed and distributed to respondents.

CHAPTER 8

RESEARCH RESULTS: CONTENT ANALYSIS

The research findings of the content analysis of the CARs of South African entities will be reported on and interpreted.

CHAPTER 9

RESEARCH RESULTS: QUESTIONNAIRE FOR PREPARERS

The research findings from the questionnaire sent to preparers of CARs will be reported on and interpreted.

CHAPTER 10

RESEARCH RESULTS: QUESTIONNAIRE FOR USERS

The research findings on the questionnaire sent to users of CARs will be reported on and interpreted.

CHAPTER 11

RESEARCH RESULTS: QUESTIONNAIRE FOR DESIGNERS

The research findings on the questionnaire to designers of CARs will be reported on and interpreted.

CHAPTER 12

CONCLUSIONS AND RECOMMENDATIONS

Conclusions are reached from both the quantitative and qualitative components of the study. Recommendations will be made about the potential for improving CARs and possible further areas for research are identified.