

CHAPTER 3

Subprocesses responsible for CARs

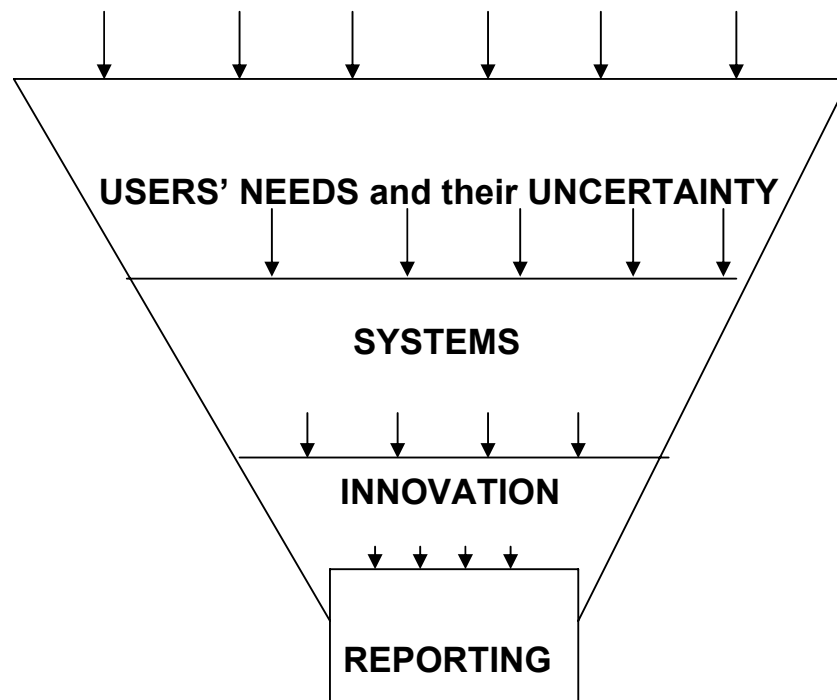
3.1 Introduction

Reporting (disclosure of information) is driven by uncertainty (Foster, 1986:15). The users' needs for understandable information to reduce uncertainty influence accounting practices and GAAP, as well as the discretionary accounting practices. These all play a role in the development of the disclosures contained in CARs. In chapter 2 some of the features that form the context of CARs were explored. Important aspects of the history and development of CARs were presented to link the past with the present and to produce insights for shaping the CARs development process. An investigation of the systems that drive disclosure in CARs was undertaken in order to interpret the functioning of the systems and their interrelatedness. An investigation of the attributes of information disclosed in CARs was also carried out using two different paradigms to determine the types of balanced information to be disclosed in CARs.

The aim of this chapter is to explore the subprocesses responsible for CARs. This will give a better understanding of the type and quality of the information currently being disclosed in CARs and will allow an opportunity to make recommendations for further improvements in this regard.

The layout of the chapter is done according to four subprocesses, that is, users' needs and their uncertainty, systems, innovation and reporting. Figure 3.1 is an illustration of the four subprocesses that drive reporting in CARs. The information to be disclosed in these documents should as far as possible address users' needs to reduce uncertainty. Then, the internal systems that produce information in CARs need to be explored in order to find areas for improvement. In addition, creative thinking and innovation will determine the types of information users need and ways in which internal systems can contribute to the production of decision-useful information. The final subprocess is the disclosure of the information produced by the systems/processes in the CARs.

Figure 3.1 The subprocesses that drive reporting in CARs



Source: Own observation

3.2 Users' needs

Uncertainty, for example a lack of general and future-orientated information on an entity, and shortcomings in one's own education, are the ultimate drivers of the disclosures in CARs. Conversely, the aim of these disclosures is to reduce uncertainty.

Every user of these reports is experiencing some type of risk (King, 2002b:76), for example investment risk and cash flow risk, which can only be managed if the right information is available. Ongoing user research into the type of information required to reduce uncertainty influences the type of information that is disclosed in CARs. The issue of risk reduction is further tested in the questionnaire for users (chapter 10) as follows: statement 22: *CARs as an information carrier should provide stakeholders with information that would help to minimise the risks [e.g. investment risks] they are faced*

with, and statement 23: *CARs are knowledge-sharing documents into which stakeholders can tap for investment risk-reducing information.*

Different users have different levels of uncertainty and users need to manage their risk by having the right type of information available. The feedback users give on their needs also influences standard setters who acknowledge that there is a wide variety of user groups, not limited to investors or potential investors. In the IASB Framework (IASB, 2005:para. 9-11) mention is made of various user groups. These include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. The framework also states that these user groups use financial statements to satisfy some of their differing needs for information, which include the following:

- *Investors. The IASB Framework (IASB, 2005 para. 9(a)) states that the providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information that enables them to assess the ability of the entity to pay dividends.*

The needs of this group of users form part of a social contract (Foster, 1986). The needs of investors for this type of information will have an effect on the statutory disclosures governed, *inter alia*, by GAAP, as well as the discretionary disclosures generated by the discretionary accounting practices presented in CARs. A certain balance must therefore be struck between statutory disclosures and discretionary disclosures.

- *Employees. The IASB Framework (IASB, 2005 para. 9(b)) is of the view that employees and their representative groups are interested in information about the stability (maybe not the most desirable state of affairs) and profitability of their employers and that*

they are also interested in information that enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

Employees' needs therefore influence the type of information to be generated by the MFIS, for example IAS 19 (IASB, 2005), which deals with disclosures on employee benefits, as well as the information generated by the DIS, for example integrated sustainable information on human resource management.

- *Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due (IASB, 2005: Framework: para. 9(c)).*

Lenders are a dominant group and as such are in a position where they are able to demand certain types of information (Foster, 1986:5) and they therefore influence the type of accounting practices used in the process of generating disclosures. The historical influence of bankers on the preparation of financial statements was significant as they not only influenced the statements themselves but also the accounting principles (Heath, 1978:41). Their needs will therefore have an effect on the information to be generated and disclosed by the MFIS and DIS in CARs. Wolk *et al.* (2000:314) is of the opinion that the quality of disclosures in annual reports results in lower risk premiums. The same applies to interest rates. This issue is addressed in the questionnaire for preparers (chapter 9) as follows: statement 28: *The quality of disclosures in CARs results in lower risk premiums.*

- *Suppliers and other trade creditors. The IASB Framework (IASB 2005: para. 9(d)) asserts that suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due and that trade creditors are more likely to be interested in an entity over a shorter period than lenders unless they are dependent on the continuation of the entity as a major customer.*

Liquidity and solvability disclosures originated as a result of the needs of creditors. They have even influenced the classification of operating capital. Suppliers influence the type of information to be disclosed in CARs, for example current assets and current liabilities, so that the current ratio of entities can *inter alia* be computed.

- *Customers. Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, it (IASB, 2005: Framework: para. 9(e)).*

The customers' need for the long-term survival of an entity will influence the type of information to be generated by the systems involved in CARs. It will, for example, influence the discretionary information generated by the DIS that is addressed in the sustainable development review section of the CARs document.

- *Governments and their agencies. The IASB Framework (IASB, 2005 para. 9(f)) asserts that governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities and that they also require information in order to regulate the activities of entities and determine taxation policies, and as a basis for national income and similar statistics.*

One may therefore speculate that all information on an entity as far as is practically possible is important to government (which can also be seen as an investor) and will influence the ultimate information to be disclosed in CARs.

- *Public. The IASB Framework (IASB, 2005 para. 9(g)) is of the view that entities affect members of the public in a variety of ways, for example entities may make a substantial contribution to the local economy, including the number of people they employ and their patronage of local suppliers, and that financial statements may assist the public by providing information on trends and recent developments in the prosperity of the entity and the range of its activities.*

The public will therefore influence the type of information to be disclosed, for example the information that forms part of the operational review contained in the discretionary information section of CARs.

Over and above the users identified by the framework, AICPA (1994:8) identifies additional user groups, that is, management and board members that use business reporting to help in making decisions to do with managing the business; competitors who use business reporting to help evaluate competitive strengths and weaknesses and business strategy; academics who use the data for research purposes; and the press, which uses the data for its copy. Business competitors and academics are therefore also users of CARs. There are also users concerned with various social causes who use business reporting to help assess a company's involvement in areas of concern, for example an entity's involvement in black economic empowerment. Disclosures in CARs should preferably be made to these various stakeholders on an equal basis. This issue will be tested in the questionnaire for users (chapter 10) as follows: statement 21: *Various stakeholders make demands on the information in CARs, and these should be provided for on an equal basis.*

The varying needs of the different users will influence the reporting (disclosure of information) in CARs in a variety of ways, as different stakeholders will have different needs.

3.2.1 Users expect more to address their needs

Researchers such as Gouws (1997:66) conclude that the objective of financial reporting has moved away from a narrow approach to a much broader one: it has evolved from its narrow intention of stewardship to a far wider intention of providing heterogeneous users with information for decision-making purposes. This issue will be further explored in the questionnaire for users (chapter 10) as follows: statement 20: *The objective of business reporting in CARs has moved away from a narrow approach of accountability to a much wider portrayal by providing information to heterogeneous users for decision-making purposes.* Clatworthy and Jones (2001:311) indicate that the annual report evolved from a statutorily produced document into one in which narratives, photographs and graphs dominate. The aspect of photographs will be tested in the questionnaire for users (chapter 10) as follows: statement 13: *In CARs photographs add value to the company profile.* The

inclusion of narratives, photographs and graphs has been necessary in order to provide users with decision-useful information. The decision-usefulness objective has, however, not totally replaced the stewardship objective, but rather encompasses it (Gouws, 1997:68). It may be concluded that the discretionary accounting practices used by the DIS in CARs to generate and disclose discretionary information encompass the accounting practices that generate the statutory disclosures in CARs.

Wolk *et al.* (2000:170) note that, from 1960, the issue of user needs and objectives has increased in prominence in accounting research. The document that first recognised the objective of decision usefulness was APB Statement No 4 published by the Accounting Principles Board (APB) during 1970 (Puxty, 1990:350). Since this recognition, “the decision usefulness approach has been characterised by an ever-growing body of research, focussing on the users themselves, their decisions, information needs and information-processing abilities” (Schoonraad, 2004:49). As mentioned above, the IASB Framework (IASB, 2005) also acknowledges the existence of different user groups.

This ongoing research into user needs has influenced the type of information that is currently being published in CARs by the management of entities. Some of this information is beyond the scope of the framework but is disclosed in the discretionary section of CARs, which is generated by the discretionary accounting practices used by the DIS in CARs. These discretionary accounting practices are important in that they influence the development of future standards and the review of existing reporting standards, that is, the International Financial Reporting Standards (IFRSs).

3.2.2 Quality information

The needs of heterogeneous users, through proper feedback systems, may determine the quality of the information found in CARs. This in turn affects the innovation process involved in accounting practices and accounting standards, which ensures that quality information as well as quantity information is reported in CARs. The characteristics of the

qualitative disclosures generated by the MFIS include understandability, relevance, materiality, reliability, faithful presentation, substance over form, neutrality, prudence, completeness and comparability. The attributes of good quality information generated by the DIS include discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. Transparency in financial statements has emerged as one of the most widely applied characteristics of desirable reporting (Mensah, Nguyen & Prattipati, 2006:47). It would then seem that there are two types of quality information in CARs: the type generated by the MFIS and that generated by the DIS. This issue will be explored further in chapter 4.

3.2.3 Discretionary disclosures

The King Report on Corporate Governance for South Africa (“the Code”) calls for a balanced approach to providing business information. The disclosure of information can therefore never be one-sided. Kaplan and Norton’s (1992) research addresses the interests of a wide range of stakeholders with regard to the fundamental principles of good financial, social, ethical and environmental practice (King, 2002a:5). These stakeholder interests (OECD, 2006) and stakeholder relationships have a direct influence on the type of information reported in CARs. This issue will be addressed further in chapter 4.

3.2.4 User characteristics

The characteristics of users are an important consideration for the preparers of CARs. Such people need to be sensitive to user characteristics, such as level of education, intelligence, communication skills, culture and relevant knowledge (Gouws, 1997:65), as these factors will certainly shape disclosure CARs in the future.

3.2.5 Feedback

Feedback is an important concept in systems theory, because the direction of a system is controlled by the feedback from the environment that a system receives. Open systems constantly have to change in order to stay the same (Cutlip, Center, Broom & Du Plessis, 2002:22). Feedback makes a system open, therefore users must use their experience of the information presented in CARs to give feedback on the types of information they need. This will influence the accounting practices that deliver entity-orientated information to the DIS for generating discretionary disclosures using discretionary accounting practices. This in turn could influence the development of future accounting standards and the review of existing standards that govern the mandatory information generated by the MFIS. For CARs to survive as a system, it has to adapt and adjust to the feedback given by users. Feedback influences the kind of reporting (disclosure of information) that takes place in CARs, as the needs of users are taken into account.

3.3 The systems and factors affecting disclosures in CARs

3.3.1 The systems

The users' need to reduce uncertainty drives the type of information to be disclosed in CARs. Hence, systems that produce the information required in CARs need to be developed and used by the role players for this purpose. The disclosures contained in CARs, the inclusion of which is driven by the needs of users to reduce uncertainty and risk, are the product of information-processing systems. The MFIS, that is, the system that is responsible for generating the statutory information included in CARs, is governed *inter alia* by GAAP. But financial statement information is only a subset of the information demanded by various parties (Foster, 1986:15).

Wolk *et al.* (2000:302) contend that financial reporting is often used as an umbrella term to cover both the financial statements themselves and additional types of information. In 1933, the Securities and Exchange Commission (SEC) distinguished between protective and informative disclosure (Wolk *et al.*, 2000:303). Starting in the late 1970s more discretionary disclosures appeared on the scene (Golub, 1981 in Wolk *et al.* 2000:304).

There was a shift away from hard information (as signified by objectively verifiable historical data) to soft information embodied in opinions, forecasts and analysis (Wolk *et al.*, 2000:304). The DIS, in contrast with the MFIS, may be regarded as the system responsible for generating discretionary information.

These systems are interrelated in that the business information created by accounting practices has the potential to become either discretionary or statutory information in CARs, and the discretionary financial information reported in CARs, if proven useful over time, has the potential of being accepted as statutory information governed by generally accepted accounting principles. Thus these systems are used to create the meaningful information to be disclosed in CARs.

3.3.2 Factors affecting disclosures in CARs

- *History*

The information presented in CARs has evolved over the centuries. As far back as 1494, Paciolo, a professor of mathematics, summarised the accounting practices of his time. He was the first writer on the subject of accounting (Brown, 1968:108). In 1494 he published his *Summa de Arithmetica, Geometria, Proportioni et Proportionalita*. His view on bookkeeping, including the double-entry system, is described in one section of the *Summa*, namely the *Particularis de Computis et Scripturis*. He did not invent the double-entry system, but he was one of the first people to describe it: the basic structure of the double-entry system first appeared about two hundred years before his publication (Lee, Bishop & Parker, 1996:12). His publication dealt with the accounting practices of the time (Gouws, 1982:49–50). In chapter 1 of this research it is stated that business information created by accounting practices has the potential to become either discretionary or statutory information in CARs. Accounting practices are therefore the research playground for the development of GAAP.

- *Role of double-entry bookkeeping*

As the first accounting practice, double-entry bookkeeping has become an embedded tradition in modern accounting theory and practice (Lee *et al.*, 1996:20). Double-entry bookkeeping only produces selected information in the form of statutory disclosures. However, users also need the contextual and discretionary information produced by discretionary accounting practices to assist them in making decisions about the control and allocation of resources.

This need for more information is catered for by “accounting of the mind” practices, which capture all the entity-related information to be screened by accounting practices and/or discretionary accounting practices. These accounting practices are responsible for accounting information and may be used by the MFIS to generate the statutory disclosures governed by GAAP. The DIS, which uses discretionary accounting practices, is responsible for generating discretionary disclosures. The information generated by accounting practices that are not utilised by the MFIS, for example the value-added statement, can be used by the DIS for disclosing discretionary information. It is important to note that, in accounting practice, if the attributes of the double-entry system only are used to generate disclosures then *other valuable information is lost* (Wheatley, 1999) to entities and stakeholders. All the information about an entity, even those entities that do not focus on economic activity only, must be captured and used by “accounting of the mind” practices.

Goldburg (2001:251) states that many characteristics that have to be captured and used by accounting practices are ignored in the double-entry system and, if recorded at all, have to be handled “outside an existing double entry system”. He goes on to mention that from each occurrence only a few of the many characteristics are selected in the double-entry process. Double entry, in this way, becomes an obstacle to providing optimal information. Here again *valuable information is lost* (Wheatley, 1999). In the CARs, the double-entry system is used primarily by the MFIS in the process of generating the statutory information to be disclosed, but double-entry records are not the alpha and omega in that they do not capture all information important for users.

- *Standard setters and rule-making bodies*

Standard setters are involved with mandatory accounting practices in transition. They are responsible for setting standards, for example those found in the IASs and the IFRSs and used as GAAP for generating statutory information. In CARs, rule-making bodies and standard setters have a particular interest in the MFIS, which produces the statutory disclosures governed by GAAP. Wolk *et al.* (2000:118) report that rule-making bodies play a major role in the process of standard setting. The American Institute of Certified Public Accountants (AICPA, 1994:113) and the Association for Investment Management and Research (Knutson, 1993:7) recommend that standard setters and regulators should increase their focus on the information needs of users, and users *should be encouraged* (feedback) to work with standard setters to increase the level of their involvement in the standard-setting process.

The reporting standards used are important and the MFIS has to meet these standards in order to disclose comparable information so that these disclosures can be audited without difficulty. Wolk *et al.* (2000:118) contend that accounting regulation will continue in the future and that it currently deals with the refinement of financial statements and the standardisation of practices, rather than with expanded disclosure, as many accounting practices have been eliminated. In accounting practice, the process starts with “accounting of the mind” practices, which entail the things humans do, for example the practices that they use to allocate scarce resources. Many of these practices are eliminated when entities capture and screen entity information, as only some of the practices are formalised into accounting practices used in the process of capturing entity information. The information captured by accounting practices and not disclosed as statutory information governed by GAAP could be disclosed by the DIS in CARs as discretionary information.

One of the rule-making bodies is the International Accounting Standards Board (IASB). The IASB, based in London, began operating in 2001. It is committed to developing, in the public interest, a single set of high quality, global accounting standards that generate

transparent and comparable information in general purpose financial statements (IASB, 2005:5). The IASB is constantly performing its own research into the development of generally accepted accounting practices and could use the discretionary accounting practices that are responsible for discretionary disclosures in CARs.

Standard setting in accounting, which has been developing since the publication of the first accounting practices by Paciolo in the fifteenth century, does not use all accounting practices for generating the statutory information to be presented by the MFIS in CARs. However, the DIS in CARs ensures that relevant information not required by standard setters is nevertheless captured by discretionary accounting practices, including cost and management accounting practices, and reported as discretionary information. This type of information may be disclosed if it proves useful for user groups.

- *Corporate communications department*

One of the functions of the corporate communications departments of entities is the communication of entity-related information to stakeholders. In Hallgreen's (2006) view, the corporate communications department forms part of the multidisciplinary team responsible for the ultimate collation of all the various inputs from other sections of the organisation regarding the statutory and discretionary disclosures of CARs. The preparers of CARs (including the corporate communications department) have the task of communicating the constantly changing information created by accounting practices in transition.

- *Finance department*

The finance department (in most cases) is entrusted with the final preparation and finalisation of CARs. Although the ultimate responsibility for the preparation of CARs lies with the directors (represented by the chief executive) of publicly listed companies, the finance department is entrusted with gathering the data for preparing the mandatory information section (e.g. the statutorily required financial statements and notes). It is also

responsible for collating all the statutory disclosures generated by the MFIS. It is usually also entrusted with gathering the data for and preparing the discretionary (voluntary) information section (e.g. integrated sustainability reporting, corporate governance matters and other discretionary [voluntary] reporting) included in CARs. This department therefore uses the mandatory information, the discretionary information and inputs from the investor relations department in the final CARs preparation process and has the responsibility for presenting the ever-changing information generated by accounting practices in transition.

- *The integrated sustainable reporting department*

This is the department responsible for collating and reporting discretionary information, particularly on aspects pertaining to sustainable development such as the entity's economic contribution, social performance (including black economic empowerment) and environmental performance. This information is then supplied to the finance department or the multidisciplinary team responsible for finalising CARs.

- *Investor relations*

As a role player in the business communication process involved in CARs, the investor relations professional should have an understanding of corporate finance, accounting, investment banking and corporate structure (Schoonraad, 2004:27). Other professional requirements include communication and marketing skills, an understanding of the full scope of corporate activity, experience in and knowledge of the financial media, experience of and skills in writing press releases, annual and interim reports and speeches, and an intimate knowledge of how capital markets work (Marcus & Wallace, 1997:319). The investor relations department provides input on the type of information that should be reported in CARs to satisfy the needs of investors (Hallgreen, 2006). The input the investor relations group makes can enhance the information disclosed in CARs.

- *Public relations/networking*

Public relations departments enhance relationships between the entity and its various stakeholders. Schoonraad (2004:99) reports that public relations are concerned with building and managing stakeholder relationships. The public relations department may be in possession of valuable information, which could be supplied to the entity in order to enhance the quality and comprehensibility of disclosures in CARs.

3.4 Innovation

3.4.1 Introduction

As the needs of user groups influence the type of information that will ultimately be disclosed in CARs, entities need to use creative skills and innovation to ascertain the best way of presenting this information in CARs. New ideas and innovations should be introduced, and new ways of presenting the information developed. CARs should be constantly adapted to ensure that the users' need for understandable and meaningful information is successfully met.

3.4.2 Reasonable knowledge

An essential quality of the information provided in the financial statements is that it is readily understandable by users who are assumed to have a reasonable knowledge of business and economic activities and accounting, and a willingness to study the information with reasonable diligence (IASB 2005: Framework: para. 25). "Reasonable knowledge" is an objective term, but might be taken to mean practical or sensible knowledge. The issue of reasonable knowledge will be covered in the questionnaire to preparers (chapter 9) as follows: statement 34: *CARs are not intended for the average layman*. Users therefore have a responsibility to obtain reasonable, practical and sensible knowledge of business and economic activities and accounting, and researchers should take this into consideration when involved in the ongoing process of upgrading accounting standards.

3.4.3 Playground for innovation

CARs, as the product of information systems, represent an interaction between entities, stakeholders and researchers. As such, the CARs document is a playground for innovation and the generation and sharing of new ideas. The CARs of any entity are an excellent breeding ground for the further development of new discretionary disclosures and statutory disclosures. The standard-setting bodies that are involved in their own research to develop accounting practices for statutory disclosures may use discretionary information disclosed in CARs and related discretionary accounting practices as a source for their research efforts.

3.4.4 Disclosure of information

As the needs of the different users of information vary, as much information about an entity as possible has to be disclosed. Disclosure is construed as an imperative postulate and is described in the literature in negative terms: "... that which is necessary to make them [accounting reports] not misleading (Wolk *et al.*, 2000:145). Disclosure also deals with, for example, forecasts of operations for the forthcoming year (PWC, 2006c:1) and management's analysis of operations (PWC, 2006a:1). Preparers of CARs need to use creative thinking and innovation to determine how best to disclose information in order for it not to be misleading and for it to be useful to a variety of stakeholders.

Wolk *et al.* (2000:146) are of the opinion that expanded disclosures, that is, discretionary disclosures, are very important. Reporting is an evolving process (PWC, 2006a:1) because expanded disclosure is already noticeable in CARs, where the amount of information published is constantly on the increase and presented in different formats, for example the information given in CARs now includes the year in review, the chairman's statement, the chief executive's report, an operational review, global activities, a sustainable development review, and disclosures about corporate governance, among other things. Discretionary disclosures complement statutory disclosures in CARs resulting in full disclosure of the big picture.

3.4.5 Global and local environments

The information from the financial, business and economic environments that is captured by accounting practices and channelled into CARs should be of a high quality. Management's knowledge of the global and local environments, including business and financial issues and the interaction between the entity and its stakeholders, which it obtains from feedback from stakeholders, should ensure that the innovation process produces financial and business reporting and disclosure in CARs that are transparent and of high quality.

3.4.6 Technology, images and colour

Technology, images and colour could enhance the quality and appearance of CARs. The issue of images and colour will be included in the questionnaire for preparers (chapter 9) as follows: statement 22: *Images and colour improve the meaningfulness of the information in CARs and create a playful and relaxed atmosphere.* AICPA (1994:53) maintains that written information should be supplemented with charts and graphs to improve management's presentation and the users' comprehension of the information. The aspect of graphs will be tested in the questionnaire for users (chapter 10) as follows: statement 14: *In CARs graphs enhance the interpretation of numbers.*

Beattie & Jones (1999:46) warn that the use of tools such as photographs and graphs by management represent part of the "impression management" process. However, in this study graphs are seen as tools for communication or voluntary presentational media (Beattie & Jones, 2001:196). Entities' CARs are usually printed on hard copy and distributed to stakeholders. However, technology has also made it possible for the CARs of most entities to be available on their websites (Barac, 2004). In turn, feedback from stakeholders obtained from these websites can be used as valuable inputs to the CARs innovation process.

Furthermore, images and colour may improve the meaningfulness (McKinstry, 1996:110-111) of the information in CARs and are powerful tools for improving comprehension. Charts, photographs, captions and other graphical design elements (Tuohey, 2003:36-37)

may create a playful and relaxed tone. Companies are trying to be more pictorial in their presentation (Pratt, 1996:13). However, stakeholders should always be aware of the attributes of impression management (Beattie & Jones, 1990:46; Stanton, Stanton & Pires, 2004:59), that is, presenting something in as favourable a light as possible, and they should not be unduly influenced by these features. The issue of obfuscation and impression management will be tested in the questionnaire for preparers (chapter 9) as follows: statement 24: *In CARs “good news” is written and presented in such a way that it is easier to read*; and statement 25: *In CARs “bad news” is written using long sentences with complex grammatical structures in order to mask and deflect the readers’ attention*; and in the questionnaire for users (chapter 10) as follows: statement 18: *Positive messages in CARs are highlighted, whereas negatively valued are avoided*; and in the questionnaire for designers as follows: statement 2: *Designers generally have some training/experience in impression management, that is, a technique to present something in as favourable a light as possible*; statement 3: *By making use of photos, graphics and graphs, negative aspects of a company can be converted into positive messages*; statement 4: *As far as CARs are concerned, design devices (e.g. photos, graphics, graphs) can be used to influence the perceptions of readers of CARs*; and statement 5: *The design of CARs is viewed as an exercise in obfuscation, that is, a method to present the company in as favourable a light as possible*.

3.5 Reporting in CARs

3.5.1 Statutory reporting

Rule-making bodies are primarily concerned with the MFIS, which generates the statutory disclosures governed by GAAP. Traditional accounting focuses primarily on tangible assets, although intangible assets such as intellectual property, for example patents and trademarks, where a market value has been established by a transaction, and acquired items such as goodwill, are also catered for (IAS 38, IASB, 2005; OECD, 2006:7). The aim of the rule-making bodies is to limit alternatives to GAAP. In some cases, IASs permit different treatments for given transactions and events, for example property, plant and equipment (PPE) may be measured after recognition in terms of the cost or the revaluation model IAS 16 (IASB, 2005). In limited cases, one treatment is identified as the

“benchmark treatment” and the other as the “allowed alternative treatment”, for example borrowing costs may be recognised as an expense or may be capitalised as part of the cost of qualifying assets IAS 23 (IASB, 2005).

An entity’s financial statements may appropriately be described as being prepared in accordance with IFRSs whether they use the benchmark treatment or the allowed alternative treatment (IASB, 2005:11). The IASB’s objective is to ensure that like transactions and events are accounted for and reported in a like way and unlike transactions and events are accounted for and reported differently, both within an entity over time and among entities to promote comparability internationally.

Consequently, the IASB intends not to allow choices in accounting treatment. In addition, the IASB has reconsidered, and will continue to reconsider, those transactions and events for which IASs permit a choice of accounting treatment; the objective being to reduce the number of these choices (IASB, 2005:11). It would therefore seem likely that in the future alternative accounting treatments would be minimised. Thus, the MFIS, which makes use of GAAP, discloses information in CARs that is more comparable across entities than the disclosures generated by the DIS.

Present-day statements of GAAP, as represented by financial reporting standards, are used to govern the statutory disclosures in CARs. In the IASB Framework (IASB, 2005) attention is drawn to the elements of financial statements, that is, the assets, liabilities, equity, income and expenses. IAS 1 (IASB, 2005) prescribes the basis for presenting general-purpose financial statements so as to ensure comparability both with an entity’s financial statements of previous periods and with the financial statements of other entities. Accounting practices not yet used by the MFIS in the generation of statutory disclosures, for example the practices that generate the value-added statement, could be used by the DIS and disclosed as discretionary disclosures.

3.5.1.1 The framework

The IASB Framework (IASB, 2005) was developed by standard setters to serve as a basis for the preparation and presentation of financial statements (the statutory disclosures). It deals mainly with accounting numbers and accompanying explanatory notes and, to a limited extent, with discretionary disclosure narratives. It therefore forms part of the MFIS in CARs that governs the disclosure of mandatory information.

The IASB Framework (IASB, 2005: para. 1(f)) states that one of its purposes is to be of assistance to users of financial statements in interpreting the information they contain. This statement indicates that the standard-setting process is currently evolving from the objectives of accountability and stewardship (the old science – refer chapter 2) to one of providing information that could be decision useful to all users (the new science – refer chapter 2).

The IASB Framework (IASB, 2005:para. 8) defines a reporting entity as an entity that has users who rely on the financial statements as their major source of financial information about the entity. It should be noted that the framework deals only with the information covered by the financial statements. The framework, together with other accounting standards (and used by the MFIS to generate statutory disclosures in CARs), governs the mandatory financial information disclosed in CARs. This system ignores other accounting practices that have not yet become generally accepted accounting principles. Some of the business information created by the other accounting practices and not used by the MFIS is being catered for by the DIS in CARs and is being disclosed as discretionary information.

The objective of financial statements is to provide information on the financial position, the performance and the cash flows of an entity (mostly products of double entry) that is useful to a wide range of users for making economic decisions (IASB, 2005:Framework: para. 12). The IASB goes on to state that the financial statements prepared for this purpose meet the common needs of most users, but that they do not provide all the information that users may need to make economic decisions since they largely portray

the financial effects of past events and do not necessarily provide nonfinancial information. This is clearly an indication that there is a great deal of information that is not presented. However, a wide range of information including nonfinancial information vital for economic decision making is published in the discretionary section of CARs.

3.5.1.2 General purpose financial statements

Another accounting standard that concerns statutory information in CARs is IAS1 (IASB, 2005). This deals specifically with the presentation of financial statements, and its objective is to promote the comparability of statements with previous years and with other entities. This standard is applicable to general-purpose financial statements presented in accordance with IFRSs.

Unfortunately, general-purpose financial statements cannot always address the information needs of all stakeholder groups, as different stakeholders have different information needs. To solve this problem the accounting profession could broaden its views on reporting and move towards developing differential frameworks and differential reporting standards for a variety of stakeholder groups, taking *inter alia* cultural differences into account, as different cultures may have different value systems. The benefits of achieving this might exceed the cost of providing it. In the United States of America there are currently three aspects of differential reporting receiving attention (Wolk, Dodd & Tearney, 2004:302). These are the reporting standards of small firms versus larger firms, summary annual reports and the Securities and Exchange Commission (SEC) attempts to streamline annual reports. Schroeder & Gibson (1992: 28) report that summary reports are shorter, simpler documents than traditional annual reports. Hence, the systems that drive reporting in CARs may be flexible and adaptable in providing the information users want for their decision making.

IAS 1 (IASB, 2005) views financial statements as structured representations of the financial position and the financial performance of an entity. IAS 1 has been revised and released on 6 September 2007. The “balance sheet” now becomes the “statement of financial position”, the “income statement” becomes the “statement of comprehensive income”, the “statement of changes in equity” remains the same, and the “cash flow statement” becomes the “statement of cash flows”. IAS 1 views the objective of general-purpose financial statements as providing information about the financial position, the financial performance and the cash flows of entities that is useful to a wide range of users in making economic decisions. It also states that financial statements show the results of management’s stewardship of the resources entrusted to it (agency theory). Agency theory deals with the issue of how to motivate managers to take decisions consistent with the interests of outside investors (Kam, 1990:48, 159). For financial statements to meet this objective they must provide information about an entity’s assets, liabilities, equity, income and expenses, including gains and losses, and other changes in equity and cash flows. IAS 1 (IASB, 2005) states that this information, along with additional information included in the notes, will assist users of financial statements in predicting the entity’s future cash flows and, in particular, their timing and certainty (AICPA, 1973). However, the information provided by the MFIS is certainly not enough for users to make predictions on. They will also need the discretionary information generated by the DIS.

Table 3.1 sets out the objectives of financial statements (Wolk *et al.*, 2000:182-183; Williamson, 2006:5-6). AICPA (1973) in Wolk *et al.* (2000:182-183) addresses twelve objectives of financial reporting and table 3.1 illustrates that, in order to meet those objectives, relevant information could be disclosed in the statutory section of CARs using the MFIS and/or in the discretionary section of disclosures in CARs using the DIS.

Table 3.1 Objectives of financial statements

	Objective	MFIS	DIS	Comments
1	Decision making	X	X	Both the MFIS and the DIS are able to provide information that is useful for making economic decisions.
2	Financial statement	X	X	The DIS could also produce information, <i>inter alia</i> , for those users who have limited authority, ability and resources. This would ensure full disclosure to all relevant stakeholders
3	Cash flows	X		The MFIS generates the information for predicting, comparing and evaluating potential cash flows.
4	Earnings	X		The MFIS generates the information for predicting, comparing and evaluating an entity's earning power.
5	Management ability		X	The DIS normally generates information taking into account management's ability to utilise the entity's resources effectively.
6	Disclosure	X	X	Factual interpretive information useful for predicting, comparing and evaluating an entity's earning power can be generated by both systems.
7	Statement of financial position	X		The statement of financial position is generated by the MFIS. Current values may be used where applicable.
8	Uncompleted transactions		X	The net results of completed earnings cycles and activities in recognisable progress towards completion of incomplete cycles can be reported through the DIS.
9	Expected information		X	The factual aspects of an entity's transactions having or expected to have significant cash consequences could be generated by the DIS and disclosed in the discretionary information section of CARs.
10	Forecasts		X	Financial forecasts for enhancing the reliability of users' predictions could be generated by the DIS.
11	Governmental		X	For governmental and not-for-profit organisations information evaluating the effectiveness of the management of resources could be generated by the DIS.
12	Social concerns		X	Information which is important to the entity's role in social concerns is normally generated by the DIS.

Source: Adapted from Wolk *et al.*, (2000:182-183)

As indicated in table 3.1, the Trueblood objectives can be catered for in the statutory and discretionary sections of CARs. To meet the Trueblood objectives full disclosure would be necessary.

The statutory disclosures generated by the MFIS are one of the products of an abundance of information disclosed in CARs. This is therefore not the only information that a user would use to predict the timing and certainty of an entity's future cash flows. For example, narrative information (which “means a verbal or written account of events. It covers a verbal or written ‘story’ that explains and complements the annual financial statements” [Gouws & Cronjé, 2001:163]) supplied by management is also important to users. This includes financial reviews, environmental reports and value-added statements. The term “describe” as used above includes a picture in words that is expressive and illustrative for the purpose of giving meaning to the numbers contained in the financial statements. Illustrative ways of expressing reality include graphs, pie charts and flow diagrams (Gouws & Cronjé, 2001:164). The use of colour and metaphor may also contribute to understanding and may be used in the disclosure of discretionary information in CARs.

3.5.1.3 Small “gaap”

Small “gaap” is another accounting practice used by the MFIS in the generation of the statutory information to be disclosed in CARs. In 1977 and 1987, Senior Council (legal advisors) was of the opinion that compliance with a statement of generally accepted accounting principles (GAAP) meets the requirements of “fair presentation” in the Companies Act, while non-compliance may constitute a contravention of the Act, but would not necessarily do so.

In September 1999, Senior Council concluded that paragraph 9 of Schedule 4 of the Companies Act requires disclosure whenever the financial statements of a company depart from any of the Accounting Practices Board (APB) statements (Stegman, 2001:70). In light of the above, two financial reporting frameworks can currently be distinguished, one based on generally accepted accounting principles (gaap – uncoded accounting principles that are generally accepted because a number of companies comply with them) and the other based on statements of Generally Accepted Accounting Principles (GAAP – IFRSs codified by the APB). Although compliance with gaap may ensure compliance with section 286(3) of the Companies Act, companies are strongly encouraged to comply with

the IFRSs. IAS 1 (IASB, 2005) does therefore make provision for the rincepliance of standards in exceptional cases. In such cases, reasons for rincepliance, as well as further disclosure, must be given.

From the above it is evident that more accounting practices than just generally accepted accounting principles do exist, and that they are currently being used by the MFIS to generate statutory disclosures.

3.5.1.4 Continuous improvement, research and innovation

Users' evolving needs for more relevant, reliable and comparable information influence the type of information that is already available in CARs (e.g. additional discretionary disclosures). This in turn influences the development of future standards and the review of existing reporting standards, that is, the IFRSs. The continuing improvement of accounting standards is also apparent in the IASB's due process.

3.5.1.5 IASB due process

IFRSs are developed through a formal system of due process and broad international consultation involving accountants, financial analysts and other users of financial statements, the business community, stock exchanges, regulatory and legal authorities, academics and other interested individuals and organisations from around the world (IASB, 2005). The IASB consults the Standards Advisory Council (SAC) on major projects, agenda decisions and work priorities, and discusses technical matters with it. These meetings are all open to the public. The IASB performs its own research and is the major role player in the development of accounting practices to be used in the CARs disclosure process. The IASB often takes note of new discretionary disclosures in CARs in its research into accounting practices. CARs therefore become an important playing field in the development of generally accepted accounting practices. The needs of certain users may result in the continuing improvement of accounting standards in transition through the inclusion of more and enhanced statutory disclosures.

3.5.1.6 Openness of meetings

In the continuous improvement of accounting standards, the openness of the meetings of the IASB (IASB, 2005:9) is noteworthy. For instance, when the IASB issues a standard or an interpretation, it publishes a “Basis for conclusions” to explain the rationale behind the conclusions and to provide background information that may help users of IFRSs to apply them in practice. The IASB also publishes members’ dissenting opinions on standards. Feedback is thus allowed and enhances the standards that govern the statutory disclosures in CARs.

3.5.2 Discretionary reporting

3.5.2.1 Introduction

In CARs the DIS, which uses the information generated by discretionary accounting practices, is responsible for capturing and disclosing the discretionary information needed to address users’ information requirements. Here signalling theory plays an important role. Wolk *et al.* (2000:101) contend that signalling theory

... explains why firms have an incentive to report voluntary [sic] to the capital market even if there were no mandatory reporting requirements ... voluntary disclosure is necessary in order to compete successfully in the market for risk capital. The ability of the firm to raise capital will be improved if the firm has a good reputation with respect to financial reporting.

Lev and Penman (1990 in Wolk *et al.* 2000:308) report that firms that disclosed expected favourable earnings were rewarded by favourable changes in security prices. The disclosure of discretionary information in CARs could reduce an entity’s cost of capital (Barnett, 2003).

The management of an entity has access to additional management and financial information that helps it carry out its planning, decision-making and control responsibilities. Management may determine the form and content of such additional information in order to meet its own needs. This internal business information is also

important to users and is sometimes presented as discretionary disclosures, captured and generated by the discretionary accounting practices used by the DIS in CARs.

The increase in the information needs of users results in the disclosure of more and different information in CARs, for example environmental information, the value-added statement and other discretionary information, to mention just a few. A recent development in operating and financial reporting has been the requirement for an operating and financial review (OFR) to be incorporated in the reporting package of entities in the UK (Rutherford, 2003:38-40). The incorporation of an OFR will be tested in the questionnaire for preparers (chapter 9) as follows: statement 17: *An operating and financial review (OFR), which captures the whole story of entities' performance and prospects seen through the eyes of management should be incorporated in CARs.* It will also be included in the questionnaire for users (chapter 10) as statement 8. The OFR should be flexible and should be an attempt to capture the whole story (Mori Report, 2000; Deloitte, 2005:28-35) of the entity's performance and prospects, seen through the eyes of management, but without merely repeating the numbers (Ross, 2005:1). The introduction of the OFR in entities could lead to some reorganisation (Ross, 2005:1) of discretionary reporting.

As the above indicates, the continuously escalating amount of information generated by accounting practices has found its way into documents such as CARs, and is presented in different formats. The view of preparers (see chapter 9) regarding this issue will be tested with the inclusion of the following statement in the questionnaire to be distributed to preparers of CARs: statement 4: *the information disclosed in CARs is continuously escalating and being presented in different formats.*

3.5.2.2 Discretionary disclosures by Sasol

In 2005, Sasol was the winning company of the annual "Excellence in Corporate Reporting" adjudication, which assessed the quality of annual reports (Everingham & Watson, 2005:9). It might therefore be useful to assess the types of reporting that Sasol

included in its annual report. Sasol's annual report comprised three documents: the statutory disclosures, the discretionary disclosures (called the annual review which includes summarised financial information) and a summarised sustainable development report.

The discretionary disclosures included in Sasol's annual report consist of the following (Sasol, 2005) and are the information products of the DIS:

- The year in review
- Our group of companies
- Chairman's statement
- Turning natural gas into low-emissions diesel
- Chief executive's report
- Sasol's integrated business model
- Operational review
- Global activities
- Sustainable development review
- The world of Sasol
- Board of directors
- Corporate governance

The discretionary disclosures, together with the statutory disclosures in CARs, represent the big picture (Mori Report, 2000) of an entity. Birken, Edwards & Woodland (2005:193) also refer to new tools and techniques of accounting that look outside the traditional boundaries of accounting and which could form part of the discretionary disclosures, for example strategic management accounting (kaizen, balanced scorecard and value chain analysis), corporate social responsibility and ethical investments. Efforts are underway to create a comprehensive framework for discretionary reporting (OECD, 2006:17). Discretionary accounting practices are therefore in a process of transition.

The main challenges that face discretionary frameworks (OECD, 2006:18) are: (i) to assist entities to disclose timely, relevant and comparable reports regarding more informed estimates of future benefits and risks (PWC, 2006c:1); (ii) not to overlap with existing discretionary disclosures; (iii) not to overload information disclosure; and (iv) not to increase preparation costs for companies listed in multiple jurisdictions. Current initiatives regarding the development of frameworks consist of moving toward sectoral disclosure frameworks (OECD, 2006:18; PWC, 2006e:1). Discretionary reporting is an evolving process.

The Enhanced Business Reporting Consortium (EBRC) intends to supplement its current disclosure framework with industry frameworks, that is, pharmaceutical, oil and gas, telecom, banking and information technology (PWC, 2006e:1). The statutory information disclosed in CARs therefore needs to be complemented by discretionary disclosures to give users the full picture of entities. Discretionary disclosures generated by discretionary accounting practices have become so important that even the curricula of professional bodies will be expanded to empower accountants with regard to this new development.

3.6 Summary and conclusion

The aim of this chapter was to explore the systems/processes that drive reporting in CARs.

Uncertainty plays a major role in the nature of financial reporting and the users' need to reduce uncertainty and risk has an influence on the type of accounting practices that generate the reporting included in CARs. Different users have different levels of uncertainty and users need to manage their risk by having the right type of information available. The ongoing research into user needs has influenced the type of information that is currently being published by management of entities in CARs. The needs of heterogeneous users, ascertained through proper feedback systems, may determine the quality of the information in CARs. A balanced approach should be followed to providing information. The characteristics of users are an important consideration for the preparers

of CARs. Users need to use their experience of the information presented in CARs to give feedback on the types of information they need. This would influence the accounting practices that generate disclosures in CARs.

The internal systems/processes and factors that affect the production of accounting practices for the disclosure of required information were also identified. The MFIS is the system responsible for disclosing statutory information generated by generally accepted accounting practices. The DIS, in contrast to the MFIS, may be regarded as the system responsible for generating discretionary information. Factors that affect disclosures in CARs include the historical development of accounting practices, for example the role of double-entry bookkeeping, the role of standard setters and rule-making bodies, other role players for example, the corporate communications department, the finance department, the integrated sustainable reporting department, the investor relations department and public relations.

Innovative ideas for new ways of disclosing information could be developed. CARs should be constantly adapted to ensure that the needs of users for understandable and meaningful information are being successfully met. Standard-setting bodies and other role players could use creative skills and innovation for developing accounting practices to generate disclosures in CARs to address the information needs of stakeholders

Finally, the statutory and discretionary disclosures in CARs were explored from a systems perspective. Rule-making bodies are primarily concerned with the MFIS, which generates the statutory disclosures of general purpose financial statements governed by GAAP. Other aspects of statutory reporting that were explored were the objectives of the IASB Framework; the objectives of financial statements; small gaap; the continuous improvement of accounting standards in the IASB's due process as well as the openness of the IASB meetings. Discretionary reporting is also important to users and the following

aspects were explored: the Operating and Financial Review (OFR) and discretionary disclosures by Sasol. The statutory information disclosed in CARs needs to be complemented by discretionary disclosures to give users the full picture of entities.

The conclusion is that the users' need to reduce uncertainty influences the type of accounting practices that generate the information that is disclosed in CARs. If, because of a lack of accounting standards (GAAP), data cannot be disclosed as statutory information then it could be disclosed as discretionary information through the development of discretionary accounting practices in other sections of CARs. This chapter has shown that the development of accounting practices is influenced by different systems/processes.