

Chapter 2 Accounting and accounting information

Accounting: “the fairest invention of the human mind.”
(Goethe)

2.1 Introduction

As intimated by its title, this thesis proposes the inclusion of information on flexibility as a means of enhancing the accounting information systems of business organisations. However, the inclusion of such information would be incomplete without a prior discussion of the purpose of Accounting and its product, accounting information. In this chapter the nature and role of Accounting is considered and the classification of information as management accounting information and financial accounting information is discussed. The purpose of providing accounting information, as well as the qualitative characteristics of decision-useful information, is addressed. In the conclusion the users of accounting information are identified and their needs summarised.

2.2 The nature of Accounting

Before the nature of Accounting can be addressed, the field of study must first be delineated. This entails an identification of the area of interest and of the borders of the discipline in relation to neighbouring disciplines. Thus a successful definition of Accounting should clearly delineate the boundaries of the discipline at a point in time, give a precise statement of its essential nature, and be flexible so that innovation and growth in the discipline can be accommodated.

A number of definitions of Accounting have appeared in the literature, each attempting to demarcate its field of study. Developing a single definition of Accounting is however beset with difficulties. The first difficulty stems from the *dynamic* nature of Accounting. Glautier and Underdown (1986, p.3) point out that the

changing environment continually extends the boundaries of Accounting, which makes defining the scope of the subject problematical.

A second difficulty, which stems from the first, is the question of *boundaries*. Accounting can be described as being simultaneously eclectic and pervasive, consequently definitions of Accounting tend to have fuzzy and changing boundaries.

A third difficulty stems from the often debated question of whether Accounting is an *art or science*. According to the AICPA (1953) Accounting is an art. The Committee on Terminology of the AICPA (1953, par.5) defined Accounting as follows:

“Accounting is the art of recording, classifying and summarising in a significant manner and in terms of money, transactions and events which are, in part at least, of a financial character and interpreting the results thereof.”

While Accounting may have started out as being an art, it is doubtful whether this view is still generally held. The increased use of scientific methods in Accounting has changed the discipline to an applied science. Mattessich (1984) for example states that Accounting is an applied science – a science because of its methodology and applied because of its goal orientation. He also suggests that it may be regarded as an induced science as it tends to solve specific problems from which general propositions are induced. Steele (1991) and Belkaoui (1996) have supported this view. They identify Accounting as a multi-paradigmatic social science based on models of human intention and rationality. Accounting can obviously no longer be regarded simply as an “art”.

More recently the AAA (1966, p.1) has attempted to give a broader perspective of Accounting in the following definition:

“[Accounting is] the process of identifying, measuring and communicating economic information to permit informed judgements and decisions by users of the information.”

However, the definition is too general. For instance, economists provide “economic information”, but they certainly do not consider themselves to be accountants (Kam, 1990, p.33).

In 1970 (par. 40) the APB of the AICPA defined Accounting as follows:

“Accounting is a service activity. Its function is to provide quantitative information, primarily financial in nature about economic entities that is intended to be useful in making economic decisions, in making reasoned choices among alternative courses of action.”

Although this definition is broad enough to encompass the domain of Accounting, the boundaries remain vague. Another serious limitation is that it limits Accounting to providing quantitative information, while the modern trend is to provide qualitative information as well.

Professional accounting bodies provided the above definitions.

An example of definitions in accounting textbooks is supplied by Kieso and Weygaardt (1992, p.3) who identify the three essential aspects of Accounting as

- the identification, measurement and communication of financial information
- on economic entities
- to interested parties, being the users of financial information.

This definition does not take into consideration the use of such information to users, and limits the information to financial data. A more comprehensive definition of Accounting is provided by Ansari, Bell, Klammer & Lawrence (1997, p.2) who state that it consists of four key ideas:

- It is by *nature* a measurement process;
- Its *scope* includes financial and operational information;
- Its *purpose* is to assist the organisation in reaching its strategic objectives;
- and

- Its *attributes* are to enhance the understanding of the measured phenomena, and provide information for decision making, and therefore encourages actions and supports and creates shared values, beliefs and mind sets.

This definition has a number of strengths. It identifies that accounting information should include both financial and operational information. It stresses the increasing importance of supporting strategic decision making in the organisation as a result of a volatile and competitive business environment. It views Accounting as more than the technique of processing and measuring data. Behavioural and social responsibility aspects are recognised in the definition as attributes. This view is, however, restricted as it defines Accounting from a Management Accounting perspective and overlooks the financial reporting aspects. Another limitation is that it does not state specifically that in Accounting change and continuous improvement are measured, although it is implied. By facilitating change, the implication is that accounting information should include aspects such as flexibility and companies' ability to adapt to change.

The construct of flexibility does not appear in any of the definitions on Accounting, because the definitions were developed during stable periods. The environment however has changed – uncertainty has increased and predictability has declined. In view of the fact that flexibility is a function of uncertainty, greater value will be attached to flexibility in organisations as uncertainty escalates. It is therefore appropriate to include the construct of flexibility in the definition especially during periods of uncertainty.

Although the term flexibility has appeared in the accounting literature if not in the definitions on Accounting, it is often referred to in a negative context. Flexibility in Accounting is viewed by some authors in a negative light. Wolk, Francis & Tearney (1984, p.242) for example, define flexibility as the choice between different accounting policies. The aim of Accounting is to reduce the number of acceptable accounting policies so that a transaction is treated consistently by different reporting entities. This implies in turn, that “flexibility” should be eliminated, too. This endless pursuit of consistency and to a lesser extent comparability, contributes to the

inflexibility of Accounting and to the negative perceptions of flexibility in the accounting community.

What is of particular interest is the evolution of definitions of Accounting over time. In 1953 the AICPA definition emphasised the technique of recording, classifying and summarising information while in 1997 the Ansari definition summarised the technique aspect as a measurement process and focused on the social and behavioural impact of Accounting. It is to be expected that the definitions of a dynamic discipline will evolve over time.

Definitions of Accounting are also influenced by the different images that researchers have of what the accounting process is or should be. Belkaoui (1992, p.51) submits that there are six different images of Accounting:

- As an *ideology* – it is viewed as a means of sustaining and legitimising the current social, economic and political arrangements;
- As a *language* – it is perceived as the language of business which is used to communicate information on enterprises;
- As a *historical record* – it is viewed as a means of recording the history of an organisation and its transactions with the environment;
- As *current economic reality* – it is viewed as the means of determining the true income of an entity namely the change of wealth over time;
- As an *information system* – it is viewed as a process that links an information source (the accountant) to a set of receivers (external users) by means of a channel of communication;
- As a *commodity* – specialised information is viewed as a product which is in demand in society, with accountants being willing to and capable of producing it.

A distinct classification of the different images of Accounting is somewhat misleading, because these images of the nature of Accounting are often intertwined in practice. In the *Conceptual framework on financial reporting* (SAICA, 1990), for example, images of Accounting as an information system are found in paragraph 25,

as a language in paragraph 39 and as a historical record in paragraph 16. These images, too, are flexible in that elements thereof can be combined to identify the nature of Accounting.

In each of these images of Accounting the construct of flexibility can be accommodated. This holds regardless of the image of Accounting that is used by a researcher as a point of departure in developing a definition of Accounting. For example, if Accounting is viewed as an ideology, flexibility could be used as a tool to protect the social, economic and political arrangement, by ensuring the continued existence of current organisations. If Accounting is viewed as a language, the inclusion of information on flexibility would enhance the usefulness of the language to the different stakeholders. A language cannot become static but will constantly evolve through the introduction of new terms such as flexibility. Even if Accounting is viewed as a historical record of company transactions, information on flexibility levels would serve as a basis, firstly for understanding the organisation's position in relation to its competitors and secondly for predicting its future competitive positions.

From a functionalist perspective, Accounting is viewed not as an end in itself, but rather as a commodity or language that is useful in decision making. This implies as mentioned before, that the continued existence of Accounting is dependent on its usefulness to society, and in a narrower context, its usefulness to the users of accounting information (see Puxty, 1993). Several of the above definitions are in line with a functionalist approach in that they emphasise the need to provide information useful in the decision-making process of users. These users of financial information can be divided into two main categories, namely internal and external users. Internal users of information include management and employees who require information for strategic, operational and administrative decisions. This type of information is communicated in internal and management reports and is the domain of Management Accounting. External users include investors, lenders, suppliers, customers, government and the public who require information for various purposes. Information to external users is communicated by means of the annual and special purpose financial reports and is the domain of Financial Accounting.

This somewhat artificial division of the discipline of Accounting is addressed in the next section.

2.3 Financial Accounting and Management Accounting

The apparently divergent needs of internal and external users of accounting information have resulted in the development of two subdisciplines within the discipline, namely Management Accounting and Financial Accounting. Drury (1996, p.4) states that Management Accounting is concerned with the provision of information to people *within the organisation* to help them make better decisions, whereas Financial Accounting is concerned with the provision of information to *stakeholders outside the organisation*.

The relationship of the internal and the external users to the information produced in an economic entity differ essentially in the following six areas:

- Access,
- Frequency,
- Detail,
- Timing,
- Required expertise and understanding, and
- Response.

The internal users have unlimited and direct access to information in the organisation. Information is available to management on demand to support strategic, tactical and operational decisions. In contrast, the external users of financial information have limited and indirect access to information and is usually reliant on the information contained in the financial reports and reported in the press.

The *frequency* with which accounting information is obtained varies between internal and external users. Management can request information on a regular basis, be it monthly, weekly or daily. External users have to rely on the annual and interim

financial reports and other sources of information such as press releases, which are available on a less frequent basis.

Management and employees have access to the level of *detail* of information they require, whereas external users receive aggregated information contained in financial statements and have virtually no access to detailed information which is not prescribed by legislation or accounting standards.

Internal users can access information directly and are supplied on a *timely* basis with the most up to date information. In contrast, external users are supplied with dated and historical information supplied in interim reports and annual financial reports, often with limited information value. Because it is obtained timeously, the information provided to internal users has more predictive value than that which external users receive.

The required *expertise* and *understanding* of internal and external users of information usually differ. Internal users are involved in the day to day running of the business and therefore have a greater understanding of the business and the industry in which the business operates and thus of necessity greater expertise than external users in interpreting trends and results.

The *responses* of internal and external users to accounting information are different. Internal users use the information to run the organisation or make strategic, operational or administrative decisions. External users use the information for a broad spectrum of responses such as whether to invest, supply materials or advance funding. Their values, culture and beliefs influence the response of users.

It is therefore not surprising that Management Accounting and Financial Accounting developed in different directions. The aim of the former is to meet the dynamic information needs of management and employees of organisations in rapidly changing and competitive business environment. The latter, on the other hand, concentrate on identifying the needs of a diverse group of users, protecting their interests through legislation and accounting statements, and extending and improving the quality of minimum disclosure requirements in financial reports.

The divergent development of Management Accounting and Financial Accounting has resulted in, effectively, two information systems within organisations. Johnson and Kaplan (1991) suggest that Management Accounting has developed faster in recent times than Financial Accounting. They argue that in the past, Financial Accounting was the foremost factor that inhibited development in Management Accounting. Once the legislative and standardised approach ascribed to in Financial Accounting was abandoned, Management Accounting became more flexible and management and accountants more willing to experiment in meeting the demands of management. As a result management has come to view financial statements as a costly but necessary exercise in order to comply with legislation and GAAP. The information contained in the financial statements is rarely useful to management and often far removed from the information needed to run the business.

The external users receive information in the financial reports which is not necessarily relevant for assessing the particular business and the performance of management. Thus it is not surprising that recommendations of the Jenkins Report (AICPA, 1994a, p.5) included the following on external business reporting:

- External business reporting must provide more information with *forward-looking* perspective, including with regard to management's plans;
- It should focus more on the factors that create long-term value and on *non-financial* measures which indicate how sectors of the business are performing; and
- It must provide greater *alignment between the information* reported externally and the information reported to senior management.

The Institute of Chartered Accountants of Scotland (1988) confirmed that the information needed by investors is the same in kind if not in volume, as that needed by management. This implies that the informational needs of external users are not as far removed from the informational needs of internal users as the diverging development implies. Obviously, if informational needs of users overlap in many respects, it is unnecessary to maintain two information systems. What is in actual

fact required, is one flexible accounting information system that meets the needs of diverse users. The use of technology may improve the position of all users by facilitating access to and improving the frequency and timeliness with which information is received. With technology it would also be possible to predetermine access levels for user groups.

The independent development of Financial Accounting and Management Accounting has widened the gap between information needed by management and the information reported to other users and is inefficient and costly in a competitive environment. As has already been mentioned, the effective use of technology can be used to develop one flexible information system in an enterprise that meets the different needs of both internal and external users. The Institute of Chartered Accountants of Scotland (1988) made proposals on how one accounting information system, by means of a set of corporate reports coupled with computer technology, could satisfy the needs of both internal and external users of information.

For the purpose of this thesis, the assumption is made that there is only one accounting information system and only one discipline, namely Accounting, which encompasses the fields of study of Financial Accounting as well as Management Accounting.

2.4 The purpose of accounting information

The product of Accounting is accounting information. Accounting information is used in deciding between different courses of action and results in informed decision making. It serves to reduce the uncertainty inherent in the business environment where decisions are made about the future. It further reduces entropy based on the assumption that chaos exists where there is no information. Littlejohn (1989, p.42) views information as a measure of uncertainty or entropy in a situation. This implies that the greater the uncertainty or entropy, the more accounting and other information are required.

The role of the accountant in producing accounting information is to observe, screen and recognise events and transactions, to measure and process them and to compile corporate reports with accounting information that are communicated to users. These are then interpreted, decoded and used by management and other user groups. The main requirement for such corporate reports is that they should be useful to users. The provision of information that is useful to the decision-making process is currently recognised as the main purpose of accounting information. This holds for theoretical frameworks on financial reporting as well as accounting literature. Gray (1994, p.9) confirms that accounting literature is currently dominated by the notion of decision usefulness. This implies that corporate reporting should continuously meet the changing needs of all users of accounting information.

The robustness and meaning of “decision usefulness” as the main objective of accounting information has, however, been criticised in the literature (Williams, 1987; Pallot, 1991). Gray (1994) calls decision usefulness a flaccid term without any element of degree. Although accounting information may be used, it does not necessarily imply that it is decision useful. In fact, very little concern seems to be given to defining what exactly decision usefulness is supposed to connote (Williams, 1987, p.179).

A number of international reports have been published since the early 1970s to determine, amongst others, the purpose of accounting information and the content of financial statements. These reports focused on the needs of external users, and identified decision usefulness as the main aim of accounting information.

In the Trueblood Report (AICPA, 1971), one of the definitive reports on corporate reporting which was published in the United States of America, 12 objectives of financial statements were identified including the following:

- To provide information for making economic decisions;
- To serve users who rely on financial statements as their principal source of information;

- To provide information useful for predicting and evaluating the amount, timing and uncertainty of potential cash flows;
- To supply information for judging management's ability to utilise resources effectively in meeting goals;
- To provide factual and interpretative information by disclosing underlying assumptions on matters subject to interpretation, evaluation, prediction or estimation; and
- To provide information on activities affecting society.

Although not mentioned explicitly, the construct of flexibility is implied in several of these objectives. For example, the third objective refers to the amount, timing and uncertainty of cash flows. Information on flexibility is useful in predicting the amount and timing of future cash flows and removes some of the uncertainty in that it provides information on the alternatives that management are likely to select (Koornhof, 1988). Similarly, information on flexibility is helpful in achieving the fifth stated objective, namely of providing information on matters which are subject to interpretation, evaluation, prediction or estimation. Information on flexibility assists users in identifying likely outcomes for the enterprise and therefore add interpretative, predictive and estimative value.

Although the 12 objectives of the Trueblood Report were intended to be equally important there is a justifiable tendency to arrange them in a definitial hierarchical structure (Belkaoui, 1992). Consequently, the first stated objective of the Trueblood Report, namely the provision of information for economic decision making, is interpreted by some as being the primary purpose of financial statements.

The findings of the Corporate Report that was published in the United Kingdom in 1975, confirmed that financial reports should seek to satisfy the information needs of users. It envisaged a more socially responsible role for Accounting: It namely advocated additional information in the form of, for example statements of value added, an employee report and a statement of money exchanges with government. In terms of this socially responsible perspective, accountability is regarded as existing not only between the management of the company and its shareholders, but

also between the management, the company and society. Accounting should therefore provide information on management's stewardship of resources to the shareholders and the other stakeholders such as creditors, employees, the government and the general public.

In Canada, the Stamp Report (CICA, 1980) on corporate reporting identified four major objectives of financial reporting:

- To provide useful information to all the potential users of such information in a form and time frame that is relevant to their needs;
- To provide information to minimise uncertainty about the validity of information and to enable the user to make his or her own assessment of risks associated with the enterprise;
- To develop standards governing financial reporting which allow ample scope for innovation and evolution as improvements become feasible; and
- To be directed towards the needs of users who are capable of comprehending a complete set of financial statements.

The construct of flexibility may also contribute towards the attainment of the objectives stated in the Stamp Report. Information on flexibility reduces uncertainty and also the risks associated with enterprises, as set out in the second stated objective (Koornhof, 1988). The introduction of flexibility into Accounting should result in a less rigid approach being adopted in the development of accounting standards, which is the third stated objective.

Whereas all these reports concentrated on the objectives of financial reporting to external users, the Institute of Chartered Accountants of Scotland (1988) considered the information needs of both management and external users. The conclusions made in the report are that an efficient market requires the communication of useful information from management to investors, that financial reports should reflect economic reality and that the information needed by investors is the same in kind as that needed by management. The finding is that one accounting system can serve the needs of both external and internal users but warns that the "patching up" of the

present reporting regime would not be the ideal solution. An entirely new corporate reporting system that is useful to both management and, in an abbreviated form, to external users, is required. This report confirms that there should be only one accounting information system that is flexible enough to meet the needs of different types of users.

In 1989 the Solomons Report, commissioned by the ICAEW (1989) reiterated that decision usefulness is the main purpose of financial reporting. Financial reports should provide information that will be useful to a variety of users who have an interest in

- assessing financial performance and the position of the enterprise;
- assessing the performance of those responsible for its management; and
- making decisions about investing in, lending or extending credit to, doing business with or being employed by the enterprise.

The theme of decision usefulness as the main purpose of accounting information is also apparent in Management Accounting. Drury (1996, p.3) suggests that management requires information that will assist them in their decision-making and control activities and Ansari *et al.* (1997, p.2) identify as an attribute of Accounting the provision of information for decision making.

Decision usefulness as the main objective of Accounting information cannot remain static, however, but will evolve and change over time. It will be influenced by political, social, economic and technological changes in the environment. Changes in the environment may influence not only the nature and objectives of accounting information, but also the needs of its users. This requires the accounting information system to be flexible so that it can adapt to the changing demands of its users. According to the Stamp Report (CICA, 1980) the standards governing financial reporting should furthermore also be flexible. A flexible information system and flexible reporting standards will not inhibit innovation, experimentation and evolution in adapting to the changing demands of users, but rather promote it.

Decision usefulness is favoured in accounting reports and theoretical frameworks on financial reporting, however it is not the only purpose of the Accounting discipline. At present there is no comprehensive theory of Accounting, and therefore no generally agreed on purposes for Accounting. The discipline is viewed rather as a multiple paradigm science. Belkaoui (1996, p.24) suggests that Accounting consists of six competing paradigms. Other authors argue that Accounting is in fact in a revolutionary phase as described by Kuhn (1970) in *The structure of scientific revolutions* (see Wells, 1976; Steele, 1991) and that no dominant paradigm of Accounting has as yet emerged.

In October 1998, on publication of the thesis, SAICA issued AC 101 on the presentation of financial statements. In the statement (paragraph 9) enterprises are encouraged to provide the following additional decision-useful information in their financial review:

- The main factors and influences determining performance, including changes in the environment in which the enterprise operates, the enterprise's response to those changes and their effect;
- The enterprise's sources of funding, the policy on gearing and its risk management policies; and
- The strengths and resources of the enterprise not reflected in the balance sheet.

These disclosure requirements are related to the positioning of the enterprise and its ability to adapt to changes in the environment. In other words, it concerns the flexibility of the enterprise. This statement recognises the importance of providing information on flexibility to users and as such underlines the farsightedness of this research.

2.5 Characteristics of decision-useful information

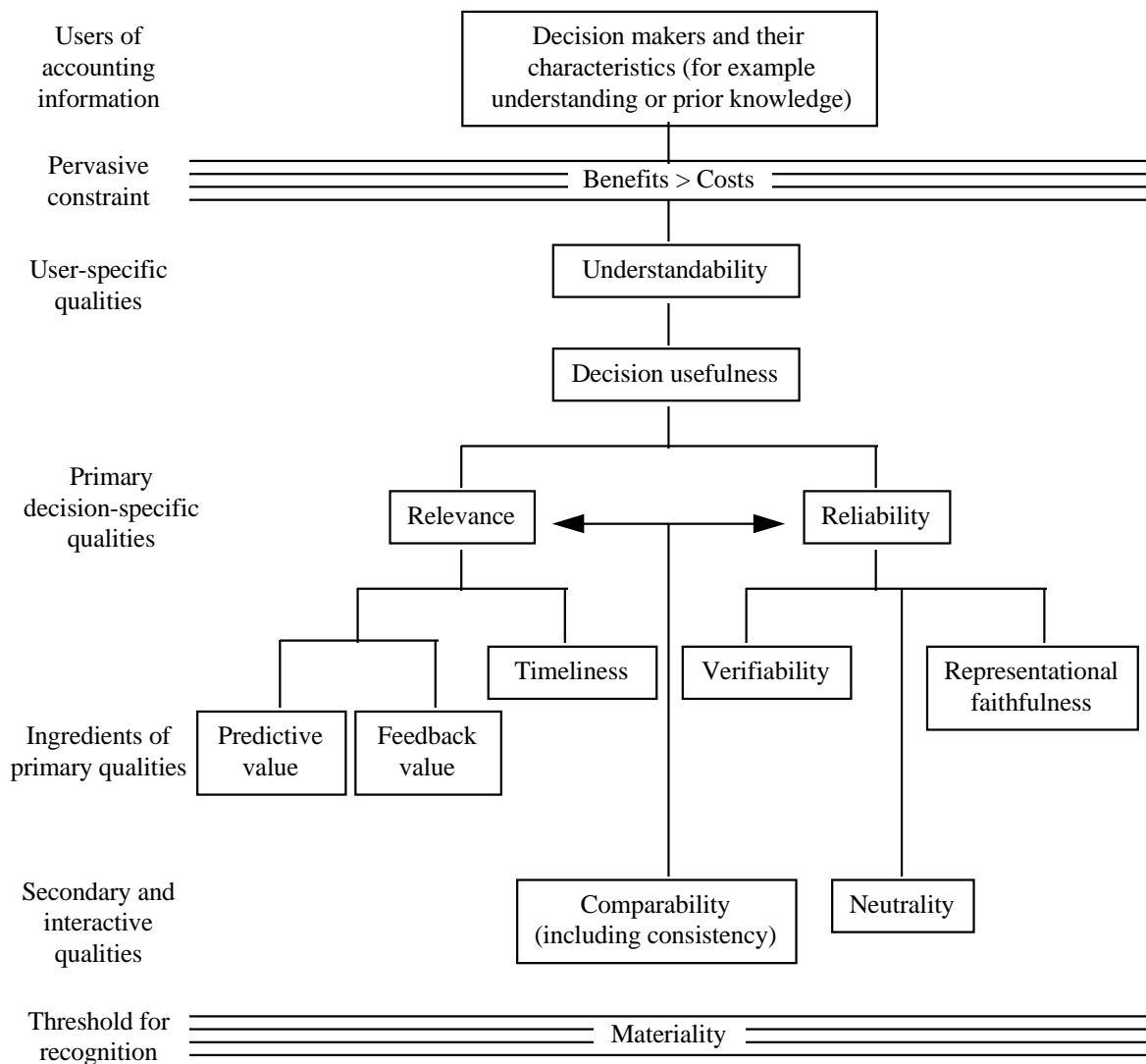
The purpose of this research is to introduce information on flexibility into the accounting information system, which meets the objective of being useful in decision making. In order to assess whether accounting information is decision useful, a number of qualitative characteristics are identified from the accounting literature.

Hendriksen and Van Breda (1992, p.123) defines qualitative characteristics as attributes of accounting information which tend to enhance its usefulness. These qualitative characteristics should be

- robust i.e. stand the test of time;
- pervasive, i.e. apply to all accounting entities;
- implementable, i.e. capable of application; and
- susceptible to objective verification.

In their conceptual framework, the FASB (1980a) distinguished between two categories of qualities, namely user-specific and decision-specific qualities. User-specific qualities refer to aspects such as an understandability and decision-useful qualities and on the ability of users, for example their knowledge of Accounting and willingness to study information. These qualities of users determine the level of complexity of information that should be reported. Decision-specific qualities concern the qualities required of information such as timeliness, relevance and completeness. The hierarchy of Accounting qualities proposed by the FASB is illustrated in figure 2.1.

Figure 2.1 : A hierarchy of accounting qualities



Source: Hendriksen, E. S. & Van Breda, M. F. (1992), *Accounting theory*, 5th ed., Homewood, Ill.: Irwin, p.132.

The characteristics proposed by the FASB correspond to a large extent to the qualities proposed in the Trueblood Report (1971), the Corporate Report (1975) and the Solomons Report (1989).

The two prime decision-specific qualities are relevance and reliability. Relevance refers to the capacity of information to influence the decision-making process of users. It enables users to make predictions about the future (predictive value of information) and to confirm or revise previous estimates (feedback value of information). In order for information to be relevant, it should be made available to

the user before it loses its capacity to influence decisions. In other words, it should be provided on a timely basis.

The predictive value and feedback value often receive less prominence than other qualities in the conceptual framework (see for example SAICA, 1990). However, predictive and feedback values form the basis for information on flexibility. Predictive value provides decision-useful information on how the enterprise is likely to respond to future change and uncertainty, while feedback allows the enterprise and the user to reposition themselves (feedback value) in response to such changes. In the light of research and AC 101 (SAICA, 1998) it is likely that the framework will be reassessed. AC 101 recommends the disclosure of information on what is effectively flexibility.

The second primary decision-specific quality is reliability. This assures that information is reasonably free from error and bias, is verifiable and faithfully represents what it purports to represent (FASB, 1980a). In order to be a faithful representation, information should maintain an agreement between the measure and description and the actual phenomenon which it purports to represent. In order to be verifiable it should be possible to substantiate and confirm the information independently. Neutrality implies on the one hand that the preparer of information is not biased towards a predetermined result and on the other that the information is not reported in a such manner that it may unduly influence the decisions of users in a particular direction.

Both the primary qualities of relevance and reliability are associated with the secondary quality of comparability. This quality of information requires that transactions and events be measured and reported in a consistent manner to enable users to compare the results of a company from year to year or with the results of different companies.

Acting as a pervasive constraint to the provision of information, is the cost versus benefit assessment. This constraint implies that the cost of providing information should not be exceeded by benefits derived by the users. Although costs can usually be quantified, the measurement of the benefits of information is on the whole more

problematic. To assess this constraint, continuous feedback is required on the effectiveness and efficiency of a system. This assumes that the accounting information systems are viewed as an open system.

Materiality forms the threshold for the recognition of information. Only material information is included in the financial statements. Materiality is however not only limited to size but also the nature of the underlying transaction or event and the impact that such information may have on the decisions of users.

A strength of the FASB hierarchy is that it adapts a customer-oriented approach. The hierarchy commences with the users of accounting information and their specific qualities, suggesting that this should form the basis for determining the decision-specific qualities. The hierarchy does not, however, emphasise the continuous feedback and repositioning required between the preparers of information on the basis of decision-useful qualities and the users with their user-specific qualities. The needs and qualities of users do not remain static but evolve over time. Therefore, the decision-useful qualities should change over time, through feedback, in response to the evolving expectations of users. Gouws (1997) suggests that feedback on the effectiveness of communication through financial statements should be encouraged as this will improve the quality of information and its decision usefulness.

Other qualities of decision-useful information are proposed in the accounting literature. The Solomons Report (1989) refers to feasibility that is the need to require only information that is feasible to provide. However, the concept of feasibility is only meaningful if considered together with the cost versus benefit constraint. The Corporate Report (1975) suggests that completeness is another quality of decision-useful information, in other words reported information should provide a full picture of the economic activities of the organisation. Substance over form is identified in the Trueblood Report (1971) as the requirement that information should be based on the economic substance of the transaction or event rather than on the legal form. Two qualities that are suggested in the SAICA framework (1990) are prudence and fair presentation. Prudence is the inclusion of a degree of caution in the exercise of judgements needed in making estimates under conditions of uncertainty, while fair presentation should be basic to all financial statements. Although this quality is not

defined in the framework, it is mentioned that the application of the principal qualitative characteristics and appropriate accounting standards would result in financial statements which fairly presents the information.

These qualities of decision useful information are not absolutes. In practice it may be necessary to weigh up the importance of conflicting qualities as the gain in one quality, such as relevance, may result in the decline in another, such as reliability. This highlights a problem inherent to the use of qualitative measures, namely that the measures may not be applied consistently – different weights may be attributed to qualities by different people and the relative importance of different qualities may change over time. Unfortunately the balancing of conflicting qualities of information and the interpretation of the importance of individual qualities are not usually apparent from financial reports. Nevertheless, these qualities are very useful in assessing what constitutes decision useful information.

2.6 The needs of users

Before the needs of users can be considered, it is necessary to identify the users of business information, as different users utilise business information to satisfy different needs. There are two main user groups:

Internal users

- Management – decisions concerning the running of the business and strategic planning for the future.
- Employees – decisions on personal matters, e.g. promotion, appointments, security and training.

External users

- Investors and potential investors – information on the risks and returns on investments.
- Unions and employee groups – information on the stability, profitability and distribution of wealth within the business.
- Lenders and financial institutions – information on the creditworthiness of the company and its ability to repay loans and pay interest.
- Suppliers and creditors – information on whether amounts owed will be repaid when due, and on the continued existence of the business.
- Customers – information on the continued existence of the business and thus the probability of a continued supply of products, parts and after sales service.
- Government and other regulators – information on the allocation of resources and the compliance to regulations.
- Social responsibility groups, such as environmental groups – information on the use of the environment.
- The public – information on the role and contribution of businesses to society.
- Competitors – information on the relative strengths and weaknesses of their competition and for comparative and benchmarking purposes. Whereas the above categories of users share in the wealth of the company, competitors require the information mainly for strategic purposes.

A serious shortcoming of the reports on financial information as well as the conceptual frameworks is that they are largely based on what is perceived to be decision useful information. Until recently the needs of especially external users had not been surveyed on a large scale (AICPA, 1994a, p.12). Consequently these reports and frameworks were based mainly on the limited available research, input from particular users groups and current perceptions as to what decision-useful information entails.

In 1994 AICPA appointed a special committee on financial reporting to complete an extensive survey of the information needs of investors and creditors in the United States of America (the Jenkins Report). The study focused on professional investors and creditors and their advisors who follow fundamental approaches to decision

making and who cannot compel companies to produce the information needed for analysis.

The survey (AICPA, 1994a, p.25) identified five broad categories of business information which are required by users:

- Financial and non-financial data;
- Management's analysis of financial and non-financial data;
- Forward-looking information;
- Information about management and shareholders;
- Background to the company.

The Jenkins Report confirmed the importance of financial statements in providing information which influences users' decision making. The financial information provides a means of evaluating and comparing the results and position of businesses by measuring transactions or events in financial terms. This does not obviate the need of users for more information on operations, as users would prefer not to rely only on financial results. They also require operating data in order to understand the nature of the business and its performance relative to competitors. Operating data may be stated in terms of currency, products or time units, number of employees and so forth or may be stated qualitatively in the form of descriptions and opinions.

The report noted that users found that management's analysis enhanced their understanding of the business reasons for changes in the information from year to year. Management is the closest to the business and therefore the best qualified to provide such information for analytical purposes. The management review includes a discussion of the changes in financial, operating and performance data as well as key trends. Users require information about changes relating to market acceptance, productivity, costs of key resources, profitability, innovation, changes in financial position, liquidity and the identity and effect of unusual or non-recurring transactions and events (AICPA, 1994a, p.28).

Users also require the perspectives of management on the future, in particular on the opportunities and risks that arise from changes in the environment of the organisation. Information on flexibility assists users in identifying the most probable future opportunities and risks confronting the enterprise, and the most likely responses of the enterprise. Forward-looking information should include information on the threat of substitute products, the nature of competition, changes in the bargaining power of customers and suppliers, concentrations in company's assets, customers or suppliers and future sources of available funding. It should also include information on flexibility, being the ability of the organisation to adapt to the changing demands of its environment. Users require more information on management's plans for the future. These plans will be influenced by management's perspective on the volatility of the future environment and the corresponding level of flexibility that should be maintained in the enterprise. Such knowledge will assist users in their predictions and assessment of the general direction or changes in the direction of the company and is an important source of information on the opportunities and risks the company will probably face in the future (AICPA, 1994a, p.30).

In particular the following information about the management and shareholders of companies is useful:

- The identity and background of directors and executive management;
- Executive management compensation, and shares held by management;
- The identity and ownership of major shareholders and the impact of existing arrangements on control;
- Related party transactions and relationships among major shareholders, directors, management suppliers, customers, competitors and the company.

Such information assists users to assess the ability of management to steer the company successfully through uncertain times and their stewardship of resources, as well as the equitable distribution of created wealth.

The study found that users require background information about the business in order to understand how the company operates and what the nature of its business

is. Information is required on the broad objectives and strategy of the company, the scope and description of business and property and the impact of industry structure on a company such as innovation, introduction of new products and product life cycles (AICPA, 1994a, p.31). This information provides a basis for predicting the future performance of the company as well as assessing its flexibility.

Users do not assess the performance of companies in isolation, but rather seeks to compare these companies with their competitors and the industry as a whole. It is therefore important that reported information should be comparable and consistent. In addition to the five broad categories discussed above, the study identified needs of users for extended and improved disclosure in the following specific areas:

- Business segment information;
- Innovative financial instruments;
- Off balance sheet financing arrangements;
- The separation of core and non-core activities;
- The uncertainty inherent in the measurement of certain assets and liabilities;
and
- Quarterly reporting.

Of particular interest in this Report was the concern of external users that the information provided in the financial reports is not closely aligned to the information used by management to run the organisation. This opinion supports the prior argument that there should be only one accounting information system.

A limitation of the Jenkins Report is that it surveyed the needs of only investors and creditors. More research is required to identify the particular needs of other user groups. The results of the Jenkins Report indicate, however, that the provision of only financial information (usually in financial reports) does not satisfy the requirements of users. Hellman (1996) suggests that there is at present no mechanical relationship between financial information and investment actions. This implies that investment actions cannot be linked to the release of financial reports. It is likely that the inclusion of more operating and non-financial information as well as

future-oriented information (e.g. on the plans of management) would influence investment decisions. These areas thus require greater emphasis and more research in Accounting.

2.7 Summary

In this chapter the nature of Accounting and its product, accounting information was considered. Accounting is used as a generic term to include both Management Accounting and Financial Accounting. The main purpose of accounting information is to provide information that is useful to decision making. In deciding what constitutes decision-useful information, two aspects were considered. Firstly, the qualities inherent to decision-useful information and secondly, the groups of users of accounting information were identified and their particular needs assessed. These needs are not static but rather dynamic, changing constantly in response to a changing environment (IFAC, 1996). This implies that the accounting information system should be flexible so that it can adapt to the changing demands of its users. The system should also be user driven; that is, the needs and expectations of the users of accounting information should dictate the type of information that is produced. The requirement that the accounting information systems should constantly reposition itself in response to changing expectations. This implies that it should be viewed as an open system. In other words, feedback both from within the system and from its environment should drive the constant repositioning of the information system.

The purpose of this thesis is to propose the inclusion of information on flexibility into the accounting information system. By labelling the construct of flexibility it becomes visible, and so that awareness of its benefits can be created. The inclusion of information on flexibility is however only feasible if it provides decision-useful information. Information on flexibility is decision useful if it is understood by users, is included in their decision-making process and influences their responses.