

## CHAPTER 4

### Quality issues in CARs

#### 4.1 Introduction

The need to reduce the uncertainty of users drives reporting (disclosure of information practices) in CARs, as users need quality information in order to make proper decisions. The insights contained in chapter 3 indicate that the users' need to reduce uncertainty influences the type of accounting practices that generate the information disclosed in CARs. There are two types of disclosure in CARs: the one entails the disclosure of statutory information generated by the MFIS making use of generally accepted accounting practices, and the other entails the disclosure of discretionary information generated by the DIS making use of discretionary accounting practices.

The objective of this chapter is to investigate the quality issues and features of the information that users need for proper decision making. This research assumes that the main purpose of CARs is to represent, in all material respects, all the information that is necessary to make proper decisions. This issue will be further explored in the questionnaire for preparers (chapter 9) as follows: statement 31: *The main objective of CARs is to represent in all material respects all the information that is necessary for users to make proper decisions* and in the questionnaire for users (chapter 10) as statement 19.

This chapter comprises discussions on (i) the quality of business reporting; (ii) the information filtering process; (iii) qualitative objectives of financial accounting; (iv) quality objectives of discretionary disclosures; (v) a balanced scorecard approach; (v) the further development of discretionary disclosures; and (vi) a focus on ethics.

## 4.2 Quality of business reporting

The quality of business reporting in CARs affects the integrity of the information being communicated to stakeholders. One of the most important implications of CARs is that they determine the flow of capital, because “if investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere” (King, 2002a:9). The business information contained in these financial statements must therefore be adjudged trustworthy and of superior quality before an investor will decide to invest. Quality is a crucial issue when offering the business information compiled for the benefit of stakeholders.

There are some practical constraints to note that still ensure quality information in business reporting, but that may reduce costs. AICPA (1994:54-57) lists the following constraints:

- *Business reporting should exclude information outside management’s expertise or for which management is not the best source. That is, business reporting should include only company-specific information that is within management’s expertise to provide* (AICPA, 1994:54-57). The business disclosures in CARs should therefore be entity related and generated by the DIS and the MFIS using accounting practices to screen entity-specific information.
- *Management should not be required to report information that would harm a company’s competitive position significantly* (AICPA, 1994:54-57). The information disclosed in CARs must therefore strike a balance between the need to inform and the need to safeguard information that might be to the disadvantage of the entity involved when competing with other entities (Visser, 1978:394). Balanced quality disclosures are therefore essential.

- *Management should not be required to provide forecasted financial statements. Rather, management should provide information that helps users forecast for themselves a company's financial future* (AICPA, 1994:54-57). Belkaoui (2004:365) states the following in this regard: "The user, rather than the accountant, transforms the event into accounting information suitable to the user's own individual decision model." The preparers of CARs therefore provide information and leave the task of transforming and using that information to the users as they deem fit. Future-orientated information is important and could be disclosed in the discretionary sections of CARs: information should be provided that assists the users in forecasting a company's financial future. As this type of information is difficult for auditors to express an opinion on, it would not be included in the statutory reporting section of CARs.

- *Other than for the financial statements, management need only report the information it knows. That is, management should be under no obligation to gather information it does not have, or need, to manage the business* (AICPA, 1994:54-57). What does the information that management knows consist of? Is it merely information on the past or also information about the future? To decrease uncertainty, accountants produce an ever-increasing amount of future-orientated information (Gouws & Van der Poll, 2004:106). In table 4.1 the attributes of past and future phenomena are illustrated as follows:

**Table 4.1: Accounting's arrow of time**

	Present	
	Past	Future
Created by:	Reality	Simulated reality
Accounting phenomena	• Real (pure) events	• Artificial (non) events
	• Physical happenings	• Simulated happenings
	• Occurrences	• Predictions
	• Transactions	• Contingencies
		• Allocations
		• Provisions and reserves
Method	• Double entry (DE)	• Book entry through DE
Orientation	• Matter orientated	• Mind orientated
	• Resource flow orientated	• No flow
Outcome	• Certainty	• Uncertainty
Paradigm	• Accountability	• Decision usefulness

**Source: Gouws (2003:11)**

The above shows that accounting transactions are part of an evolving process over time (Gouws 2003:11). The same applies to CARs, which is a product of accounting practices in transition. Managers using the MFIS for disclosing statutory information in CARs will be concerned with past and present phenomena in order to create their reality. But is it true that many items in CARs are concepts without any reality behind or in them (Gouws, 2005)? Managers using the DIS for disclosing discretionary information in CARs will also consider future phenomena to create simulated reality. As reality is a mental construct it has the attributes to appear in CARs.

- *Certain elements of business reporting should be presented only if users and management agree they should be reported – a concept of flexible reporting* (AICPA, 1994:54-57). In CARs, the DIS generates flexible reporting, which is not necessarily prescribed by law or accounting standards. Users will opt for information that might reduce their uncertainties.

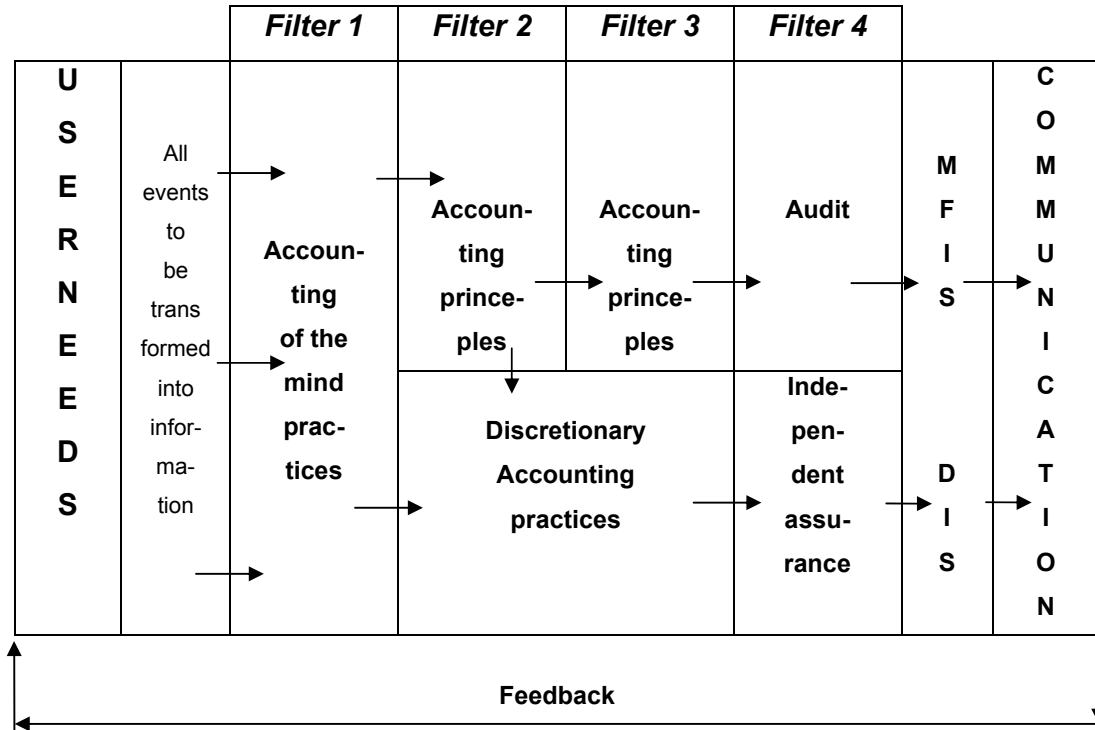
- *Companies should not have to expand reporting of forward-looking information until there are more effective deterrents to unwarranted litigation that discourage companies from doing so* (AICPA, 1994:54-57). There are risks for entities reporting forward-looking information, because if users have based their decisions on forecasted information that reflected a brighter outcome than the actual outcome, companies may be held liable where users made improper decisions. Entities will therefore be cautious about disclosing forward-looking information in CARs until there are more effective defensive measures against indefensible and unreasonable litigation.

All of the above constraints are applicable to CARs and have quality implications. It is therefore necessary to consider the quality features of information within the boundaries of these constraints. In order to do so, it is also necessary to consider the process of quality information flows, which is driven by user needs.

### **4.3 The filtering process**

The process of quality information flows is illustrated in table 4.2. The role of CARs is to provide stakeholders with the quality information they need to make proper decisions fairly in all material respects. The filters in table 4.2 reduce the types of information to be disclosed in CARs. Events to be transformed into information are screened by four filters. The four filters for statutory information generated by the MFIS are “accounting of the mind” practices, accounting practices, accounting principles and audit. The four filters for discretionary information generated by the DIS are “accounting of the mind” practices, accounting practices, discretionary accounting practices and independent assurance. The statutory disclosures and the discretionary disclosures are the information and communication products of CARs.

**Table 4.2: CARs as providers of quality information**



Source: Own observation

**Filter 1**

During this stage of the filtering process the quantity of information is reduced. The process starts with user needs, which influence the “accounting of the mind” practices that capture and screen all events that have to be transformed into information. These practices consist of the natural activities performed by human beings when making decisions about the control and allocation of resources. They include *inter alia* the recording of transactions and past experiences in the memory, for example in the form of habits. The business information created by these practices has the potential to become either discretionary disclosures or statutory disclosures in entities’ channels of communication, of which CARs is the most dominant. “Accounting of the mind” practices focus on the needs of users. The information that filters through filter 1 is thus concerned with the control and allocation of resources.

## Filter 2

The second filter in the process consists of accounting practices and discretionary accounting practices. The accounting practices select some of the “accounting of the mind” practices and are the drivers of quality accounting information. Staubus (1995:95) maintains that accounting practices are the generators of accounting information and can be described as a set of activities intended to reduce the decision-making risks of users. Accounting practices stem from prevalent industry practices and the literature, such as textbooks and journal articles (Belkaoui, 2004:57), but Staubus (1995:96) points out that “... the criteria on which accountants decide to account for, or ignore, events are not clearly stated in the authoritative literature of accounting...”. These encompass all practices and procedures that are being used in the accounting value chain by users, management, management accountants and analysts, to name but a few, in order to capture and record data and to make information more understandable.

Gouws (2005) is of the opinion that these practices include and link up with other practices such as the calculation and compilation of earnings per share (EPS), the value-added statement, the balanced scorecard, economic value added (EVA), opportunity cost and the cost of capital. A list of such accounting practices includes observing and discovering events; recording such events, for example identifying and recognising; and classifying, measuring and reporting (Beattie & Jones, 2001:195), as well as, summarising, analysing and interpreting. These activities include postulates, axioms, assumptions, doctrines, conventions, constraints, principles and standards (Wolk *et al.*, 2000:137).

Accounting practices have largely evolved from practical operating necessities, but have also appeared in theoretical works written in the formative years (1930–1946) (Wolk *et al.*, 2000:136). Accounting practices screen out certain information to generate financial reporting disclosures. Beattie and Jones (2001:199) refer to micro-based accounting practices as well as macro accounting practices. These can be visualised as follows:

**Table 4.3: Micro- and macro-based accounting practices**

<b>Accounting practices</b>	<b>Attributes</b>	<b>Countries</b>
Micro-based accounting practices	Comparatively weak governmental influence on accounting, relatively strong accounting professions and comparatively active equity markets	Australia, the Netherlands, the US and the UK
Macro accounting practices	Comparatively strong governmental influence on accounting. Relatively weak accounting professions and comparatively inactive equity markets. Accounting practices are legalistic and tax-based, tending to be uniform and inflexible.	France and Germany

**Source: Beattie & Jones (2001)**

Although there are differences in accounting practices between developed and developing countries, a body such as the International Accounting Standards Board (IASB) strives to harmonise accounting standards globally for the sake of comparability (IASB: 2005). Discretionary accounting practices also use information generated by accounting of the mind practices to be disclosed as discretionary disclosures. The discretionary disclosures form the context in which to understand mandatory disclosures.

### **Filter 3**

The third filter in the filtering process consists of accounting principles. Accounting principles are sometimes seen as being synonymous with practices (Grady, 1965:ix). This is the case in South Africa; however, in the US the term “accounting principles” is preferred and, in order to avoid confusion, accounting principles will also be used in this research. Principles are postulates that have been successful in practice.



AICPA (1970) in Wolk *et al.*, (2000:141) asserts that generally accepted accounting principles are rooted in “experience, reason, custom, usage, and ... practical necessity” and “... encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time”. They could also be termed standards or concepts. They contain definitions of basic accounting terms, proposed rules for presentation and measurement of accounting data, and concepts to be applied to published financial statements (Wolk *et al.*, 2004:125). Generally accepted accounting principles rest on a foundation of the basic concepts and broad principles that underlie financial reporting. These principles and concepts are based on qualitative characteristics such as, understandability, relevance, reliability and comparability (IASB, 2005: para.24-46).

Principles may be defined as “[a] general law or rule adopted or professed as a guide to action, a settled ground or basis of conduct or practice ...” (AICPA, 1953 in Wolk *et al.*, 2004:125). A principle closely relates to a law; however a law differs from a principle in that the former contains elements observable by empirical techniques whereas the latter does not. If a principle could be empirically tested and proven true (or at least not proven false) it would be capable of becoming a law (Wolk *et al.*, 2004:125). Principles are general standards that influence the way we view phenomena and the way we think about problems (Harré, 1970:206). Principles are general approaches used in recognising and measuring accounting events. The postulates and principles approach largely ignores the question of user objectives. Accounting policy decisions (the selection of accounting principles) influence the timing, quality and quantity of public financial information (Walker, 1988:170). With the forming of accounting policy, entities decide which measurement and reporting alternatives are acceptable and which are not (May & Sundem, 1976:763).

Accounting principles may also be termed “accounting praxes”; these entail established and accepted accounting practices used in the process of reporting. They represent exalted accounting practices or *institutum*. As stated in chapter 3 of this study, the IASB develops global accounting standards that generate transparent and comparable information (IASB, 2005:5), for example the International Accounting Standards (IASs)

and the International Financial Reporting Standards (IFRSs). The aim of standard-setting bodies (Special Committee on Research Program, 1958:62–63 in Wolk *et al.* 2000:131) is to advance the written expression of what constitutes generally accepted accounting principles. This moves beyond merely a survey of existing practice and unsettled and controversial issues to include continuing efforts to determine appropriate practice and to narrow the areas of difference and inconsistencies in practice. The transition of accounting principles in the US (Zeff, 2005:1-32) is set out below:

**Table 4.4: Accelerating growth of US GAAP**

<u>Year</u>	<u>Event</u>	<u>Comments</u>
<u>1932-33</u>	Introduction of broad principles of accounting.	The purpose was to improve accounting practice.
<u>1934</u>	Congress creates the Securities and Exchange Commission (SEC).	The aim of the SEC was to insist on comparability, full disclosure and transparency practices.
<u>1936</u>	Introduction of the term “generally accepted accounting practices”, known as GAAP.	GAAP was used for the first time to generate statutory disclosures.
<u>1938/39</u>	The Institute begins issuing ‘Accounting Research Bulletins’ to provide the SEC with support for proper accounting practice.	These were the first signs of a standard setting process of accounting practices.
<u>1938/39</u>	Congress permits different accounting practices for inventory	Today the aim of standard setting bodies is to limit alternative accounting practices.
<u>1940</u>	American Accounting Association publishes Professors W.A. Paton and A. C. Littleton’s monograph, “An Introduction to Corporate Accounting Standards”.	This reflects further growth in accounting practices.
<u>1940s</u>	The use of alternative accounting methods is allowed when there is diversity of accepted practice.	Currently, a main aim of the IASB is to minimise alternative accounting methods in order to promote comparability.
<u>1950</u>	Criticism emerged for the allowance of alternative accounting methods.	Currently, GAAP (used for the disclosure of statutory information in CARs) tends to be more uniform, while discretionary accounting practices (used for the disclosure of discretionary information in CARs) tend to more flexible.
<u>1959</u>	Research is now performed in establishing accounting principles by the APB.	The discretionary disclosures in CARs are an important research breeding ground for the further development of GAAP.

<p><u>1968</u></p>	<p>Introduction of a Management's Discussion and Analysis of Operations (MD&amp;A), a narrative discussion.</p>	<p>The type of information required by the MD&amp;A for American companies can be disclosed for South African companies in the Directors Report as well as part of the Operational and Financial Review (OFR) in the discretionary information section of CARs. The information would <i>inter alia</i> cover risks and uncertainties, and could include forward-looking information disclosures.</p>
<p><u>1970</u></p>	<p>Basic concepts and accounting principles underlying financial statements are introduced.</p>	<p>South African companies use the IASB Framework (IASB, 2005), which sets out the concepts that underlie the preparation and presentation of financial statements (the statutory required section of CARs) for external users.</p>
<p><u>1970/71</u></p>	<p>Criticisms lead to the establishment of the Wheat Study Group on "the establishment of accounting principles" and the Trueblood Study Group on the "objectives of financial statements"</p>	<p>Criticisms have also lead to the transition of accounting practices. The mandatory financial information system (MFIS) responsible for statutory disclosures utilises these accounting practices, which form part of a closer system, as it <i>inter alia</i> changes through cataclysmic events. The discretionary information system of CARs on the other hand is an open system as it interacts and reacts freely with the feedback from user groups.</p>
<p><u>1973</u></p>	<p>The formation of both the FASB and the IASC brings the term 'standard setting' into general use.</p>	<p>Currently the FASB (USA) and the IASB, with its head office in London, negotiate on an ongoing basis in an effort to reconcile the different accounting practices applicable to US companies and those applicable to the rest of the world.</p>
<p><u>1973</u></p>	<p>The Trueblood Study Group introduces a 'decision usefulness' approach to the development of accounting standards</p>	<p>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. This statement is further examined in the questionnaire for preparers (statement 30, chapter 9). This decision-usefulness approach influences the evolution of accounting practices.</p>
<p><u>1975</u></p>	<p>Interpretations of practices are being introduced.</p>	<p>The International Financial Reporting Interpretations Committee (IFRIC) is a committee of the IASB that assists it in establishing and improving standards of financial accounting and reporting for the benefit of the users, preparers and auditors of financial statements. The role of the IFRIC is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRSs or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop. It thus promotes the rigorous and uniform application of IFRSs (IASB 2005:2087).</p>

<p><u>2002/03</u></p>	<p>The SEC Chairman and others call for a return to 'principles-based standards' to overcome the current emphasis in the FASB's standards on length and detail.</p>	<p>In chapter 9 (statement 13) of this study, preparers of CARs are in favour of principles-based accounting standards. 75.6 percent of the respondents disagreed with the statement that GAAP should be rule based as opposed to principles based.</p> <p>This shows that the development of accounting practices is a never ending process.</p>
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**Source: Zeff (2005) adapted**

The above shows how accounting practices evolve over time. The information allowed through by filter 2 (the accounting practices) is now further screened by filter 3 (the accounting principles or praxes). These accounting principles are used by the MFIS to generate the statutory information presented in CARs. The information screened out by filter 3 may still find its way into CARs through the DIS to be presented as discretionary information, for example the value-added statement, which is generated by accounting practices and is currently disclosed as discretionary information and not as mandatory information.

The information that succeeds in passing through all the filters of the MFIS will ultimately be presented as the statutory information in CARs. The information that succeeds in passing through all the filters of the DIS will ultimately be presented as the discretionary information in CARs.

#### **Filter 4**

The fourth filter in the process of quality information flows is the audit process. The information generated by the MFIS and governed by generally accepted accounting principles will be subject to a statutory audit and this information will form part of the statutory disclosures in CARs. The information generated by the DIS using discretionary accounting practices and disclosed as discretionary information might be subjected to some auditor involvement such as independent assurance. AICPA (1994:105-106) makes *inter alia* certain recommendations regarding auditors' involvement in business reporting:

- *Allow for flexible auditor association with business reporting, whereby the elements of information on which auditors report and the level of auditor involvement with those elements are decided by agreement between a company and the users of business reporting (AICPA 1994:105-106).*

The independent assurance report that auditors issue regarding discretionary disclosures (specifically sustainable development matters) is an example of flexible auditor association.

From the above it is evident that information on an entity that is communicated to users flows through different filters. This filtering process reduces the types of information that will eventually be presented in CARs in the form of audited financial information produced by the MFIS. However, the information that is filtered out finds its way back to the user through the DIS of CARs and makes its appearance as discretionary information. As a result of this filtering process, the CARs, as provider of quality information, reduce the risks and uncertainties that stakeholders are confronted with (Gouws, 2006) and help various stakeholders in their need to allocate scarce resources. To ensure that the disclosures contained in CARs are of high quality, users should be able to give feedback in this regard. The issue of feedback will be tested in the questionnaire to preparers (chapter 9) as follows: statement 35: *CARs must also provide for feedback from users.*

#### **4.4 The qualitative objectives of financial accounting**

Belkaoui (2004:166) summarises the qualitative objectives of statutory information generated by accounting principles in CARs to include relevance, understandability, verifiability, neutrality, timeliness, comparability and completeness. This is in line with the qualitative characteristics given in table 4.5. In the IASB Framework (IASB, 2005: para.24-46) a description is given of the qualitative characteristics that make the information provided in the statutory section of CARs useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

The following characteristics of statutory disclosures, according to the framework (IASB, 2005) shown in table 4.5, are also applicable to the discretionary disclosures generated by the discretionary information system (DIS) in CARs.

**Table 4.5: Qualitative characteristics of statutory disclosures**

<b>Understandability</b>	Information created by accounting practices and provided in the statutory section of CARs should be readily understandable by users.
<b>Relevance</b>	For information generated by accounting practices to be useful it must be relevant to the decision-making needs of users.
<b>Materiality</b>	Information is material if its omission or misstatement could influence users' economic decisions taken on the basis of the statutory section of CARs.
<b>Reliability</b>	Information generated by accounting practices must be free from material error and bias and users should be able to depend on it.
<b>Faithful representation</b>	Most financial information is subject to some risk of being a less than faithful representation of that which it purports to portray.
<b>Substance over form</b>	Information must be accounted for and presented in accordance with its substance and economic reality and not merely its legal form.
<b>Neutrality</b>	The information contained in the statutory section of CARs, generated by GAAP must be neutral, that is, free from bias.
<b>Prudence</b>	Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty.
<b>Completeness</b>	The information created by accounting practices in the statutory section of CARs must be complete within the bounds of materiality and cost.
<b>Comparability</b>	Users must be able to compare the statutory section of the CARs of an entity through time in order to identify trends in its financial position and performance and be able to compare the statutory section of CARs of different entities in order to evaluate their relative financial position, performance and changes in financial position. This can only be done if accounting practices are uniform.
<b>Timeliness*</b>	If there is undue delay in the reporting of information generated by accounting practices it may lose its relevance.
<b>Balance between benefit and cost*</b>	This characteristic would help to ensure that only information truly needed is included in business reporting and only the information that can be provided at an acceptable cost (AICPA, 1994:91).

<b>Balance between qualitative characteristics*</b>	In practice a balance, or trade-off, between qualitative characteristics is often necessary in order to produce CARs timeously and so that benefits exceed the cost of providing CARs.
<b>True and fair view/ fair presentation</b>	The application of the principal qualitative characteristics and of appropriate accounting standards normally results in the statutory section of CARs, which conveys what is generally understood as a true and fair view, or as presenting fairly such information.

\* Also regarded as constraints by the IASB Framework (2005)

**Source: Adapted from the IASB Framework (2005)**

As far as the understandability characteristic is concerned it must be borne in mind by the preparers of CARs that the accounting information will not always be understandable to users owing to its complexity.

As far as the relevance characteristic is concerned, preparers of CARs should note that the more relevant the information is, the less reliable it may be, that is, information obtained (and audited) further back in the past is more reliable than recent (not yet audited) information that is more relevant. In CARs the statutory information created by GAAP would be more reliable, while the discretionary information created by discretionary accounting practices would be less reliable. A balance must therefore be struck between relevant and reliable information. Preparers of CARs should be aware that as far as the comparability characteristic is concerned, comparability is impossible without recognising the contextual/initial conditions, for example the inputs and the processes. This is catered for by the discretionary information system (DIS), which gives the contextual information. It is important to disclose information about the various inputs and processes of the accounting and financial information presented (Gouws & Lucouw, 1999:105), as given by the discretionary information section of CARs, as it is important to give sufficient indication of the changes in forces, processes and capabilities that determine the numbers (outputs). Only then is comparability possible, as the statutory section of CARs seldom informs users about how the results were achieved. The aspects of inputs, processes and outputs will be further tested in the questionnaire for users (chapter 10) as follows: statement 5: *Narrative disclosures in CARs are more understandable than numbers and ratios.*

For a balance between the benefit and cost characteristic, AICPA (1994:53) asserts that this characteristic should help to ensure that only information truly needed is included in business reporting and then only information that can be provided at an acceptable cost. Foster (1986:38) states: “A common argument presented against disclosure is the cost incurred when competitors use the disclosure to their own advantage.” However entities in industry have a rich network of information sources on what their competitors are doing (OECD, 2006:18). It would therefore be difficult to support an argument that increased disclosure of many items in financial reports as this, would result in a major competitive disadvantage (Foster, 1986:38). The benefit versus cost characteristic therefore also acts as a filter that reduces the information that is eventually disclosed. CARs comply with this requirement as business information in CARs that is not useful or comprehensible is discarded or replaced, which helps to balance benefit and cost. AICPA (1994:91) is of the opinion that standard setters should search for and eliminate less relevant disclosures in this regard.

In the above section, the quality features of statutory financial information as prescribed in the framework with which the MFIS in CARs is involved have been identified. The following section deals with the quality aspects that apply to the discretionary information section, that is, that involved in the DIS in CARs.

#### **4.5 Quality objectives of discretionary disclosures**

Discretionary (or narrative) disclosures in CARs are not a recent development (OECD, 2006:13). The narrative reporting sections in American and Canadian annual reports are known as Management Discussion and Analysis (MD&A), and in Britain, the Operating and Financial Review (OFR).

The OECD (2006:13) lists the following recurring themes that are addressed by discretionary disclosures: (i) contextual information that enables a more complete understanding of current and prospective financial results and position; (ii) expanded



information on both financial and nonfinancial performance measures; (iii) forward-looking information (PWC, 2006c:1) for assessing prospective performance; (iv) the risks and uncertainties that may affect the company's long-term value; and (v) information on key performance indicators (KPI) that companies use in managing their business (PWC, 2006b:1). The disclosure of trends in working capital on a monthly basis throughout the financial year in order to monitor cash flow risk could also be useful. This aspect will be addressed in the questionnaire for users (chapter 10) as follows: statement 12: *Monthly averages of working capital should be included in CARs*. All of the above information is disclosed in the discretionary section of CARs. The discretionary disclosures include specific reporting about intellectual assets (OECD, 2006:13).

In 2002, the Institute of Directors of Southern Africa published the King Report on Corporate Governance for South Africa ("the Code") with the aim of improving the quality of corporate governance disclosures. These disclosures also appear in the discretionary section of CARs.

#### **4.5.1 Background**

As statutory disclosures in CARs may fail on their own to give a complete picture of a company, it is necessary to supplement statutory disclosures with discretionary disclosures. The MFIS responsible for generating mandatory disclosures in CARs only discloses information that can be measured in monetary terms. Certain intangible assets are, for example, not disclosed by the MFIS. The OECD (2006:7) is of the opinion that "[a]lthough accounting standards can probably be developed further to take into account a wider range of intangibles, clear limits are set by the difficulty of establishing monetary values (valuation) that are at the same time consistent across firms, verifiable and that cannot be easily manipulated".

Other information in CARs needs therefore to fill the gap in order to give a complete picture of an entity. This information is catered for by the DIS, which generates discretionary disclosures in CARs through the utilisation of discretionary accounting practices.

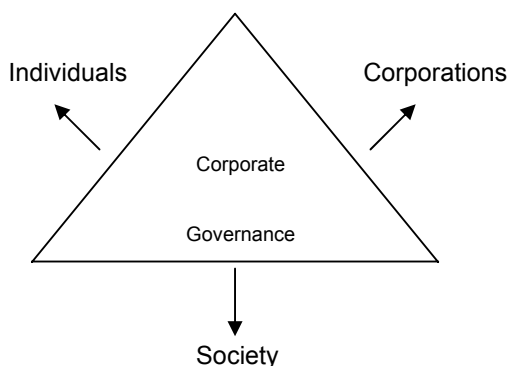
In order to assist investors and other users to ascertain the true value of an entity, several guidelines to aid narrative (discretionary) reporting have been developed that promote the disclosure of contextual information (OECD, 2006:13). These include material, qualitative and forward-looking information about an entity's value drivers, trends, risks and uncertainties (OECD, 2006:13, PWC, 2006c:1). Discretionary information is not necessarily information to which numbers are attached.

In order to address the quality of business information, the King Committee reviewed corporate governance standards and practices in South Africa. In the introduction of the Code (King, 2002a), the following quote encompasses the quality of management and information in the communication with an entity's stakeholders:

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals ... the aim is to align as nearly as possible the interests of individuals, corporations and society.

This alignment may be visualised as follows in figure 4.1.

**Figure 4.1: Interests of individuals, corporations and society**



The first King Report indicated that entities, societies and the environment are interdependent. The King Report 1994 went beyond regulatory and financial aspects of

corporate governance and advocated an integrated approach to good governance that also included the reporting of quality information to stakeholders. In CARs the DIS generates the disclosures that go beyond the regulatory and financial aspects of corporate governance. This integrated approach was necessary to address the interests of a wide range of stakeholders having regard to the fundamental principles of good financial, social, ethical and environmental practice (King, 2002a:5). The aim was therefore to include the disclosure of quality information to all stakeholders in CARs.

#### 4.5.2 Triple bottom line

The quality of information presented by entities must embrace the economic, environmental and social aspects of an entity's activities (Bennett & James, 1999:477; King, 2002a:9). The attributes of the triple bottom line can be presented as follows:

**Table 4.6: The triple bottom line**

<b>Aspects</b>	<b>Attributes</b>	<b>Application to the disclosures in CARs</b>
Economic	The economic aspect includes the familiar financial aspects as well as the nonfinancial ones relevant to the business of an entity.	The financial aspects and the non-financial ones relevant to the business will generally be disclosed in the discretionary disclosure section of CARs.
Environmental	The environmental aspects embrace the effects that an entity's products and/or services may have on the environment.	Good and bad news about environmental aspects of entities are normally addressed in the discretionary disclosures section of CARs.
Social	The social aspects encompass values and ethics, and reciprocal relationships with stakeholders other than just the shareowners.	The social aspects are disclosed in the discretionary disclosure section of CARs.

**Source: King (2002a)**

Entities cannot just address the interests of one stakeholder group in CARs, but need to provide quality information that addresses the needs of all stakeholder groups following the guidelines of the triple bottom line. But, "... financial measurement and reporting is still

evolving and there is no universally accepted measurement – framework-only generally accepted accounting practices (Bennett & James, 1999:477). GAAP and discretionary accounting practices are in a process of change in order to provide quality information in CARs that can address the needs of all stakeholder groups.

#### 4.5.3 Attributes of quality discretionary information

The following table has been compiled using the seven characteristics of good corporate governance (King, 2002a:10-11). These characteristics have been applied to determine the attributes that quality information should possess in order to be presented to different stakeholders in CARs.

**Table 4.7: Attributes of good quality information**

<b>Characteristic</b>	<b>Attribute</b>
Discipline	Disclosures universally recognised and accepted to be correct and proper.
Transparency	Disclosures should be such that stakeholders can make meaningful decisions with ease.
Independence	Mechanisms should be put in place to avoid potential conflicts of interest in the disclosure of information e.g. management might not want certain sensitive information to be disclosed.
Accountability	The information concerning stewardship is normally disclosed in the statutory sections of CARs.
Responsibility	To ensure that information is valid, and where misrepresented, corrective action must follow and those guilty of false presentation must be penalised.
Fairness	Rights of various groups to be acknowledged and respected.
Social responsibility	Awareness of social issues, with a high priority on ethical issues.

**Source: Adapted from King (2002a:10-11)**

If the preparers of CARs are aware of the above characteristics and apply them in an ethical manner when disclosing information in CARs, then the information presented in CARs should be of a high quality. In practice the possibility exists that disclosures are not made following the above characteristics. The disclosure of bad news for example may be downplayed. This aspect is tested in the questionnaire for users (chapter 10) as follows:

statement 15: *The disclosure of bad news regarding environmental and social issues is often avoided in CARs* (Cronjé, 1998:9-10; Beattie & Jones, 1999:46).

#### **4.6 Balanced scorecard approach**

In the past, business information concentrated on financial aspects only, that is, accounting numbers created by the MFIS of CARs. Unfortunately these reporting practices only show how effective a company has been in the past (OECD, 2006:13). In order to convey quality information on an entity as a whole, the use of a range of frameworks could be considered, for example the balanced scorecard approach (Kaplan & Norton, 1992) and the value chain scorecard practices (Lev, 2001:123).

A balanced scorecard approach entails broader issues that are becoming more important in accounting. In the use of the balanced scorecard, measurement is done from four perspectives, namely the financial, customer, internal business, and innovation and learning perspectives. The balanced scorecard retains measures of financial performance, but supplements these with measures regarding customers, internal business processes, and learning and growth. It therefore enables organisations to track financial results while monitoring the progress made in respect of building the capabilities needed for their growth (Vermaak & Cronjé, 2001:302; Cronjé & Vermaak, 2004:481). The balanced scorecard approach is a confirmation that performance measurements other than GAAP are in a development phase and will in time attain greater acceptance.

A balance should be maintained between the need to inform and a fear of disclosing too much information, as the latter could be to the disadvantage of an entity in its competition with other entities, which might take unfair advantage of such information (Visser, 1978:394; King, 2002a:14). This balance in the disclosure of information could be seen as yet another filter and may influence the type of information disclosed in CARs. The balanced scorecard approach is in a development phase and will in time gain greater acceptance.

#### **4.7 Further development of discretionary disclosures**

Discretionary disclosures in CARs generated by discretionary accounting practices should be reliable and consistent and should be presented in such a way that they improve the quality of corporate communication. Apart from the MD&A and the OFR, other guidelines, such as those issued by the FASB (2001), could be consulted to enhance discretionary reporting in CARs. The drivers and preparers of CARs could identify what is perceived to be useful decision-making information in terms of users' needs and could respond by improving the discretionary information content of CARs (Myburgh, 2001:214). The discretionary information created by the DIS of CARs will contribute to the quality of the information presented in CARs, as these need to reassure stakeholders that there is evidence of good stewardship by the directors. The discretionary section of CARs could *inter alia* comply with the criteria laid down in the Sustainable Reporting Guidelines of the Global Reporting Initiative (GRI). The disclosure of discretionary information will add to the context in which to better understand the statutory disclosures in CARs.

According to OECD (2006:17) efforts are underway to create a comprehensive framework (Enhanced Business Reporting Consortium [EBRC], a project of the AICPA's Special Committee on Enhanced Business Reporting launched in 2004) for discretionary reporting that will contribute to (i) improved capital market efficiency, (ii) a lower cost of capital, (iii) a lower bid/ask spread and (iv) reduced share price volatility. As far as the disclosure of intellectual capital is concerned voluntary reporting would (OECD, 2006:17) (i) make intellectual assets and their value drivers more visible; (ii) reassure stakeholders that the specific risks arising from the intellectual assets are properly managed; and (iii) report intellectual asset-specific key performance indicators that portray the performance of the company in terms of how it has managed its intellectual assets. This information could then be disclosed in the discretionary information section of CARs. The issue of intellectual capital is further explored in the questionnaire for users (chapter 10) as follows: statement 16: *I would like to see more disclosure on intellectual capital.*

A disclosure framework draft was released by the EBRC in October 2005 to promote greater transparency on corporate strategy and performance (OECD, 2006:17). During October 2005 the IASB released a reporting framework called the Management Commentary (MC), which proposes the development of a principle-based standard containing nonmandatory evidence to provide forward-looking and contextual information for investors (OECD, 2006:17). Another role player that reviews best practices is the International Corporate Governance Network (ICGN). South African companies could make use of an OFR, such as that already in use by UK companies, to structure their discretionary disclosures in CARs. The adoption of the best discretionary accounting practices would improve the quality of discretionary disclosures in CARs.

Entities could consult with users on an ongoing basis to determine the discretionary disclosures that would best add to understandability. The CARs should supply stakeholders with quality information that is understandable and that would enable them to judge the stewardship, performance, conformance and sustainability of an entity on a continuing basis.

#### **4.8 Focus on ethics**

Accounting practices should be used in an ethical way to generate disclosures in CARs. A holistic focus on ethics could, but would not necessarily, enhance the quality of business information in CARs. The focus on ethics is, *inter alia*, an effort to enhance the credibility of directors and the accounting profession. Terry (2002:9-10) reports that as a result of the corporate failures in recent times of entities like BCCI, Robert Maxwell and Barings Bank in the UK, Masterbond, MacMed, Leisurenet and Regal Treasury in South Africa, as well as Global Crossing, World Com, K-Mart and Enron in the US, to name a few, the question of ethics in business reporting has once again become an area of concern. Distorted business information may for instance be the result of pressure (as a result of greed) from investors for favourable short-term financial results (Terry, 2002:9-10). If the business objective is merely the achievement of favourable short-term financial results, it will pressurise financial directors to present manipulated business information in CARs.

Distorted business information in CARs will not assist investors in making proper investment decisions.

Rossouw and Van Vuuren (2004:265) contend that, "... managing ethics in a value-based manner is much more complicated than doing so in a rule-based manner, for the simple reason that whilst rules can be prescribed, values cannot be ...". Unfortunately ethics can never be just a list of procedures or a set of rules, but has to be rather a state of mind. Preparers of CARs need this state of mind in order to disclose credible information through the use of accounting practices for the benefit of users. The issue of credible information will be further explored in the questionnaire for preparers (chapter 9) as statement 26a: *It is my view that CARs provide credible statutory information* and statement 26b: *It is my view that CARs provide credible discretionary information*. The same statements will be included in the questionnaire for users (chapter 10) as statements 6a and 6b.

From an ethical point of view CARs should not be used for propagandistic purposes. CARs should not contain information that is untrue and they should not dis-inform or discriminate between users. CARs should not be used to predict.

#### **4.9 Summary and conclusion**

In this chapter the attributes of quality business reporting were identified. The quality of business reporting in CARs affects the integrity of the information being communicated to stakeholders. Business reporting must be adjudged trustworthy and of superior quality before an investor will decide to invest. The practical constraints on ensuring quality information were discussed (AICPA, 1994:54-57), as they are applicable to CARs and have quality implications.

The process of quality information flows driven by user needs was also considered. It was shown that events to be transformed into information are screened by four filters. The four



filters for statutory information generated by the MFIS are “accounting of the mind” practices, accounting practices, accounting principles and audit. The four filters for discretionary information generated by the DIS are “accounting of the mind” practices, accounting practices, discretionary accounting practices and independent assurance. Filtered information on an entity that is communicated to users reduces the risks and uncertainties that stakeholders are confronted with.

The qualitative objectives of financial accounting were considered that make the information provided in the statutory section in CARs useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability. The qualitative characteristics of statutory disclosures are also applicable to the discretionary disclosures generated by the discretionary information system in CARs.

As statutory disclosures in CARs may fail on their own to give a complete picture of a company, it is necessary to complement statutory disclosures with discretionary disclosures. In order to assist investors and other stakeholders in ascertaining the true value of an entity, several guidelines to aid narrative (discretionary) reporting have been developed that promote the disclosure of contextual information (OECD, 2006:13). These include material, qualitative and forward-looking information about an entity’s value drivers, trends, risks and uncertainties (OECD, 2006:13, PWC, 2006c:1). The King Report advocates an integrated approach to good governance that also includes the reporting of good quality information to stakeholders. Information presented by entities must embrace the economic, environmental and social aspects of an entity’s activities (King, 2002a:9). The attributes of good quality discretionary information were considered and if preparers of CARs apply these characteristics in an ethical manner when disclosing information in CARs, then the information presented should be of a high quality.

A balanced scorecard approach may be followed in presenting disclosures in CARs. In the use of a balanced scorecard approach, measurement is done from four perspectives, namely the financial, customer, internal business, and innovation and learning perspectives. The balanced scorecard approach entails broader issues. It retains measures of financial performance, but supplements these with measures that take into

account customers, internal business processes, and learning and growth. The balanced scorecard approach is in a developmental phase and will in time gain greater acceptance.

The further development of discretionary disclosures was considered. A comprehensive framework is currently being developed (OECD, 2006:17) for discretionary reporting that will contribute to (i) improved capital market efficiency, (ii) a lower cost of capital, (iii) a lower bid/ask spread and (iv) reduced share price volatility. In October 2005 the IASB released a reporting framework called the Management Commentary to encourage forward-looking and contextual information for investors (OECD, 2006:17). Another role player that reviews best practices is the International Corporate Governance Network (ICGN). South African companies could make use of an OFR, such as that already in use by UK companies, to structure their discretionary disclosures in CARs.

Consideration was also given to the fact that accounting practices need to be used in an ethical way to generate disclosures in CARs. A holistic focus on ethics could, but would not necessarily, enhance the quality of business information in CARs.

The conclusion is that quality is the focal point of business information. The disclosure of high quality information results in a lower risk premium for highly evaluated entities, which leads to lower debt costs and therefore an increase in earnings (Wolk *et al.*, 2000:315; OECD, 2006). Better disclosure in CARs therefore results in a better bottom line. CARs determine the flow of capital; therefore business information must be adjudged trustworthy and of high quality before an investor will decide to invest.