Comments on the Conceptual framework.

Associate Professor Jean Raar
Swinburne University
Lilydale campus.

Objectives of financial reporting.

The following discussion is based on a paper recently published in Critical Perspectives on Accounting, (Vol 19 pp 785-804, 2008) and also many years of research (including a doctorate) on the subject of social and environmental accounting issues by the author.

A copy of the paper entitled "*A basic user utility preference to reduce uncertainty: A dissent to reporting and asset measurement*" is attached.

Primarily this paper covers the variety of choices, which add to issues of interpretation and lack of transparency. The paper is based on the aspect that users of financial information do not have homogeneous needs. The focus of the paper is the need to add clarity and transparency in the process of communicating financial information. The paper also adds to the discussion on the inclusion of information that is not measurable in terms of 'fair value', and the information that requires information measurable in non monetary trms.

The recommendation in the paper is that reliability and transparency be added to relevant information by the inclusion of a 'market bid' i.e. a level of probability that supports management's ability to obtain a relevant market sale price. Given that the profession does not indicate a change to eliminate 'value – in use' assets, the conclusion of the paper suggests a reclassification of items according to their measurement type. That is, items that are deemed to have a market value can be displayed in one classification/category, while 'value-in-use' items are reported separately. In this way the ratios associated with financial statement analysis, particularly the risk related ratios of debt/assets, ROI may provide more 'relevant' information on the ability of the firm to pay its debts if such a situation arose. This approach does not suggest a liquidity situation, just a reclassification of asset types according to measurement – market value vs non market value.

Furthermore, attached to the assets with a market value could be a level of probability that the figure displayed could be attained in an active market. In so doing the requirement removes the potential for overstatement of asset values, which and report preparer choices. Reliability is revisited as users of accounting information do not have homogeneous needs.

This reclassification approach offers an opportunity to extrapolate the reporting of market value – non market value, to include classification/s that require measurement in nonmonetary terms. Adopting a reclassification approach also allows other users of annual reports to obtain the information necessary for their decision making, including the flow of human and natural resources. For years, accounting academics

and professionals have been calling for the inclusion of intellectual capital as an intangible asset. In addition the reputation of the firm in the twenty-first century is supported by its approach to corporate responsibility. Some external users view sound social and environmental responsibility and evidence of good management and hence a reduction in longer term financial risk.

By reclassifying the information communicated in financial statements, the addition of 'value – in – use' items can include intellectual capital and offer a potential opportunity for the addition of reputation measurement. Therefore, the user who is interested in the firm's financial risk and the ability of the assets to provide sufficient funds to pay liabilities can isolate this information from other classifications.

The reclassification approach can provide users with more reliability, and offers opportunities for the accounting profession to restrict the opportunities for interpretation, interpret judgement, and intruding bias by preparers. It also allows the accounting profession to add value to annual reports by reporting information that is relevant to financial risk in the longer term, albeit separated from shorter term performance.

Stewardship vs decision-making.

Some recent literature (for example, Gettler, 2008, The Age 9th July) highlight the problems associated with 'fair value', in a corporate failure situation, particularly the options and potential to recover the amount reported in the financial reports.

Paradoxically, the problems of profit levels, and inability to recover asset values displayed in financial reports, initiated a change in the objective of financial reporting to refocus from the stewardship role associated with the historical cost system to that of decision-making. Criticisms of historical cost line the library shelves of accounting libraries, and were a focal point for the normative accounting theories of CCA, CPP and Chamber's Continuous Contemporary Accounting (CoCoa), formulated in the sixties and seventies.

The failure of historical cost to estimate the opportunity for future cash flows was a concern. This was based on the separation of ownership and control and the perception that investors where interested in future cash flows to make their decisions. The concept of entity theory overtook that of proprietary theory, which was associated with smaller firms. In pursuit of conceptual framework that supports the entity approach, perhaps we have forgotten that small investors may be deemed to have personal goals associated with a proprietary perspective. They are concerned with their individual wealth, particularly the ability to recover their capital in a crisis, that their individual assets are sufficient to pay their own bills. Without adequate capital they are not in a position to be concerned with investments and future cash flows. Concerns about historical cost and have been replaced with concerns of verifiability and transparency issues that allow investors to make their decisions according to the individual risk preference on whether to sell, hold or buy shares in a particular firm.

Our current conceptual framework includes the decision-making focus – an objective requiring relevant information – future information – predictive information. Therefore, as the abovementioned paper indicates the issue of reliability and

particularly verifiability appears to fade. Opportunities for creative accounting have simply changed direction.

Intangible assets.

The trend towards triple bottom line reporting provides a rethink of the role of stewardship, particularly as carbon credits, water and natural resource usage are more focused on 'performance' – a stewardship role. The business community is now moving towards an interdisciplinary approach towards the reporting of 'environmental footprints'. There are professionals both within the accounting profession and outside its jurisdiction that consider mandatory reporting of environmental and social performance is the best path to take. Such an approach may prompt organisations to address social and environmental performance, and manage their intellectual capital more soundly. However, given the diversity of information communicated to external parties of business firms, (financial reports, social performance, environmental management and impact) when combined may not add transparency or comparability. Therefore, the need for transparency and reliability support the provision of 'relevant' information.

Summary.

The accounting profession has not been recognised for its 'speedy adaptability'. We appear to be more reactive to community pressure resulting from a spate of corporate failures and share market changes rather than adopting a proactive stance to reporting corporate performance. The accounting profession is a unique position to be the co-ordinator and basic provider of relevant and reliable business information. We have an opportunity to rectify that reputation and add credibility to the process.

A basic user utility preference to reduce uncertainty: a dissent to reporting and asset measurement

By

Jean Raar Ph.D

Deakin University,
Melbourne Campus
Victoria
Australia

Phone: +61 (03) 9244 6470

Fax: +61 (03) 9244 6283
Email: jean.raar@deakin.edu.au

Abstract

Legitimacy and self regulation of the accounting profession dictates that it typifies integrity and credibility in both the form and substance of its accounting standards. Unsound and dishonest business practices are not evident in the financial reports, nor are they the responsibility of accounting standard setters. Nevertheless, professional accountability is not enhanced if the financial reporting standards permit a great deal of choices, variation and interpretation, particularly in asset values. In pursuit of professional legitimacy and the credibility, accounting standards can reduce opportunities for intruding bias, inept judgement, or interpretation perspectives adding to user uncertainties. The thesis of this conceptual paper is that key user groups have an intrinsic homogeneous preference utility for information relating to financial risk, which can be satisfied by a simple asset value, based on a market bid. The balance sheet can contain a segregation of asset values, either in supplementary or classification form.

Keywords: user utility preference, accounting standards, accountability, professional integrity, asset value.

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1. Introduction

This paper revisits basic accounting issues in an eclectic and multidisciplinary discourse on core propositions relating to the issue of uncertainty. The research objective is to ascertain if user utility can offer a pragmatic approach to reduce uncertainty in the financial measurement of assets. Premised on the need for the profession to continually address integrity and credibility, and aid objectivity in the financial reports the paper revisits one of the more extensively researched topics in accounting – that of financial measurement (Chambers, 1964; Lee, 1989; Bell, 1982; Walker & Jones, 2003; Staubus, 2004a & b). The discussion is conducted within the context of basic routine judgements made between the agency relationships - managers and the 'key group of potential users of financial information'.[1] Differing issues are considered: a) disclosure in the financial statements that incorporates uncertainty and allows room for interpretation, and (b) dishonesty and lack of trust by contracting parties, which Schipper (2005) suggests is outside the role of standards setters. However, uncertainty attached to measurement or value of 'future economic' benefits is within the jurisdiction of standard setters. Reporting processes and measurement that offer opportunities for reporting diversion do not necessarily support transparency and visibility of meaning.

The ongoing academic debate centres on the evolving communication process that signals the optimum accounting information to provide users with insights into management decisions (Hendriksen, 1970, p. 121). As standard setters are at the forefront of a communication process financial information to various publics (Hines, 1988), their 'tools of trade', should support legitimacy, integrity and credibility.

The concept underpinning this paper is that stakeholders require informative data on the outcomes and/or implications resulting from management decisions.

Without sufficient information to ascertain the realistic effects connected to management decisions, users may not be in a position to determine the risk associated with their financial transactions or contracts. Hence, the financial decisions made by individual users, particularly investors and unsecured creditors, may not be based within their own accepted risk continuum range. The discussion herein centres on the provision of a user utility preference ranking in the context of homogeneous monetary information needs required to support user's financial decision requirements.

The remainder of the paper is organised as follows. The next section details the use of conservatism to reduce uncertainty under historical cost measurement. A lack of trust and public unease with the accounting sector following recent corporate failures follows, which also includes a brief discussion on the subsequent literature debate on measurement. In Section 3 the basic accounting topics of proprietary and entity theory, and financial risk are revisited. This section also includes agency theory and its relationship to (a) investor capital, and (b) utilitarianism. Section 4 links public trust and user utility. This is followed by Section 5 which discusses differing viewpoints on the concepts of accounting and asset measurements used within financial reports and their relationship to uncertainty, user utility and decision-making. Discussion and recommendations are followed by a summary of the paper.

1.1. Uncertainty and conservatism.

Since the 19th century conservative valuations were used in financial reporting to curb the optimism of owners regarding their company's ability to provide cash inflows to pay accounts and adapt operations (Lee, 1989: Watts, 2002), and avoid overstatements 'of profit and valuations were more dangerous to owners than understatement' (Henriksen, 1970, p.119). That is, bankruptcy was more a concern to owners than a financial gain. Conservatism was viewed as reducing user uncertainty:

> The term 'conservatism' is generally used to mean that accountants should report the lower of several possible values for assets and revenues, and the highest of several possible values for liabilities and expenses. It also implies that expenses should be recognised sooner rather than later, and that revenues should be recognised later rather than sooner. Therefore, net assets are more likely to be understated than 'overstated, and income is more likely to be understated. Thus pessimism is assumed to be better than optimism in financial reporting. (Hendriksen, 1970, p. 118)

Hendriksen (1970) considered conservatism could counteract overoptimism, which can be reflected in pressure from creditors, and assist in the management of risk, in terms of the truth or untruth of information communication. Alternatively, Hendricksen also suggested conservatism (a) is a poor approach to the treatment of uncertainty in valuations and income determination, (b) may lead to a lack of comparability, (c) has no place in accounting theory as it can misguide decisions as easily as optimism, and (d) an understatement of financial values may lead to bad decisions, just as readily as overstatements. However, dimensions and viewpoints

differ. What is viewed as 'conservative' to one external party, i.e. a creditor may be a misrepresentation to a selling shareholder (Baxter & Davidson, 1962).

> Accounting many years ago was naturally conservative since it was essentially on a cash basis, or was primarily for completed ventures. As the need has grown for the measurement of numerous transactions in various stages of completion, the problems have increased tremendously, but some of the obsolete accounting has been retained. ....Conservatism has also been one of the reasons for the wide variety of alternative accounting practices that are all considered to be 'generally accepted'. These reflect different levels of conservatism (Catlett, 1962, p. 383).

Conservatism can also influence the measurement system - the higher the level of conservatism the more prudent will be the disclosure (Mathews & Perera, 1991), and is inconsistent with relevant information, and the rapid write-off of assets (Belkaoui, 1985). While conservatism can also offer users a degree of trust that the firm has sufficient monetary support to undertake repayment or transfer of goods and commodities, the use of conservatism can also distort the figures in the financial statements for example, the anticipation of losses, but delays the recognition of gains in earnings.

Prior research by Basu (1997) found that 'bad news' (including losses) was reflected in current earnings, while 'good news', including profits that are not fully anticipated by the market, is spread over both current and future years. Basu suggested the result is consistent with conservatism. However, from a managerial manipulation of earnings perspective (Hanna, 2002) considered Basu results were consistent with management write-down of assets to increase future earnings, as there

is no loss of bonus. Hayn (1995) and Givoly et al., (2006) also provide evidence to support that the timing of the earnings response to 'good or bad news' is inherent with the principle of conservatism. However, Hayn (1995) suggests that the asymmetric relation between earnings and share returns is consistent with management liquidating the firm, as losses cannot be sustained.

The 'pattern of conservatism observed around the world, and in the United States over time, is not explained by the value-relevance criterion' and that it may be due to contracting, litigation, tax issues and that financial reports serve a 'multi-purpose' (Holthausen and Watts, 2000, p.33). The literature does not provide an explicit reason for the continuing use of a conservative or careful approach.

2. 'Unease' In the Financial Sector

The continued use of a conservative approach has added to management's discretionary accounting and measurement choices, particularly in terms of the measurement adopted for a particular attribute, and its associated probability range. While conservatism can increase prudence, opportunities for management manipulation are enhanced, rather than reduced. The essentials of a faithful representation of asset values may not always be apparent, particularly when these values are based on dishonest conduct, as the custodial role of management is relinquished.

Although a lack of honesty and ethical conduct on the part of management is outside the jurisdiction of the accounting profession, inequitable conduct on the part of accounting professionals can influence the financial results. Asset values and measurement is one avenue within the jurisdiction of the standard setters, where self-

interest and bias may introduce inequity into the calculations and communication of current and future cash flows associated with relevant measures.

Significantly, alongside corporate failures of Enron and WorldCom in the United States of America (U.S.A) and HIH in Australia there has been an associated questioning of the ability of the accounting and auditing professions to 'protect the public' interest (Lee, 1995). More importantly, the integrity and ethical underpinnings of the accounting and auditing professions were queried. The disrepute and reduction in the public trust surrounding the failures of the abovementioned firms did not enhance the credibility of accounting information. Resultant impositions are evident in the US Sarbanes-Oxley Act (2002) and the Australian CLERP 9 Bill which were formed to promote transparency, corporate governance and accountability.

Moreover following the corporate failures, professional unease in the academic and professional accounting literature became evident, and covered a range of issues. For example topics included the lack of public trust (DiPiazza Jr, & Eccles, 2002); principles versus rules approach to standard setting, particularly the 'true and fair' criterion (Dean & Clarke, 2004); Walker & Jones, 2003) discussed measurement and the qualitative characteristics of relevance and reliability; Walker (2003) provided a comprehensive evaluation of SAC 1, SAC 2 in relation to the objectives of financial reporting, and Rosenfield (2005) outlined the disclosure issues relating to the proprietary and entity theory including classification within the equity section of the balance sheet. Staubus (2004a) revisited his personal views on measurement, and compared it to those of Chambers, (1964:1966:1991). Schipper (2005) in her discussion on fair value measures and new demands on information systems in relation to objectivity, identified that the problems of management bias, ineffective and inefficient internal controls, and other adverse influences on measurement and

value. Alternatively, areas within the realm of the accounting profession are (a) the epistemological subjectivity of accounting measurements, and (b) including the 'range of probabilities' for valuing assets. Our professional integrity would suggest that opportunities to manipulate information signalled to external parties be minimised.

In revisiting the issue of measurement, both Staubus and Chambers agree that the objective of financial reporting is decision-usefulness, albeit from differing perspectives. Staubus has adopted decision-usefulness for external parties from an investors and creditors perspective in terms of profit performance. Staubus, (2004a, p. 270) terms the current literature on the Chambers approach as the current 'Sydneysiders' view. Discussion focuses 'on the financial position 'an enterprise's liquidity position and the decision of people controlling the enterprise's spending transactions'. Basically, the distinction in emphasis is between the profit and future investment returns, or the ability of the firm to pay its debts. From the perspective of the user, which is paramount, or are they both reflected in the firm's share price? The following sections discuss these issues, albeit from the perspective of accounting basics.

3. Agency Issues And Owners' Equity

Users of financial reports prepared by large firms are not in a position to specify either the measurement of elements in the financial statements, or the degree of variation in probabilities. As arguably the primary external users of financial statements are investors and creditors, the financial information communicated to them must support a diversity of financial risk preferences and decision-making needs. Barton (1982, p.58) suggests investors' utility functions embody their personal risk taking attitudes, their return prospects, and investment time horizons which can

be subjective, and also personal. Nevertheless, decisions involve choices between alternative courses of action for both management and investors, each requiring a set of data that is consistent, current and future oriented information. This relevant information intrinsically includes a zone of 'uncertainty' associated with (a) the realisation of non current assets at some future date, (b) future cash flows available to provide dividends to investors, and (c) access to sufficient cash to pay the bills, if and when they fall due. These issues are raised using the basic accounting topics of:

a) proprietary and entity theory;
b) agency relationship and maintenance of investor capital; and
c) agency relationship and utilitarianism.

3. 1 Proprietary and entity theory

Accounting has evolved from the recording of simple transactions in a marketplace local to the multifarious transactions of multinational corporations. The small firm and proprietorship theory led to entity theory alongside the separation of ownership and control, which underpins the current conceptual framework (Rosenfield, 2005).

The financial performance of a firm at any given time is supported by the maintenance of financial capital; investors' capital. Under the proprietary theory, the assets and liabilities of the firm are considered to be those of the owner, which is translated into $A - L = P$ (Rosenfield, 2005). According to Hatfield (1927, p. 221) this 'represents the net wealth of the proprietor'. This theory is consistent with the smaller firm whose owner has invested personal funds in an operation that is expected to improve their personal financial rate of return, and to provide an income. At the time of the investment the level of personal financial risk was apparent to the owner.

In the smaller firms of sole traders and partnerships, there is *no* separation of ownership and control, and all the legal and financial risk associated with the activities of the business remains, and ultimately resides with the personal funds of the owner. Hence, the accounts are prepared for an individual with whom all legal rights, associated accountability, and risk persist - even if the business ceases to operate. These rights include possession, benefits from, control, use and disposal of assets of the business, with the personal finances of these owners remain continually at risk (Des Jardins, 2001). As the owner has complete access to internal information for management and owner perspective, the level of financial risk is readily perceived. Any decisions made by the owner incorporate this knowledge into the process. As such, the content of external financial reports is consistent with regulatory requirements, and not the provision of general purpose accounting information for the owner's financial decision-making.

The increase in larger corporations removed the legal and personal responsibility of owners to honour the debts of the corporation. Shareholders' financial risk is restricted to their capital contribution and its associated opportunity cost of capital. With this separation of ownership, investors and creditors placed their monetary resources with an 'agent' – the management of the corporation, with the associated right to control and use these resources in the ongoing operations of the firm. Management obligations also include trust: a duty that capital contributions will be preserved, stakeholder interests will motivate their decisions, and that financial risk will be controlled.

Under the entity theory, the Assets = Liabilities + Owner's Equity. Both creditors and shareholders are classified as equity, albeit with different rights, correspondingly different levels of financial risk, and an associated 'income centred'

focus (Belkaoui, 1985). Unfortunately, the type and degree of proprietary information accessible to owners of the smaller corporations is not accessible to external parties of larger corporations. Hence, they may be restricted in their ability to gauge the current level of associated financial risk.

The accounting profession formulates accounting standards in an effort to maximise total user utility. Ideally, the standards allow individual stakeholders to gauge their financial risk via the objective of decision-usefulness. A heterogeneous set of users is supplied with a single set of financial information. New information sets may be applied by standards setters within the realm of this single set of reports. However, the necessary skills and knowledge to evaluate these may be outside the ability of ordinary shareholders and creditors. It is recognised that the published financial reports can only provide some of the information required by these external users (Barton, 1982). Hence, complexities in measurement and valuation may aid confusion, rather than enlightenment.

3.2 Agency theory and maintenance of investor capital

The agency relationship between the manager and shareholder –dictates agents owe stakeholders respect, and should refrain from undertaking actions contrary to their preferences (Jensen & Meckling, 1976; VanDeVeer & Pierce, 1998, p.33). Nevertheless, as a business mechanism[2], investments in the shares of a large firm are not capital guaranteed. Capital inputs can be lost or eroded through greed, ignorance, or bias depleted through management inefficiency, or even wantonly destroyed (Des Jardins, 2001, p. 132). Hence management can create financial risk through their incremental decision choices.

The underlying intrinsic and monetary concern of the investor is the maintenance of the invested capital and its associated opportunity cost of capital – that management will not in fact make decisions that will cause these to be minimised, within the time frame that the investment is held, or is intended to be held. At some point in the future it is expected this investment will be repaid, with an associated return on capital. As Kendriksen (1970) points out,

> ....the concept of capital maintenance is also important to bondholders, preferred stockholders and the providers of short-term credit. All of those equity holders are interested in the probability of repayment at some future date. The prospect of repayment is less if the capital is diminished either through losses or by the payment of dividends in excess of earnings.....Since invested capital reflects, in part, the ability of the firm to continue the payment of a return to equity holders in the future, changes in the amount of invested capital are vital in decisions regarding the future flow of this return to any class of equity holders (Kendriksen, 1970, p.127).

As pointed out by both Hendriksen (1970) and Staubus (1959)[3] shareholders have residual equity in the firm, and upon final liquidation – the net assets. The reporting of changes in the investment capital is consistent with both the stewardship role and contracting theory (Holthausen & Watts, 2000). Although the interests of individual principals will differ and are not equal – their basic homogenous interests or utility preferences can be ranked as:

(a) information that can offer insights into the current financial risk associated with their investment?[4]

Then,

(b) based on an operational continuum, and the accrual system of accounting, stakeholders '*demand to know how much a concern makes in a year*' (Hatfield, 1962, p.11).

Once this information is established, investors and creditors can then make individual decisions regarding their alternative courses of action. Unfortunately, the issues of adverse selection problems may arise which are essentially information-based problems because the principal is unable to accurately report the agent's input choice, the principal is not in a position to verify information that is private to the agent (Chua, 1986, p. 616).

3.3 Agency theory and Utilitarianism

Agency theory also highlights the human behaviour of self-interest: self-survival or self actualisation, depending on one's economic circumstances. Watts & Zimmerman (1979: 1986) in their theory on positive accounting assume the self-interest of individuals – utility maximization (Chua, 1986). Personal utility maximization may influence manager's decisions to the extent that the interests, or indeed the choices of individual stakeholders or indeed groups of stakeholders, are not considered (Regan, 1989).

Even if management decisions and choices are undertaken with the presumed goal of economic efficiency and providing 'good' to the greatest number of stakeholders (Des Jardins, 2001). For example, to change technology, run down certain assets in terms of quantity and value, or the disposal of business segments, can influence the firm's potential to pay the accounts. Even if the firm's management are acting in 'good faith', they may decide that the firm should be merged, sold, or even dissolved, in the next few years. Often the outcome of business decisions of this type

can be to the detriment of indirect participants that did not form part of the contractual agreement (VanDeVeer & Pierce, 1998).[5]

Legal and regulatory controls endeavour to reduce this self-interest and management bias, however the expectation of external parties is that of responsibility.[6] This expectation of responsibility is evidenced in the term *contractarianism* which is applicable between agents and principals with a direct monetary or human capital input to the firm (Regan, 1998).

> Here, very crudely, is the root idea: morality consists of a set of rules that individuals voluntarily agree to abide by – as we do when we sign a contract (hence the name; contractarianism). Those who understand and accept the terms of the contract are covered directly – have rights created by, and recognized and protected in, the contract........And there is nothing in contractarianism of the sort we are discussing that guarantees or requires that everyone will have a chance to participate equitably in framing the rules of morality (Regan, 1998, p. 106).

4. Business And Professional Trust

Nevertheless, the basic rules of morality are related to honesty and trust. When these are not introduced into business transactions or the financial accounting systems and reporting process, the calculations and estimations associated with future cash flows and risk factors are questionable.

> Equity, trustworthiness and fair dealing relate not to some morality higher than and beyond the bounds of commercial affairs; they are necessary conditions for the continued and more or less harmonious collaboration between parties

with diverse and sometimes opposing interests in property and power (Chambers, 1991, p. 20).

The prospects of a firm are predominantly reflected in economic forecasts, based on its performance, and reflected in the share price. Eventually, the market price of the firm's shares will reflect dishonest and/or inefficient management practices. 'Market forces tend to pull factor prices in line with consumers' valuations of the output forgone' (Gould, 1962, p. 220). Unfortunately, there can be a time lag between the actual activities and the market's perception of this increased risk. So, at all times the information communicated by firms and their advisors in the financial reports requires a faithful representation of the economic activities of the firm.

Nevertheless, information itself does not predict action – it provides an objective basis for limits, both financial and general to be predicted. Dishonesty, interpretation and subjectiveness is not isolated to management decisions, it can also undermine the preparation of the accounting information. Many members of the business community, including the accounting profession, have come to see their job not to provide financial information to represent the substance of business activities, but to help businesses use the rules or options in accounting standards to distort financial outcomes (Frohnen & Clarke, 2002). Financial analysts are also responsible for using the financial reports to supply investors with information that is free from bias and of high-quality information (DiPiazza Jr. & Eccles, 2002), that is useful to their decisions making.

The usefulness of accounting reports for decision-making are deemed to be fundamental to the theory and practice of accounting standards, although if it is not understandable it is not useful[7]. Walker & Jones (2003) have recommended the

redefining of the term 'understandability' in order that quality of the information provides the user with a basic knowledge of commercial affairs.

> .....the phenomena which are being abstracted in financial form...Failing to achieve such a recognition, the report becomes a statistical abstraction to him (Fertakis, 1969, p. 690).

The user, even with a basic knowledge of commercial affairs, may find the diversity of measurements contained in the accounting standards confusing. The range of measurement alternatives requires judgements and interpretation by management, accountants, and users. It is with these judgements and interpretations that further opportunities for misleading, biased or even dishonest information, can arise. Although some agent managers and indeed accounting professionals may accept moral or legal responsibility for bad management practices, others may not, as the financial risk rests with the creditors and shareholders of the firm. As many creditors have secured loans the predominant financial risk eventually resides with ordinary shareholders.

The self regulation of the accounting profession relies on honesty and trust. Shearer (2002) expressed a need for accountants to become involved in the moral dimensions of economic life and explore the adequacy of economic accountability given our increasing globalisation of a market driven, or consumer oriented economy. However, 'what is morally right should not be thought of as identical with whatever maximizes utility', particularly management utility (VanDeVeer & Pierce, 1998, p. 26).

Avoiding moral relevance is not in the best interests of professional integrity for any profession. Therefore, the call for the profession is to reflect on the options

available to overcome some of the problems and to consider that 'what is right' is what users want (VanDeVeer & Pierce, 1989, p. 25). A minimum effort to optimise the qualitative characteristics of relevance and reliability would be to reduce opportunities for interpretation, uncertainty and dishonesty. This suggests information is prepared at a level of integrity that offers users the opportunity to make their decisions, regarding the actual behaviour of the entity (VanDeVeer & Pierce, 1989).

4.1. User Utility

Nonetheless, Fertakis (1969. p. 683) in his discussion on the nature and scope of user queries for accounting-based information, highlighted that the 'user is a shadowy figure at best'. Furthermore, the conflict in utilities and needs of each user may not provide information that results in aggregate utility, and indeed even an assignment of a utility to different users albeit with similar interests can be arbitrary (VanDeVeer & Pierce, 1998). There is also a lack of guarantee that all users of accounting information are provided with an equitable chance to obtain the information that is suitable for their specific decision-making needs.

> In view of the lack of a definition of a single user of the accounting statement response, the logical question then becomes whether all these potential and real users might be asking different questions for which a single response may suffice (Fertakis, 1969, pp. 683-4).

A single response in the form of a set of general purpose financial reports is viewed as information suitable for key decision-making needs of all concerned parties. These groups are not considered to have strictly homogeneous needs. Based on the previous discussion however, it is considered herein that there is a user utility preference in

terms of financial information. This is consistent with a preference ranking of (a) the need to ascertain the firm's financial risk, and (b) use information on projected future cash flows and profit to allow individuals to choose between their personal financial alternatives.

> Shareholders must make economic decisions about whether to maintain their investment in the company's shares, and whether they should sell their shares or buy additional ones. These decisions involve a comparison of the rewards expected to be derived from retaining the existing shares in the company with the costs incurred in retaining them, and the risks incurred. The rewards come primarily in the form of dividends and appreciation in the share price, whereas the risks take the reverse form; the cost of retaining shares is given by their current selling price (Barton, 1982, p. 13).

This is consistent with an efficient market, however, uncertainty and/or dishonesty is proprietary, or 'insider' information.

5. Asset Valuations

One controversial approach for accountants is the financial risk associated with dishonesty and uncertainty is terms of asset measurement (Chambers, 1964, 1991; Bell, 1982: Lee, 1989). Blaikie (1962) highlights the professional change from the term 'balance-sheet' to that of 'financial position'. He also states that

> We first ruled out 'condition' in a possible title for the statement – on the grounds that it conveyed ideas of realizable value, and possibly liquidation.......At the same time the profession had discontinued use of the qualifying adjective 'financial' (Blaikie, 1962, p.512).

The diversity in the asset valuations contained in current financial statements is discussed briefly in Table 1. These different attributes for heterogeneous user utility are consistent with viewpoint of Staubus (2004a and b) who highlights the job of accountants is to separately value individual assets and liabilities in the balance sheet, providing surrogates for economic value.

[Table 1 about here]

Table 2 displays a taxonomy of the (a) attributes, (b) emphasis, (c) focus in financial reports, and (d) decision-usefulness of a measurement system. Specifically, the historical cost system, and the normative accounting systems of replacement cost accounting (Edwards and Bell), Chamber's system of Continuously Contemporary Accounting (CoCoA) and the mixture of these diverse measurements or values, consistent with the decision-usefulness approach of Staubus (2004)[8]

[Table 2 about here]

As outlined earlier, in their literature debate over the decades both Staubus (2004a) and Chambers (1991) maintain 'decision-usefulness' as the primary objective for financial reporting. Staubus and Ijiri (1975) support the use of a mixed accounting system to suit the performance of individual decisions, particularly those of investors. The difference between the focus of financial information is highlighted below by Staubus, who states

> My work on external financial reporting has always focused on the world of investors in securities who are concerned with the enterprise's future capacity to pay (cash, in the normal course of enterprise activities, unless otherwise stated). The result has been an emphasis on the positive and negative cash-flow potentials of enterprise assets and liabilities. In the absence of observable market quotations for those cash-flow potentials, a surrogate

market price must be chosen on the basis of its reliability and its relevance to investors' cash-flow-oriented decisions.....she typically seeks information *from the enterprise* that will help her judge its capacity to pay dividends over some investment horizon. I call that *cash-flow-oriented information* regarding *the enterprise.* In sum, Sydneysiders start with a focus on financial position (an enterprise's liquidity position), and the decisions of people controlling the enterprise's spending transactions. I start with the decision-usefulness objective and decisions by external investors who are vitally interested in prospects of cash flows from the enterprise....(Staubus, 2004a, pp.269-70).

Theoretically, under a mixed measurement system, each measurement method will be matched to the particular attribute.[9] The variety of measurements, that is, fair value, market value, net present value, replacement cost, and historical cost accounting, are all underpinned by qualitative characteristics. The proposition underpinning this approach is that 'what is measured will get managed' in a measurement system that is based on reality and prudence. The calculations for individual value-in-use assets controlled by the firm are proprietary information – the details of which are not disclosed in the financial reports. They are not subject to public scrutiny.

Arguably, the most relevant economic value of an asset is its present value of its future cash flows. This will be incorporated in the 'second-bid' price of an item that has an active market. When an active market is not available for an individual asset – value-in-use asset other proxy valuation approaches are used. These are considered briefly.

5.1 Discounting future economic values

The practice of discounting future interests finds a contemporary expression in the economic concept of discounting the present value of future payments. In this view, one dollar held now is worth more than one dollar held at some time in the future because we could invest that dollar today, earn interest on it, and therefore, have more than one dollar at that future date. Thus, future dollars must be discounted to be equivalent to the present value (Des Jardins, 2001, p. 78).

Although from a philosophical perspective the future is important for discounting asset values and future cash flows across time, from an economic perspective, the longer term future looks less important (Norton, 1998) and there is empirical evidence to support the theory that the time preference for decision-makers is 'the present' (Hardin, 1988), as the uncertainty of the occurrence of future values counts for less than the present (Des Jardins, 2001).

Des Jardin (2001, p.78) also suggests that no matter the size of the discount rate, 'any discounting eventually reduces future values to nothing'. Interests can vary, and indeed discounting applies to money and items that be exchanged for money. Money invested at compound interest today will not buy the same in the future as it does currently, although it will buy something different (VanDeVeer & Pierce, 1998, pp.458-9).

So if an asset cannot be bought or sold and it is measured at net present value, then the firm can gain something 'equivalent' if a discount rate is used (Goodin, 1998) - an ability to adapt and replace items for ongoing operations. The use of a discount rate introduces a subjective decision on the financial risk underpinning the firm's activities and also the uncertainty associated with future cash flows. The

calculations include a range of probabilities from the lower bound level to a higher bound level, together with associated results. As mentioned earlier, using a result based on the choice of the lower bound probability level of any measurement can also introduce distortion similar to conservatism.

5.2 Alternative measures.

Adopting the approach by Staubus (2004a,b) of matching the attributes with measurement, the use of replacement cost, fair value, current market value, and original cost are well established (Mock & Grove, 1979). The result is

> ....accounting's well-know aggregation problem. The aggregation problem refers to the fact that the monetary amount assigned to total assets is obtained by adding together a variety of items which are individually 'measured' in terms of various attributes such as current general purchasing power (for Cash), current Market value (for Marketable Securities), historical cost (for Land), "unexpired" historical cost (for Buildings and Equipment), present value of expected future benefits (for Capital Leases), etc....The dollar total derived from adding such a list has no *objective* referent in either brute physical reality or in institutional reality (Mouck, 2004, p.535).

This discussion albeit briefly reverts back to the arguments presented for adoption of the normative theories of Current Cost Accounting, Continuously Contemporary Accounting (CoCoA) particularly measurement and additive issues espoused by Chambers.

5.2.1 Current Cost Accounting

Replacement cost assists in the measurement of decision attributes associated with the maintenance of operating capacity, although historical cost is preferred for purposes of measuring monetary stewardship. Replacement cost is aligned to the value to the business (Lee, 1989) vis-a-vis the attribute of an individual asset. In terms of reliability, it is only the competing measurement systems of replacement cost, present value and market value that are at issue (Mock & Grove, 1979).

Ijiri (1975, p. 98) argues against the use of replacement cost as a basis for the measurement of performance, unless the information is tailor-made to specific decisions and report and a particular time. Replacement cost is deemed satisfactory when resources are replaced or frequently disposed. However, if the disposal of an asset is remote from the present decision-making, the use of this measure may not be suitable for performance measurement.

5.2.2 Continuously Contemporary Accounting (CoCoA)

Chambers (1964) viewed accounting as a system of measurement rather than valuation, and as such is based on an assignment of monetary units or numbers, which are additive. Chambers measures the economic cost arising from the opportunity to sell the assets as an alternative to its ongoing use – the cash flow available in the immediate future to support and maintain a continued economic existence. That is the selling price in an orderly market.

His capital maintenance concept refers to the total stock of net assets owned by the firm at the beginning of the period, and profit is measured by periodic comparisons of stocks of adaptive capital. It is his belief that firms' constant change 'as any severable means in the possession of an entity' (Chambers, 1966, p.120),

severable is taken to mean that these are capable of conversion by exchange or in the process of production.

Basically, can the firm pay for what it has undertaken or intends to undertake without reducing the shareholders capital? Chambers reduces uncertainties by including reliability of cash flows based on net realisable value of assets should they need to be sold to avail management of cash to pay bills or indeed to ultimately return the capital of the investor. However, Chambers method includes advantages and criticisms: Briefly, Stamp (1983); Perrin (1976) and Trowell (1977) outline the following:

- Time and cost involved in obtaining NRV on all non-monetary assets, and verification of restated values could be difficult. However, the assets NRV rules may be embodied in rules or standards.
- If the market was glutted with a particular product/asset, NRV will be artificially depressed. Resale markets are volatile and far from perfect.
- Shareholders should gain from holding assets, as well as the trading of them (unrealised profit).
- The criticism that current cash equivalents is not additive – this is the only the cash if purchasing power is additive.
- The objective of decision-usefulness is relevant, although past decisions need to be evaluated.
- The maintenance of capital should be ascertained based on specific rather than general purchasing power.
- CoCoA does not satisfy the stewardship function.

One of the main criticisms of the use of Chambers method, was the need for a complete change in the system, as value-in use assets and depreciation are ignored.[10]

The method does however offer users' decision-making utility, particularly associated 'financial risk'.

The normative systems outlined above were formulated to replace the historical cost system, not provide homogeneous characteristics specifically for individual measurement options for individual asset attributes (Staubus, 2004a). The current application of 'fair value' to assets without a market requires the installation of internal information systems to support the value provided in the balance sheet (Schipper, 2005). This internal information may assist in fundamentally representing the reality of the measurement basis for 'value-in'use' assets. Consistently, so does the compilation of an information system to support the range and determination of a particular market value on the balance sheet. However, there is chasm between the construction of valuations in the internal system, the options for management choices, and the facilitated representation of the measurement eventually communicated for 'user needs'.

The primary focus of any accounting information system is to consider the issues of accountability, decision-usefulness, specifically financial risk and profit, and stewardship, albeit all under the umbrella of professional integrity. As stated previously, the use of market values, and indeed any asset value can be questionable when surrounded by uncertainty and dishonesty. In order to obtain insights into areas of potential financial risk, the financial reporting framework must support legitimacy of the profession.

6. Discussion and Recommendations.

On an ongoing basis, a lack of corporate governance or dishonest business practices will ultimately be reflected in the firm's share price. To a degree some

aspects of management practices can be controlled through legislation and regulatory constraints. However, there is a time lag between dishonesty aspects, and their inclusion in the share price. In the meantime, uncertainty issues can compound information alternatives and user decisions.

In terms of individual asset values, their market price contains the market's reflection of the net present value of its future cash flows. Thus presentation of financial reports based on assets with an active market immediately indicates the present value of their cash flows to the user. The 'bid' at an auction is deemed to be the value corresponding to the market's perception of the net present value of the asset's future cash flows. Uncertainty reduction and reliability would suggest that the choices surrounding the firm's choice of market 'bid' or value be fully disclosed. Then the use of an active market can reduce some opportunities for subjectivity and distortion in calculations together with opportunities for interpretation, and also for management to 'smooth' earnings.

In addition and based on the afore-mentioned user-utility ranking preference, Chamber's approach can provide a simple, understandable balance sheet and income statement. The use of a selling price in an active market is a financial reality that supports economic reality. Unfortunately, the conceptual framework accommodates the valuation of individual assets on the basis they promote the total net information utility of financial reports. Chambers approach is towards a system where all non-current assets are measured, and if there is no applicable selling price, there is no measurement or valuation attached to that item.

In practical terms, a point of commencement to retain reporting credibility is the reclassification of balance sheet to accommodate the different values of non current assets. A section indicating the items with an active market and their

associated selling price, consistent with a specified 'bid' can be aggregated, and associated ratios determined.

For individual utility, different users have different utility preferences and different perspectives of income. Therefore, to accommodate those individual users who require details of assets without an active market value, the chosen proxy measurement, together with its chosen probability associated with uncertainty calculations can also be disclosed in a separate classification on the balance sheet, or alternatively a supplementary statement to support market values in the balance sheet, consistent to the suggestion by Walker & Jones (2004). This approach is also consistent with FAS 157 *Fair Value Measurements* issued September, 2006.

This outlook would add clarity, and a logically consistent reporting practice to provide investors and lenders information to sufficiently undertake decisions based on their individual preference for financial risk. There are also opportunities to expand the classification areas, or alternatively supplementary information.

This expansion of classifications to aid visibility is not a new phenomenon. For example, Ijiri (1975) developed an axiomatic structure, to provide alternative ways to determine price (e.g. replacement cost, net realisable value) and also for the determination of quantities.

> We have emphasized that alternative valuation methods arise from differences in the axiom of exchanges and not from differences in the axioms of control or quantities. In other words, a recording of transactions based on quantity measures provides the basic data useful for any valuation method. Since the valuation measure is a product of price and quantity, transactions in quantity measures can be recorded and reported regardless of what prices are to be used (Ijiri, 1975, p. 99).

Distinctive users that is, the various publics, have different information requirements, albeit in a profitable 'going concern'. To aid transparency, Ijiri's (1975) supporting information may include non-monetary measurements which are also associated with a triple bottom line reporting approach (Hughes II, 2000; Möller & Schaltegger, 2005).

Future research efforts may explore user needs in terms of the content of supplementary information in financial reports, and the relationship with the financial results and/or nonfinancial results. Furthermore, the perennial topic of the inclusion in the balance sheet of 'value-in-use' assets that have no active market can be revisited in light of segregated or supplementary information.

Standard setters are at the forefront of measurement and reporting processes, and

> ....the ever-expanding information demand for accounting information may be because of this intrinsic ambiguity which allows complex trade-offs among interest groups (Chua, 1986, p. 617).

Ultimately, the legitimacy of a firm must be supported by the willingness of investors and creditors to assign their funds to its commercial activities. Hence the discussion in this paper has reverted to the basic rationality upon which the foundation of mainstream accounting information commenced.

7. Summary

The use of conservatism or prudence began the discourse in this paper. It highlighted that conservatism or prudence, can add distortion even to market information, unless it is supported by associated lower-higher bound levels upon which the valuation was determined. Catlett (1962) indicated a return to the 'natural

conservatism' or cash basis as the preferable choice to maximise total user utility and reduce financial risk. As this is an extremely dubious prospect –the use of a reclassification reporting approach based on selling price offers a diminution in conflicts associated with the interpretive aspect of accounting information.

Yet, decisions of the majority of users relate to financial risk in some context. To gain the necessary information users are required to interpret a heterogeneous mixture of past acquisition costs, replacement costs, and market values in the same balance sheet (Lee, 1989) without full disclosure of the associated probabilities surrounding their inclusion. Hence, perspectives were presented suggesting that users of financial reports have personal risk preferences upon which they make investment and decisions in relation to their resources (a) a user utility preference for financial information supporting the segregation of asset values for non-current assets, particularly those with market values, together with (b) a reduction in opportunities for management choice on the range of probabilities associated with values for example, fair value, and also value-in-use .items.

The dialogue in the paper has been developed to more finely attune financial reports with the credibility and integrity of the accounting discipline. The comments herein should be viewed as a mixture of eclectic insights offered to gain a fuller understanding of user needs for a simple and understandable set of financial reports that aid transparency.

It is not suggested that the concepts outlined can completely eliminate the problems relating to uncertainty, manipulation and distortion in financial reporting. Although the sequential utility benefits may outweigh the costs of implementation, and these concepts may add value when defending criticisms levelled at the

accounting profession. It may be an opportune time to consider these issues alongside legislation to restrict dishonest management and business practices.

> We had come to realize that, in the words of an early *Accounting Research Bulletin*, 'the test of the corporate system and the special phase of it represented by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole – not from that of any one group of interest parties'. But if the results are to be judged in a test of the corporate system, then there must be a common ground of understanding between the results and the judges. And this common ground must be achieved on trust derived from honest and effective reporting (Blaikie, 1962, pp.516-7).

NOTES

[1]For the purposes of this paper the primary users are those who stand to lose the most financially on the failure of a corporation – the investors, lenders, creditors, and even employees.

[2] A term used by Fertakis (1969)

[3] George J. Staubus, "The Residual Equity Point of view in Accounting," Accounting Review, Vol. XXXIV (January, 1959) p.13; cited in Kendriksen (1970, p. 501).

[4] The term original 'capital input' refers to the initial funds invested at original dollars. Shareholders will always prefer to have this return, plus any opportunity cost of this capital during the time period it was used by the investment firm. This may not always arise. The opportunity cost of capital will be foregone, however investors would be concerned if their original capital input is lost. The investment amount may take a substantial time to recoup.

[5] This point formed the basis for Rawls (1971) in his book A Theory of Justice.

[6] This is increasingly evident in the current stakeholder focus on corporate governance and citizenship issues. The Social Reporting Index (SRI) for firms perceived to be displaying corporate citizenship management goals supports this viewpoint.

[7] Lev and Zarowin (1999) found that the usefulness of financial accounting information decreased during the 1978 – 1996 period, and particularly for firms that incurred research and development expenditure.

[8] These normative theories were each based on the assertion that the historical cost information results in more adverse consequences than good outcomes, for decision makers.

[9] The reader is referred to Chambers, R. J. (1964) and Abdel-Magid, M. (1979).

[10] For the purposes of this paper the debate on the concept of purchasing power parity for the original capital in terms of measurement additivity is excluded (Barton, 1982).

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Table 1

Information Needed	**Attribute**	**Measurement Method**
Liquidity:		
Stewardship of capital Realised profit	Contributed capital in original dollars Actual dollar amounts of items sold	Historical cost
Potential cash commitments	Operating capacity	Replacement cost
Potential cash proceeds Unrealised profits	Market value	Market value, replacement value.
Net cash position	Net present values	Present values.
Impact of inflation	Nominal dollars – purchasing power changes	Purchasing power parity adjustments
Fair value	Quasi market values	Present values

Adapted from Mock and Grove, (1979, p. 94)

Table 2

System	**Attribute**	**Emphasises**	**Income statement**	**Focus**	**Decision-usefulness**
Historical cost	Investment Stewardship	Balance sheet	Realised profit	Maintain invested resources	Limited: based on past information
Replacement cost (Edwards and Bell)	Potential cash commitments/ productive capacity.	Income Statement	Unrealised profit – value change (holding gains)	Product capacity (replacement of)	Relevant and reliable.
Chambers	Investment Decision-usefulness	Wealth and financial position Adaptability	Purchasing power and holding/gains losses	Decision usefulness and financial risk/liquidation .	Relevant and reliable

Staubus	Investors' and capital market decision-making needs.	Income and cash flows.	Current cost and maintains the realised profit concept	Decision-usefulness (investors' perspective)	Relevant