How Corporate Reporting Underpins a Financial Conception of the Firm

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Demand for corporate financial reporting

- Stewardship accounting and accountability:
  - ➢ Have directors and managers of a company used the resources entrusted to them by shareholders in an appropriate manner?
- Investor and creditor decision-making:
  - ➢ Should I buy, hold or sell equity shares in a company?
  - ➢ Should I lend money to a company?
- Taxation:
  - ➢ How much tax should a company pay in a given period?

Early influences on stewardship accounting

- Landed estates:
  - ➢ Medieval manors and the duties of a steward to the lord of the manor
  - ➢ The strict settlement – trust structures and separation of capital and income
- Double-entry bookkeeping:
  - ➢ Recording of transactions – bias towards historical cost
  - ➢ The early balance sheet

Early corporate accounting – I

- The incorporated joint stock company:
  - Originally required royal charter or act of parliament
  - Companies in regulated industries such as railways:
    - Double-account system, based on separation of capital and revenue accounts
  - General company statutes from 1844
  - Rudimentary requirements for annual balance sheet
  - Legal restrictions on payment of dividends

Early corporate accounting – II

- Early accounting conventions:
  - Assets recognised only if they have a measurable cost
  - Assets not normally shown subsequently at an amount greater than cost – **prudence**
  - Fixed assets with limited useful lives should be depreciated, irrespective of fluctuations in market value – **going concern**
  - Known losses and expected liabilities should be accounted for immediately, but expected gains should be included only when realised – **prudence and realisation**

From stewardship to decision-usefulness – I

- Countries such as France and Germany tended to prefer conservative, stewardship-focused, corporate reporting
- In the USA, regulation of corporate accounting was a by-product of the post-Wall Street Crash regulation of stock markets:
  - Emphasis on protecting **potential** as well as current stockholders and bondholders
  - Different philosophies of accounting

From stewardship to decision-usefulness – II

- Emergence of formal statements of accounting principles:
  - UK – *Recommendations on Accounting Principles*
  - USA – *Accounting Research Bulletins;* Accounting Principles Board *Opinions*
- Accounting standard-setters:
  - UK – Accounting Standards Steering Committee (1969)
  - USA – Financial Accounting Standards Board (1973)
  - International Accounting Standards Committee (1973)

Decision-useful financial reporting

- Objective of general purpose financial reporting:
  - To provide information about reporting entities that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity
- What decisions?
  - Buying, selling or holding equity and debt instruments
  - Providing or settling loans and other forms of credit
  - Exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources

The balance sheet and its “elements”

- **Asset**: a present economic resource that has the potential to produce economic benefits.
  - Economic resources are rights that have the potential to produce economic benefits
- **Liability**: a present obligation of the entity to transfer an economic resource as a result of past events
- **Equity**: the residual interest in the assets of the entity after deducting all its liabilities

Measuring assets

- Entry values:
  - Historical cost
  - Replacement cost
- Exit values:
  - Value in use – present value of future net economic benefits
  - Net realisable value (fair value less costs to sell)
- Fair value is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date"

An example – leasing

- Traditional view:
  - Lessee is not the legal owner of the leased item, so cannot reflect an asset
- Form and substance:
  - Lessee is "in economic substance" the owner as the lessee has virtually all the rights and obligations associated with ownership
  - Therefore recognise an asset and a liability for the future lease payments
- Current view:
  - Lessee has an asset in the form of the "right to use" the leased item and a liability representing the present value of the future lease rental payments

Accounting and a financial conception of the firm

- Increasing use of fair value measurement:
  - Financial assets and liabilities
  - Non-financial assets and liabilities
- The problem of intangibles:
  - Often not recognised if there is no measurable “cost”
  - Importance of business combinations – identifiable intangibles measured at fair value and included on consolidated balance sheet
  - Existence of acceptable valuation methods helps to define what the intangible is in legal terms and facilitates marketability

Integrated reporting and multiple "capitals"

- Six capitals:
  - Financial
  - Manufactured
  - Intellectual
  - Human
  - Social and relationship
  - Natural
- Will new International Sustainability Standards depend too heavily on a financial model?

Final remarks

- Assumption that shareholders are prime stakeholders:
  - ➢ Applies in practice to both stewardship and decision-usefulness accounting
- Alternative approaches available:
  - ➢ Integrated reporting
  - ➢ Value-added reporting
- Accounting, through practices of recognition and measurement, helps to define and reinforce legal rights and obligations and is therefore central to the “coding of capital”

Thank you!

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