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"How should corporate reports be made valuable ? A study of professional initiatives especially in North Britain - 1971 - 1991"

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HOW SHOULD CORPORATE REPORTS BE MADE VALUABLE?

A Study of Professional Initiatives

especially in NORTH BRITAIN

1971-1991

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Summary - Accounting systems and traditions have been studied in their depth and diversity throughout Europe. Here less official, professional initiatives are examined especially for interaction with legislation and within the regulatory framework for corporate report established in Britain in 1990. Distinct roles for English and Scottish chartered bodies and for academics are evident; but their initiatives are not welcome to those seeking harmonised reporting throughout the European Community.

Challenges to the Professions

"Forging Accounting Principles in Five Countries" was the title of Stephen Zeff's study up to 1970/71. Efforts in England and Scotland were described therein. And subsequent events are too numerous to be described here extenso. We may however narrate and highlight some relatively recent developments which will illustrate recent expectancies in the UK from the European Community and national legislation and also the roles expected from officials, auditors and academics. On many matters, the United Kingdom will appear imperfectly united!

Problems for British accountants may be traced to their successful expansion throughout the Empire and United States until the end of last Century. Then American branches achieved some independence and often provided leadership in the Big Eight or Six. Problems of auditing branches in many countries prompted multinational accounting firms to seek high and uniform audit tests and accounting practices which enabled group consolidations. This search inspired the efforts of the FASB and of the IASC; and it has been the chief motive for so much of the research and technical work of the Big Six in UK.

David Solomons (taught in Bristol, the London School of Economics and Wharton, Philadelphia, demonstrating his Englishry in important proposals for the education of accountants and now for guidelines on standards), Peter McMonnies (editor of "Making Accounting Reports Valuable", former director of research with the Scots Institute and Thomson McLintock, KPMG. After 1964 when the Scots Institute became a member, McMonnies collaborated in projects of the Union Europeene des Experts Comptables Economiques et Financiers (UEC) such as the multilingual Lexicon) and David Tweedie (McMonnies' successor in Thomson McLintock, Visiting Professor and now Chairman of the Accounting Standards Board from 1991). These and many more have collaborated with verve in 'research' directed towards change in Corporate Reporting.

If the motivation was not only an alleviation of the problems of diversity of practice, alternative springs of action may be sought. Competition between accounting firms was certainly growing, and was intensified by structural change and take-over. But other internal professional changes and pressures may be traced. Recruitment and education have been competitive, and subject to 8th Directive, (UK 1989 Companies Act, sec.II) pressures where chartered accountants sought registration to audit. Management (CIMA) and public sector (CIPFA) accountants were also recognised by Privy Council Charter. The former have contributed their own report on 'Corporate Reporting: the Management Interface' (1990).

Since the failure in 1970 of merger proposals, a Consultative Committee of Accountancy Bodies had sought collaboration among the chief six accounting bodies in the British Isles. External relations, auditing practices and accounting standards were the chief activities of its committees. Neither this committee nor its important subordinate committees fully co-ordinated the initiatives by the research committees of the institutes members. The relation of the Accounting Standards Committee to these initiatives is also problematic (unless in patronising the work leading to the "Corporate Report" of 1975. For the present, we point to originating ambitions located neither at international nor European level nor in UK collaborative committees but within Scots and English institutes which attempted ambitious research into the frameworks and applications of corporate accounting.

The arena of accounting in the UK (and also in Ireland) has thus within the last decade at least been not only changing, but also often confusing and very competitive. Other institutes developed strategies for continuing independence, when merger proposals failed; and there were many initiatives. Some of these only are here to be chronicled. But first we may review progress in standard setting, and note the academic collaboration there partially received.

An Accounting Standards Steering Committee was set up in Britain in 1970 at the instigation of Prof. E. Stamp of Lancaster University. Sir Ronald Leach of Peat, Marwick and Mitchell was a leading early chairman with membership allocated among the six accounting bodies according to budget contribution. From 1976, the committee was re-named The Accounting Standards Committee and issued consultative documents, exposure drafts and ultimately Statements of Standard Accounting Practice (SSAPs).

"The Watts Report" of 1978 recommended a widening of membership to include not only preparers but also users of accounting reports and some civil servants. Academics have played important roles in the ASC, (e.g. Bromwich of LSE; S. Gray of Glasgow).

Twenty-five SSAPS have been issued to June, 1990 covering major or minor problem areas from Acquisitions and Mergers to Leases. Revisions have become necessary for certain practices. In other areas, the ASC has preferred to issue a Statement of recommended practice (SORP) for such matters as pension scheme accounts or charities. Uniformities with acceptability have been sought usually by tighter prescription than that attempted in the Standards set by the International Accounting Standards Committee.

Both for ASC and IASC Standards, there are problems of enforcement, which some hold will be minimally necessary provided that auditors report departures from standards in any Accounts which they certify. Mme Downes (FRTWF, p.57) suggests that "sophisticated, informed senior management is no longer prepared to be hustled by SSAPs, SORPs and the threat of a qualification."

Among the most contested problems have been appropriate treatments for price-inflation, which exceeded 10% before and after 1980 and in 1990. Exposure drafts 8, 18, 24, 35 resulted in a provisional standard and a formal standardisation of current cost accounting from 1980 through

efforts to have current rather than historic price-levels comprehensively adopted, rather than ad hoc revaluations.

The Corporate Report was the title of a study prepared under the chairmanship of Derek Boothman of the English Institute for the ASSC in 1975. Stamp and Peasnell of Lancaster University were among those responsible for the preparation of a radical document of 103 pages. There were new terms and assumptions. Annual Accounts were converted into a comprehensive package to meet "user needs". Entities were responsible custodially for the resources they used. They should report in manifold form - Value-added; Employment; transactions with government; Foreign currency; Prospects and objectives; Social accounting, etc. Varied bases for "measurement" were suggested, with value-to-the-firm deserving research. Although inflation was a preconcert of that time, "The Corporate Report" found varied rapport in pre-Thatcherite Britain and prompted many experiments in reporting format. The study clearly influenced ideas more than a decade later. Moreover it encouraged the idea that a professional committee could make an important contribution on the scope and content of annual reports as long as its basic assumptions were not seen as tendentious, parochial or as researched and argued too shallowly. The Boothman Report contrasts in impact and depth with work on the conceptual framework of accounting and reporting.

The Regulation of accounting practice was carried further as a consequence of the Dearing Report on the Future of Accounting Standard Setting (1989). Review was necessary owing to the ASC's reduced authority, the increasing problems as to what constitutes economic reality, and the growth of securities markets, of international pressures and to the changes (noted above) in the UK audit profession. A Financial Reporting Council has therefore been established under Dearing himself. This Council works through a Emerging Issues Panel, a Review Panel with powers to insist on the re-issue of Accounts which failed to comply with standards, and a new ASB. This Board has paid members, David Tweedie being the first Chairman faced with technical and conceptual problems.

The challenges facing the Council and especially the Standards Board may be understood in the light of the above pages. Their work must move towards conceptual integrity, unless political or other forces prevent actions other than "firefighting" of issues suddenly igniting. These challenges

and the professional contributions which have aroused interest beyond England and Scotland must be placed in the perspective of a conceptual framework not for the firm or its accounting per se, but rather of its formalised and annualised reporting.

Such conceptual frameworks have been earlier sought in law or economics. But in America more recently it has been considered possible to found accounting in a reporting or indeed in an information role to "users". User classes have been distinguished, each with an interest definable in terms of amounts and certainties of future cash. The AICPA "Trueblood Report" (1973) supported such information and cash expectancies of the firm. FASB subsequently produced reports on decision-usefulness; on "elements" defined; and on the qualities of information.

Normative or empiric bases can be distinguished on which frameworks could be erected. In practice of course, hypothesised best practice may be tested against observed current principles or contrived tests. Much work has been devoted to tests of feasibility and acceptability and economic consequences. For instance, the interests and reactions to news of specific "user- groups" may be deduced or made subject of enquiry. TA Lee and Tweedie adopted questionnaire methods in clarifying what a sample of shareholders understood and felt about Accounts. Their conclusions were queried; but their methods represent an interesting alternative to the accepted categorisation of those with interests in a company and to any simplist/static reductionism of those interests.

When it is remembered how robust are the alternative normative and historicist Schools in the social sciences and economics, and how many new methods of critique are available, one must realise that no straightforward description of our texts is possible. Yet such a description must be attempted in the first place without any preconcern how successful the reports may be in providing a coherent base in establishing priorities between areas where further standardisation seems possible or more directly in aiding the solution of elusive problems.

Thus two institutes have sought to fill the gap in conceptual thinking on accounting in Britain, commissioning the Solomons Report or "Guidelines for Financial Reporting Standards" and "Making Corporate Reports valuable.

Making Corporate Reports Valuable was a discussion paper prepared by the Research Committee

advocate of Cash-flow and Net Realisable Values.) Participation from the South was obtained as early as 1987, when an early draft was "tested to destruction". A phoenix remains, however, as tribute especially to the enthusiasm and genius of Jack Shaw. (Jack has been part-time professor at Glasgow University for many years; and moved from a senior partnership with Deloitte in Edinburgh to be chief executive of Scottish Financial Enterprise till 1990).

The document is comparable in length with the "Corporate Report" of 1975; and has not dissimilar chapter titles. There are differences in assumptions and recommendations, however.

Decision-usefulness is the touch-stone, with the inference that accounts should portray economic reality. Legal form is denigrated in favour of "economic substance". Further similarities are seen in the information needs of management and of outsiders, with the conclusion that much of the internal data-base can be disclosed. Periodic rather than open (or real-time?) disclosure is assumed. And (so-called) current and future information is preferred to "past information".

Courageously, then, realisable values are to be reported by firms, in order to secure some additivity at current prices. They are also congruent with DCF investment models, and when summed NRVs can be compared with the Economic value reflected in each quoted firm's market capitalisation. The values of groups of interdependent assets, each with minimal NRVs, are to be noted. Historic costs are regarded as uninformative since yesterday's pound does not equal today's. Replacement costs will often approximate NRVs, but precise replacement is uncommon. Moreover they are not a "measure of value" (6.25).

Net assets are accepted as never signifying the real worth of the entity (5.20). The present value of all the future cash flows to the entity is too subjective to be disclosed, unless after research and experimentation in this area which is described as "Highly desirable". So that external users and management themselves should be aware of the approximate value of the unidentifiable (intangible?) net assets from which an entity benefits and which forms part of its market capitalisation. Meanwhile, MCRV considers that it would be helpful if managements disclosed market capitalizations, even though these are affected by many factors beyond their control (5.21).

They should also comment on the difference between market capitalisation and net book values.

Some exemplification of recommendations was given in MCRV, but more fully and recently in the specimen accounts of Melody plc (1990). A Statement of Changes in Financial Wealth shows first the wealth generated by operations (or EBIT), then changes (in NRV) of fixed assets, but no other value changes except in loan stock. Proposed dividends are then deducted to give a realisable change in financial wealth for the year. Distributable Wealth however requires a separate statement headed by the pre-dividend realisable change which is reduced by a sum sufficient to counter the effect of inflation on shareholder wealth. Opening and closing balances of "wealth" are then shown, adjusted for dividends proposed but specifically described as "not forecastable".

The management of Melody plc have set themselves Plans to the nearest thousand pounds for each line in the Accounts and show against the Actuals for previous and just completed years the forecasts made for the immediate past and incoming year. One notes especially the refusal to forecast the sums distributable to shareholders and the tightly conditioned certificate by the auditors or "independent assessors" of Actuals as well as forecasts (the disclosure of which is admitted (p.36) to be in contravention of Stock Exchange regulations!)

A preference for economic substance over legal form is variously expressed and applied. We read first of the need to "show what is actually happening" through financial reports which ought to "reflect economic reality"(1.2). Complete and fair disclosure is also justified, relevant at different levels to shareholders and to management (1.12). The latter are said, however to make little use of annual corporate reports, which concentrate on "the legal form of transactions more than on their economic substance and frequently does not reflect economic reality", concentrating on the past rather than the future, cost rather than value and profit rather than wealth and changes to it (1.13)

Reality is thereafter referred to, but not always helpfully, as numerous statements and disclosures are offered in a comprehensive "package". Objection is raised to the write-off and exclusion from subsequent balance sheets of Goodwill created on acquisitions, unless no value exists (4.17). Moreover strictly legal definitions of a group had made it possible to conceal the truth on control exercised in practice (4.18). Contrarily "arithmetic" calculations of relationships with implacably

rather than legal ownership, MRCV held that economic substance should always prevail over legal form (5.28).

Legal matters emerge also in brief reference to fraud. Management is required to disclose areas of special risk; but MRCV expresses itself unqualified even to suggest whether management should disclose significant fraud (5.35).

More important perhaps is the preference throughout for the term "management" in denoting those elected by shareholders to operate the company and to report whether they have managed its affairs properly (7.2). With current reporting, it is suggested (4.24), external report users are asked to take on trust the competence of management. "The Corporate Report" of 1975 had urged publication of more details on directors. MRCV goes further in asking for information on directors and managers to assist "lenders who invest in or lend to an entity to judge whether those who control its affairs are fit and proper people to do so" (5.45).

We may have samples enough the objectives, tone and content of MRCV which appeared prior to Prof. David Solomons' Guidelines for Financial Reporting Standards was prepared for the English Institute's Research Board after several reviews of progress by the American FASB (e.g. McVe, 1981). Our review may be based on Solomons' talk (1990) which began with an argument that diverse users are interested in profitability and viability, and can have their needs met together. And profit is best interpreted in terms of changes in balance sheet position, Assets and liabilities are therefore the only true elements of financial statements.

Valuation represents the prime problem; and this Solomons proposes to resolve at a "Value to the Business" or Current Cost or lower recoverable value. Profit is then the change in owners' equity during a period, excluding prior period adjustments and contributions by or distributions to the owners. However real financial capital is to be maintained with comparable purchasing powers.

Solomons gave attention to definitions, especially those of Faithfulness, Comprehensiveness and verifiability. Items should be recognised in accounts dependent upon their materiality and the

reliability of their "measurement". Detailed problems are faced in an appendix where for example it is argued that Goodwill should be excluded entirely from balance sheets.

MCRV and Solomons are compared by Whittington (1990) as originating in professional research committees, and intended for discussion and fruitful exchange. Both assume the same user groups and interests to which accounting data should be relevant. Both advocate a comprehensive income statement including asset appreciation, with a financial capital maintenance concept.

There are differences of course. Solomons focuses on two basic statements while MCRV proposes a wider package with information common in part to that available to managers. Relevance and economic reality are featured by both; but there is no general agreement as to how these should be achieved.

Further negotiations were also surveyed by Whittington (1990,p.103ff) with reference to a generally felt need for change. Some doubt was expressed on the new framework for regulation and standardisation. He felt that a well researched and reasoned framework based upon the MCRV/Solomons consensus might meet a serious need, dependent partly on the "Fundamental state of the market for financial reports". Audit competences and user exploitation of new information were also crucial.

Problems and implementation have been discussed on three occasions recently when the two research committees and others met, first in April, 1989 at Nantwich, and then in November at Edinburgh. From the first, symposium papers were published under the title "Financial Reporting: the way forward"(FRTWF), and from the second emerged precise recommendations on "The Future Shape of Financial Reports". Further discussions took place at an Accountants' Forum in Edinburgh in March, 1991; and the Scottish President, Ian Percy has taken MRCV, as exemplified in Melody PLC, to the American Institute and Australasia.

Before testing the latest Accounting Standards Board's releases for consistency with MRCV /Solomons (such as one might expect from the authority of David Tweedie), we may sample these lesser documents for key themes and important changes.

addressees. Copies of a summary version can now be posted to shareholders who express no preference for the full version (Coys Act, 1989.s.15). Accounting exemptions are available for companies of small or medium size. The publishing of statutory accounts in an official gazette is not required in Britain so there are no such constraints on the disclosure-package.

One alternative to communicating through Corporate Reports was referred to by David Solomons. The Securities and Exchange Commission in America now operates an EDGAR (Electronic Data Gathering Analysis and Retrieval system) to replace filings on paper, and make referral possible "on line". There could be a totally different menu of information and timescale of availability, he said: "What kind of accounting standards if any shall we need then?" (FRTWF,p.xvii).

More surprisingly, the Scots experts in periodic reporting made no reference to Events reporting, nor did they give any justification or rationale for periodicities of reporting.

Time series however were well covered in Skerrat's study of the Contribution of Market Based Accounting Research (FRTWF,p.59ff). Much research over twenty plus years carried out in the UK and USA supported conclusions, such as that capital markets see through manipulations of accounting data and often anticipate the news value in periodic releases. Nevertheless economies can be achieved if information is processed and released by firms. And cost-beneficial forms and quantities of disclosure may be found by firms slowly but by markets or regulators quickly, and then imposed. Regulators however may actually hold up change.

Skerrat advances some interesting propositions for disclosures. For instance, where one measure is arbitrarily chosen, users should be given information sufficient to calculate alternatives.

But (with Keynes) he sees that uncertainty arises less because of inadequate information on future flows than because of the problems in forecasting market reactions and price changes. Moreover he gives evidence that the managerial forecasts, prepared under a comparative disadvantage in macro-economics, are less accurate than those of analysts. But management will have a comparative advantage in assessing for instance what research costs should be capitalised, and should publicise the information lest private, insider gains be made from leaks in this and other areas,

The Future Shape of Financial Reports was prepared by an Action Group from the English and Scots institutes to extend the momentum of previous work into 1991 and forward perhaps for the new Accounting Standards Board to which David Tweedie transferred his loyalties.

Dissatisfaction is expressed with a financial reporting based on historic rather than current amounts; as focused on a single earnings number; as inattentive to cash; as backward-looking; and as emphasising legal form rather than the substance of transactions.

An improved package would include statements of

- + objectives and plans; for Future time;
- + assets and liabilities; for Current time;
- + income; for Past time;
- + gains; for Past time;
- + cash-flows; for Past time;
- + and on future prospects for Future time (cf.Sec.2-3)

Explicitly a "clean sheet" is preferred, largely ignoring existing and other legal constraints. Significant changes in the nature of financial reporting may affect contracts so that old and new methods might be required until contracts are revised. A final paragraph suggests that "further research should be undertaken to identify the extent and incidence of legal constraints, to determine whether their origin lies in national law or in European Community directives and to consider the nature of change required to overcome these constraints" (Sec.5-4)

New disclosures will reduce confidentiality. Complete openness could damage future profitability; and judgement is required by management (1-4). A brief justification for comparability is given. But consistency of information requirements externally and internally is soon reached:

"In so far as all groups require information to help them make decisions concerning the future, albeit at different levels of detail, it is economical and sensible for external reports to draw directly on the information provided for internal management purposes"(2-1).

All users and decision-makers are said to be concerned with the future. Profitability and viability for well-being are of interest to all. And cash-flows link these two. But less consistency is found

Here the hotch-potch of historic and current valuations permitted at the moment is criticised on not unfamiliar grounds before an "eclectic system" is preferred which offers useful information rather than adherence to any single measurement model. For there is no "true value" for value exists primarily in the eyes of the beholder. Current cost or NRV may therefore be applied in most cases, although historic cost may be used or adjusted for specialised and intangible assets, where companies should be encouraged to experiment. And discounting will be required for long-term receivables and payables which carry rates of interest different from prevailing rates (3-1). " It is important that assets be revalued regularly, ideally annually and not at infrequent intervals".

Directors are invited to discuss movements in the market capitalisation of the firm, and the differences between such capitalisation and the sum of net assets valued as above (4-2).

Critique. Some points will be clear to observers in the United Kingdom and outside. First perhaps is a lack here of a historic perspective in the country where printed corporate reports originated. Secondly there has been an apparent insularity with little participation or consultation from outside Britain. This explains perhaps the assumption that the law and fisc never express essential equities nor the very spirit of a country but are always simply constraints on its traders. Further one notes that ephemeral objectives are to be reported rather than the registered Objectives of the company. Forecast and Actual form a model favoured here to an extent never distinguished formally from the Plans and Actuals of Socialist countries. Moreover an annuality of communication is emphasised rather than prompt Events reporting. Even less justified is the concentration on the utility of a new and complete annual "package" just at a time that most share-holders accept Summary Reports. For Actuals and Forecasts, only the "Cost of Sales", functional Profit format is used, although many firms prefer the alternative 4th Directive, and 1985 Companies Act statement which shows expense by type. And little attention is given to the information potential of quantitative rather than financial data. Most difficult is to see how such idealism in proposal and exemplification could ignore positive law and the realities of our European Community so long. On 1st March 1991, the representative of the Commission at Brussels had to emphasise in Edinburgh that important changes could only be made within the European framework.

Of course capital markets are bounded by no continent, and governmental or tax requirements may

be ignored by idealists, who say that we are facing a "last chance"(FRWF,p.xxiv) or advance to a new Age of Enlightenment (op.cit.p.51). But in Scotland as in France, it may appear that wider issues remain to be discussed outside the British audit and accounting profession and open to factors beyond its immediate interests before any major advance can be expected after the milestones of the Companies Acts of 1981, 1985 and 1989.

DARF

TEXTS

Boothman (Chair) - *The Corporate Report* (ICA E&W,1975)

DS - David Solomons - *Guidelines for Financial Reporting Standards* (ICA E&W,1989)

FRWF - *Financial Reporting - The Way Forward*, ed. JA Arnold, MJD Cooper, JC Shaw
(Instits. of CAs of England and Wales and of Scotland),1990

FSFR - *The Future Shaoe of Financial Reports* by J. Arnold, P. Boyle, A. Carey, M Cooper, and K.
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Melody PLC - *ANNUAL REPORT [Exemplification]* (ICA of S) 1990

Zeff S - *Forging Accounting Principles in Five Countries* (Stripes) 1971