Trends in the Developments of Financial Reporting Approach and Its Implication on Accounting Educators

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ABSTRACT

Accounting is the heart of business. It is the language for business where it provides essential business information for making important economic decisions. The framework for financial reporting is based on the dominant financial reporting approach. This approach is initially derived from generally acceptable accounting practices. Accounting practitioners form accounting professional bodies which collectively set accounting standards in pursuit of enhancing the quality of accounting information. The development of financial reporting approach is influenced by the evolution of business entities. When people first trade, they operate as sole entrepreneurs. Therefore, they only need accounting to calculate income or loss. At that time financial accounting approach is based on profit and loss approach where expenses are matched against income in order to determine whether the business is making profit or loss. Any accrued expenses and unexpired assets are reported in the balance sheet. In other words, a balance sheet is merely by-product of the profit and loss account. Accounting educators are trained to teach students related accounting concepts such as definitions of income and expenses, matching concept, conservatism and specific methods of calculating and presenting income and expenses. However, businesses grow into larger entities that call for the establishment of companies and group companies, thus, assessing the value of companies are becoming more important. Hence, the emphasis is now shifted to a balance sheet and the financial reporting approach is considered to be more balance sheet based. Now, accounting educators need to ensure students are familiar with identification, classification, measurement and presenting elements of a statement of financial position, namely, assets and liabilities. This paper provides some empirical evidence of an increasing dominance of a balance sheet based financial reporting approach and its implication on accounting educators.

Keywords: *financial reporting approach, a balance sheet based approach, an income statement based approach, accounting educators, international financial reporting standards (IFRSs)*

Introduction

Accounting does evolve as business forms and environments changes over time. However, its main purpose remains unchanged that is to provide relevant financial information for making economic decisions. Initially, accounting produces information related to the business performance. Business owners want to know how well the business is performing more than how much the business is worth because they, as the business owners can directly assess the value of their businesses. As the business form changes from sole proprietorship into partnership and company, information on the financial position of a business is becoming important too because business ownership is now shared with other owners. In addition, not all owners are directly involved in the business operations. Hence, accounting system produces a balance sheet which is later known as a statement of financial position. Over time, a balance sheet or an income statement is taking turn to be the dominant approach to financial reporting. The next section provides an overview on the development of financial reporting approach.

Literature Review

Theoretically, there are two main financial approaches; a matching approach or a revenue/expense which is also known as transaction-based or income statement based approach and a valuation approach or an asset/liability, is also known as a balance sheet based approach (Fox et al., 2003). Which approach is better to fulfil users' information needs has been long debated (Dichev, 2008). However, some argue that international financial reporting standard (IFRS) is more balance sheet focus as evidenced by its wider application of fair value accounting (Barker, 2004) and by assuming reporting for stewardship is accomplished via reporting for decision-usefulness (Lennard, 2007). The following paragraphs describe general evolution of financial

reporting approaches.

Current financial reporting is still based on mixed approaches; a valuation and a matching approach (Fox et al., 2003). The international accounting regime may be more inclined towards a valuation approach. Local accounting regime is more inclined towards a matching approach and is likely to better cater for local business needs and local investors' information needs (Jermakowicz & Gornik-Tomaszewski, 2006). These differences are originated in different interests between the practitioners and accounting regulators relating to the financial approach. Based on the IFRS conceptual framework, the international accounting regime is more inclined to further shift financial reporting approach towards a valuation approach (Dichev, 2008). The practitioners and some academics argue that it would cause earnings to become more volatile as they are more likely to include non-operating income such as income from revaluation of assets and liabilities.

Historically, financial reporting was simply reporting financial position of a business entity to its owners. Before the 20th century, a business was owned by fewer owners who managed its day-to-day operations, then a simple statement of financial position or the balance sheet was an adequate report. Although business owners were more interested with the best way to measure business performance, they could directly obtain such information from the business entities (Fox et al, 2003). However, as a business entity grew larger and larger, capital provider groups became bigger and their agents, the managers would manage the business. Separation of ownership and management requires both financial position and financial performance reports. The latter report is not only meant to assess the business performance but also as a yardstick to measure the managers' performance. The owners or are now more commonly known as the shareholders, appoint their representatives, the board of directors to monitor and to oversee the management. Therefore, during the 20th century, the business reacted to changes in information needs by introducing a matching-based income statement as the primary financial statement and the balance sheet became the repository of unmatched costs (Dichev, 2008; Fox et al., 2003).

Later, reporting how well the business is managed is becoming more and more important because the growing number of business entities or players is intensifying business competition. Financial reports help the stewards or the management to make right business decisions. Keeping shareholders happy and attracting new fund providers are also crucial to the business survival. Therefore, reporting for stewardship is the main purpose of financial reporting at that time. Income, or earnings, the key business performance indicator is determined based on a transaction-based approach. This approach in the determination of profit or income is also known as the income statement approach (Fox et al., 2003).

However, a transaction-based approach which relies heavily on proper recognition of revenue and matching expenses against the revenue was criticized as enabling income smoothing (Barker, 2004) as part of a creative accounting strategy. This issue dominates key arguments in the Solomon Reports which form the underlying basis behind the International Accounting Standard Board's (IASB's) Conceptual Framework. In addition, accounting regulators, academics and researchers started to shift their focus to an alternative view under the articulated approach in the income determination; a balance sheet-based approach (Dichev, 2008). This approach started to gain support from the accounting standard setters such as the Financial Accounting Standard Board (FASB) and the IASB. Income under this approach is implied in the definition of assets and liabilities. An income is defined as 'increases in the economic benefits during the accounting period in the form of inflows or enhancements of assets or liabilities that results in an increase in equity, other than those relating to contributions from equity participants' (International GAAP, 2008).

Fox et al. (2003) review existing literature relating to the theoretical bases underlying United Kingdom (U.K.) accounting standards and international standards. These bases are a matching approach and a valuation approach. A matching approach compares revenue with costs and deducts from the revenue any direct costs incurred to achieve revenue for a particular period. On the other hand, a valuation approach determines income as an increase in the value of a company during an accounting period (Sterling, 1979) and it requires proper identification and measurement of assets and liabilities (Belkaoui, 2004). Based on a simplified scenario under a set of assumptions, Fox et al. (2003) provide evidence that U.K. and international accounting standards are based on both a matching approach and a valuation approach. Unless, changes in equity under both approaches are constant over time, they argue that partial application of both approaches causes companies to report income with no defined meaning and this income could mislead users who interpret it with a single internally consistent approach. However, the advantage formally adopting a valuation approach in the Statement Principles (Accounting Standard Board, 1999) is to encourage a more consistent use of a valuation approach by practitioners.

A greater emphasis on balance sheet by the accounting standard setters (e.g. IASB and FASB) would have a profound effect on earnings properties (Barker, 2004) and a further shift from matching approach would have impaired the value relevance of earnings. Barker (2004) compares feedback and predictive properties of earnings and its components (revenue and expenses) and finds those earnings' components are of higher value to investors. Since accounting standard setters could not operationalise the concept of extraordinary items under current financial reporting, Barker (2004) proposes an alternative presentation of earnings, comprehensive income that shows income from the business activities and income from the re-measurements of assets and liabilities. This presentation of financial performance is more useful to users as it facilitates the analysis of a company's financial performance, particularly for users such as analysts to deal with the measurement subjectivity under the mixed financial reporting approach. In addition, it can avoid much of the anticipated problems relating to a balance sheet based approach such as practical problems in applying the fair value accounting.

In addition, less emphasis on matching concept under the financial reporting approach may reduce accruals. Previous studies such as Dichev and Tang (2008), find evidence of poorer matching of expenses against revenue for the past 40 years in the U.S. and the same trend is likely to occur in the U.K. because the FASB to a certain degree has influenced IFRS. An example of application of a valuation approach of income is the annual revaluation of assets and charging impairment or assets/liabilities write offs to the income statement. The accounting treatment for goodwill provides a good example of this application. Goodwill is amortised or immediately written off to the income statement under U.K. Generally Acceptable Accounting Principles (GAAP) in contrast to the required annual test for impairment under IFRS (Roberts et al., 2008). Chalmers et al., (2008) suggests this change produces higher incremental value of goodwill in Australia. Other example is accounting treatment for deferred tax. International Accounting Standard 12's timing differences are more balance sheet orientated than Financial Reporting Standard 19 Deferred Tax which uses 'temporary differences' to recognize deferred tax. Generally, International Accounting Standard 12 is more likely to increase deferred tax liability and the shareholders' equity due to its wider scope and the removal of discounting method (Horton and Serafeim, 2009).

As accounting literature indicates a significant shift towards a balance sheet approach to financial reporting, this paper proposes that the accruals level is significantly lower under IFRS.

Methodology

This paper used accounting data of listed companies in the U.K. They were taken from a list of all listed companies on the London Stock Exchange on 21 December 2008. The list was generated by the Data Stream. These companies had adopted IFRS for the first time since 1 January 2005. There were 789 companies which have met the selection criteria; use pound sterling as the reporting currency, are established prior to the year 2000 and with no missing data for the study period. However, only 200 hundred companies which had adopted IFRS for the first time since 1 January 2005 were selected in order to enable a pre and post test where each company with equal number of financial years for pre-IFRSs and post-IFRSs adoption was required. The pre-IFRS period was from the year 2002 to 2004 and the post-IFRS period was from the year 2006 to 2008. The remaining companies have either adopted IFRS in 2006 or 2007.

Accounting information to determine accruals from the selected companies were extracted from the Data Stream. Accruals are proxies for a matching approach or income statement based approach to financial reporting. Lower accruals indicate lower emphasis on the income statement approach. Two categories of accruals are widely used in the literature, namely, operating and total accruals. Accruals were calculated using both direct method and indirect methods. Hence, this study used four proxies for accruals.

Changes in the accruals levels were tested using a paired t-test. The accruals level of a particular company prior to the IFRS adoption is compared against its post-IFRSs adoption level. Thus, this study controls the influence of firm-fixed characteristics factors such as firm size and nature of business.

Findings

The test results indicate change in accruals is only significant for one of the four proxies for accruals, i.e. total accruals. The total accrual is significantly lower under IFRS GAAP as compared to under U.K. GAAP.

Changes in the other three proxies of accruals; operating accruals, total current accruals and total noncurrent accruals are not significantly lower under IFRS.

A greater emphasis on a balance sheet based approach to financial reporting implemented by the international accounting standard board is argued by some researchers to bring major impact on the accounting information (Dichev, 2008). However, the impact is only critical from conceptual and theoretical stances only. In practice, empirical evidence does not indicate that a further shift from an income statement based approach to a balance sheet based approach is significant.

A major reason for this finding is most accounting standards are still being developed based on mixed bases. Accounting for property, plant and equipment provides an example of such accounting standard. At initial measurement, historical cost is used to determine the value of property, plant and equipment. This amount is based on the amount transacted which is supported by the past event. However, for subsequent re-measurement, other than intangible assets, fair value can be applied to property, plant and equipment and investment properties where companies are allowed to choose either cost approach or revaluation approach (Cairns, 2006; Roberts, et al., 2008). Under the revaluation approach, the revalued amount is the fair value at the revaluation date less any depreciation and subsequent accumulated impairment loss (para. 31, IAS 16) (Roberts et al, 2008).

Furthermore, the main critic of a balance sheet as providing misleading earnings has now been rectified by requiring companies to separate operating income from other incomes in their statement of comprehensive income. Statement of comprehensive income is more informative than former statement of income or the profit or loss as users, particularly investors can ascertain whether an increase in earnings of a particular company is due to operating activities or asset revaluation exercises.

Conclusion

Which approach to financial reporting is more dominant will affect how accounting educators teach accounting subjects. Financial reporting evolves as business forms and business environment do changes from time to time. Accounting educators now need to familiarise with the IFRS's conceptual framework and integrate its principles into their lessons.

Although, empirical evidence does not suggest significant change in the dominant financial reporting approach, the IASB does prioritise a balance sheet approach as the dominant bases in setting new international accounting standards. Malaysia Accounting Standard Board follows closely any decision taken by the IASB and our local accounting regulator has adapted the international accounting standards into Malaysian accounting standards. Therefore, Malaysian accounting students must be properly taught the international conceptual framework principles where the dominant financial reporting approach is moving towards a more balance sheet approach.

A balance sheet approach calls for more subjective approach in measuring and recognising accounting items (IFRS Foundation, 2010). The process requires more professional judgment and includes more future estimates in the financial statements. Unless Malaysian accounting students, who are Malaysian future accountants are well versed with the principles under the balance sheet based approach, the quality of financial information might be adversely affected for bad judgment and making inaccurate estimates. Inaccurate estimates of assets and liabilities will directly affect the calculation of earnings. This could lead to misleading business information which could subsequently result to misallocation of resources, an outcome that any developing nation must avoid. Therefore, accounting educators must be aware of the trends in the development of the dominant financial approach that can help them to keep abreast with recent changes in accounting education.

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