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FINANCIAL ACCOUNTING RESEARCH, PRACTICE AND FINANCIAL ACCOUNTABILITY

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ABSTRACT

Financial accounting is essential to financial accountability, which is essential to a prosperous society. There are many examples of how improvements to financial accounting, supported by research, have enhanced financial accountability. Such research requires a strong relation between accounting academics and practice; this relation has ebbed and flowed during the life of Abacus. The relation seems to go out when accounting academics hold related fields and flows when the importance to accounting practice emerges. Economics and finance have provided new perspectives and meaningful insights about the information investors need to make informed decisions. Regardless, there are many interesting and open questions awaiting accounting research that can provide insights into how financial accounting-and thus financial accountability-can be improved. The future is bright for financial accounting researchers who do research relevant to accounting practice and want to contribute to a prosperous society.

KEYWORDS: *Financial Accounting, Accountability, Academics, Perspectives, Financial Reporting.*

Introduction

Financial accounting literature and is intended for students interested in getting a quick idea of financial accounting literature field and evolution. Since the field is so broad, I chose as the nexus all through the paper, the idea that financial accounting research is called to provide some Insights to standard setting.

I coincide with Watts and Zimmerman (1986) that in accounting we are dealing with the shifting sands of a body of research. Their book's purpose was to provide students with the tools and understanding to draw their own maps of future literature. Therefore this is my personal map based mainly on Watts and Zimmerman (1978, 1986), Hendrickson and Van Breda (1992), Scott (1997) and Beaver (1998). Although the contributions to financial accounting evolution and understanding have been impressive, there still remain some unanswered questions. The main contradiction found so far is that the best financial reporting system to align manager shareholder interests need not be the best system to inform investors. Given that there is only one bottom line that is observable by all constituents; the need of accounting standard setting arises. Standard setting is viewed as a form of regulation that attempts to mediate the conflicting interests of managers and Investors in financial reporting.

However such a clear call for accounting research, it seems that the topic is so complex that it has not been satisfactory resolved yet. This paper is organized around the role research plays in standard setting. The second section presents the introductory and basic concepts of the economic approach to accounting theory and historic evolution of accounting. Information asymmetry is presented as a central issue because it is the reason for standard setting, because there are investors more informed than others. Section three relates information asymmetry with users and section four relates it with preparers. Section three covers the research focused on users, specially the work done in the

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measurement and informational perspective, including information content of both earnings and prices. This analysis is complemented with an overview of earnings forecast. Section four pays attention to the research done from the preparers 'perspective, in particular to the economic consequences approach, therefore topics such as earnings management, voluntary disclosure and executive compensation are covered. Section five outlines and justifies the idea that the same bottom line cannot be used for the two perspectives, users and preparers. This idea of the unsolved contradiction is not a new discovery, but the main contribution of this paper is making it evident through an organized literature review of the field that permits a clear understanding of the academic research incompleteness assessment of standard setting as a mechanism to reduce information asymmetry between managers and investors and between different groups of users of financial accounting reports.

Objectives of Financial Accounting Research and Practice

- Financial accounting useful to investors and creditors in decisions making.
- Tells about economic resources, claims to resources and changes in resources.
- Ascertain the financial position.
- To properly match income with expenses.
- To provide a reliable set of data with which to prepare financial reports for analysis purposes for owners, lenders, investors etc.
- Provide financial reporting information to a wide variety of users.

Limitations of Financial Accounting

Advantages of accounting discussed in this lesson do not suggest that accounting is free from limitations. Anyone who is using accounting information should be well aware of its limitations also. Following are the limitations:-

- Financial accounting permits alternative treatments No doubt accounting is based on concepts and it follows "generally accepted accounting principles", but there exist more than one principle for the treatment of any one item. This permits alternative treatments within the framework of generally accepted accounting principles. For example, the closing stock of a business may be valued by any one of the following methods: FIFO (First-in-first-out); LIFO (Last-in-first-out); Average price, Standard price etc., Application of different methods will give different results but the methods are generally accepted. So, the results are not comparable.
- Financial accounting is influenced by personal judgements18 Inspire of the fact that convention of objectivity is respected in accounting but to record certain events estimates have to be made which requires personal judgment. It is very difficult to expect accuracy in future estimates and objectivity suffers. For example, in order to determine the amount of depreciation to be charged every year for the use of fixed asset it is required to estimate (a) future life of the asset, and (b) scrap value of the asset. Thus in accounting we do not determine but measure the income. In other words, the income disclosed by accounting is not authoritative but approximation.
- Financial accounting ignores important non-monetary information Financial accounting takes into consideration only those transactions and events which can be described in money. The transactions and events, however important, if non-monetary in nature are ignored i.e., not recorded. For example, extent of competition faced by the business, technical innovations possessed by the business, loyalty and efficiency of the employees etc. are the important matters in which management of the business is highly interested but accounting is not tailored to take note of such matters. Thus any user of financial information is, naturally, deprived of vital information which is of non-monetary character.
- Financial accounting does not provide timely information financial accounting is designed to supply information in the form of statements (Balance Sheet and Profit and Loss Account) for a period, normally, one year. So the information is, at best, of historical interest and only post-mortem analysis of the past can be conducted. The business requires timely information at frequent intervals to enable the management to plan and take corrective action. For example, if a business has budgeted that during the current year sales should be Rs. 12,00,000 then it requires information – whether the sales in the first month of the year amounted to Rs. 1,00,000 or less or more? Traditionally, 19 financial accounting is not supposed to supply information at shorter intervals than one year.

- Financial accounting does not provide detailed analysis the information supplied by the financial accounting is in reality aggregate of the financial transactions during the course of the year. Of course, it enables to study the overall results of the business activity during the accounting period. For proper running of the business the information is required regarding the cost, revenue and profit of each product but financial accounting does not provide such detailed information product-wise. For example, if a business has earned a total profit of, say, Rs. 5,00,000 during the accounting year and it sells three products namely petrol, diesel and mobile oil and wants to know profit earned by each product. Financial accounting is not likely to help him.
- Financial accounting does not disclose the present value of the business In financial accounting the position of the business as on a particular date is shown by a statement known as balance sheet. In balance sheet the assets are shown on the basis of going concern concept. Thus it is presumed that business has relatively longer life and will continue to exist indefinitely, hence the asset values are going concern values. The realised value of each asset if sold today can't be known by studying the balance sheet.

Research Methodology

Quantitative research has been chosen over qualitative research as the data used will be numerical and the research has a specific focus of substantiating or contradicting the hypothesis (Denscombe 2007). The hypothesis is developed after having reviewed the literature. In this case the literature indicates that the answer to the research question is: "Yes, perceptions of the usefulness of banks' financial reports have changed as a result of the financial crisis" The literature also indicates a reason for the loss of confidence being the lack of adequate transparency in financial reporting. The hypothesis, therefore, is: "There has been a loss of confidence in the usefulness of financial reporting of banks after the financial crisis because of a lack of sufficient transparency." The primary research tests this hypothesis in the Finnish business environment and gives direction to future research and discussion.

In financing, quantitative research is more common, though qualitative research has Been gaining stature (Cassel, Behrens & Simon 2006). The benefits of quantitative Research are that it allows the researcher to concentrate on a chosen few issues that have been brought up in the literature review and it is more generalizable and Objective than qualitative research. The benefits of using a survey to obtain Quantitative data are that answers will be easy to codify and easy to analyse. The Disadvantage is that qualitative data would give a deeper look into the subject instead of just answering the specific research question. In the case of this research, Quantitative methods have been chosen because the research question is one that Needs a simple answer that either supports or contradicts the literature review. Though qualitative research would give more depth to the research, quantitative Methods can also include open questions, which in the case of this research, are adept 21 at giving depth and allow exploring the issues more widely. The research also takes an empirical outlook as the information is sought out instead of being set.

Accounting Theory Fundamentals

This paper attempts to describe a conceptual framework within which to understand financial Accounting and to point to a fundamental gap in our knowledge. In this literature review the purpose financial accounting research is limited to only provide clues that help in the process of standard setting in order to reduce the information asymmetry between investors and managers. An economic Approach to accounting theory must be used because microeconomics theory has provided the basis for contemporary accounting theory. Since accounting exists from ancient times, this papers is only Concerned with its evolution and development in the last century, especially in the last three decades of the twentieth century. This section presents a brief overview of the concept and meaning of accounting theory and the different phases of its historical evolution.

- **Economic Approach to Accounting Theory: Accounting** theory may be defined as a coherent set of hypothetical, conceptual, and pragmatic principles forming a general frame of reference for inquiring into the nature of accounting. Modern accounting theory, which is founded in microeconomics, focuses on the enterprise as an economic entity with its main activities affecting the economy through its operations in the markets. This approach takes as its fundamental premise that financial information has inevitable economic consequences. The

objective of accounting theory is to explain and predict accounting practice, with explanation meaning to provide reasons for observed practice, and prediction of accounting practice meaning that the theory predicts unobserved accounting phenomena. Accountants have long attempted to interpret accounting concepts in terms of economic concepts. Since the 1960's there has been an explosion of research exploring the correspondence between economic interpretations and accounting data. The objective of most research is to provide an understanding of the theory underlying the economics-based empirical literature in accounting. We assume that the various parties in selecting or recommending accounting and auditing procedures act so as to maximize their own welfare (or expected utility). For instance if the corporate manager's welfare is dependent on the market value of the corporation (as it is via stock option plans, debt agreements, stock awards and other mechanisms), the corporate manager wants to know the effect of the accounting decision on stock and bond prices. Therefore the manager wants a theory that explains the relation between accounting reports and stock and bond prices, in order to assess the impact on their own welfare that a certain accounting rule might have. While a single general theory of accounting may be desirable, accounting as a science is still in a primitive stage for such a development. The best that can be accomplished in this development stage is a set of theories (models) and sub-theories that may be complementary or competing. Currently competing theories arise in accounting because available theories are still imperfect and none can prove a theory correct beyond any doubt. So far, all academics and researchers can do is test theories.

- **Historic Evolution of Accounting: As** a social science, accounting has experienced radical changes during the twentieth century. Although its origins can be traced back to ancient civilizations, like China and Egypt, this paper is interested in reviewing modern accounting, its role and evolution. Through the recent history of accounting three stages can be identified: a) merely descriptive of facts and practices, b) prescriptive, and c) descriptive with explanatory and predictive power. Accounting theory evolved into a stewardship theory of how best to measure assets, liabilities, equity, and earnings, comparing the accounting measures with economic concepts. Early this century we have a good example of this approach that was aimed at collecting and organizing good and widespread practices. Paton (1922) stated that to avoid improper applications and erroneous general conclusions, the accountant must see clearly the foundation upon which he or she is standing.

  Toward that end he listed six postulates:

- The existence of a distinct entity.
- The continuity of this entity.
- The balance sheet equation.
- The monetary postulate (a statement of assets and liabilities in dollars and cents is a complete representation of the financial condition of the enterprise on the date of the statement).
- The cost postulate (cost gives actual value for purposes of initial statement).
- The revenue recognition postulate (net revenue or profit suddenly appears, full-blown, on some specific occasion, commonly that of the sale).

Accounting Research from the Users Perspectives (Investors)

In this section two main approaches will be described. The information and measurement perspectives are addressed, being the first divided in the information content of earnings and the information content of prices. From an informational perspective, financial reporting provides value-relevant information. A measurement perspective takes a different view, because its origins are in the setting of complete and perfect markets. From a measurement point of view, the financial reporting measures assets, liabilities and equity. Beaver (1998) considers the Olson's model contribution as another approach to the relation between accounting data and security valuation, which is considered neither informational nor measurement in its perspective. Despite Beaver's opinion, this paper analyzed Olson's model under the measurement perspective, because the implications of its main underlying concept: the Clean Surplus Relation (CSR)

- **Studies on the sensitivity of price changes to earnings changes and the Earnings Response Coefficient (ERC**): It is accepted that the correlation between price changes and earnings changes is less than one. At the individual security level the average is 0.38according

to Beaver (1998). Beaver Lambert and Ryan (1987) estimate a linear regression in which Price changes are the dependent variable and earnings changes are the independent variable, where a 33% earnings changes on the average is associated with approximately a 10% change in Prices. This might be explained by several factors, among them the existence of other sources of Information, and transitory components of earnings. Somehow related, Hayn (1994) shows that the Earnings sensitivity coefficient is lower for firms reporting losses rather than positive net income. Therefore is concluded that losses are less informative than profits about the firm's future prospects, because losses are not expected to perpetuate. Another interesting element of this line of research is the hypothesis that the earnings sensitivity coefficient varies across firms. Kormendi And Lipe (1987) show that the earnings response coefficient varies not only with persistence but also With growth, risk, and the level of interest rates, which are elements particular to each firm. The identification and explanation of different market response to earnings information are related with the Earnings Response Coefficient (ERC) research. An earnings response coefficient "measures the extent of a security's abnormal return in response to the unexpected component of reported earnings of the firm issuing that security"7. Scott (1997) makes an interesting list of reasons Used to explain ERC:

- **Beta:** lower ERC for higher-beta securities tested in Collins and Kothari (1989)
- **Capital Structure:** lower ERC for more highly levered firms tested in Dhaliwal, Lee and Fargher (1991).
- **Persistence:** ERC will be higher the more the good or bad news in current earnings is expected to persist into the future, tested by Kormendi and Lipe (1987).
- **Earnings Quality:** higher ERC for higher quality earnings tested by Lev and Thiagarajan (1993).
- **Growth Opportunities:** higher ERC are related with higher larger variations of reported earnings tested by Collins and Kothari (1989).
- **In Formativeness of Price:** the more informative the price is, the less the information content of current accounting earnings will be, this has been tested by Collins and Kothari (1989) and is referred as price changes lead earning changes.

- **Accounting based Valuation Methods:** Accounting-Based Valuation Models (ABVM) usepast, present and forecasts of accounting information to infer equity value. Since ABVM are based on accounting figures, they are affected by accounting conventions. For fundamental analysis and valuation, the accounting literature relies on the Dividend- Discounting Model (DDM) like the capitalized earnings model or the residual income model. The Earnings Capitalization Models (ECM) are a transformation of the dividend-discount model that is rewritten in terms of forecasted values of future earnings and future investments. ECM are popular in accounting and much of the earnings response coefficient literature relies on them. Residual Income Valuation Models (RIVM) are a transformation of the dividend-discounting model, but it is expressed directly in terms of current and future accounting numbers, book values and earnings. Starting with a DDM, the residual income valuation model expresses value as the sum of current book value and the discounted present value of expected abnormal earnings, defined as forecasted earnings minus a capital charge equal to the forecasted book value times the discount rate.

The Ohlson (1995) and Feltham and Ohlson (1995) RIVM have become broadly accepted and tested in the last years. The Ohlson (1995) model assumes a dynamic time-series structure on the abnormal Earnings process that affects value. Feltham and Ohlson (1995) model the relation between a firm's market value and accounting data concerning operating and financial activities, proposing a separation between the net operating assets and the net financial assets of the firm that is important in the presence of conservative accounting. Book value equals market value for financial activities, but it can differ for operating activities. Operating and financial activities raise distinct accounting measurement issues, which, in turn, influence the analysis of a firm's market value as a function of the financial statements' components. Financial activities involve assets and liabilities for which there are relatively perfect markets. In contrast the accounting for operating assets precipitates more intricate concerns because these assets are typically not individually traded in perfect markets.

- **Standard Setting Process and Financial Accounting Research:** In this last section, I consider why it could be interesting to introduce the standard setting process as a potential way to solve the conflicts posed by the current accounting model. According to PAT, rationales differ

and are inconsistent across accounting standards because they are the result of political action. The outcome depends on the relative costs that the involved parties are willing to incur to achieve their goals. The establishment of accounting policies determining the amount and type of information disclosure, measurement rules and procedures, and the form of presentation of financial statements is a complex process. Accounting has economic consequences for its users, that is, some benefit and some lose financially when a new standard is promulgated. As a result, the choice of accounting standards and the principles used to justify them are as much a political as technical choice. Beaver (1998) provides a good summary of potential economic consequences:

- Wealth distributions among investors and others.
- Aggregate level of risk incurred and risk sharing
- Among individuals.
- Rate of capital formation.
- Allocation of resources among firms.
- Use of resources for interpretation of disclosures.
- Use of resources in discloses regulation.
- Use the resources in the private-sector search for non-public information.

Conclusion

In this paper I tried to summarize the financial accounting literature that might support standard Setting. Microeconomics and finance fundamentals of current accounting research were introduced. A historical analysis allows us to focus on the research that has dominated the field since the late 1960's.This paper evolved from user perspectives and problems (mainly investors) towards preparer view and difficulties (mainly managers), covering the two conflicting roles of financial accounting as an investment-decision-making tool and a contracting mechanism. The purpose was to review the accounting research to understand it and to see what contributions it has made to standard setting. The main contributions have been helping in understanding markets functioning and reactions as well as manager behaviours and incentives. Few contributions of accounting research can be extrapolated to accounting standard setting process, outcome and effects. The conclusion is that financial accounting projects false image of a mature discipline, just because most of its researchers discuss similar issues. There have been important breakthroughs in the last 40years of accounting, but very few during the 1990sand beyond. So far it seems that the question posed at the beginning of the paper remains unanswered. Given that accounting was born in the crisis of 1930with the aim to reduce information asymmetries through standards, it is expected that accounting research must help in this regard. In spite of such clear call, this review shows that most of the previous work of financial accounting academicians was not very helpful to the standard setting task. Perhaps this happens because financial accounting research is based on hard disciplines such as economics and finance, while it is agreed that accounting standard setting is more a political process that lacks the hardness required by publishable research in financial accounting journals.

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