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DISCLOSURE OF ACCOUNTING INFORMATION

3.1.0 COMMUNICATION AND ACCOUNTING INFORMATION

3.1.1 COMMUNICATION AS A HUMAN ACTIVITY

The disclosure of accounting information has been developed in the business community as a practical procedure to satisfy the requirements of the business community and fund providers. However, the disclosure of accounting information is based on the concepts involving communication. As Lee says "...Accounting is as much about communication as it is to do with measurements. No matter how effective the process of accounting quantification, its resultant data will be less than useful unless they are communicated adequately."\(^1\)

"The communication can be broadly defined as the transmission of a message."\(^2\) Even animals communicate their desires and feelings by using sounds and physical body movements. The man, in addition to these things, uses structured grammatical languages of combined words, arts, sculptures, and mechanical, electrical, electronic and computer equipment to transmit messages from person to person or institution to institution. Historical evidence of man's effort to improve organized communication could be traced back even to Greek and Roman periods.

A school of teachers called "SOPHISTS" taught ancients to speak well. The "TEACHERS OF RHETORIC" taught ideas that in later years appeared in published works. Thus, today we

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recognize names such as Socrates, Plato, Aristotle, Cicero, and Quintilian as contributors to the history of communication.

Communication could take place within an individual or between and among persons which include organizations. When people get together and work together to achieve goals and objectives organizations are formed. Any organization must return more benefits to its constituent members than it costs them, for the survival of the organization. Communication is one of the major factors involved in keeping the group together to achieve objectives through day-to-day operations. Communication is a very significant procedure in a business organization. It cannot function without communication and its activities require human beings to interact and react. In a system, the actors exchange information, ideas, plans and make decisions by choosing appropriate strategies for implementation of activities, in order to achieve objectives. Any organization would consist of two communication systems: internal and external. The discipline of accounting is involved in both. The internal communication can be "upward" or "downward" or "horizontal". Interactions, reactions, and feedback between the organization and the outside parties could be classified as external communication. This is very valuable for an organization. As Murphy and Hildebrant point out:

Messages to persons outside the company can have a far-reaching effect on its reputation and ultimate success. The right letter, proposal, report, telephone call, or personal

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conversation can win back a disgruntled customer, create a desire for a firm's product or service, help negotiate a profitable sale, encourage collections, motivate performance and in general create goodwill.\textsuperscript{4}

Communication could be oral or visual or written. The media such as audio, video and printing and display have been developed to connect the sender and the receiver for communication purposes. Several factors influence the communication process. They are "Perception, Sender, Message, Channel, Audience[Receiver], Transfer of meaning, Feedback [and] Noise "\textsuperscript{5}. Any weakness in any one or more of these factors could effect the process of communication.

On theoretical development of communication two basic concepts have been set forth by communication oriented researchers. "One is the idea of the technical communication of information; the other is the idea of the human aspects of the communicative process. These have popularly been known as the 'information theory' and the 'theory of human communication'.\textsuperscript{6}"

The effect of information theory on accounting theory and practice is a recent development, and more attention has been paid to this only after the introduction of computer accounting systems to process data from accounting source documents. However the application of computers in processing management information, including accounting information, is developing rapidly. In the past managers were faced with the time consuming analysis

\textsuperscript{4} Ibid.
\textsuperscript{5} Bowman and Branchaw, op.cit., p.7.
\textsuperscript{6} Himstreet, William C. and Baty, Wayne Murlin; Business Communication; Wadsworth Publishing Company Incorportation; Belmont, California, 1969, p.4.
of data or waited for periodically supplied information for decision making. Today managers can access a wealth of data from their microcomputers whenever the need occurs. The use of computers in processing data will shift the performance of managers from data to information, which will improve the decision making process and the structure of the management. "...as soon as a company takes the first tentative steps from data to information, its decision processes, management structure, and even the way its work gets done begin to be transformed" 7

The effect of the communication theory on accounting is a recent development. However, the development of the theory of human communication has been long-standing.

3.1.2 ACCOUNTING COMMUNICATION

Accounting has been accepted as one of the important information systems of an organization for communication purposes. The definition given by the American Accounting Association in its 'a Statement of Basic Accounting Theory' describes accounting as given below:

Essentially, accounting is an information system. More precisely, it is on application of a general theory of information to the problem of efficient economic operation. It also makes up a large part of the general information systems, which provide decision-making information expressed in quantitative terms. 8

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Accounting is a form of communication between the users of accounting information and the organizational entities. The theoretical foundation of accounting has been developed on the basis of communication theory. Accounting is concerned with the transmission of messages relevant to transactions, transformations, and events between or among the individuals in the form of signs representing the economic activities. The accounting information should have the capacity to influence the decision making process of the users of accounting information.

Under the present economic environment of large scale production and distribution, the size, physical area and activities of the business organizations are considerably large and it is not possible for the users of accounting information to access direct experience on economic activities of business organizations, in which they have the interest. They have to rely on variety of complex signs and signals generated relevant to economic activities of business organizations. Under the discipline of accounting, a series of procedural techniques have been developed to compute required quantified information in the form of signs and signals of economic activities.

The quality of accounting communication is based on the ability of and the technique used by the communicator to translate the perceived economic activities into signs and signals to be transmitted to the user. The user must possess the adequate capability to perceive, comprehend, and understand the signals and signs supplied by the processor. In order to achieve these skills of both processor and the user of accounting information, there has to be a consistent, coherent, and logical system of
accepted rules for processing economic activities into signs and signals of accounting information.

The criteria highlighted by Chambers, a well known authority in accounting research on measurements, to maintain and improve quality of accounting communication, can be classified as general criteria, processing criteria and user criteria.  

Reliability and comprehensibility of accounting information could be grouped under the term general criteria. The maintenance of consistency in processing and communicating accounting information, objective of its measurement and capability of corroboration could be classified under processing criteria. Neutrality and comprehensibility of information can be considered as user criteria.

It can be seen that all over the commercial world, specialized professional accounting organizations have been developed in order to maintain and improve accounting information systems. In addition to that, academic accounting organizations such as American Accounting Association, British Accounting Association, European Accounting Association, Indian Accounting Association and etc. have been established to find solutions for accounting problems.

However, accounting is not the only formal information system providing information to management. Officers at different levels of management require, quantity, value, and descriptive information for decision-making purposes. To satisfy their requirements, information is

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provided through other functional areas such as, production, marketing, and personnel in combination with the management information system.

3.2.0 MEASUREMENT OF ECONOMIC ACTIVITIES PRIOR TO DISCLOSURE IN ACCOUNTING REPORTS

3.2.1 ACCOUNTING AS A KNOWLEDGE BASE

The disclosure of accounting information is provided in accounting and financial statement reports, and they are the products of the accounting system and process. In order to understand and discuss about disclosure of accounting information, a clear perception of the accounting system and process is necessary.

Accounting has been often defined as the 'language of business' \(^{10}\). The man in the society uses the language to communicate ideas with his fellow beings and to store the knowledge gathered and improved by him for future use of the mankind. Similarly, the business community of the society uses the accounting for communication and storage of entity information. The specialists and other actors of the business world such as owners of business organizations or shareholders, company directors, managers, brokers, attorneys, engineers, accountants and etc. use accounting terms and concepts to describe the economic activities of organizations. The American Institute of Certified Public Accountants in its Accounting Terminology Bulletin No. 1 has defined accounting as “Accounting is the art of recording, classifying, and summarizing in a significant manner and in

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terms of money, transactions and events which are, in part at least of a financial character, and interpreting the results thereof.²³¹

It seems that this definition is limiting the accounting function to the monetary area of economic activities of business entities. A brief look at the historical development of accounting would disclose the concept of quantity accounting used for recording of transactions. Even at present, generally, business transactions are performed and measured in terms of quantities at the primary stage. Raw materials are purchased in terms of kilograms, meters, liters & etc. Human labor is measured in terms of hours, days and months. Similarly overheads are measured in quantities. Generally, at the lower and middle levels of management quantity accounting figures are used for decision-making.

In the prevailing traditional system of accounting, quantity information is maintained. Source documents such as invoices, receipts, payroll analysis sheets, bin cards, stock ledger & etc. contain quantity information. In the process of auditing and investigations the value of this type of information is highly regarded. The bin cards, stock ledgers and investment accounts are a few number of examples for quantity accounting records. The significance of quantity accounting is at a very higher level in computer based accounting systems. In such systems for each sales item the cost of goods sold is calculated and recorded instantly, and this is a very valuable, promptly given information for the management. Even in cost

accounting transfers from one process to another process are based on quantity accounting information.

American Accounting Associations' Committee to Prepare a Statement of Basic Accounting Theory in its Statement of Basic Accounting Theory has defined accounting as "... The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information..." 12

Even though, in the accounting literature, a number of definitions for accounting is available the above definition can be seen frequently. It covers all types economic information, which has been subjected to identification, and measurement, which includes not only the value information but also the quantity information.

Paul A Grady in his Accounting Research Study No. 7 provides a more comprehensive definition for accounting:

Accounting is the body of knowledge and functions concerned with systematic originating, authenticating, recording, classifying, processing, summarizing, analyzing, interpreting, and supplying dependable significant information covering transactions and events which are, in part at least, of the financial character, required for the management and operation of an entity and for the reports that have to be

submitted thereon to meet fiduciary and other responsibilities.\textsuperscript{13}

This definition covers almost all the steps involved in the accounting process.

Wilcox and Miguel define accounting as ".... The process of (1) collecting financial information; (2) analyzing it to determine what information is relevant to particular decisions, (3) presenting the relevant information to the user (4) assisting and advising the user in interpreting the information and applying it in the decisions making process." \textsuperscript{14}

The American Accounting Association in its ' A statement of Basic Accounting Theory' describes the objective of the accounting function as " Measurement and communication of data revealing past, present and prospective socioeconomic activities." \textsuperscript{15}

According to the Dictionary for Accountants, accounting means recording and reporting of transactions and further description of this covers areas given below, \textsuperscript{16}

(a) Timing, quantification in physical units and monetary terms and classification of transactions.

(b) Processing of transactions involving system design and internal check.

\footnotesize{\textsuperscript{13} Grady, Pual A; \textit{Accounting Research Study No. 7}, in Accountants' Handbook (ed); Wixon, Rutus, Kell, Walter G and Bedford, Norton M.; Ronald Press Company, New York, 1970, Section 1-1.}

\footnotesize{\textsuperscript{14} Wilcox, Kirkland A. and Miguel, Joseph G.San; \textit{Introduction to Financial Accounting}; Harper and Row Publishers; New York, 1980, p.5.}


\footnotesize{\textsuperscript{16} Kohler, Erie L.; \textit{A Dictionary for accountants}; Prentice - Hall Inc; New Jersey, 1970, pp.7-8.}
(c) Book keeping involving recording and grouping
(d) Internal reporting
(e) Internal auditing
(f) Preparation of financial statements
(g) External auditing
(h) Reporting
(i) Services to the management

As given in the Accountants Handbook the field of accounting covers areas such as financial reporting, tax determination and planning, independent audits, data processing and information systems, cost and management accounting, internal auditing, budgeting, fiduciary accounting, national accounting, and management accountancy. It may be possible to add computer based accounting and public sector accounting to the list mentioned above.

A review of these definitions reveals that there is no major change in the definition and function of accounting; it has been unchanged almost from its inception. The ultimate objective is to provide information to users of financial statement in order to help them in their decision making.

3.2.2 ACCOUNTING PERSONNEL, PROCESS AND DOUBLE ENTRY SYSTEM

The ultimate risk of a listed company is born by the equity holders. They have provided the risk capital for the company. To run the organization

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in order to achieve objectives, economic resources are acquired. When residual capital is not sufficient to operate with required economic resources or economic resources are acquired for subsequent settlements, economic obligations are incurred. The accountant and his staff perform the accounting function with the cooperation received from the other divisions of the organization.

**ILLUSTRATION 3.1**

**FUNCTION OF THE ACCOUNTANT AND HIS STAFF**


The function of the accountant and his staff is depicted by the ILLUSTRATION 3.1. The economic activities taking place in a business organization affect on the economic resources, economic obligations, and equity
capital. Generally, economic activities take place in non-accounting departments and data on economic activities are collected and sent to the accounting department. The accountant and his staff apply the Generally Accepted Accounting Principles to measure the data of economic activities. They produce accounting reports containing information to satisfy the needs of the users of accounting information. "The major functions of accountants (are) ...... analyzing the information, presenting it, and advising the user."\(^{18}\)

**ILLUSTRATION 3.2**
**INPUT, OUTPUT, AND PROCESS OF ACCOUNTING.**

![Diagram](image)


In the ILLUSTRATION 3.2 the input of economic data to the process of accounting and output of accounting information from the process of accounting are presented. In the business environment unlimited data are available. Only the required data of economic activities are taken into the process of accounting. In order to decide the required data for processing generally accepted prevailing rules are applied. At the end of the accounting process output information is supplied to the users.

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ILLUSTRATION 3.3

STAGES OF ACCOUNTING PROCESS

Production Activities  Marketing Activities  Personnel Activities  Purchasing Activities  Financial Activities

Accounting Activities in Non-accounting Departments

Observation

Documentation

Accounting Activities in Accounting Departments

Recording and Summarization in Journals

Recording in Ledger Accounts

Allocation

Valuation

Communication of Accounting Information

Summarization in Ledger Accounts

USERS OF ACCOUNTING INFORMATION

ILLUSTRATION 3.3 presents a picture of the accounting process. Generally, in an organization, accounting information system is designed, organized, implemented and controlled by the accountant with the
assistance of the other departmental heads and officers. Economic activities take place in other departments. Under a designed accounting system officers of these departments observe, identify and document transactions.

In the process of documentation, source documents are created. Invoices, credit notes, receipts, and goods received notes are examples for some of the source documents. Value as well as quantity information is recorded in source documents, and they will be used subsequently for further processing and authentication. Generally, officers handling observation and documentation stages of the accounting process are not from the accounting department. Copies or originals of the source documents are grouped under each category and sent to the accounting department for recording purposes. The recording procedure is undertaken by using primary books and secondary books.

Under the recording in primary books, separate daybooks/journals are maintained to enter or write each type of transaction, according to the chronological order. Sales daybook, Sales Returns daybook, Purchases daybook, Purchases Returns daybook, CashBook, and the General Journal are examples for these books/journals. Periodical totals or summaries are calculated for further processing. Entries in the daybooks are used for subsequent tracing of evidence and posting purposes. In addition to the value data of transactions, quantity data are also recorded in some of the daybooks.

Postings to General Ledger accounts and recording in accounts of the Subsidiary Ledgers such as Debtors Ledger, Creditors Ledger, and

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19 In very small organizations creation of source documents may not take place.
Inventory Ledger are completed at the secondary recording level. Separate individual accounts are maintained in ledger books to record changes relevant to sub-items of assets, liabilities, equities, expenses and income. There are some economic activities and results of economic activities, which cannot be conveniently measured as assets, liabilities, expenses, or income until the end of the financial period. Annual depreciation of fixed assets, prepayments and accrued expenses are some of the examples. These undocumented economic activities, under the day to day normal routine procedure of the accounting system have to be documented and recorded in the books, using journal entries. This subprocedure has been identified as allocation. Valuation is another activity performed by the accounting division with the assistance of other managers, at the end of the financial period. Adjustments of historical cost values to market values if the latter value is less than the first value, creation of a provision for doubtful debts, disclosure or adjustment of security values, writing off of goodwill balance, revaluation of fixed assets on the basis of management decisions are examples for valuation. At present, there are controversial arguments relevant to allocation and valuation in the current literature of accounting. Once, all the economic activities are recorded, according to the Generally Accepted Accounting Principles, summaries of individual accounts are extracted and processed for preparation of accounting statements and communication of them to users of accounting information.

Recording of economic transactions in ledger accounts is mainly based on the concept of double entry. According to available records this system was in operation among the merchants of Venice during the 15th
century, and Luca Pacioli wrote the first available book on this method during that period. Today all over the world the technique of double-entry method is being used. Even though the transformation of accounting from the manual
system to computer based system is being taking place the basic principles of double entry system has not changed.

The ILLUSTRATION 3-4 presents the double entry system of accounting. Once a transaction is read, its affect on accounts are identified. Effected accounts are taken one by one for making entries. In an asset or expense account an increase is a debit entry and decrease is a credit entry. In a liability or equity or revenue account increase is a credit entry and decrease is a debit entry. This procedure is followed again and again until entries are made in all the effected accounts of the transaction. In most of the transactions only two accounts are effected. However, there can be situations where more than two accounts are effected.

Maintaining of accounting records is very essential for business organizations. If accounts are not maintained, it is difficult for an organization to evaluate past results and current position. In addition to the above, to answer queries from the tax department, internal and external auditors, availability of a set of accounting books is essential. Relevant to partnership businesses, ownership disputes could be resolved by reference to accounting records. In the case of companies registered under the companies’ act of Sri Lanka every company has to maintain accounting records. Under the section 143 sub-section (1) of the companies Act every company shall cause to be kept proper books of account with respect to:

(a) all sums of money received and expended by the company and the matters in respect of which the receipt and expenditure takes place;

(b) all sales and purchases of goods by the company;
(c) the assets and liabilities of the company.

Accounting information is communicated to users by using financial statements. They are prepared and supplied after taking into consideration the users' requirements, and by using the prevailing accepted accounting and reporting practice.

3.2.3 ECONOMIC ACTIVITY DATA EXTRANEOUS TO THE DOUBLE-ENTRY SYSTEM

Double-entry system is an accounting method gradually developed over the last 500 years on the basis of recognition of dual aspect of a transaction, mainly, in order to maintain arithmetical accuracy relevant to the dual aspect. This has become very significant for the accounting process. However, considerable amount of data relevant to economic activities does not go through the double entry process.

Some economic activities entered in the source documents such as, invoices, receipts, payment vouchers and etc. are not taken unto ledger accounts. Quantity information appearing in an invoice is an example. In the invoice quantity sold, selling price of each item, and the total value are documented. These detailed data may or may not be entered in the sales journal. However in the general ledger, only the monetary values are accounted for further a processing.

Another type of economic data omitted from the double-entry process is the quantity data available in ledger accounts and not taken into the double entry process. Quantity data of shares in investment accounts,20

number of containers in container accounts, quantity of goods in goods on sale or return accounts, quantity of inventory in stock ledger accounts and bin cards are few examples for this. This quantity information is not processed through the double entry system. The difficulty in processing data measurement by using different types of quantities by using the manually maintained accounting system would have been the main cause for the dropping out of quantity data at half-way.

There are some accounting data, though they are taken into the double entry system in terms of monetary value, due to prevailing practice of accounting do not disclose in financial statements. They are either aggregated / sub-divided under sub-headings of assets, liabilities, equity, expenses and income or may be removed from the double entry system. "Salaries and Wages" classified under different headings of prime cost, overhead expenses, administration expenses, marketing expenses are examples, and it is not possible to identify the total added value of human resources used in the organization, without reprocessing data. Removal of the balance of goodwill account from the ledger is another example. SSAP 22 permits two diverse methods for accounting for goodwill.

Its preferred method is for purchased goodwill to be eliminated immediately against reserves. The permitted alternative allows purchased goodwill to be capitalized as an asset and to be subsequently amortized through the profit and

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21 ibid., pp. 524-531.
22 ibid., pp. 537-541.
23 Wald, J. (ed.); Biggs' Cost and Management Accounts; McDonalds and Evens; 1978, p. 38.
24 ibid., p. 39
loss account over its expected useful life. The expected useful life must not exceed 20 years.

In an expanding business, the value of goodwill, generally, will be increased. But the recommendation of the professional accounting bodies is to write off. Disclosure of negative effect of organizational activities on the economic and social environment is another example. Misuse and misapplication of natural resources, environmental damages due to business activities, and allocation and application of organization funds to rectify or reduce the environment damages are important information which are required by the users.

The environmental costs of an organization can be divided into environmental measures and environmental losses. The environmental measures include the costs of prevention, reduction or repair of damage to the environment and the conservation of resources. The environmental losses cover costs, which bring no benefit to the business such as legal damages. "Corporate reports which disclose the performance and position of companies without significant environmental cost reporting will be showing a distorted view of the business." 26

There are some significant information of economic activities which are not generally recorded in the prime-entry books or ledger accounts. Information of human resources, current values of assets, and futuristic accounting information are a few number of examples.

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Human resource used in an organization is a very valuable asset, though it is not accounted in the balance sheet as an asset. Manpower is the main gearing factor of an organization. All the other resources, such as land, building, machinery, equipment, stocks, cash & etc. cannot be efficiently and effectively managed without proper control and performance by the human resources.

Although, human resources are not accounted as an asset in financial statements, examples of the implicit treatment of human resources as business assets can be found easily;

... More and more large corporations are purchasing, small, technically oriented companies not for their bricks and motors, but for their skilled engineer's and scientists. Business organizations are spending ever-increasing sums of money to retain their managers. And financial analysts stress that the valuation of a company's securities is often based more on the quality of its managers than on any other factor.27

Further more Hekimian and Courtis state that "...if a company is to develop to its full potential, the top managerial, commercial, and technical skills must be considered as assets" 28

Under the current practice of accounting, human resources are shown as expenses and accrued expenses. "... when executives seek an explicit framework for treating humans as assets, they find little

28 ibid., p. 106
assistance in the management literature. Instead, most of the literature implicitly assumes that employees are an expense item." 29

Balance sheets, revenue statements, and cash flow statements are prepared, generally, on the basis of historical cost. Market value of investments and revaluation figures of fixed assets are some of the current value information, which could be seen in financial statements from time to time. Researchers such as Chambers 30, Sterling 31, Edward and Bell 32, Ijiri 33, Mattessich 34, have emphasized the significance of preparation of balance sheet items on the basis of current market values. The market value can be either realizable value or replacement value. Another useful information for the users of accounting information is the economic value or investment value of fixed assets. According to Howieson:

... It can be argued that if valuation of investment properties are to be useful to the users of financial reports, the valuation should reflect the stock of economic benefits embodied in the properties, namely the net rental stream and the expected terminal sale price. In an efficient property market we should expect the market value to be equivalent to the investment value... 35

29 ibid.
35 Howieson, Bryan; 'Real Estate on the Balance sheet (2)'; Australian Accountant; 1992 September, p.29.
"Historical cost" is the value of fixed assets presented through the routine double entry based accounting system. If directors are not prepared to revalue fixed assets and incorporate such values into accounts the real value of fixed assets may not be available for the users through the accounting information system. Lennie recommends the incorporation of significant values in the financial statements. "The accounting bodies must be ready to modify the current standards to cope with the additional disclosure of two real estate values [Market value and the Economic value] and more details of values..." 36

The Australian and Canadian concept statements specify two criteria for recognition of assets and liabilities. "One is reliable measurement, the other is the probability that the future economic benefit will arise or be sacrificed." 37 It seems that measurement and probability issues are not yet properly addressed by the accountants relevant to the market and economic values of fixed assets.

Accounting information of an organization can be related to past, present, and future. The information presented through the financial accounting system and its financial statements are related to past. Information on present activities and position is generally supplied to the management. Under standard costing, marginal costing, and budgetary control, some information on planned activities is computed. As Hicks and Johnson point out:

36 Lennie Owen; 'Real Estate on the Balance Sheet (1) '; Australian Accountant: 1992, September, p.27.
A real limitation is that the accounts now presented deal with past periods; and while the results of past years can be used to build up a financial history of a company, this is itself is only a limited value as a guide to future performance. The subject of future performance is of paramount interest to all shareholders and it is in this area that the information published by companies is deficient.\(^{38}\)

The professional accounting organizations have expressed not to consider the balance sheet as a predictor of future events. Robert Kirk in his review of FRS 4 capital instruments, describes it as "... the balance sheet is not to be regarded as a predictor of future events? it should only record the current position of the reporting entity at the period and ..."\(^{39}\)

There is very limited disclosure requirement in the Companies Acts to provide information on future plans and prospects of a company. A note on the balance sheet of some contingent liabilities and future capital expenditure, stating the estimated amounts respectively contracted for but not provided for, and authorized by the directors but not contracted for are the only items of future information specifically required by the Companies Act. The accounting standards have considered events occurring after the balance sheet date but before the preparation of the annual accounts and have recommended that although any such event may properly be excluded from the accounts under consideration, the events may be of such

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39 Kirk, Robert; ' Accounting Standards: Moving into Second Gear'; Management Accounting; 1995 April, p. 5.
importance that they need to be disclosed to shareholders through other medium.

It is possible for the management of a company to make forecast on the basis of future plans relevant to profitability of the company, and subsequently these forecasts could be compared with the actual results and the disclosure of forecast and actual results will be really useful for decision making by the users of accounting information.

3.3.0 CONCEPTUAL FRAMEWORK FOR DISCLOSURE OF ACCOUNTING INFORMATION

3.3.1 DISCLOSURE AS A CONCEPT

Organizational activities are planned, executed, and monitored by the managers. These activities relevant to use of economic resources are recorded and communicated through the process of accounting. Internal users of accounting information possess access to them. However, the external users of accounting information such as existing and prospective shareholders, lack the authority to prescribe the accounting information they need from the enterprise. In order to satisfy their requirements to make economic decisions external users will have to depend on the information communicated to them by the management. The information received by the users is not an end in itself. According to the FASB publication of the Statement of Financial Accounting Concepts No. 1 paragraph 9, "Financial reporting [including accounting reporting] is not an end in itself, but is intended to provide information that is useful in making business and economic decisions for making reasoned choices among alternative uses of
scarce resources in the conduct of business and economic activities."  
40 In paragraph 7 it further states, "Financial reporting includes not only financial 
statements but also other means of communicating information that relates, 
directly or indirectly, to the information provided by the accounting system 
that is, information about an enterprise's resources, obligations, and earnings 
and etc."  
41

In the process of communication through reporting, 
information has to be disclosed. Undisclosed or unclearly presented 
information may confuse the users of information.

Kohler defines disclosure as "a clear showing of a fact or 
condition on a balance sheet or other financial statement, in side heads, 
in footnotes, or in the text of an audit report."  
42 This definition, reflects the 
broad implications of the disclosure concept. The Accountants' Handbook 
presents a definition for disclosure as given in the AICPA's Committee on 
Auditing Procedure, as follows:

These matters relate to the form, arrangement and content of 
financial statements with their appended notes, the 
terminology used; the amount of detail given; the 
classification of the items in the statements; the basis of 
amounts set forth, for example, with respect to such assets 
as inventories and plants; liens on assets; dividend arrears 
ages, restrictions on dividends, contingent liabilities; and the

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40 Financial Accounting Standards Board; Statement of Financial Accounting Concepts 
No. 1; paragraph 9, in Seidler, Lee J. and Carmichael, D.R.; Accountants' Handbook, 6th 
41 ibid., paragraph 1.3 and 4.
42 Kohler, Eric L.; A Dictionary for Accountants; Prentice-Hall, India, 1972, p.163.
existence of affiliated or controlling interests and the nature and volume of transactions with such interests. This enumeration is not intended to be all-inclusive, but simply indicative of the nature and type of disclosure necessary to make financial statements successfully informative.\textsuperscript{43}

The adjective term 'adequate' has to be added to the term 'disclosure' to make it more precise and comprehensive. Buzby has used the term 'adequate disclosure'.\textsuperscript{44}

The subject of disclosure of accounting information encompasses very wide area, and it plays a central role in both accounting theory and practice. Activities of various pressure groups, throughout the history of accounting have foster expansion of the arena of accounting disclosure. According to Hendriksen "The topic of disclosure is broad enough to encompass almost the entire area of financial reporting".\textsuperscript{45}

Maurice Moonitz in his Accounting Research Study no. 1 'The Basic Postulates of Accounting', has stated that accounting reports should disclose that is necessary to make them not misleading.\textsuperscript{46}

The Accounting Principles Board in its statement of the Accounting Principles Board No. 4 'Basic Concepts underlying Financial Statements of Business Enterprises' has indicated that financial information

\textsuperscript{43} American Institute of Certified Public Accountants' Committee on Auditing Procedure; SAP No. 33; in Wixon, Rufus et al., 1970, Accountants' Handbook, Ronald Press Company, section 1-22 and 1-23.


\textsuperscript{45} Hendriksen, Eldon S.; Accounting Theory; Richard D. Irwin, Homewood, 1977, p.545.

\textsuperscript{46} Moonitz, Maurice; The Basic Postulates of Accounting; AICPA, 1961, p.50.

The matters, which may require disclosure, can be classified into two general groups;

a) Facts applicable to the statements show the results of operations during a period and the financial position at the end of the period.

b) Information relative to the subsequent events or prospective events.

The first category is relevant to the historical results shown by the balance sheet, profit and loss account, and the cash flow statement. The second category covers the prediction and forecasting by the management which is not yet generally accepted as a part of disclosure.

Pressure groups such as shareholders, bankers, security exchanges, journalists, accounting academics, professional accounting organizations have been emphasizing on better disclosure of accounting information. However, there are arguments put forward by the anti-disclosure groups. Hendriksen has listed these arguments as given below; 48

1. Disclosure will aid competitors to the disadvantage of the stockholders,

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47 Buzby, op. cit., p.551.
48 Hendriksen, op. cit., pp. 546 - 547.
2. Unions are said to gain an advantage in wage bargaining by a complete disclosure of financial information,

3. Investors cannot understand accounting policies and procedures and full disclosure will only mislead rather than enlighten,

4. Other sources of financial information may be available to provide the information at a lower cost that it was provided by the firm in its financial statements,

5. A lack of knowledge of the needs of the investors.

3.3.2 CONCEPTS IN DISCLOSURE ENVIRONMENT

Accumulation of knowledge in any discipline commences with the activities of the man in the empirical world. In order to organize and improve the knowledge of a discipline, and to make predictions in relation to the future, theoretical aspect of the knowledge has to be developed. A field of study without its theory means that it is at a primitive or rudimentary stage. A theory of a discipline is based, build, and expanded on its concepts. The field of accounting commenced development as a way of doing things. Concepts, principles, standards, and theory in the field of accounting have been developed subsequently. Paul Grady has described earlier discussions about accounting concepts as given below:

There is general agreement among accounting teachers and practitioners that there are a number of concepts which underlie or permeate accepted accounting principles. The first comprehensive exposition of concepts in accounting literature was in An Introduction to Corporate Accounting Standards by
W.A. Paton and A.C. Littleton. This pioneering classic in accounting thought, published in 1940 by the American Accounting Association, discusses seven concepts. A lesser number of concepts had been discussed by Professor Paton in an accounting text book written some twenty years earlier.  

Accounting concepts can be at different levels of the knowledge of accounting, as in any other discipline. Concepts which are very close to the empirical field could be easily understood even by a layman and those are distant from the empirical field would be more abstract and may not be understood by a layman. Fields of knowledge such as culture, sociology, politics, economics, philosophy & etc. consist of many common concepts. There is a great deal of overlapping and interfacing among the general concepts. Justice, truth, and fairness are three of them "... (These) three general concepts of social systems form at least the core of ... fundamentals of accounting." 50 These three, fairness, truth, and justice can be considered as the fundamental concepts of disclosure of accounting information.

**Fairness**

The concept of fairness is that there shall be no service to a special interest or interests. Fairness clearly means unbiased and impartial.

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50 Putnam, Donald P., Disclosure Criteria for Business Enterprises; A Dissertation Submitted to the Faculty of Claremont Graduate School for the Degree of Doctor of Philosophy in the Graduate Faculty of Business Economics, Claremont, 1975, p.50.
Fairness tends to be a supplement to the concepts of truth and justice and approximately be referred to as the interfacing between the truth and justice.  

**Truth**

In the case of truth, the accountant must avoid taking a narrow and meticulous attitude. Truth is taken to mean something more than isolated facts; it is taken to include relationships between facts. In addition, truth is relative and every statement of facts is only a partial truth. It is truth only to the extent that the facts have been properly and unbiasedly perceived.

**Justice**

The concept of 'Justice' tends to reflect an overview of all the concepts. The views of D.R. Scott reflects the importance of justice in Accounting. As he says "Because of the relation with which it deals, accounting is more directly concerned with the principle of justice...This principle of justice is the cornerstone, so to speak, of accounting theory and accounting practice."  

Framework for the Preparation and Presentation of Financial Statements issued by the International Accounting Standard Committee, in 1989, can be considered as a landmark in disclosure of accounting information. This statement has been reproduced without or with slight

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51 Ibid., p.40.
52 Ibid.
changes by the professional accountancy bodies of countries such as the United Kingdom, Australia, New Zealand, and Sri Lanka. A reasonable number of disclosure concepts have been discussed in this statement and they are listed as: Understandability, Relevance, Materiality, Reliability, Faithful Representation, Substance over Form, Neutrality, Prudence, Completeness, Comparability, and True and Fair Presentation.

**Understandability**

Users of financial statements must be able to understand the information provided in the statements. It is assumed that the users are generally in a position to understand the economic and business activities and presentation of them through accounting. There could be some complex accounting information, which may not be able to be understood by some users. Users of accounting information are supposed to have a willingness to study the information.

**Relevance**

The users of accounting information make decisions relevant to use of resources. Dividend payments, salary payments, bonus declarations, earning capacity, bonus and right issues, security price movements, ability of the enterprise to meet commitments as they fall due are some of the information in which users are interested. They need information to make decisions, predictions and to confirm or modify previous predictions. Therefore the accounting information provided must be relevant to the requirement of the users. If the provided information does not assist the users it becomes irrelevant and valueless.
Materiality

In the APB Statement No. 4, 'Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises' the Accounting Principles Board referred to materiality as a basic feature of financial accounting. In the Barchris case the Judge McLean followed the definition of materiality from a 1934 case before the SEC.

A fact which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing (or holding or selling) the securities in question.

If the economic decisions taken by the users of accounting information have been effected due omission or misrepresentation of information, it can be considered as material.

Reliability:

If the accounting information is to be useful for decision making it has to be reliable. Reliability derives from the unbiasness and free from material error of the information. "... for example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the enterprise to recognize the full amount of the claim in the balance sheet." Faithful representation, substance over form, neutrality, prudence, and completeness are the factors effecting the reliability of information.

56 Putnam, op.cit., p. 46.
57 Institute of Chartered Accountants of Sri Lanka; Sri Lanka Accounting Standards : ICASL, Colombo, 1997, p. 18
Faithful Representation

In order to be reliable, the accounting information should represent the economic activities, faithfully. However, in an organization there are some economic activities, which cannot be precisely recognized or measured under the prevailing Generally Accepted Accounting Principles. They are subject to some form of risk for being less than faithful representation. "For example, although most enterprises generate goodwill internally overtime, it is usually difficult to identify or measure that goodwill reliably."58

Substance over Form

Substance over form is an accounting concept which requires financial statements to be presented on the basis of underline commercial substance of transaction of an organization, rather than taking into consideration, there legal form.

"A good example is the required accounting treatment for finance leases setout in SSAP-18: Accounting for Leases and Higher Purchase Contracts. The substance of a finance lease transaction is that it combines both a purchase of an asset and a loan agreement which finance that asset purchase. SSAP-18 requires the purchase and loan components to be accounted for separately based on substance, rather than on the form of the agreement as a lease transaction."59

58 Ibid.
59 Mackenzie, April and Westwood, Mark; 'Reporting Substance over Form'; Chartered Accountants Journal; 1996 July, p.8.
Neutrality:

In order to information to be reliable, it has to be free from bias, and the selected information must not lead the decision-maker towards a predetermine decision.

Prudence

"Prudence is the inclusion of a degree of caution in the exercise of the judgments needed in making the estimates required under conditions of uncertainty."\textsuperscript{60} Some economic activities and their results are surrounded by uncertainties. Annual depreciation, and doubtful debts are two examples. They are to be measured in preparation of financial statements, by applying human judgment and using the prudence concept.

Completeness

If accounting information is to be reliable, it has to be complete within the bounds of materiality and cost. "An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance."\textsuperscript{61}

Comparability

Study of the trend in financial position and performance is significant for the users and comparing financial statements of a company over the time and financial statement of different companies of the same period can perform it. If the companies have followed the same accounting policies, the comparison would have been easier. The change of the economic environment may compel companies to change the accounting policies.

\textsuperscript{60} Institute of Chartered Accountants of Sri Lanka, \textit{op.cit.} P. 19.

\textsuperscript{61} \textit{Ibid}; p. 20.
adopted, so the disclosure of accounting policies will facilitate the comparability of financial statements.

ILLUSTRATION 3-5
CONCEPTS RELEVANT TO COMMUNICATION OF ACCOUNTING INFORMATION

ACCOUNTING AND FINANCIAL REPORTING CONCEPTS

EMPIRICAL FIELD
COMMUNICATION OF ACCOUNTING INFORMATION

LIST OF CONCEPTS

1. Disclosure
2. Justice
3. Truth
4. Fairness
5. Understandability
6. Relevance
7. Materiality
8. Comparability
9. Reliability
10. Faithful Presentation
11. Substance over Form
12. Neutrality
13. Prudence
14. Completeness
15. True and Fair

True and Fair View:

Financial statements are prepared by using data of economic activities of an organization, and they are expected to represent the reality of the summaries of economic activities. Generally, this can be
achieved by applying Generally Accepted Accounting Principles in preparation of the financial statements. However, there can be instances in which deviation fromGenerally Accepted Accounting Principles is required to present the true and fair view.

In order to present a better perspective of the concepts relevant to disclosure the ILLUSTRATION 3-5 is used. Communication of accounting information is part of the subject matter in the concrete empirical field of accounting. Disclosure can be considered as the main concept involved in Accounting and Financial Reporting. Justice, Truth, Fairness, Understandability, Relevance, Materiality, Comparability, Reliability, Faithful Representation, Substance over Form, Neutrality, Prudence, Completeness, True and Fair are other concepts developed for better understanding of the activities of the empirical field of communication of accounting information. These concepts are interrelated to each other and connected to the empirical field through the main concept of disclosure.

3.4.0 ANNUAL REPORTS AS A DISCLOSURE MEDIA

3.4.1 DISCLOSURE MEDIA OF ACCOUNTING INFORMATION

Generally, companies listed in a stock exchange prefer to disclosure favorable information to the users, and it can lead to popularity of shares in the market and increase in the share price. Higher, and increasing tendency of share prices in the market will minimize the risk involved in collecting new funds from the market. Alternatively, bad news about a company will bring down the market price of shares, which will increase the risk element in collecting new funds by issuing shares. Therefore, some directors prefer not to disclose bad news of companies. "...[Some
companies] attempt to dilute the quality of their financial statements. They do this by filtering out unfavorable news in an attempt to sanitize the information provided in financial statements.  

Listed companies, generally, use different types of methods to disclose accounting information, and they can be listed as quarterly reports, prospectuses, meetings of the shareholders, special meetings of interested groups with the management, press releases, press advertisements, and publication of annual reports.

Supply of quarterly or half-yearly financial statements, (Balance sheet and profit and loss account) to the shareholders by the listed companies is a requirement of most of stock exchanges including the Colombo Stock Exchange (CSE). These statements are not required to be audited according to the requirement of the CSE and most of other stock exchanges. "Audits of interim financial reports are rarely required by national securities legislation, listing requirements or professional standards." Generally, they do not provide schedules and footnotes; only summary information is provided. As Pacter has pointed out:

... Financial analysts say that they want to know about earning: volatility, unusual gains and losses, and turning points in trends of earnings and liquidity, and in good time too...academic researches have consistently found that forecasts of earnings and share prices are more accurate when

62 Laswad, Fawzi; "Annual Reports and Performance"; Accountants' Journal; 1992 August, p. 42
based both on historical annual data and on interim data than when based only on historical annual data. Moreover, the studies show that interim data does, in fact, influence investor decisions.⁶⁴

When a public company needs to invite the general public to subscribe for its new shares a prospectus is issued incorporating financial statements of the company. It is the general practice to provide summary financial information of last five or ten years in addition to the latest financial statements. According to "A survey conducted by Ernst and Young indicates that over 90% of Australia's leading institutions want prospectuses to include a financial report with historical and prospective information prepared by an independent accountant"⁶⁵

When a private company is converted to a public company a statement in lieu of prospectus has to be filed with the Registrar of Companies, and this filed statement contains information of the latest financial statements.⁶⁶

Meetings of Shareholders of a company are another instance at which accounting information of a company could be presented and discussed. It is compulsory for a company to submit latest audited annual reports at the annual general meeting of the company.⁶⁷ At the extraordinary general meetings and special general meetings a company may discuss

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⁶⁴ ibid., p.70.
⁶⁶ Companies Act No. 17 of 1982; op. cit., Second Schedule, part II.
⁶⁷ ibid., Section 144 (1).
information relevant to accounting matters if the calling of the meeting warrants it.

Special meeting of the interested parties with the management of a company is another instance at which accounting information could be discussed. Some listed companies, from time to time, call for meetings of the interested parties including journalists to disclose information about companies. New projects to be undertaken, future plans and profitability, and past performance are some of the matters usually discussed at these meetings.

Speculators in the share market, long-term investors, and the general public are interested in company affairs. Appearance of press releases and press advertisements of company financial affairs, in public mass media can be frequently seen.

3.4.2 ANNUAL REPORTS

Publication of annual reports is the most significant media of communication of company financial affairs. Under the companies Act of Sri Lanka every public company is required to send a copy of the annual report of the company to every shareholder and debenture holder, 21 days prior to the annual general meeting, and a copy of it with other required documents have to be filed with the Registrar of Companies. 68 According to the rules of the CSE annual reports of public listed companies have to be supplied to the CSE.

Traditionally, the annual report has been accepted as a

68 ibid., Section 154 (1).
document of record of the past. However, as Gus van de Roer of van de Roer Design Group says the annual report retains its duel function of a marketing instrument and document of record.  

3.4.3 FINANCIAL STATEMENTS IN ANNUAL REPORT

The companies Act of Sri Lanka (only the profit & loss account and balance sheet) and Sri Lanka Accounting Standards (Profit & Loss Account, Balance sheet, and cash flow statement) require companies to prepare financial statements for every financial year of the company. The balance sheet at the end of the financial year, Profit and Loss Account and Cash Flow Statement for the period ending the Balance Sheet date with relevant notes and schedules attached to them are considered as financial statements.

Financial Statements are prepared by the accountants and their staff in accordance with the Generally Accepted Accounting Principles, on behalf of the directors of the company. Financial statements must be singed by two director of the company and presented to the shareholders with the prescribed information. It seems that there is a broad consensus on the purpose of annual reports, which contain financial statements.

... The broad consensus on the purpose of financial reports that exists between the Trueblood report (AICPA, 1973) in the USA and the Corporate Report (ASSC, 1975) in the UK in the 1970s, and more recently, the conceptual framework project of the Financial Accounting Standard Board (FASB)

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in the USA and of the International Accounting Standard Committee (IASC, 1989), the Solomons Reports (Solomons, 1989), and the ICAS publication, Making Corporate Reports Valuable (McMonnies, 1988), in the UK. Although there are important differences of detail, all of these sources are broadly agreed on the following:

1. The financial reports are intended to save users and that equity investors and lenders are important components of the user constituency,

2. That the balance sheet and the income statement (or profit and loss account), supplemented by a flow of fund statement (or possibly a statement of cash flows) are the fundamental financial statements,

3. That users are concerned with economic evaluation and decision making. This implies that measurement should strive to reflect actual economic opportunities and steers us towards current valuation and the estimation of future prospects, rather than historical cost valuation and concentration on past transaction. Insofar as disclosure is concerned, it implies disclosure of all matters which are material to economic decision and evaluation. The ICAS group (McMonnies 1988) bravely pins its faith in identifying economic reality,
and Solomons adopts the concept of representational faithfulness.  

3.4.4 AUDIT OPINION ON FINANCIAL STATEMENTS

The independent audit opinion on the Balance sheet, profit and loss account, and the cash flows has to be expressed by the independent statutory auditors of the company. The auditors may express an unqualified or clean opinion or qualified opinion or subject to opinion or disclaimer of opinion. The audit opinion brings the value to the financial statements.

3.4.5 OTHER ACCOUNTING STATEMENTS

Accounting statements supplied in annual reports are not limited to financial statements required under the Companies Act or Accounting Standards. While some listed companies operate disclosure requirements only within the stipulated rules and regulations, there are other companies in the CSE operating disclosure performance beyond the stipulated limits. They provide additional accounting information under other accounting headings. Summary of financial information of last ten years / five years, information on employees, statement of share holdings, statement of stock exchange share values, graphical presentation of financial and operational information are some of the statements which could be frequently seen in listed company annual reports. Information appearing in these statements is not subject to external auditor’s perusal under the currently prevailing auditing standards and practice in Sri Lanka.

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3.4.6 ACCOUNTING INFORMATION IN NON ACCOUNTING STATEMENTS

Accounting information can be found even in non-accounting statements of annual reports of listed companies. Directors' report and chairman's reports are non-accounting statements of a company. Under the Companies Act of Sri Lanka 71 the directors are required to report to the shareholders, through the annual reports, following information:

1. The amount which they recommend to be paid as dividend.

2. The amount, which they propose to carry to, reserves.

3. Directors direct or indirect interest in any contract or proposed contract with the company.

These disclosure items can be classified as accounting information appearing in a non-accounting statement. In some annual reports of listed companies, chairman's report of the company appears. Generally, this is a management discussion to which the annual report is related. ED-65 and FRS-2 on Presentation of Financial Reports of New Zealand suggest to provide management discussion and analysis (MDA) as supplementary information in the presentation of financial reports. This exposure draft states that an understanding of financial reports may be assisted by a report of management explaining the information given and its significance. 72 Even the Securities and Exchange Commission of USA has recognized the value of management discussion and analysis in the annual reports. "Since 1974,

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71 The companies Act No. 17 of 1982, op.cit. Section 152 (1).
72 Laswad, Fawzi, op.cit., p.42
the United States Securities and Exchange Commission (SEC) has required registrants to include MDA. The MDA section in annual reports presents management's views on three main topics - Liquidity, capital resources, and results of operation. Future plans and expectations also can be seen in this report.

Hicks and Johnson suggested in 1969 that the "Information as to the future would be of more use to the shareholders," and proposed to extend the directors report to incorporate this. For many years, the need for financial forecasting has been debated. There are arguments both for acceptance and rejection of inclusion of forecasts in financial reports. In America, this question was finally taken up in 1972 by the Securities and Exchange Commission, who were concerned with the limited and selective manner in which forecast information was being distributed." Information, facts, predictions and forecasts appearing in the report are not subject to external auditors examination.

3.5.0 USERS AND THEIR NEEDS OF ACCOUNTING INFORMATION

3.5.1 USERS OF ACCOUNTING INFORMATION

Accounting information is a product of the accounting system, which based on the accounting practices and procedures followed. The accounting standards and principles guide accounting practices and procedures and they are developed to achieve objectives of disclosure in accounting and

73 ibid.
financial reports, which are supposed to be based on the needs of the users of accounting information.

The International Accounting Standards Committee in its Framework for the Preparation and Presentation of Financial Statements, has included present and potential investors [shareholders and debenture holders], employees, lenders, suppliers and other creditors, customers, government and its agencies and the public as users of financial statements. The Tax Department [Inland Revenue Department], Registrar of Companies, Securities and Exchange Commission, Accounting and Auditing Standards Monitoring Board, Census and Statistics Department, Central Bank, and the Planning Department could be included under the government and its agencies. To this list, it can be conveniently added professional accounting bodies such as the Institute of Chartered Accountants, financial analysts and advisers, financial press, stockbrokers, trade associations, and managers as users of accounting and financial statements.

While some users have direct interest in accounting information, others have an indirect interest. The government and its agencies, financial analysts and advisors, stock exchanges, financial press, reporting agencies, trade associations and labor unions, and professional bodies can be classified as users with indirect interest in company affairs.

Even though, there are many interested parties in financial affairs of companies, both existing and potential investors have been singled out as the dominant user group. According to Jawahar Lal:

76 International Accounting Standards Committee, op. cit., p. 142.
Traditionally, investors (both existing and potential) are singled out as the dominant user-group... In a study, Hay found that management accords 100% priority to investors in preparing the annual report. A [Another] study conducted by the Financial Executive Institute concludes that among corporate executives current shareholders and prospective shareholders... are the primary audiences for corporate financial reporting. The study finds that 90% of the companies allocate first priority in financial reporting to the existing shareholders. Accordingly, only about 10% of the companies positioned the existing shareholders as other than priority. 77

When the users of accounting information are diverted and separated from the activities of an organization, they have to depend on the information available and supplied to them in the market. Following two quotations from Chambers and Lee will explain it respectively.

Investments in firms by shareholders or creditors are not irrevocable. They may be made or unmade at the will of investors and creditors, through the use of transferable securities and the negotiation and re-negotiation of credit. Where negotiations are face to face, financiers may make such stipulations and require such information as they deem necessary for the protection of their interests. There is

no less reason for enabling investors in transferable securities, who do not deal face to face with the issuers of shares and debentures, to have factual information for the protection of their interests. 78

... the accounting actor (for example manager, investor, lender, banker, etc.) relies on accounting communication for knowledge of the economic events and effects from which he or she is removed. This creates a major problem for the actor because,... the actor has no direct knowledge of the economic events and effects being reported on to be able to rectify the faults in the information which describes them. 79

Ownership of a person (natural or created) in a company established under the companies act is represented by shares of the company. Shareholders are the owners of shares of the company. Resources of the company are owned by the company and for the liabilities the company is responsible and not the shareholders. Basically, shareholders can be classified as ordinary shareholders and preference shareholders on the basis of types of shares. On the basis of market classification, shareholders could be grouped as private persons and institutional investors. In deciding the type of accounting information to be provided, this classification seems to be more appropriate. “In the United Kingdom there are two main classes of shareholders; 1. Private persons and 2. Institutional investors. In terms of numbers, the private investors are far greater than the professional

78 Chambers, R. J.; ‘The Role of Accounting: Difficulties are No Excuse for Inadequacies’; The Accountant, 1969 February, p. 255.
79 Lee, op.cit., p. 158.
institutional investors, but in terms of money invested the difference narrows considerably."

Shares quoted in a stock exchange can be bought and sold in the open market of the stock exchange. Generally, investors own shares in listed companies with all or some of following objectives.

1. Long term investment objective,
2. As speculators of the market,
3. For prestige of owning shares.

Benefits are accrued to shareholders through the ownership of shares by following means:

1. Dividends received form companies,
2. Capital gains through appreciation of market value of shares,
3. Bonus shares received from companies,
4. Shares received from companies under right issues.

One may argue, that through bonus and right issue of shares, shareholders do not access any additional new benefits. However, due to imperfect characteristics of the share market shareholders’ gain through bonus and right issues could be observed.

The shareholders’ interest in a company is shown in the balance sheet under the equity section, and proposed and paid dividends are disclosed in the appropriation section of the profit and loss account.

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Prospective investors are the persons who are willing to acquire the ownership of shares of a company. Shares of a listed company can be owned by a person either purchasing existing shares from another owner of shares or subscribing for shares in a new issue of shares or purchasing rights in a bonus or rights issue and subscribing for them.

Debentures are special type of loans of companies, which could be transferred from one person to another without effecting the loan given to the company. Through acquisition of a debenture, the holder does not get the ownership of the company. Debenture holders are entitled for interest from the company. If the debentures are listed at the stock exchange they could be bought and sold at prevailing market prices.

Employees are the people who sell their labor to the company and their service can be full-time, part-time, permanent or temporary. While, full-time and permanent employees have a long-term interest in the company, temporary and part-time employees may work until their service contracts are over.

Lenders provide loans to a company, which could be long-term or short-term. Banks, insurance companies, finance and leasing companies & etc. provide loan facilities to companies.

Suppliers and other creditors provide goods and other services required for the operation of the company. Since the company has the option to change the suppliers of goods and services, their interest in the company can be short-term. However, if the suppliers could continue their activities with the company the interest involved could be a long-term one.
Customers purchase goods and services from the company. Revenue of a company derived from the customers. If a company could not satisfy customers relevant to quality and quantity of goods and services, the company may not survive in a competitive economy.

The tax department of the government is responsible for collection of revenue on behalf of the government. Generally, companies are liable to pay income tax, turnover tax & etc. to the tax department. The organization responsible for implementation of the Companies Act is the Registrar of Companies. Under the Companies Act, all companies should file their annual reports with the Registrar of Companies. Securities and Exchange Commission is the government institution established for the development and monitoring of the capital market. Accounting and Auditing Standard Board is a government body corporation responsible for the supervision and monitoring of application of accounting and auditing standards. The Census and Statistics Department, Central Bank, and Planning Department collect information about companies in their routine operations.

The professional accounting bodies such as the Institute of Chartered Accountants of Sri Lanka, are responsible for the development of accounting education and practice. Financial analysts, accountants, and lawyers have been providing expert services and advises to the investment community. Financial newspapers, business pages of daily papers and periodicals, and journalists could be included under the business press. They bring in news, and feature articles relevant to interest of the business community. Stock brokers and agents are involved in bringing together
buyers and sellers of securities. Trade associations are interested in developing their own trade and satisfying the members’ common needs. Managers work in business organizations performing their duties to achieve objectives of companies.

All of these individuals and organizations are interested in accounting information disclosed through annual reports of public listed companies. However, the interest they possess may vary according to the stipulated or implied requirements and business environment.

3.5.2 USERS' REQUIREMENTS

Historically, shareholders of companies have been considered as the primary users of accounting information in published company annual reports, and they have been prepared to satisfy, mainly, shareholders' requirements.

The idea that stockholders are the primary annual report audience is a consequence of the emergence of large corporations in American Society [this idea is equally applicable to any country where large scale private sector economic units are in operation within a free enterprise system] In light of the separation of ownership and control that is characteristics of these organizations, most people agree that owners have a right to receive a periodic accounting from those to whom they entrust economic resources. This accounting should provide information so that
the stockholder can decide whether to buy, sell or continue to hold an ownership interest in the firm.\textsuperscript{81}

Shareholders are concerned with the risk inherent in the cost incurred in acquisition of shares. The difference between the price paid for a share and its market value would interest the shareholder. Ability of the company to pay dividend, issue bonus shares and to collect new funds through new issues and right issues would help the shareholders in making decisions.

Preference shareholders, generally, receive a cumulative fixed dividend prior to payment of any dividend to the ordinary shareholders, therefore, they are interested in ability of the company to pay preference dividend continuously, in the long run.

Debenture holders or bondholders are entitled for annual interest. The interest on debentures is considered as an incurred expense of the company whether it is paid or not. So, debenture holders are interested in ability of the company to pay annual interest. If debentures are secured on a fixed asset or assets, their realizable market value would interest the debenture holders. In the case of debentures being redeemable, the ability of the company to redeem the debentures on the due date is important for them. If the debentures are not redeemable the money invested would not be refundable under normal circumstances. So the debenture holders would pay attention to the market value of the debentures and ability of the company to repay the nominal value of debentures on liquidation.

Long-term and short-term lenders are interested to find out the ability of the company to pay interest and the capital amounts when they are due for settlement.

Employees and their trade unions are interested in the strength, stability, and profitability of their company. The information on ability of the company to pay remuneration, retirement benefits, health insurance, training, promotions and better working conditions are important for the employees. If employees are not satisfied with the prevailing working conditions and the company environment a higher labor turnover could be expected. Generally, the directors of a company do not like to disclose company information to employees, reason being that such disclosure may lead to strengthen the bargaining power of the trade unions.

Suppliers and other creditors need information to decide ability of the company to settle the amounts due to them during the expected settlement period. They are generally interested in settlements within short periods.

Since customers do purchase goods and services form the company, they are interested in knowing the ability of the company to supply them in good quality and required quantity within the required time periods. They would like to know about the credit facilities available for them and the cash and trade discounts provided by the company.

"The government and their agencies are interested in the allocation of resources, and therefore, the activities of enterprises. They also require information in order to regulate activities of enterprises, determine
taxation policies and as the basis for national income and similar statistics.  

The tax department requires specific reports of financial statements prepared on the basis of prevailing tax laws and regulations. The tax authorities as additional information could use the published annual reports of companies. The general public can refer the published annual reports filed with the registrar of companies. The annual reports supplied to the stock exchanges are used for regulatory purposes.

The professional accounting bodies, financial analysts and other advisers, financial press, stock brokers and trade associations use financial information available in annual reports to satisfy the requirements of their clients or members and the general public.

The public listed companies, generally, are the large organizations of an economy. Their activities effect the general public in number of ways. There could be positive as well as negative contribution by the listed companies towards the society. As large organizations they could provide direct and indirect job opportunities for the general public. By using local suppliers, subordinate industries and economic activities in the environment could be developed. Similarly, large enterprises may destroy and damage available economic resources. Pollution and destruction of natural habitat can be seen around large-scale business organizations. It is possible to provide information to the general public about the development

\[82\] International Accounting Standards Committee, *op. cit.*, p. 141.
and contribution towards the economy and the activities undertaken to protect the environment, by using annual reports of public listed companies.

The managers of an organization are spread over different divisions and they carry out planning, decision making, implementation, and control activities of the company. It is possible for them to obtain required specially prepared information statements for their day to day activities. However, information provided through the annual reports is useful to managers of the company. Overall summarized picture of the financial matters and other important activities relevant to past, present and future could be obtained through published annual reports of companies.

3.5.3 USEFULNESS OF FINANCIAL STATEMENTS

Accounting information provided in published annual reports has been accepted by the business community and the researchers in accounting as significant. However, problems in communication through annual reports prevail.

<table>
<thead>
<tr>
<th>Sources of Information</th>
<th>% Greater than MID point of 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Newspapers and magazines</td>
<td>53</td>
</tr>
<tr>
<td>2. Stockbroker advice</td>
<td>48</td>
</tr>
<tr>
<td>3. Corporate annual reports</td>
<td>42</td>
</tr>
<tr>
<td>4. Half-yearly reports</td>
<td>34</td>
</tr>
<tr>
<td>5. Advisory Services</td>
<td></td>
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<tr>
<td>e.g. Accountants or lawyers</td>
<td>21</td>
</tr>
<tr>
<td>6. Advice of friends and relatives</td>
<td>14</td>
</tr>
<tr>
<td>7. Tips and rumors</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: Adopted from the article, ‘Small Share Holders’ Perception’; by Goodwin, Jenny, Goodwin, David and Konieczney, Kathy; Accountant's Journal of New Zealand, vol. 75 No. 7; 1996 August, p.34.
According to a study carried out, small shareholders do not consider corporate annual reports as the best source of information. The TABLE No. 3-1 shows that the corporate annual reports take the third place as a source of information for the investors.

According to this study newspapers and magazines and stockbroker advice are more important than the corporate annual reports, to the small investors.

According to the observations of Jamieson, majority of shareholders do not read the main accounting statements.

Many surveys have been undertaken, trying to establish just who are the potential users of accounts and whether, in fact, they read them. Most studies come to the conclusion that the majority of shareholders do not read the main accounting statements, which is not surprising when most of us would concede that to a layman, they are unreadable. In other words the surveys establish conclusively that unreadable accounts are not read.\(^\text{83}\)

In another study, by Abdel Salam and Satin, it has shown non-reaction of the actors to earning announcements, in annual reports. "The authors found that earnings announcements do not significantly affect Saudi stock returns. This fact itself may be intrinsically uninteresting, but it contrast with Beaver's price reaction study."\(^\text{84}\)


\(^{84}\) Abdelsalam, Mahmoud and Satin, Diane; ‘The Impact of Published Annual Financial Reports on Share Prices in Saudi Arabia’; The International Journal of Accounting; Vol 23, No. 2, 1988, Spring, p.113.
In accounting, in addition to the problems of measurement, problems could be seen in the areas of users of accounting information. However, in deciding the type of information to be provided and the system of measurement to be used requirements of the users have to be considered.

3.6.0 SUPPLIERS OF ACCOUNTING INFORMATION

3.6.1 RESPONSIBILITY OF DIRECTORS

The shareholders provide funds with relatively higher risk, to be used in operations of the company by the directors of the company. They need assessment of the stewardship.

An early understanding of financial reporting was as a stewardship function where management acts as stewards to whom suppliers of capital entrust control over their financial resources. In this context, the role of financial reporting was to provide an assessment of the stewardship of management to the suppliers of capital.\(^{85}\)

The directors as officers of the company provide information through annual reports to users. “Annual reports are the vehicle through which the officers of a company disseminate information to various audiences...”\(^{86}\) The board of directors is the top management and policy decision makers of the company. The overall responsibility for management and control of the company is vested with them. “Every public company should be headed by an Effective Board

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\(^{86}\) Osundiya, George; ‘Making the Annual Report More Relevant’; Management Accounting; 1977 March, p. 58.
which can both lead and control the business.\footnote{Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance; Exposure Draft of the Code of Best Practice; The Institute of Chartered Accountants of Sri Lanka; 1997, p. 17.} Usually, the board of directors of a public company consists of executive directors and non-executive directors. The Exposure Draft of the Code of Best Practice has emphasized the significance of the position of non-executive directors.

The committee emphasizes the importance of the ‘performance’ function of the independent non-executive directors and their role as advisors to the Board, particularly by assisting the board to resolve the conflicts as they are less directly effected. Therefore the Board’s effectiveness can be achieved by combination of Executive Directors with their intimate knowledge of the business and of ‘outside’ Non-executive Directors who can bring a broader view to the company’s activities.\footnote{Ibid., p. 17.}

Generally, an annual report of a public listed company provides information about the Board of directors.

Quite often the barest details of who’s who on the board are given, sometimes without photographs. It is a worthwhile bonus to show their line of expertise or/function and/or qualifications. Surely this sort of information must give confidence to all parties concerned that the direction of the organization is in good, expert hands! \footnote{Osundia, op. cit., p. 58.}

The head of the board of directors is the chairman. He is expected to maintain order in conducting board meetings in a proper manner. The chairman
should encourage both executive and non-executive directors to play a useful role at board meetings in order to obtain the maximum contribution from them. Today, in Sri Lanka, in a considerable number of listed companies the chairman’s post is held by the Chief executive of the company. The Exposure Draft of the Code of Best Practice has recommended separation of power between the chief executive of the company and the chairman.

It is desirable that the chairman is not involved in the day to day operations of the company, but operates in such a way so as to ensure that the Board is in complete control of the company’s affairs and fully alert to the obligations towards the shareholders ... we consider it a desirable practice that this [chairman’s] position should be separated from that of the Chief Executive. This is mainly to avoid the domination of power by a single individual...there should be a clear accepted division of responsibilities at the Head of the company to ensure a balance of power and authority.  

3.6.2 BOARD OF DIRECTORS AND ACCOUNTING STAFF

Legal responsibility for providing financial information is vested with the board of directors. However, the preparation of financial information is a duty and official responsibility of the accountant and his staff. The ILLUSTRATION 3-6 SHOWS the relationship among the three groups providers of finance, board of directors, and accounting staff.

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ILLUSTRATION 3-6
RELATIONSHIP AMONG THE PROVIDERS OF FINANCE, BOARD OF DIRECTORS & ACCOUNTING STAFF

PROVIDERS OF FINANCE

Shareholders

Lenders

BOAD OF DIRECTORS

ACCOUNTING STAFF

1. Audited Financial Accounting Information,

2. Votes,

3. Covenants,

4. Audited Financial Accounting Information,

5. Management Accounting Information,

6. Cost Accounting Information,

7. Financial Accounting Information,

8. Instructions received from the Board of Directors.


Shareholders and lenders provide funds as providers of finance for companies. Shareholders possess controlling power on the activities of the board of directors at company meetings through votes (No. 2). They receive audited financial accounting information from the board of directors (No. 1). Lenders could obtain audited financial accounting information (No. 4) from the board of
directors while introducing covenants (No. 3) for the security of the funds provided. The accounting staff provides information of management accounting (No. 5), cost accounting (No. 6), and financial accounting (No. 7) according to the instructions received from the directors (No. 8).

3.6.3 NEW DEVELOPMENT IN THE RELATIONSHIP BETWEEN THE DIRECTORS AND INVESTORS

Today, among the business community, a tendency is being developed to strengthen the relationship between the company directors and the providers of company funds. As Cooling says:

...many of the world’s major companies today are employing senior executives to fill a specific investor relations post. The titles may differ – Investor Relations’ Director, Controller, or Manager – but the post recognizes the need to maintain a continuous dialogue with the company shareholders and the investment community. A recent survey conducted by London-based Business Planning and Research International (BPRI) on behalf of the Investor Relations Society of the UK showed that 98% of the chief executives...considered investor relations...to be essential or very important for the organization.\(^9\)

In the USA the relationship between the companies and the investors has been increasing. “The practice of investor relations within the US is growing dramatically each year, as more and more companies recognize that to stand out from the crowd of public companies, they must seek outside assistance to

improve the quality and quantity of their communications with the investment community. 92

3.6.4 THREAT TO CONFIDENCE

Shareholders and other users of financial information expect the directors to run the company successfully, and to provide favorable as well as unfavorable information relevant to the company. They expect good governance from the company directors.

The public imagination is often stimulated by particular causes cilibres, and there have been a number recently which have suggested failure of corporate governance, and have involved associated criticism of auditing and accounting practices. These include the business failures of Polly Pack, the Bank of Credit and Commerce International (BCCI), and the Maxwell Companies. 93

Even in Sri Lanka, in the recent past, there were company failures, which led to lose confidence in the company directors and other officers.

Like in many other countries, Sri Lanka too, has witness in the recent past, failures of companies, especially Finance Companies with no one being prepared to take the responsibility for such failures. Many reasons have been attributed to such failures. These failures resulted in many investors loosing faith in the regulatory and semi regulatory framework, as well as in the standards of

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92 Jacobs, Marisa; ‘Investor Relations in the USA’; Accounting and Business; 1998 October, p.17.
financial reporting, and this situation almost reached crisis proportions at a certain time.\textsuperscript{94}

Users of accounting and financial information enter into business and investment contracts on the basis of accounting and financial information provided to them by the directors. Ormrod and Cleaver describe the directors' involvement in accounting based contracts (ABS) as follows:

The impact of director discretion upon ABCs may, however, be of much more concern than the signaling implications. Directors, by controlling the yardstick by which ABCs operate, may be able to effect transfers of wealth, power, and risk between groups of stakeholders. Thus in using some of the above mentioned techniques to enhance assets and income, directors may, for example, be able to: enhance profit related pay; prevent restrictive covenants in lending agreements from applying; artificially increase cost-plus based prices, and reduce taxation.\textsuperscript{95}

Chow and Wong-Boren have highlighted the fraudulent accounting practices prevailing in Mexico.

Unstructured interviews with seven Mexican CPA firms' managing partners suggested that law enforcement is generally lax, and fraudulent accounting practices are common. Thus, firms in Mexico seem to have much more flexibility in accounting and disclosure practices than those in the US. Consequently, their accounting and

\textsuperscript{94} Committee to Make Recommendation on Matters Relating to Financial Aspects of Corporate Governance; \textit{op. cit.} p.10.

\textsuperscript{95} Ormrod et. al., \textit{op. cit.}, p. 433.
disclosure choices are also more likely to reflect voluntary responses to market forces.\textsuperscript{96}

Some directors are more partial towards showing good results while undermining poor results.

Some research also shows that companies with poor results tend to write in more convoluted language than those with good results (Adelberg, Accounting and Business Research, 1979). Whether this observation is intentional or unintentional is, of course difficult to assess...The findings of Pava and Epstein (Journal of Accounting, March 1993) in the USA are particularly striking. These researchers investigated the disclosure of predictable future events and trends that may effect businesses, future operations. They found on average, that companies were more than twice as likely to correctly predict positive economic events than negative ones.\textsuperscript{97}

3.6.5 GOLDEN OPPORTUNITY FOR DIRECTORS

The publication of company annual reports by the directors of the company is a golden opportunity for companies to convey appropriate massages to shareholders and other interested user groups. Audited financial statements and auditor's report have been the major components of annual reports. Accounting and non-accounting narratives have been subsequently incorporated in the annual reports, and they have been user-friendly and more popular among the readers. "Accounting narratives present management with a good opportunity to


\textsuperscript{97} Jones, Mike; 'Accounting Narratives: An Emerging Trend'; Management Accounting; 1996 April, p. 41.
communicate effectively to their shareholders.” The chairman’s report, directors’ report, management discussion and analysis or operating and financial review and graphical presentations and statistical summaries provided by the directors through the annual reports are considered as statements containing accounting narratives. The chairman’s report and the directors’ report have been accepted as most widely read and useful.

Several studies (most notably Lee and Tweedie, Accounting and Business Research, 1976) have demonstrated that the chairman’s statement is the most widely read and best understood part of the corporate report by private investors. More recently Harte, Lewis, and Owen (Critical Perspectives in Accounting, 1991) show the chairman’s report and the directors’ report to be among the most useful parts of the annual reports.99

The regulatory authorities in the USA and the UK have accepted the significance of accounting narrative statements. In 1980, the Securities and Exchange Commission of the USA mandated that public companies include a ‘management discussion and analysis’ (MDA) section in the annual report to assess the liquidity, capital resources and operations. In 1993, Accounting Standard Board of the UK introduced the ‘operating and financial review’ to the annual report. Inclusion of the operating and financial review in the annual report is not mandatory. “Most companies have seen it as complimentary not only to the financial statements, but to the traditional accounting narratives, the chairman’s statement and directors’ report.”100

98 ibid.
99 ibid.
100 ibid., p. 41.
Narrative statements, such as 'management discussion and analysis' or 'operating and financial review' included by the directors in the annual reports are not subjected to annual audits of the external auditors. However, according to the USA Statement of Auditing Standards (SAS No. 8), the external auditors have to see that the contents of the narrative statements are not inconsistent with the contents of the audited financial statements.

The statement (SAS No. 8) requires the auditor to consider whether the 'other information' ... is materially inconsistent with information, or the manner of its presentation appearing in the financial statements ... Although, auditor is not required to corroborate other information in the document, he must see that material inconsistencies are eliminated, or take other actions such as reporting upon the inconsistencies. ¹⁰¹

A similar requirement and practice prevails also in the UK.

Neither the directors' report, the chairman's statement, nor the OFR is required to be audited formally. Financial information issued with audited financial statements, the relevant UK auditing guideline, deals principally with the directors' report, but also covers other information (such as the chairman's statement and OFR).

Essentially, the auditors should ensure that the credibility of the financial statements is not undermined by material inconsistencies between the financial statements and other financial information (including accounting narratives). Discussion with management

and/or potential amendments to the corporate annual report may result if material inconsistencies or misleading statements are found.\(^\text{102}\)

3.6.6 CORPORATE GOVERNANCE

It is the responsibility of the directors to govern the company on behalf of the providers of funds in order to achieve the objectives of the company. In recent years poor performance of corporate governance by the directors has adversely effected the shareholders and providers of funds.

The use of creative accounting methods has misled the shareholders in the share market. As Whittington says:

The obvious increase in the use and variety of creative accounting methods in the 1980s...reinforced these anxieties about the effectiveness of shareholders and their stock market behavior as a medium of corporate governance. Clearly, management [bodies] were going to considerable extent to represent performance as measured by the accounts in an unduly favorable light. This suggested either that creative accounting could fool shareholders or that directors thought wrongly that they could be fooled. In either case there would seem to be some failure in the shareholders’ capacity to monitor directors.\(^\text{103}\)

In corporate governance, financial reporting by directors through annual reports to the users of financial information is an important element. Failures in corporate governance will lead to poor financial reporting.

\(^{102}\) Jones, op. cit., p. 41-42.  
\(^{103}\) Whittington, op. cit., pp. 311-312.
Report of the Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance has defined 'Corporate Governance' as follows.

Corporate Governance is popularly understood as the system by which companies are directed and controlled. Board of directors is responsible for the Governance of their companies. The shareholders’ role in Governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include the setting out of the Company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship.104

The Cadbury Committee Report in the UK and the Exposure Draft of the Code of Best Practice (in Sri Lanka) which was based on the Cadbury Committee Report have recommended a list of best practices to be followed by the company directors. At present, adherence to them by the companies is not compulsory. However, some companies of the CSE are following this practice. "The Committee recommends that, once the code is in practice, all listed companies and others to whom it is directed make a statement setting out the status of their compliance with the code, in the Annual Report and Accounts and give reasons for any areas of non-compliance."105

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105 Ibid, p. 16.
3.7.0 FRAMEWORK FOR THE PROTECTION OF USERS' INTERESTS

3.7.1 FRAMEWORK FOR PROTECTION

The public listed company is an artificially created person under the prevailing company law of a country. While the company is run and managed by a board of directors, the parties who are interested in affairs of the company will have to rely on the institutional framework, which has been developed through the past experience of the business community. In this section, protection through the Companies Act, Involvement of the Securities and Exchange Commission, requirements of stock exchanges, accounting standards and auditing standards published by the professional accounting bodies, Accounting and Auditing Standards Act, Urgent Issue Task Force and recommendations for financial aspects of corporate governance will be discussed as the framework for the protection of user’s interest.

7.2 PROTECTION THROUGH THE COMPANIES ACT

The Companies Act No. 17 of 1982 provides the major legal protection, mainly, for the shareholders of a company. Every company is required to keep proper books of account with respect to all sums of money received and expended by the company and matters in respect of which receipt and expenditure takes place; all sales and purchases of goods by the company; and assets and liabilities of the company.\(^\text{106}\) The books of account must be kept to give a true and fair view of the state of the company’s affairs and to explain its transactions. The ‘matters in respect of which the receipt and expenditure takes place’ denotes the requirement to maintain book-keeping and accounting records under sub-

\(^{106}\) Companies Act No. 17 of 1982; op. cit., Section 143 (1).
classification of different types of assets, liabilities, equities, expenses, revenues, other debits and other credits. The external users do not possess any right to inspect books of account kept by a company. However, the books of account have to be kept at the registered office of the company or at such other place as the directors think fit and shall at all times be open to inspection by the directors, the registrar, or other officer duly authorized in writing by the Registrar or by the auditors of the company or any person duly authorized by the auditors in writing.  

Even though the shareholders do not possess right to inspect books of account of their company, they have the right to receive financial statements of the company.

The directors of every company shall at a date not later than eighteen months from the date of incorporation of the company and subsequently once at least in every calendar year lay before the company at a general meeting a profit and loss account or in the case of a company not trading for profit an income and expenditure account for the period, in the case of the first account, since the incorporation of the company, and, in any other case, since the preceding account, made up to a date not earlier than the date of the meeting by more than nine months...  

The balance sheet and the profit and loss account should give a true and fair view of the position and operations of the company.

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107 ibid., Section 143(3).
108 ibid., Section 144 (1).
3.7.3 SECURITIES AND EXCHANGE COMMISSION

The Securities and Exchange Commission is an organization established in Sri Lanka for the development of the capital market in Sri Lanka. The Government of Sri Lanka under the Securities Commission Act No. 37 of 1987 established the Securities Council of Sri Lanka in 1987. During the year 1991, the name was changed to the Securities and Exchange Commission. This act was based on the Securities and Exchange Act of USA. In the USA the original securities acts were established in 1933 and 1934. The Securities and Exchange Act of 1934 was "...largely the result of the recommendations of a US Senate Committee on stock exchange practices which revealed the vast extent of manipulation in American securities markets during the 1920s, a period which ended with the Great Crash of 1929 and the ensuing years of depression."\(^{109}\) The Securities and Exchange Commission, which was established and subsequently improved under subsequent acts, was the main authoritative body in America in order to protect the interest of the investors and smooth running of stock exchanges.

The Securities and Exchange Commission established in Sri Lanka is considered as a capable and fair regulator and controller of the securities markets. The Securities and Exchange Commission works in collaboration with the Colombo Stock Exchange (Pvt) Ltd., the only stock exchange in Sri Lanka, in order to develop the share market in Sri Lanka at both fronts, fund using companies and fund supplying investors. Creation and maintenance of a fair and orderly securities market, protection of the financial interest of the investors,

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operation of a compensation fund to compensate investors against the loses arising from the failure of brokers/dealers to fulfil their contractual obligations and regulation of the securities market and maintenance of professional standards in the securities market are the broad objectives of the Securities and Exchange Commission of Sri Lanka. In order to achieve these objectives the Commission has been entrusted with powers, duties, and functions in relation to licensing, regulating, controlling, advising, examining, settlement, and discretion.

Under the licensing power the SEC is empowered to issue licenses, to stock exchanges, stockbrokers, stock dealers, and unit trusts. It has the power to issue directions to stock exchanges and unit trusts to ensure proper conduct of the business, under the regulatory powers. If evidence is available it has the controlling power to suspend or cancel the listing or trading of any security for the protection of investors from irregularities and malpractice. Under the advisory power SEC provide advice to the Government for the development of the security market. Whenever there is a reason to believe that an irregularity or a malpractice has been done by a licensed stock exchange, a stockbroker, a unit trust, or a public listed company the SEC has the power to inquire into its business affairs and examine its books. The SEC has the settlement power to solve disputes between investors. Under the discretion power the SEC can declare decisions regarding any misconduct by a trading floor share broker, a share dealer, or a public listed company.

3.7.4 THE COLOMBO STOCK EXCHANGE

The Colombo Stock Exchange (Gte.) Ltd. is a company registered under the Companies Act of Sri Lanka for organizing and running of the only share trading floor in Sri Lanka. Shares of public listed companies are traded through the
trading floor of this company. The CSE is interested in protection of the interest of
the investors as well as public listed companies. In order to see a smooth operation
of the trading it carries out activities such as listing of companies, pricing of shares
through incorporated brokers on the basis of supply and demand for securities,
publication and listing of daily share prices traded in the trading floor, publication
of share market indices, notification of bonus issues, right issues and dividend
payments, and managing of its subsidiary company, Central Depository System
(Pvt) Ltd.

The CSE requires public listed companies to apply Sri Lanka Accounting Standards in preparation of accounts and reporting through financial statements, balance sheet, profit & loss account, and cash flow in annual reports. If a public listed company does not publish and supply annual reports within six months from the date of balance sheet, the CSE publicize that information for the benefit of the users of annual reports. All public listed companies are required supply unaudited quarterly balance sheets and profit and loss accounts to shareholders.

3.7.5 STATUTORY AUDIT

It is a legal requirement to incorporate the statutory auditor’s report on the financial statement of the company in supplying financial information to the shareholders. “A report of the auditor on the annual accounts of the company is appended to every balance sheet.”110 In public listed companies the auditor acts as a trustee of the shareholders to safeguard their financial interests. Generally, the auditor is appointed by the shareholders at the annual general meeting of the

company. "Shareholders are assured that the accounts have been properly
maintained and the directors and managers of the company have not taken any
undue advantage of the position and have conducted the company affairs in the
interests of the whole body of the shareholders."111

According to the requirements of the CSE accounts of public listed
companies have to be audited by the members of the Institute of Chartered
Accountants of Sri Lanka. The use of service of members of a professional
accountancy body helps to bring confidence of users of accounting information.
Even the format of the audit report has been developed to remove unnecessary
wordings and to present an understandable clear meaning to the unsophisticated
users of financial statements. The expression of auditor’s opinion may be
unqualified or qualified or piece-meal or he may disclaim expression of any
opinion. The standard audit report consists of the scope paragraph and the opinion
paragraph. The brief, comprehensive, and precise statutory auditor’ report assists
the users’ of accounting information in developing confidence on financial
statements.

3.7.6 ACCOUNTING AND AUDITING STANDARDS ACT

The Companies Act No. 17 of 1982, Banking Act No. 30 of 1988,
Insurance Act No. 25 of 1962, Finance Companies Act No. 78 of 1988, Securities
and Exchange Commission Act No. 36 of 1987 have been enacted with an
intention of protecting funds provided by different parties who have no direct
access to management and information. However, provisions contained in these
acts have been limited to specific categories of business organizations and do not
contain sufficient general provisions to provide legal backing for processing and

111 ibid., p. 13.
communication of business accounting information. The Sri Lanka Accounting and Auditing Standard Act No. 15 of 1995 has been enacted in order to provide quality accounting information to the providers of funds and other users of accounting information. The provisions contained in the Act are applicable to specified business enterprises defined in the schedule to the Act. The Companies listed in a stock exchange licensed under the Securities and Exchange Commission Act No. 36 of 1987 are a type of business enterprises for which the Accounting and Auditing Standards Act is applicable.

The Institute of Chartered Accountants of Sri Lanka (ICASL) has been involved in development of Accounting and Auditing Standards. However, it had no direct legal authority to develop Accounting and Auditing Standards until the Accounting and Auditing Standard Act empowered it to do so. According to the Act:

The Institute of Chartered Accountants of Sri Lanka...shall, from time to time, adopt such accounting standards...as may be necessary for the purpose of maintaining uniform and high standard in the preparation and presentation of accounts of business enterprises.\textsuperscript{112}

A similar legal authority is granted to the Institute under Section 3 (1)of the Act.

\textsuperscript{112} Sri Lanka Accounting and Auditing Standards Act No. 15 of 1995, p. 1.
The Institute shall, from time to time, adopt appropriate auditing standards...as may be necessary to govern the conduct of the audit of accounts of business enterprises.\textsuperscript{113}

The ICASL has received legal authority to revise, alter, and amend the Sri Lanka Accounting Standards and Sri Lanka Auditing Standards, whenever necessary.

All specified companies, including public listed companies, are required to prepare accounts by applying Sri Lanka Accounting Standards and the financial statements should be prepared to present a true and fair view of the performance and position of the organization. The company must see that in the process of auditing, auditing standards are being followed:

It shall be the duty of every specified business enterprise to prepare its accounts in compliance with the Sri Lanka Accounting Standards and take all necessary measures to ensure that its accounts are audited in accordance with the Sri Lanka Auditing Standards with the object of presenting a true and fair view of the financial performance and financial condition of such enterprises.\textsuperscript{114}

It is a requirement under the Act, to audit accounts by the members of the Institute of Chartered Accountants holding a certificate to practice. It is the duty of the auditors to “...certify in their audit report that the audit has been conducted in accordance with the Sri Lanka Auditing Standards and that accounts have been prepared and presented accordance with the Sri Lanka Accounting Standards.”\textsuperscript{115} The Sri Lanka Accounting and Auditing Standards Monitoring

\textsuperscript{113} ibid., p. 1.
\textsuperscript{114} ibid., p. 2.
\textsuperscript{115} ibid.
Board appointed under the Act monitor the preparation and presentation of annual accounts. "It shall be duty of every specified business enterprise to submit to the Board a copy of the annual accounts of such enterprise to enable the board to determine whether the accounts have been prepared in compliance with the Sri Lanka Accounting Standards."\textsuperscript{116} If the Board requires some additional information from the company or auditors of the company such information has to be provided within the stipulated period under the Act.

3.7.7 CONTRIBUTION BY THE INSTITUTE OF CHARTERED ACCOUNTANTS OF SRI LANKA

The Institute of Chartered Accountants of Sri Lanka, the premier national body of professional accountants of Sri Lanka, was established under the Act No. 23 of 1959. One of its key strategies is its contribution for the capital market development.

The Institute’s Corporate Plan sets out as one of its key strategies, its contribution to ‘capital market development’, with the particular action being to: (a) Contributes the Institute’s knowledge, skills, and expertise in the capital market development effort contributing actively to its policy formulation through the Securities and Exchange Commission of Sri Lanka and other relevant agencies/bodies. (b) Liaise with relevant agencies in developing policy to attract local and foreign investment into the country.\textsuperscript{117}

\textsuperscript{116} ibid., p. 8.
\textsuperscript{117} Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance; op. cit., pp. 11-12.
Steps taken by the ICASL to promote better communication of accounting information is praiseworthy. The Institute has undertaken the development of accounting and auditing standards and implementation of them. The Code of Best Practice on Matters Relating to Financial Aspects of Corporate Governance has been issued as an exposure draft, In 1997, with an idea of implementing in the near future. The Urgent Issue Task Force was established to answer accounting and reporting issues not covered or not clearly specified under the accounting standards. In order to encourage publication of improved annual reports, the Best Corporate Report and Accounts Competition has been conducted for a long period. By 30 June 1997, the ICASL has issued 33 accounting standards and six of them have been withdrawn. The balance 27 standards are to be adhered to. It is the intention of the Institute to incorporate International Accounting Standards in local standards.

As a condition of its membership of IASC, the ICASL is obliged to support the work of IASC by informing its members of IAS, to work towards implementation to the extent possible of IAS, and specifically to incorporate IAS in Sri Lanka Accounting Standards. ICASL members are expected to comply with SLAS. Failure to do so may result in ICASL inquiring into a member's conduct.118

According to section 1 of the preface of the Sri Lanka Accounting Standards:

The Institute of Chartered Accountants of Sri Lanka (ICASL), as a member of the International Accounting Standards Committee

118 ISASL; Sri Lanka Accounting Standards: Preface; 1997, Sections 1 and 2.
(IASC) is committed to IASC’s broad mission of the development and enhancement of accounting standards. In working towards this mission, IASC develops and issues International Accounting Standards (IAS). IASC believes that the issue of such standards will help to improve the degree of uniformity of accounting throughout the world.\textsuperscript{119}

‘The framework for the preparation and presentation of financial statements’ issued by the IASC has been presented by the ICASL with the Sri Lanka Accounting Standards for their users. It emphasizes on the development of the future Sri Lanka Accounting Standards, reducing the number of alternative accounting treatments, assisting users of financial statements in interpreting the information contained in financial statements, assisting preparation of financial statements in applying accounting standards & etc.

The practice of auditing in Sri Lanka is governed by the auditing standards issued by the ICASL. These standards are originally developed by the International Auditing Practices Committee, (IAPC) established by the International Federation of Accountants (IFAC) which is committed to the broad mission of development of a global accounting profession to provide quality service for the society. The ICASL adopts the International Standards of Auditing as a basis for the Sri Lanka Standards of Auditing.

As a condition of membership, the ICASL is obliged to support the work of IFAC by informing its members of every pronouncement developed by AFAC, to work towards implementation, when and to the extent possible under local circumstances, of those

\textsuperscript{119} ibid., Section 1.
pronouncements and specifically to incorporate IFAC’s International Standards on Auditing (ISAs) in the Sri Lanka Standards on Auditing.\footnote{120}

The members of the ICASL are expected to be complied with the Sri Lanka Standards of Auditing.

The publication of the Code of Best Practice on the Financial Aspects of Corporate Governance can be considered as another significant contribution by the ICASL for the protection of the interest of users of financial information.

The need for such a code has been discussed in business circles for sometime. The Institute as the official body vested with the power of setting accounting and auditing standards was of the view that a Code of Best Practice on Financial Aspects of Governance was an important corollary to the task of standard setting as they will complement each other in producing excellence in financial reporting in Sri Lanka.\footnote{121}

The overall objective in setting the committee was to improve the corporate governance in Sri Lanka and to build the confidence in financial reporting and auditing. The financial recommendations arising from...[the] report being categorized as follows:\footnote{122}


\footnote{120}{ICASL; Sri Lanka Standards of Auditing: p. 1.}
\footnote{121}{Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance; op. cit., p. 3.}
\footnote{122}{ibid., p. 6.}
b. Possible amendments to the rules and regulations of the Colombo Stock Exchange,

c. Possible amendments to the Companies Act.

d. Possible amendments to the ICASL Act,

e. A code of best practice, as applicable to all listed companies.

The Code of Best Practice in Sri Lanka was based on the Cadbury Committee report in the United Kingdom.

The ICASL has been conducting the annual competition for selection of best corporate reports from different categories of companies, since 1964. Private sector industry and commerce—large companies, Private sector industry and commerce—small companies, Public corporations involved in industry and commerce, Banking and financial institutions, and Newly incorporated companies are the categories for which generally applications for the best corporate reports are called for. If sufficient number of entries are received for any other category that will be considered for the competition. Following are the general objectives of the competition.\textsuperscript{123}

\begin{itemize}
  \item[a.] To encourage clear and meaningful presentation of accounts in compliance with relevant statutes,
  \item[b.] To ensure timely presentation of accounts,
  \item[c.] To popularize the use of accounting standards and best accounting practices,
\end{itemize}

\textsuperscript{123} Ariyasena, I.L.; ‘Best Corporate Report and Accounts Competition’; \textit{Special Supplement to Commemorate the Silver Jubilee of the Best Corporate Report and Accounts Competition}; The Institute of Chartered Accountants of Sri Lanka; 1989, p. 5.
d. To improve disclosure of accounting and financial information with emphasis on greater accountability in the private and public sector,

e. To create public awareness of acceptable basis of accounting information and to create confidence for the development of active capital markets,

f. To give formal recognition to organizations which have produced good annual reports.

The competition annually organized by the ICASL facilitates the improvement of disclosure of accounting information among business organizations.

The ICASL set up the Urgent Issue Task Force (UITF), in 1993, following the tradition of the Accounting Standard Board in UK. In the UK, the UITF is a committee of the Accounting Standards Board, established in 1991, consisting of highly competent and experienced members in the field of financial reporting. The UITF of Sri Lanka has a mandate to provide clarification and interpretations of the Sri Lanka Accounting Standards. "Today, the UITF is perceived by the business and financial community as a useful body in promoting the understanding and application of the Sri Lanka Accounting Standards and its rulings are accepted as quasi standards, particularly where the standard itself is not clear on a particular issue."¹²⁴

¹²⁴ Committee to Make Recommendations on Matters Relating to Financial Aspects of Corporate Governance; op. cit., p. 11.
3.8.0 INTERNATIONAL HARMONIZATION OF DISCLOSURE OF ACCOUNTING INFORMATION

3.8.1 INTERNATIONAL REQUIREMENT OF ACCOUNTING INFORMATION

As discussed at the beginning of this chapter, financial reporting is a communication process. The companies translate economic activities into its financial reports so as to provide users with information about its periodical operations and financial position. The translation process depends on the accounting policies adopted by the companies. A Company has to decide whether to translate a particular transaction or event and the degree to which it is to be disclosed in its annual reports. In addition to that, the company has to decide the method of accounting to be applied. The choice between alternative methods of summarizing, allocation, valuation, profit determination, consolidation, and presentation are some examples. In deciding the relevant policy for accounting and reporting, the accounting standards are used.

When following an accounting policy the company's choice between alternative degrees of disclosure and alternative accounting methods is restricted by standards. Standards will be defined as any financial reporting rule published by either the government or a private standard setting body. These standards can refer either to the degree of disclosure or to the accounting method to be applied.125 Each country has its own accounting standards accepted to be used in financial accounting and reporting. Since business environment of a country

vary from that of another country, reporting rules, standards, and procedures may not have been developed in the same format and pattern.

Accounting principles and reporting practices provide a means of international communication and, in theory should know no frontiers. They should cross boundaries as freely as the business practices they are intended to reflect. In practical terms it is, of course to be expected that these principles – and perhaps even more so, reporting practices – should reflect the economic and social environment of separate nations and regions. Therein lie the seeds for differences in accounting principles and financial reporting practices.126

Today, in the global economy investments and investors are moving across country boundaries, enterprises have become multinational, communication technology has been advancing. "[There is] a need for closure coordination of securities markets and standards of financial accounting and reporting on an international basis."127

Investors in multinational companies and even in non-multinational companies spread over different countries. Shares and debentures of companies are being quoted in stock exchanges of different countries in which accounting and reporting standards vary from each other. There is a need to communicate accounting information to a wide audience. Users of multinational financial statements include not only investors, but also local customers, local employees,

and local regulatory authorities of different countries. The preparation and presentation of financial statements would involve consolidation of financial statements of many subsidiary companies in many different countries. These subsidiary company financial statements would have been prepared on the basis of accounting standards of those countries. Holding companies would prefer elimination of awkward adjustments. The multinational companies are using multiple reporting system. As van der Tas says there are three forms of multiple reporting:

a. A company provides two financial reports, each based on different accounting method,

b. A company provides one financial report with two sets of annual accounts based on two different accounting methods,

c. A company provides one financial report with one set of annual accounts, but gives additional information so that the primary accounts can be transformed into secondary accounts based on another accounting method.

Multiple reporting is not a solution to the problem of international reporting. It is a temporary substitute for proper reporting, due to lack of generally accepted (worldwide) accounting and reporting standards. “[In addition to this] problem of comparability, message distortions caused by accounting measurement and reporting differences could lead to poor investment decisions, reducing capital market efficiency and ultimately social welfare.”

International harmonization of accounting and reporting of economic activities of business organizations has

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128 Van der Tas, op. cit., p. 158.
become a necessity. If harmonization of accounting and reporting practices could be achieved, investors and other users of financial statements would be able to understand the information. "It would improve the internal communication of accounting information and staff could be transferred to different countries without the need for training. It would assist the appraisal of overseas companies for takeovers and joint ventures."¹³⁰ There is a business and commercial pressure in most of the countries, trying to please foreign investors, foreign stock exchanges, or foreign regulators. "Some large companies have pressed their governments for removal of the domestic requirements so that dual accounting is not necessary, and governments have complied."¹³¹

3.8.2 HARMONIZATION OF FINANCIAL REPORTING

There is considerable number of journal articles published on harmonization of financial reporting. The origin of this may dates back to 1950s. "The harmonization of accounting standards on an international basis has been discussed since the late 1950s when Kraayenhof proposed the establishment of multinational accounting standard setting committee."¹³² Tay and Parker defines harmonization and standardization as follows:

Harmonization [a process] is a movement away from total diversity of practice. Harmony [a state] is therefore indicated by a clustering of companies around one or a few of the available methods...Standardization (a process) is a movement towards

¹³¹ Nobes, Christopher; 'European Moves Towards International Harmonization'; Accounting and Business; 1998 C November/December, p. 33.
uniformity (a state). It includes clustering associated with harmony, and reduction in the number of methods.\textsuperscript{133}

Coordination of two or more objects can be called harmonization. If the financial reports are more in harmony, it would be beneficial for the users for better understanding. Sub-divisions or different methods of harmonization have been classified by Van der Tas as given below:

Harmonization of financial reports will be called material harmonization while harmonization of standards will be called formal harmonization. Material harmonization can take place without being initiated by standard setting. This will be referred to as spontaneous harmonization. The harmonization of financial reports or standards can refer either to the degree of disclosure or to the accounting method to be applied. Harmonization of the extent of disclosure will be called disclosure harmonization, while harmonization of the applied accounting methods will be called measurement harmonization.\textsuperscript{134}

3.8.3 INTERNATIONAL ORGANIZATIONS INVOLVED IN HARMONIZATION

Various organizations are involved in preparation of pronouncements for the harmonization of international accounting and reporting. These include the Organization for Economic Corporation and Development (OECD), the United Nations Commission on Transnational Corporation, European Community (EC), and the International Accounting Standards Committee (IASC).

\textsuperscript{133} Tay, J.S.W. and Parker, R.H.; 'Measuring International Harmonization and Standardization'; Abacus; Vol. 26, No. 1, 1990, p. 73.
\textsuperscript{134} Van der Tas, op. cit., pp. 157-158.
The governments of 24 mainly industrialized countries established the OECD. It has issued code of conduct and guidelines for voluntary disclosure of financial information by multinational companies. It has a working group on accounting standards to work on improvement of harmonization and comparability of accounting and financial reporting.

The UN established a Committee on Transnational Corporations through its Intergovernmental Working Group of Experts in Relation to International Accounting and Reporting Standards. This committee observes current developments in different countries and relevant technical topics.

The objective of the European Community (EC) is to establish common standards in the domestic company laws of its member countries, and directives are issued for the purpose. These directives are to be incorporated into national laws and regulations of member countries, which become the law throughout the community. In the development of accounting practices of member countries, these directives have introduced some harmonization. Out of these organizations, the International Accounting Standards Committee seems to be the widely accepted and more effective body on harmonization of accounting and reporting practices and standards. Even the European Community has been supporting the IASC.

The European Commission [Community] has become supportive of the IASC, largely abandoning its own law-based harmonization program. This is because the Commission has realized that the future has room for only one world benchmark: either IASC or US rules. There are several European accountancy bodies on the IASC
board and the commission is an observer, whereas there is no direct European influence on USA rules. Consequently, the Commission is now backing the IASC.  

3.8.4 CONTRIBUTION BY THE INTERNATIONAL ACCOUNTING STANDARDS COMMITTEE

Henry Benson founded the International Accounting Standards Committee (IASC) and the first meeting was held in Summer, 1973 with committee members from accountancy bodies of nine countries. "[By 1998, the membership] ...comprises more than 120 bodies from over 90 countries. All the power is invested in the IASC’s board, which comprises accounting bodies from 13 countries...and three bodies representing preparers and users of accounts." Currently, Board Members come from: professional accountancy bodies of Australia, Canada, France, Germany, India-shares with Sri Lanka, Japan, Malaysia, Mexico, the Netherlands, the Nordic Federation, South Africa-shares with Zimbabwe, the UK/Ireland, and the United State. In attendance with voting rights are representatives form financial analysts, Swiss industrial holding companies and finance executives. There are observers from the Chinese Institute of Certified Public Accountants, the European Commission, the Financial Accounting Standards Board (USA), International Organization for Securities Commissions, and the Public Sector Committee of the International Federation of Accountants.

135 Nobes, Christopher; ‘International Accounting Standards and Their Effect on the Financial Reporting of UK and Other European Companies’; Management Accounting; 1998 b July/August, p. 18.
136 Australia, Canada, France, Japan, Mexico, The Netherlands, The UK and Ireland, The United States, and Western Germany.
137 Nobes; op. cit., 1998b, p. 18.
The detail objectives set out in IASC’s constitution are as follows:\textsuperscript{138}

To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their world wide acceptance and observance. To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

There has been a gradual development in the progress and acceptance of International Accounting Standards. During the first 15 years it has issued 26 standards. “In 1989...the IASC issued a conceptual framework, closely in line with the US version of the 1970’s...”\textsuperscript{139} In 1989, an agreement was signed between the International Organization for Securities Commissions and the International Accounting Standards Committee. According to the agreement, if the IASC could remove options, increase disclosures, and cover several other topics, IOSCO would consider making IAS’s acceptable for companies listed in foreign exchanges.

The first generation [prior to the agreement] of standards was very permissive (i.e. standards were multi-optional, with many different permissible accounting treatments): By the late 1980s, this permissiveness proved to be an impediment to worldwide adoption

\textsuperscript{138} CIMA Publishing Picks a Topic; \textit{op. cit.}, p. 61.
\textsuperscript{139} Nobes; \textit{op. cit.}, 1998b, p. 18.
by IOSCO. As a result IASC adopted an improvement/comparability project, in 1989.\textsuperscript{140}

The IOSCO and the IASC came to an important agreement in July 1985. The IASC agreed to complete a core set of standards by 1999 (subsequently the year was advanced to 1998). Once this core set of standards is completed, IOSCO has agreed to consider them for endorsement. If IOSCO endorses them, they will be recommended to national regulators for use in cross-border offerings and listings as an alternative to national accounting standards. This agreement gave a real strength to the international importance of the IASC. By 1998, the IASC has issued 34 accounting standards and two of them have been withdrawn. Some of the standards issued at the earlier stage with more options have been revised.

The International Accounting Standards are persuasive rather than mandatory. Member bodies use their effort to put them into practice in preparation of financial statements. Governments, stock exchanges, and other regulatory bodies are persuaded by the member accounting organizations of respective countries to implement International Accounting Standards.

Another development designed by the IASC "was the establishment of the Standing Interpretation Committee (SIC) [in 1997]...along the line of the UK’s Urgent Issue Task Force..."\textsuperscript{141}

The impact of the IASC has varied from country to country. A threefold differentiation has been discussed: effect on European countries, capital market countries, and less developed countries.\textsuperscript{142}

\textsuperscript{140} Jones, Mike; 'The IASC Twenty Five Years Old This Year'; \textit{Management Accounting}; 1998 May, p. 31.
\textsuperscript{141} Nobes; \textit{op.cit.}, 1998b, p. 18.
\textsuperscript{142} Jones; \textit{op.cit.}, p. 31.
3.8.5 EFFECT OF INTERNATIONAL ACCOUNTING STANDARDS ON EUROPEAN COUNTRIES

In European countries the main users of accounting information have been considered as the banks and providers of loan capital. The shareholders have a secondary place as users of accounting information. In European accounting systems, accounting and reporting rules are designed by the government rule making bodies not by the non-governmental organizations such as professional accounting associations. These countries have favored very regulated, taxdriven, creditor based accounting practices.

Expansion of multinational companies, quotation of company securities at stock exchanges of other countries, multinational investors and etc. have pressurize the European countries to look for international rules or internationally recognized rules for accounting and reporting. The IASC rules are international rules and USA rules are internationally recognized rules. Now, there is a move in Europe towards international harmonization of accounting and reporting.

The French, German, and Italian Parliaments have made changes to law, allowing certain listed companies to depart from the details of national law for their statutory consolidated financial statements, if international accounting standards are followed instead. Other countries such as Belgium and Denmark are also thinking along these lines.\(^\text{143}\)

It seems that European multinational companies favor International Accounting Standards to USA rules. "In 1995, 23 out of 100 leading French

\(^{143}\) Nobes; op. cit., P. 31.
industrial companies referred to IAS...Since 1995, at the European level there appears no appetite for developing a set of European standards. IASs are therefore preferable..."\textsuperscript{144} Many more French and German companies may move to IAS for their consolidated accounts in the future.

\textbf{3.8.6 EFFECT OF INTERNATIONAL ACCOUNTING STANDARDS ON CAPITAL MARKET COUNTRIES}

In capital market countries, shareholders have been considered as the main users of accounting information. In these countries accounting and reporting rules are designed and introduced by the professional accounting organizations of private sector, not by the government rule making bodies.

Capital market countries such as the UK, Canada, Australia, the USA have accounting and reporting standards, which approximate to International Accounting Standards. "Until very recently, there has been a great reluctance to endorse fully all aspects of the IASs. Before the IOSCO agreement in 1995, the impact of the IASs had been much reserved and found to be marginal."\textsuperscript{145} It seems that the attitudes of the UK companies are being changed.

Until the 1990s, IASs always allowed UK practice, and UK companies could see no advantage in explicit compliance with IASs. Now, both these points have changed. First, the revised and stricter IASs contain several differences from UK standards...Second; there may already be greater world acceptance of IASs than UK rules.\textsuperscript{146}

\textsuperscript{144} Jones; \textit{op. cit.}
\textsuperscript{145} Jones; \textit{op. cit.}, p. 31.
\textsuperscript{146} Nobes; \textit{op. cit.}, 1999b, p.18.
Because of the closeness of the work-programs of the IASC and the UK Accounting Standard Board the British companies are being affected by the IASC in a major way. According to Nobes the process of approximation of UK and IASC rules seems likely to continue for following reasons.\textsuperscript{147}

a. The existence of certain joint projects,

b. The closeness of the UK (ASB) and IASC framework,

c. Chairman (Sir David Tweedie) is one of the UK representatives on the Board of the IASC,

d. Requirement of International Accounting Standards by large British companies,

e. Recognition of IASs by IOSCO.

In some capital market countries such as Australia, there is a process being undertaken to remove inconsistencies from national standards.

\textbf{3.8.7 EFFECT OF INTERNATIONAL ACCOUNTING STANDARDS IN DEVELOPING COUNTRIES}

Most of the developing countries were previous colonies of developed countries and the prevailing accounting and reporting systems have been inherited from the colonial masters. Developed countries possess the economic strength in order to develop accounting standards. However, many of the developing countries or emerging markets do not have the resources for the purpose. “Many emerging markets do not have the resources to develop their own accounting requirements. They can use International Accounting Standards in the knowledge that they have already been tried and tested elsewhere.”\textsuperscript{148}

\textsuperscript{147} Nobes, Christopher; ‘The Continuing Merger of UK and IASC Standard Setting’; Accounting and Business; 1998a May, p. 25.

International Accounting Standards have a strong influence in less developed countries. Almost all the developing countries have given up setting national standards of their own through research procedures. They either adopt international accounting standards or develop national accounting standards on the basis of international accounting standards to suite the local environment.

International Accounting Standards are used in a growing number of emerging markets as national accounting requirements or as a basis for national accounting requirements. Countries like Malawi, Malaysia, and Zimbabwe use virtually all International Accounting Standards as national standards. Pakistan has incorporated the Standards that are relevant in its particular environment within its law for listed companies. Egypt, India, Kenya, Nigeria, and Singapore are among many that are using International Accounting Standards as the basis for national requirements...Zimbabwe issues all International Accounting Standards, but only after national review involving the accounting profession, business community, and others. Both Malawi and Malaysia develop national forwards that give guidance on any conflicts between the Standards and national law. Kenya and India develop national requirements that reflect their local environments, but which are based on International Accounting Standards.\textsuperscript{149}

It seems that in the long run almost all the countries are going towards a single system of accounting and reporting. Though it takes time there

\textsuperscript{149} ibid., pp. 41-42.
will be only room for one world language of accounting for multinational listed companies.

3.9.0 DISCLOSURE OF ACCOUNTING INFORMATION AND INFORMATION TECHNOLOGY

3.9.1 COMPUTERS AS A NEW TECHNOLOGY

Developments of telephone, telegraph, wireless, television, and computer systems have reduced the communication gap from country to country and man to man. The computer system is the latest innovation of these communication systems and its rate of growth is considerably rapid. Its benefits have covered almost all the fields of human knowledge. The continuous developments in new chip technology of computer replace outdate, and obsolete the previous systems and models within a very short period of time.

3.9.2 COMPUTERS AS AN ACCOUNTING TOOL

The system of computers has encroached the business and accounting fields. It has open new horizons for improved computation and communication in the accounting arena. At the earlier stage of development of computers with mainframe systems large scale business organizations had the opportunity to acquire the systems for processing accounting information. Information service organizations acquired mainframe systems and commenced providing accounting services to other organizations. The development of mini-computer systems had reduced the initial cost and running expenses of computers, and use of computers for accounting purposes had been increased. The latest innovation in the computer industry- microcomputer system- has revolutionized the accounting system. The accounting staff is faced with addition, subtraction, division, multiplication, summarizing, scheduling, presentation, and communication in the process of translating business economic activities in to
accounting information for communication to the users. Today, these activities could be entrusted to microcomputers. Software companies have developed general as well as specialized accounting packages to be used in business organizations at affordable prices. The initial cost and running cost of microcomputers being relatively at a lower level, even the small scale business organizations have commenced to use computers for processing accounting data. These systems have reduced processing time, dependence on manual clerical efforts, and removed processing errors. It has improved the timeliness of accounting and financial reporting.

3.9.3 USE OF ACCOUNTING ORIENTED SOFTWARE

In addition to development of low-priced computer accounting packages, electronic spreadsheet, and word processing packages have been introduced to facilitate activities of the accounting departments. Electronic spreadsheet packages such as Excel, Lotus 1-2-3, SuperCalc, PerfectPlan and etc. have reduced the work load of the accountant and his staff, tremendously. Accountants are faced with the burden of calculation of figures in tabular and columnar format. The use of spreadsheet packages has converted this tedious procedure to a simple task. The packages like Windows, and Lotus Smart have made it easier to transfer information between accounting, spreadsheet, word processing, and database packages. Rewriting, reentering, and rescheduling of data prevailed under the manual accounting processing system have been almost completely eliminated.

Today, for preparation of financial statements such as balance sheets, profit and loss accounts, and cash flow statements and other presentations in annual reports electronic spreadsheet and word processing packages are being
used. This has reduced the time taken by the companies to present annual reports to the shareholders.

3.9.4 COMPUTER GRAPHICS AND REPORTING OF ACCOUNTING INFORMATION

The use of graphics for reporting of accounting information is another area of accounting, which is popular due to use of computers.

The new computer graphic technology has the potential for creating a revolution in financial reporting that may broaden the accounting profession's ability to present complicated data in a simple and dramatic form...computer graphics can help accountants make serious dent in the paperwork explosion and enable CPAs to aid their clients in handling the growing mountain of tabular financial data and details...[The development of computer graphic technology] allows the presentation of charts and graphs on the cathode ray tube (CRT) and permits the copying of that picture onto a 35 mm. Slide, an overhead transparency of regular paper. The transfer to either slide or paper is rapid, and the cost is dropping quickly- lowering the preparation costs of graphic presentations. The CRT can translate data into a clear and accurate graphic presentation and a plotter/printer can reproduce that exact presentation in color.\(^\text{150}\)

The accountants can use the computer graphic technology to assist the board of directors in presenting accounting information through annual reports and this technique of presentation can be used at the shareholders meetings.

Generally, shareholders and other users of accounting information receive financial statements such as balance sheet, profit and loss account, and cash flow statement in tabular format. Graphical format has been used in some annual reports in Sri Lanka to provide additional financial information such as ratios. Presentation of some financial information in graphical form seems to attract users of financial information. The understandability in graphical presentation is more stronger than that in tabular, narrative or verbal presentation. Even regular financial statements such as balance sheets, profit and loss accounts, and cash flow statements can be prepared in graphical form. Irwin M. Jarett has tested this system of presentation as a primary medium for presenting regular financial statements with his clients of small and medium size business organizations.\footnote{ibid.} He has prepared balance sheets, profit and loss accounts, and statements of changes in financial position by using graphical format and found to be popular. It may be possible to consider presentation of financial statements in graphical form in the annual report, in addition to the traditional form of presentation.

\subsection*{3.9.5 INTERNET WEBPAGES AND ACCOUNTING INFORMATION}

Development of the internet and expansion of webpage facilities to public listed companies will bring considerable change to publication of financial information in annual reports. This will assist the shareholders and other users of
financial information to access annual reports of public listed companies through the internet. The decreasing cost of maintaining internet facilities will make this communication system more popular in the future.

**3.9.6 FROM VIEW-DRIVEN TECHNOLOGY TO EVENT-DRIVEN TECHNOLOGY**

At present, generally, commercial accounting procedures are based on the view-driven system. The database of the accounting system, whether it is run on manually or with computers, considered and organized as a system based on a separate database. The concept of event-driven technology in management and accounting information system is being discussed in the literature of information system. Under the event-driven system accounting and non-accounting data are organized within a single management information system. If the acceptance of event-driven system by the accountancy profession could be obtained, accessibility of accounting and non-accounting information from the same data base in the preparation of annual reports will improve the quality of annual reports of public listed companies. "The transition to event-driven technology already is under way. Corporations such as Sears Roebuck, Alcoa, IBM, and others are using event-based system concepts." Further development of the computer technology and expansion of the field of computer accounting may enforce the acceptance of the event-driven technology.

**3.9.7 ADAPTABILITY OF THE NEW COMPUTER TECHNOLOGY BY THE ACCOUNTANCY PROFESSION**

Application of computers for accounting, reporting, and disclosure of accounting information will definitely improve the decision making process of

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the users of accounting information. However, in order to achieve this, attitude of
the accountants and their staff towards information technology has to be changed.
Still, negative attitude towards information technology, among the accounting
officers and staff could be found both developed and developing countries. In
developed countries competition among the professionals has compelled the
accountants to accept the computer based information technology. Following two
quotations, the first from a developed country and the other relevant to a
developing country indicate the required changes of the attitudes of the accountants
and their staff.

An organization may implement the latest software and extensively
redesign the closing process, but this will not necessarily deliver
faster reporting. People will have to want to work within the new
processes and time tables. Local resistance to change, particularly
change 'imposed' from above is quite common.\(^{153}\)

Computer suppliers reported that, generally, accountants had a
negative attitude towards computers, which they viewed as being
complicated.\(^{154}\)

Conservative nature of the man, and the reluctance to change to new
information technology systems can be seen in most of the social systems.
However, the development of the business community and their information need
will force the reluctant accountants and their staff to change the negative attitudes
on information technology.

\(^{153}\) Fenning, John; 'The Key to Faster Reporting'; Management Accounting; 1998 December, p. 39.
\(^{154}\) Ronan, Nessan; 'IT and the Developing Country'; Certified Accountant; 1993 May, p. 25.
3.10.0 CONCLUSION

Disclosure of accounting information is being considered as significant for capital formation of public listed companies. Accounting information produced through the process of accounting measurement is provided through the process of communication to the users of information. In the accounting literature, conceptual and theoretical development of disclosure of accounting information has been discussed. Different disclosure media have been developed for the benefit of the users. Annual reports of public listed companies play a major role among them. Significance of the users and their requirements are being given special preference by the listed companies. Directors’ role, responsibility, and corporate governance are considered as areas, which need improvements. For the protection of the users’ interests, governmental and non-governmental institutional framework has been developed. The interest in accounting information and its disclosure has passed national boundaries and has become a subject of international interest. The expansion of the arena of disclosure of accounting information has been accelerated by the development of the information technology in the field of accounting, reporting, and disclosure.