A Study on ‘the Users of Financial Reporting’ in the New Conceptual Framework Developed by IASB

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Abstract

As the corporations are getting more independent and powerful, the changing economic circumstances have challenged to accounting standards as the working rules to provide their visibility to a society by asking who should be primary users of financial accounting. Recently, IASB changed its view of the primary users of financial reporting in the Objective (finally revised in 2010) from the existing shareholders to the broader capital providers who transferred (or will transfer) their economic resources to a reporting entity. We regarded the changing view for the users in the Objective as a fundamental factor that would affect the developments of IFRSs and we attempted to evaluate the meaning of the broader users adopted in the Objective based on the institutional theories, especially the concept of transaction costs. This paper challenged the particular assumption that equity investors should be a proxy for all other users. As changing the users helps create a standard setting cycle, this research has direct implications for explaining the standard setting.

Ⅰ. Introduction

IASB/FASB launched a joint project for the revision on the conceptual framework for financial reporting in 2004. The both boards completed the first part of "Phase A: the Objective of Financial Reporting and Qualitative Characteristics" and finally revised it in 2010. The Objective of Financial Reporting (hereafter, the Objective) has changed its view of the primary users of financial reporting from the shareholders to stakeholders by using the term of 'capital providers' who transferred (or will transfer) their economic resources to a reporting entity.

Tweedie as the Chairman of IASB revealed that they needed to update the existing concepts to reflect the changes in markets, business practices and the economic environment and recent global financial crisis brought a sharp focus on some of the fundamentals of financial reporting such as who are the primary users of financial reports in a response letter to a comment letter (Satoh [2010], p. 142).

This changing view for the users has provoked much controversy since the revision process started. Discussion Paper (IASB/FASB [2006]) suggested a broad range of the users, such as the present and potential investors, lenders and other creditors who make decisions on their resource allocation (OB3). It included equity investors, creditors, suppliers, employees, customers, governments and their agencies and regulatory bodies, members of the public and so on (OB6), without specifying a primary user group. But after receiving the comment letters that suggested the board to limit a primary user group, the boards proposed the present and potential equity investors, lenders and other creditors as a primary user group in the Exposure Draft (IASB/FASB [2008]). According to the IASB (2009), most comment letters supported having a primary user group of financial reporting but there were still differing views regarding who those primary users should be. Most opinions acknowledge that general purpose financial statements serve a broad range of users but make an assumption that equity users can be proxy for all other users of financial statements (ASB [2006]; LSE [2006]; AAA [2006]). That assumption is justified on the basis that the considering the needs of all users would be impossible (Deloitte [2006]; Ernst & Young [2006]) and equity investors incur the most risk and they should have priority (Jensen and Meckling [1976], pp. 312-330).

As IASB has claimed the standards to be principles-based accounting, the conceptual framework is expected to play the most basic role in setting the IFRSs (IASB [2013], p. 5). The scope of the primary users of financial reporting as well as the objectives in the Objective composes of the foundation of the conceptual framework. However, the conceptual frameworks have not gained much respect in the accounting research despite of its

significance to the standard setting and further to the financial reporting process (Hepp [2004], p. 3).

In this context, we regard the changing view for the users in the Objective as a fundamental factor that would affect the developments of IFRSs and we attempts to evaluate the meaning of the broader users adopted in the Objective based on the institutional theories, especially the concept of transaction costs. This paper challenges the assumption that equity investors are a proxy for all other users. As changing the users helps create a standard setting cycle, this research has direct implications for explaining the standard setting.

Ⅱ. Institutional Economics and accounting regulation

1. Institutional approach to accounting [(1)]

Despite of the advances in accounting research over the past years, accounting theory has not arrived at a satisfactory theory of standard setting yet (Hepp [2004], p. 1). At one time it was expected that capital market researches to use empirical models would inform standard setting by providing an operational test of usefulness (Ball and Brown [1968], pp. 160-161). This stream of accounting research relies heavily on theories of efficient markets and assumptions of zero transaction costs. Gonedes and Dopuch (1974, pp.116-118), however, criticized early on that capital market information could not be used to determine the content of standard but only to evaluate their effects. Institutional economics theory may have more explanatory power for standard setting because it explains logics for the existence of institutions in a society based on optimal efficiency.

Individuals constitute a society and they interact within that society. These individuals have intention to solve the problems that have occurred during their interactions in their own ways. The computational capacity of each individual is, however, limited in processing, organizing and utilizing information regarding the others' activities. Thus, uncertainty arises as a consequence of the complexity and variety of the problems to be solved in the problem-solving ability possessed by a single individual. From a combination of capacity and the uncertainties involved in deciphering the environment, social rules emerge and evolve to simplify the process. Institutions, working rules in a society exist in order to alleviate these uncertainties that result from human interactions.

An institution is defined as an optimal choice based on the bounded rationality of human beings [(2)] in institutional economics. For example, firms are optimal institutional choices for reducing 'transaction costs' (Coase [1937], pp. 390-398; Williamson [1979], pp. 233-235; [1981], 548-549; [1985], pp. 16-19; [1996], pp. 54-56). Individuals have formed firms by comparing between the costs that are incurred from the outside market and from the

internalized organization. As the result, they have chosen forming firms in order to save the costs. Here transaction costs are defined as the incurred costs to participate and make economic exchanges in a market. The determinants of transaction costs are asset specificity, frequency and amount of transactions, uncertainty and complications of surroundings (Williamson [1979], pp. 245-254).

Accounting is being used in response to social expectations by providing visibility of social entities and processes in monetary numbers (Hopwood [1984], pp. 167-187; Meyer [1986], pp. 345-347). Accounting standards are also an institution that contributes to the construction of society and to the increase in interpersonal communication among its actors. They are often referred to as 'Generally Accepted Accounting Principles', and these phrases reveals that the standards are recognized as an institution in a society (Kim [2007], pp.70-71).

2. Accounting regulation for public interest

Historically to say, demands for accounting regulation has been increased so as to protect the public interests against on some potential adverse economic effects, for examples, financial speculation, the exercise of economic power, cross border financial flows, and so on. For examples, after the Great Depression, the listed companies were required to file to the SEC by the Securities Exchange Act of 1934. The intent of the act clearly reflected both the economic power and the speculative mania issues (Hepp [2004], pp. 13-15). The purpose of the Securities Exchange Act of 1934 stated in section 2 that it was to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions (McGerr [2003], pp. 305-310). Shareholder protection in the original act was mainly protection from unscrupulous or insolvent brokers and there was no intent to protect shareholders from losses (McGerr [2003], pp. 305-310). To the extent investors were protected, it was by transparency. Transparency was a key element of general purpose financial reporting, which was be able to be summarized information about the transactions of complex organizations including the property rights of the organization and allocation of those rights to priority and residual interests. For many users, it has been only information available about the operations of the reporting entity (FASB [1978], SFAC No. 1, par. 7). This act and the requirement for the audited financial statements created the modern accounting profession in the United States and changed the nature of the work that auditors performed for clients form a contractual obligation for the benefit of the board of directors or management to a legal obligation for the public benefit (Previts and Merino [1998]; pp.

290-294). The SEC required audited financial reporting to the listed companies but it soon became clear that the institution was not complete. Although the companies were required to prepare and disclose financial statements, they could continue to manage the presentation and to interpret the transactions of data in an opportunistic way. By 1938, the SEC recognized the need for accounting standards and pressed upon the accounting profession to establish a standard setting body.

Accounting is disclosure about transactions by providing visibility of entities and processes in (monetary) numbers. Accounting rules, however, are never complete (Pistor and Xu [2002], pp. 69-71), because it is impossible to anticipate all situations in setting them. But, the nature and extent of the standards changes over time as new transaction forms, such lease, are created or increase in the extent of their application. Therefore, the rules, like other social rules evolve for resolving disputes among parties in pragmatic and ethical ways (Van de Ven [1993], pp. 150-151). In the institutional economics, accounting standards are necessary as working rules to define the economic substance of transactions and to delineate the line between public and proprietary information. Lower transaction costs and the stronger institutions empowered by transparency lead to higher economic growth (North [1990]; pp. 66-67). These days, corporations have extraordinary powers to organize and produce wealth. In return, the broader society obtained the right to deserve financial transparency. Financial transparency has become an institution that enables the economic, ethical and judicial institutions of society, providing information for decision-making in formulating, revising and enforcing what Commons called the working rules (Hepp [2004], p. 18). The basic elements of those working rules are being replicated throughout the world as IFRS. One thing to remember here is that accounting regulation as the working rules started to work for national general welfare ultimately.

Ⅲ. Developments of the users of financial reporting in the Objective

1. The course of the revision

IASB/FASB initiated a joint project to revise their conceptual frameworks based on the Norwalk Agreement in 2004. The both standard boards issued the Discussion Paper in 2006 and the Exposure Draft in 2008 of "Phase A: The Objectives of General Purpose Financial Reporting and Qualitative Characteristics of Useful Financial Information" and they completed and revised the following the two chapters in their conceptual framework, Chapter 1: The Objectives of General Purpose Financial Reporting and Chapter 3: Qualitative Characteristics of Useful Financial Information in 2010. In 2010, IASB/FASB, however, suspended the further joint project. IASB solely restarted its conceptual

framework project in 2012 aiming to complete the full revisions by the end of 2015. IASB announced the Discussion Paper of "A Review of the Conceptual Framework for Financial Reporting" in July 2013 but the board said that they had no intent to fundamentally reconsider the chapters of the conceptual framework published in 2010, that is, Chapters 1 and 3.

The role of the conceptual framework is expected to be the basis for development of IFRSs and other reporting guidance because the conceptual framework is a coherent system of interrelated objectives and fundamental concepts that prescribes the nature, function and limits of financial accounting and reporting and that is expected to lead to consistent guidance. The role of the Objective in the conceptual framework is expected to be the foundation of the framework because the framework is a coherent system of concepts that flow from an objective (IASB/FASB [2006], IN1). Other aspects of the framework, such as qualitative characteristics, elements of financial statements, definition of a reporting entity, recognition and measurement, and presentation and disclosure-flow logically induced from the objective. Those aspects of the framework help to ensure that financial reporting achieves its objective (IASB/FASB [2008], OB1).

2. Users of financial reporting in the revision

In the Discussion Paper 2006, the boards said "the objective of financial reporting stems largely from the needs and interests of those users" and suggested the users of financial reporting as a broad range of users, which included equity investors, creditors, suppliers, employees, customers, governments and their agencies and regulatory bodies and members of the public (IASB/FASB [2006], OB6). The boards also referred that they expected that the needs of those other members generally would be essentially the same as the needs of existing ordinary shareholders (IASB/FASB [2006], BC1.17). They changed the primary users of financial reporting from the existing shareholders to the existing and potential stakeholders.

After receiving the comment letters to the Discussion Paper that mostly criticized that the users were too broad and suggested to have a primary user group, the boards proposed to appoint capital providers as a primary user group in the Exposure Draft 2008.

In the ED 2008, they suggested the users of financial reporting as the followings.

> OB 2 *The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also*

be useful to other users of financial reporting who are not capital providers.

OB 5 *The information provided by general purpose financial reporting focuses on the needs of all capital providers (those with a claim on the entity's resources) not just the needs of a particular group.*

OB 6 *An entity obtains economic resources from capital providers in exchange for claims on those resources. By virtue of those claims, capital providers have the most critical and immediate need for general purpose financial information about the economic resources of an entity. Capital providers include equity investors, lenders and other creditors, who have common information needs.*

(a) ***Equity investors.*** *Equity investors include holders of equity securities, holders of partnership interest, and other equity owners.*

(b) ***Lenders.*** *Lenders includes purchasers of traded debt instruments, provide financial capital to an entity by lending it economic resources.*

(c) ***Other*** *creditors. Other groups provide resources as a consequence of their relationship with an entity, even though the relationship is not primarily that of a capital provider. For example, employees provide human capital in exchange for a salary or other remuneration, some of which may be deferred for many years. Suppliers may extend credit to facilitate a sale. A customer may prepay for goods or services to be provided by the entity. To the extent the employees, suppliers, customers or other groups make decisions relating to providing capital to the entity in the form of credit, they are capital providers.*

OB 7 *The primary user group includes both present and potential equity investors, lenders and other creditors, regardless of how they obtained, or will obtain, their interests. In the framework, the terms capital providers and claimants are used interchangeably to refer to the primary user group.*

The boards concluded that a focus on a broader primary user group would fulfill the needs of the full range of capital providers both in jurisdictions with a corporate governance model that focuses on stakeholders, which was a broader group than the existent shareholders (IASB/FASB [2008], BC1.22). The users are subjected to provide their capital to a reporting entity in the form of credits based on the traditional stewardship(3).

Who should be the primary user group of financial reporting? According to the comment letters, most respondents to the ED supported having a primary user group but there were still differing views regarding who should be the primary users (IASB [2009]). Most of them supported the proposed primary user group, that is, the present and potential equity investors,

lenders and other creditors. The boards considered most of the issues raised by respondents about the composition of the primary user group and they recommended them to be capital providers. They said, however, that no new information was provided by those who supported expanding the primary user group to include management, employees and governments and they would not add them to the list of primary users.

In the final revised Objective, they kept these stances about the users of financial reporting, saying that “The objective of general purpose financial reporting to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity (OB2).” The reason that they should be the primary users are that “many existing and potential investors lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed (OB5).”

As the results, IASB has changed the primary users of financial reporting from the existing ordinary shareholders (IASB [1989], par. 10) to the existing and potential investors, lenders and other creditors recognizing the broader stewardship.

Ⅳ. Transaction costs and the users in the Objective

According to the Objective (2010), the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments and providing or settling loans and other forms of credit (OB2). By doing so, IASB/FASB defines a transaction as an external event involving transfer of something to be valued between two or more entities.

The former frameworks for accounting standard setting failed to pay attention to the transactions that corporation have nowadays and still had an assumption that equity investors could be proxy for all users and they bear the residual and most risk. The conceptual frameworks of IASB/FASB has acknowledged that general purpose financial reporting serve a broad range of users (IASB/FASB [2006], OB6), but they made an assumption that equity investors could proxy for all other users of financial statements (IASB [1989], par. 10). That assumption is justified on the basis that financial statements need a focus because to satisfy the needs of all users would be impossible and that the equity investors bear most risk among the all users and should be given priority (Jensen and Meckling [1976], pp. 312-

330). The equity investors can be indeed proxy for all other users of financial statements?

The less attention paid to the definition of a transaction in the conceptual frameworks is a bit puzzling in light of the importance of the transaction as the ultimate unit of economic activity in institutional economics (Hepp [2004], p. 31). This suggests that the conceptual frameworks should re-visit and elevate the importance of the definition of a transaction to that of an element of accounting. The work of Commons gives us an excellent starting point for that discussion. Institutional economics views transactions differently. The transaction is the ultimate unit of economic activity and therefore the elemental unit of analysis (Commons [1931], pp. 652-653; Williamson [1981], pp. 548-549). Transactions arise out of three elements, conflict of interest, or economic scarcity, interdependence of interest, or the demand for exchange, and order of compromise, demand for institutions (working rules) to serve as the basis for exchange. Commons (1931, pp. 652-653) distinguishes three types of transactions based on the status of the participants; (1) bargaining transactions, (2) managerial transactions and (3) rationing transactions. Bargaining transactions are those where the participants are legal equals, such as equity investors or creditors. These are the traditional purview of financial accounting. Managerial transactions take place between legally unequal parties such as employers and employees. Lastly, rationing transactions also occur between legally unequal partners such as governments and citizens. Whether bargaining, managerial or rationing in nature, all transactions are at the heart of accounting standard setting, because firms relate to these transactions after all. For examples, a firm is a product of rationing transaction having the legal right to exist and conduct business under the law. Legal entities in corporate form have several advantages including unlimited life, facile transferability of ownership, limited liability and self-government (Hepp [2004], pp. 28-31).

Accounting for bargaining, managerial and rationing transactions are one means of taking into consideration the multiple purposes of general purpose financial statements and the contracting, litigation, political and tax considerations that affect GAAP (Holthausen and Watts [2001], pp. 1-3). The primary difference between definitions of transactions could be viewed as the different information between evaluating the future net income of a firm and the future gross income. While equity investors are interested in the future net income, all other parties transacting with the firm are interested in their particular future revenue streams including future wages, tax payments, purchases, sales, etc. As Commons (1924) observed "the fact that the expected net operating income of the concern belongs to the stockholders, after deducting interest on debts, supported the idea that the going concern exists only

in the proprietors and not also in the employees, agents, bondholders and other investors (Commons [1924], p. 161).” All of them are not alike in that they each have a stake in the net income.

Moreover, recently, the equity investors and many creditors are getting less risk-bearer and the other stakeholders with non-diversifiable interests are getting more risk-bearer. Equity investors and many creditors are able to diversify their market risk away, which means that the investors may bear less risk than other stakeholders with non-diversifiable interests in the future revenue of the firm such as employees. The OECD acknowledges the inadequacy of the sole focus on equity investors in corporate governance and defines investors as shareholders, creditors and suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets (Oman [2001]; p. 13). Nonetheless, accounting standard setting still regards the equity investor as most risk bearer. Equity valuation relies heavily on the assumption of efficient capital markets and zero transaction costs (Kothari [2001]; pp. 105-231). But, in the real world, there are transaction costs, the cost that been incurred by market participants in making economic activities. The determinants of transaction costs are asset specificity, frequency and amount of transactions, uncertainty and complications of surroundings (Williamson [1979], pp. 245-254).

These changes have direct implications for explaining standard setting. The changing nature of transactions and the property rights they create or alter helps create a standard setting cycle. As the old rules are inadequate, the quality of financial reporting decreases. As the quality of financial reporting for a particular transaction deteriorates, it may come to the attention of auditors, users, regulators, and standard setters (Hepp [2004], p.34). The IASB/FASB listed the users including investors, employees, lenders, suppliers and other trade creditors, customers, government and their agencies, and the public (IASB/FASB [2006], OB6). This is much more clearly focused on the organizational field, distribution issues, and transaction costs.

The cost of measurement is the key to transaction costs defined as the cost of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements (Dahlman [1979]; 161-162). By measuring valuable attributes, recording and revealing transactions and the resulting property rights and claims to those property rights, accounting and financial reporting reduce transaction costs and inform institutions. This role is its major contribution to the commonwealth and is synonymous with its public interest. As we described how accounting standards emerged before, it was historically expected to address the public interest. While the accounting frameworks mention accounting in connection with economic decision

making, financial reporting is more broadly used in a society. As a practical matter, the purpose of general purpose financial reporting is to inform institutions consisting of the working rules for resolving conflicts of interest, necessitated by scarcity, concerning ethics, economizing and jurisprudence. Stated differently, Accounting provides a means of measurement for use in enforcement of social, political and economic institutions (North [1990], pp. 125-126).

V. Conclusions

As the corporations are getting more independent and powerful, economic changes has challenged to accounting as the working rules to provide their visibility to a society by asking who should be primary users of financial accounting. Recently, IASB changed its view of the primary users from the existing shareholders to the broader capital providers. This paper attempted to examine who should be the primary users of financial reporting based on the view of institutional economics. In institutional economics, accounting standards are regarded as the working rules to serve for public-interests to lower transaction costs.

Nonetheless, the IASB/FASB still confines the definition of transaction to bar gaining transactions, not considering power relationships such as employee-employers or government-citizens. All other economic transactions are described as "events", a vague term that provides little guidance for standard setting. This is unfortunate as the transaction is the both the ultimate unit of economic activity and the main topic of accounting standards. Accounting is a useful institution for trading in equity markets but also credit, product, tax and labor markets (Davis et al. [2003]; pp. 61-63).

One more thing that we should notice is about the objectives in the Objective. They still remain the same as the objectives in the 1989's conceptual framework, despite of the changes in the range of a primary user group.

Notes

(1) Three most commonly used institutional theories in the accounting studies are New Institutional Economics, Old Institutional Economics and New Institutional Sociology. Although these three theories have tried to explain about institutions and their change, they have the different theoretical assumptions and definitions. Transaction cost economics is usually classified as one branch of New Institutional Economics (Kim [2009], pp. 44-46).

(2) The bounded rationality is composed of inertia, myopia, and trial and errors or experiments (Aoki and Okuno [1996], pp. 278-280).

(3) APB Statement No. 4 classified the external accounting events into the two categories, (1) exchanges-the reciprocal transfers between an entity and other entities and (2) nonreciprocal transfers-the transfers from other entities to an entity in only one direction. Exchanges have no responsibility to the entity because the event is completed by exchanging each other. But the latter events causes a responsibility, that is, accountability based on the unfinished stewardship (Chen [1975], pp. 533-534).

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