

MG433 Foundations of Management

Essay topic 3:

The claim that accounting provides information is so commonplace as to be nearly colloquial. Discuss this claim, providing substance to it, by discussing the various uses and users of accounting information, and the differing informational demands that various uses and users place on accounting. A good starting point is to distinguish between managerial and financial accounting. In the course of your answer, also discuss which theory(ies) can help us in understanding such informational demands.

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Introduction

Accounting is indeed a source of information. Yet examination of this colloquialism in details requires significant setup. Particularly, we need to be clear about what we mean by uncertainty, accounting and information. Discussing accounting from an information content perspective, it is absolutely crucial to address the concept of informational demand. Informational demands create information, as well as guide us in evaluating the quality of it. The essence of information will be discussed in the first part of the essay. The second part will be dedicated to further understanding of uses and users of accounting information, and consequently characteristics of informational demands that each of them displays. We will specifically refer to agency theory on the way of revealing conflict of interests among the users of information. In the last section, the essay refers to the contemporary issues in transforming informational demands and challenges that accounting needs to meet in order to provide valuable information; information which has a utility.

The essence of accounting information

In the wide range of accounting literature the very definition of accounting theory insists that accounting is a source of information. According to Atrill and McLaney (2007), the main role of accounting is to help people make informed financial decisions. Christensen and Demski (2003) refer to accounting as providing data on organisation's financial history. What makes this data information is the fact that it reveals knowledge we did not possess before. In other words, we view accounting as having the potential to tell us something we did not know about the organisation's financial history. So information is an observable which has the potential to mitigate uncertainty. Consequently, it leads to a change in probability assessment.¹ It should be mentioned as well that the interest in the organisation's financial history is an interest in solving resource allocation problem. The main role of information lies in improving these processes: managers require accounting

¹ We will need this statement when discussing the uses of accounting information. For details, please refer to Christensen, J.A., & J.S. Demski. 2003. Accounting theory: An information content perspective, ch. 5.

information to ensure that economic resources are allocated in an efficient manner. Here is where the primary utility of accounting information is seen.

All forms of accounting are concerned with collecting and analysing financial information and communicating this information to those who make decisions. Consequently the most important deduction from the analysis of accounting as an information system is that the goal of the system is to provide information that meets the needs of its users (decision makers), and the needs of the users in turn should determine the type of information that is produced by accounting system. As Glautier and Underdown (2001) fairly mention, the objectives of an accounting information system are determined by the needs of the users of information.

So the question here is to identify the users of accounting information. These users have their specific informational needs, and they actually evaluate the utility of the consumed information. Among the main users of accounting information are various interested groups such as shareholders and investors, employees and management of the organisation, government, regulatory authorities, creditors, auditors, competitors, suppliers and other groups like local community and customers; the latter being popular especially in the recent years. These users can be classified into general groups of internal users (mainly management, employees, etc) and external users (government, creditors, competitors, investors, etc).

Based on the separation of user groups, accounting has been divided into two main strands: management accounting and financial accounting. Management accounting seeks to meet the needs of internal user groups, while financial accounting addresses the needs of external user groups. Regarding the characteristics of information, it is interesting to mention that management accounting provides information concerning past and future performance of the company, and financial accounting addresses the results of the company's past performance. Among other fundamental differences it is the regulated nature of financial accounting vs. unregulated nature of management accounting. Also it is important to mention that financial accounting refers to mostly quantifiable in monetary terms data (more objective), while management accounting provides both financial and non-financial data (less objective, but still demanded).

Whilst differences between the information needs of management and financial accounting users, there is also an extensive overlap between those as well.² For example, internal users might sometimes request information on historical overview of financial data; equally external users might be interested in receiving future-oriented information such as planned level of profits or non-financial data regarding product innovations.

It is important to keep in mind the main characteristics of financial and management accounting, while we proceed to the various uses of accounting information. The reason is that the formers are accurately reflected in the specificities of those uses.

Uses of accounting information

Information content of accounting is possible to discuss when and only when that information is actually used. So it is the right time to refer to the uses of accounting information; specifically valuation and managerial contracting uses. Valuation use of information refers to information as the means for valuing a firm. Managerial evaluation setting uses accounting information in evaluating the firm's management team; in contracting with a manager. These uses can be attributed to financial and management accounting functions respectively (as already mentioned), since they refer to external and internal users in the context of our study.

It is not a trivial task to understand the uses in action. In their research, Christensen and Demski (2003) have tried to model specific situations, using mathematical language to exercise informational uses. They specifically feed information to each of the settings, and follow how the information will be used.

In the first experiment with valuation use the authors contrast the phenomenon of market (economic) valuation and the accounting system itself, while treating accounting as the only information source. Market valuation (market price) here is a risk-neutral valuation of the expected cash flows. Accounting is described by simple calculus. In short, the debate is whether accounting is able to capture all the information from the economy to reflect it accordingly in its results. The theory, which helps understanding informational

² Atrill, P. & E. McLaney (2007). Management Accounting for Decision Makers. Financial Times Prentice Hall, 5th Edition. p. 27

processing in the market, is Bayesian rule.³ In contrast, accounting system uses linear processing of information, thus the information comes coded in a specific measurement scale. This difference of information processing is fundamental. Without going deeper into the details of the model (it is a topic for a separate research), it leads us to an important conclusion: even being objective and risk-neutral⁴, market valuation of information still differs from the information processing of accounting system. Moreover, the risk neutrality suggests that there is no demand for early resolution of uncertainty, and no demand for accounting to convey any information about what cash flows will materialise. Additionally, information sources are diverse (often being of non-accounting nature), and accounting system is unable to capture all available information at any given moment. For example, public information, audited accruals, firm's environment, technology, market structure are sources which greatly influence the content of specific accounting information. Thus, accounting provides information, but it does not necessarily agree with the market demand for it.

In the second experience, information is fed to a contracting exercise. In valuation setting accounting information is delivered to the external market, and there is only a one way action. To contrast, the specificity of this model is that now we deal with the manager. Trading in labor market, where manager's compensation is exchanged for his professional service, is executed on mutual basis: the manager too might take actions on his own. The key issue which arises here is the discrepancy in the level of information each of the parties, the employer (principal) and the manager (agent), might possess. Agency theory helps us understand firstly the characteristics of their informational demands, as well as the results of the trade in labor market. Agency theory refers to the conflict of interests of the principal and agent in the situation of information asymmetry between these two parties. In the best case, when the agent's activity is observable and verifiable, we have no information asymmetry. In other cases, when the agent's actions

³ Bayesian rule refers to conditional and marginal probabilities of two random events. It provides a mathematical rule explaining how you should change your existing beliefs in the emergence of new evidence. In other words, it allows to combine new information with existing knowledge. It is relevant to information processing, since information potentially mitigates uncertainty and is tightly connected to probability assessment.

⁴ The market is indifferent between fair insurance and risky choice. This means it can process information for the decision-making purpose more objectively, than in case of being risk seeking or risk averse.

are unobservable and unverifiable, we have information asymmetry. If the agent potentially has more information about the product she sells, and her actions are somewhat unobservable, the principal and the agent are unlikely to agree on how to best allocate manager's resources. Here we come across the problem known as moral hazard. This means that the agent may act in her own interest and against the interests of the principal, possessing larger amount of information than the principal does. In the interest of simplifying the study, the agent is assumed to be strictly risk averse, while the principle is characterised as risk neutral.⁵ Skipping the details of the model's calculations, there are important conclusions to be drawn.

First, a decrease in the quality of the principal's information increases welfare loss. Moreover, welfare loss increases when the agent becomes more risk averse.⁶ Second, the principal-agent problem leads to the need for monitoring and performance measurement system. In other words, the conflict of interests raises demand for accounting information in the aim of evaluating manager's performance. Third, under imperfect market conditions and moral hazard problem, the efficient contract with the agent is a pay-for-performance arrangement. Here is where the principal needs effective information whether the agent did actually perform in a desired way.

Accounting information is widely used to find solutions in a complex conflict of principal-agent problem. This includes analysing employee incentives, development and application of optimal performance measures, information aggregation procedures and compensation methods (e.g. bonus pools). Nevertheless, contracting setting has certain weaknesses in efficiently meeting informational demands. Many of the optimal performance measures are more complicated than those observed in practice. The cost of communication and contracting is not incorporated in the model. There is also a growing need for measuring the performance of "knowledge workers". Their efforts cannot be

⁵ Christensen, J.A., & J.S. Demski. 2003. Accounting theory: An information content perspective, McGraw-Hill, p. 235

⁶ Grossman, S., and o. Hart. "An Analysis of the Principal-Agent Problem." *Econometrica* (January 1983). p. 43

directly contracted for; hence there is a need for further research in understanding the incentives of such workers.⁷

Moreover in some cases there is no need for further accounting information. Removing assumptions about agent's risk aversion, personal cost term and substantive uncertainty, the optimal trade agreement would be trivial. The efficient contract with the agent would be a fixed compensation, and there would be no need for further accounting information for evaluation purposes. So the absolute condition for a demand in accounting information on performance is the conflict of interests in principal-agent problem.

Finally, the results of the experiment conclude that information content in a valuation setting does not imply information content in managerial contracting (evaluation) setting and vice versa. The two settings seem to be similar on the surface, but they are completely different in reality. A possible solution could be concentrating on financial sector's requirements. The logic is that accounting should prove a value-added service, which implies the need to focus on the valuation market. As Christensen and Demski imply, there is no better way to emphasize value creation other than using "the market".

Changing informational demands and challenges for accounting

Highlighting the conflict of uses, multiple sources of information, as well as inevitable individual judgment in resolving resource allocation problem, it is absolutely important to view accounting information in equilibrium. The challenge for accounting is whether it provides information which is modeled in harmony with all these factors. It is also important that accounting keeps up to date to meet changing informational demands in contemporary business environment. There are certain trends which accounting will need to follow on the way of creating valuable information.

- The basic challenge for accounting is the ability to conform to both the internal and external purposes. Reconciling informational needs to the technical requirements of financial reporting become rather burdensome, requiring more resources, therefore higher costs. And that is one of the risks of the function today.

⁷ Bhimani, A. 2006. Contemporary Issues in Management Accounting. Oxford University press. p. 38-39.

- Accounting needs to find a way in developing and using metrics that inform the management and the outside world about the elements that are traditionally not measured but are crucial to firm's comparative advantage. Things like customer satisfaction, staff loyalty and retention, brand maintenance and brand value are in fact measurable, but still not used or used inefficiently within traditional accounting systems. The purpose is that once these elements get measured by accounting system, they can effectively be managed.
- The transactional side of accounting is being severely minimised due to automation and improvements in organisational processes. There will be a need for the rest of accounting to provide business insight into existing data. In other words accounting will need to concentrate on value creation: information that has a value for investors. Investors today demand breaking down the company's value chain into components. They want to understand where the competitive advantage of the company comes from. For example, investors want to know if the firm's profits originated from good customer service, or quality of the product, or effective advertising, etc. At the moment accounting is based on the ultimate results of company's activities, while it needs to break down the value creation to the individual components. It will need to move to analytics and consulting. And that is what is going to be increasingly demanded.

Conclusions

Accounting is an important institutional fabric in our society. It certainly does provide information; both of internal and external use. The context of these uses is the key determinant of the value and efficiency of that information. Given the conflict among the various uses and users of accounting information, it is important to realise that no universal prescription is to be found. Accounting can provide information, but that does not cover all available information. Accounting certainly needs to be viewed in equilibrium with other informational sources, market structure, technological and other specifications of the firm's environment. Moreover, to evaluate the utility of accounting information, professional judgment in each specific context is essential. Additionally, accounting will need to understand requirements of diverse range of managers appreciate

the needs and requirements of decision makers and better understand contemporary business environment. That is when accounting has a chance to create truly valuable information in the twenty-first century.

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