

Financial Reporting: What's Really in the Eyes of the Beholders?

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Understanding financial statements can be a tricky business. Even for experienced business professionals, discrepancies in formatting and the sheer volume of data can often lead to an inability to interpret information effectively.

Compounding the problem is the widespread use of "creative accounting", a term given to disclosure practices deliberately designed to be misleading while still operating within the legal framework of the Australian Accounting Standards Board and the International Financial Reporting Standards. While industry insiders and sophisticated investors may be alert to "creative accounting", most people are oblivious to financial information being presented in this way. There is still enough discretion within accounting standards to present a deliberately misleading view without operating outside of the rules.

For example, firms can classify their leasing obligations in a way that avoids the need for them to appear as liabilities in the balance sheet. Similarly, the "fair value" accounting rules allow scope for overstating or understating the value of an asset. The less liquid or transparent the market is for assets, the more this is potentially a problem.

Listed companies are typically in focus for "creative accounting" practices since it's often capital market – share price related – issues that drive the incentive to report better performance. Other "incentives" to manage earnings also come from contracts, such as executive pay arrangements, and debt contracts that might specify limits on the extent of borrowing.

Apart from "creative accounting", an important disclosure issue is the way in which companies present their results to the market. A particular concern is "pro forma" accounting, which is a statement of a company's financial activities excluding "unusual and nonrecurring transactions" when stating how much money the company actually made, also known as non-GAAP (Generally Accepted Accounting Principles) earnings. Companies often highlight key figures such as "core earnings" or "non-cash earnings" in media releases. At issue is the lack of a standard definition for such income numbers, both between firms at a point in time and among firms over time.

In the wake of the global financial crisis, the formatting and presentation of financial statements has become a hot issue, not only due to the potential for poorly and erroneously presented information to mislead creditors and investors, but also due to the increasing number of people retiring with substantial superannuation payouts to invest. If unable to comprehend financial information effectively, this is likely to have a significant effect on investors' decision-making.

Eyeing Off Disclosure

There are common pitfalls in reading financial statements, according to [Jeff Coulton](#), a lecturer in Accounting at the Australian School of Business. First up is understanding what the statements represent, he says. "You need to ask, 'what are the actual component parts of a financial statement? What are the rules?' It's not just the income statement, the balance sheet, the cash flow statements, there's a lot of information in the footnotes – and people often overlook them."

A collaborative team, encompassing researchers from science and accounting disciplines from the



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University of New South Wales at the Australian Defence Force Academy (UNSW@ADFA) and their counterparts at the University of Canberra, now are attempting to tackle formatting issues in more detail, by tracking readers' eye movements as they peruse financial statements.

Using a Tobii portable eye-tracking device, the team has devised a way to monitor eye movements to determine how financial information is interpreted in relation to how it's presented. Using a small infrared light fixed to the base of a computer, the eye-tracker records light reflected from the surface of the eye to "triangulate" precisely what is being looked at on the screen and for how long. Sophisticated software then produces a detailed map with co-ordinates for analysis and referencing.

"By identifying where people look and for how long, we can establish whether disclosure practices are helping or hindering the usability of financial statements," says [Frances Miley](#), a lecturer at UNSW@ADFA who is leading the research with Andrew Read, an accounting professor in Business and Government at the University of Canberra. "If you think of financial statements as a map, we are able to see how easily people find their way around that map."

The research aims to add a dimension to the understanding of how accountants, auditors, creditors and investors view accounting information and to inform the standard-setting processes, says Miley.

While eye-tracking techniques have previously been popular with marketers and advertising agencies to monitor the effectiveness of campaign strategies, it's the first time the technology has been applied to the financial sector. The idea to apply eye-tracking technology to financial statements was sparked after a conversation between accounting academics and [Amy Griffin](#), a lecturer in Geographic Information Science at UNSW@ADFA, who was using the eye-tracker technology in her behavioural sciences research.

"Eye tracking is a way of objectively measuring what people are doing," notes Griffin. "Behavioural methods in the past have tended to rely on people directly telling you their thoughts, but this is tempered by their preconceived expectations of what researchers want to know, so their responses are filtered by their own cognitive processes. With eye tracking we are no longer reliant on these responses, we can see for ourselves."

A pilot study on accounting students at the University of Canberra has been planned, followed by wider research among professionals in the banking and accountancy sectors.

"In our global community, it is essential we develop the most universal format for financial reporting to support the dependency we all have – directly or indirectly – on the information provided in financial statements," highlights [Lyn Grigg](#), lecturer in Accounting and Finance at UNSW@ADFA. By understanding what captures people's attention on a financial statement, as opposed to what they say they have noticed, there's real potential to help improve decision-making, Grigg says.

"Beyond gains for general academic financial accounting research, there is a genuine opportunity to support governments' initiatives, as well as the professional accounting bodies, in their efforts to further develop the international financial statement framework, public sector reporting and non-profit sector reporting."

Shifting Standards

Read hopes the team's research will ultimately lead to International Financial Reporting Standards factoring in a new framework for disclosure. Read believes the standards-setting body, the International Accounting Standards Board, does not specify clearly enough how much detail is required with disclosure practices. "There is a massive amount of work to be done both in Australia and internationally but eventually we hope to be able to tell the International Accounting Standards Board precisely what's important to put into the standards and what is not," says Read.

However, Coulton says the issue of discretion in financial reporting is a double-edged sword. "Giving financial managers discretion with financial reporting is what is both good and bad about the system," he says. "And that discretion can be used to communicate how well or badly managers think the business is going or is likely to be going, [and] can improve the efficiency of financial reporting."

The flip side is that the same discretion can be used to hide performance. What might be called the "earnings management" side of things. You can't have one without the other, the alternative could be that we might go to "bright line" rules (which clearly define the accounting treatment to be used), but we know that managers will manipulate those as well," Coulton says.

For real comprehension of financial statements, knowledge of what a particular business is doing is required from the outset because the aim is to get "a good sense of the underlying business performance", notes Coulton. And to a large extent, understanding financial statements has much to do with the eyes of the beholders. "A lot of people don't have [insight into the business] and without understanding what you would expect to see, it would be difficult to interpret things like standard ratios or performance measures," Coulton says.

When weighing up the options, Coulton believes a good understanding of what the business is doing and therefore what you would expect to see is probably more important than increasing transparency. "What's pivotal is an understanding of the rules that govern financial statements. The more complex the rules, the more difficult it is for people to understand. Obviously the role of auditing is important, as is general user education."

It's an area where the push to increase widespread financial literacy is crucial, Coulton points out. "Clearly the implication from the recent Centro Properties decision in the Federal Court is that people do need to understand what's in financial statements," he says. In late June the Federal Court found eight Centro directors had breached their directors' duties in failing to accurately disclose the company's liabilities to shareholders in the 2007 financial report. Central to the case was a simple accounting mistake in which short-term debt was placed in the long-term column. While the directors claimed they had relied on auditors to spot the error, Justice John Middleton determined: "Each director was aware of, or should have been aware of, the relevant accounting principles which would have alerted each director to the apparent error in the proposed financial statements."

Clearly, all users of financial statements need educating, suggests Coulton, who also raises the importance of consistency in promoting understanding. There's a need to keep the rules as simple as possible "without continually changing them", he says.

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