Appendix 3.02.5 Theory and Academics

The role of financial reporting and auditing in the modern semi-capitalist economy (that is a mixed private-public economy)

The basic idea is that, in a modern capitalist economy, the optimum result can be achieved only if the various parties are supplied with information that is reliable, relevant and free from bias. In this way, resources are allocated in the most efficient way, to the benefit of all members of society. The capitalist system depends on credit. Credit involves one person entrusting resources to a second person in the expectation of receiving a higher reward in the future. The essence of capitalism is that a person (the capitalist) entrusts resources (typically money) that are excess to his consumption plans, to a third party to be employed in productive activities. The capitalist is prepared to forgo immediate consumption in return for a higher future reward.

This arrangement reflects the technological characteristics of the modern economy which requires substantial long-term investment in tangible assets, such as machines, and intangible assets, such as complex information systems. Short-term credit is also important. Almost all sales between firms (the great majority of transactions in the modern economy) are made on credit. The proper functioning of the credit system depends on trust – that the credit-receiver will honour his promise to repay the credit-giver. With advances in payment systems it may be that trade debtors and creditors become things of the past thus changing the landscape of credit provision using more intermediation.

The need for reliable data to support the trust inherent in the credit system was made abundantly clear during the 2008 financial crisis when, at one point, the US economy was on the verge of collapse, since a lack of reliable information meant no one was prepared to trust the other party and therefore refused to offer credit. The credit system breaks down when trust disappears. For the system to function properly, both parties to a credit agreement must trust the other party to keep their promise and, in particular, to provide reliable information.

Academic literature and negativity

This is not a through literature reviewer, more like a random walk through some of the literature. There has been much criticism by academics of financial reporting as well as the wider concept of corporate reporting. Our author John Flower is a big critic and thinks the system is broken, but his criticism goes wider to the nature of capital markets and even the political system. He would want a better and more socially responsive system with reporting to match.

Others are equally critical. For example, Crowther (2016)[1]. For him, the change in focus of corporate reporting over time means that the current form of reporting is one in which the report itself is now all that matters and there is no longer any need to consider the actual results of the firm in any detail. He argues, with evidence, that these results are now incidental to the purpose of such reporting. Indeed the forward-looking nature of such reporting means that all that is necessary for the production of the report is that the semiotic (signs and symbols) created makes the present look better than the past, and the future look even more attractive than the present. This semiotic has now become the principal function of corporate reporting: such reports, or rather the semiotic inherent in such reports, must stand favourable comparison with other reports – either past reports of the organisation or current reports of other organisations.

He claims that in this way corporate reports can now be viewed as little more than image creation mechanisms. The image created through the semiotic and the consumption of that image is all that remains of corporate reporting. Thus such reports can be considered nothing more than simulacra, which need have no bearing on anything other than themselves and no reference point other than previous corporate reports. As long as they are consumed as real by their recipients, this consumption suffices to legitimise their existence and disguise the absence of any relationship with corporate activity. This maintenance of the corporate report as simulacrum, through its consumption as real, is an essential part of the maintenance of the dialectic in its present from, and the maintenance of the primacy of managers in organisation hierarchies.

And this abstract from Macintosh et al (2000)[2]

> This paper draws on two independent strands of literature — Baudrillard's[3] orders-of-simulacra theoretic, and financial accounting theory — to investigate the ontological

[1] A Social Critique of Corporate Reporting: Semiotics and Web-based Integrated Reporting Paperback – 28 Nov 2016 by David Crowther (author), Routledge; 2 edition (28 Nov. 2016).
[2] Accounting as simulacrum and hyperreality: Perspectives on income and capital. Available from:
https://www.researchgate.net/publication/222521999_Accounting_as_simulacrum_and_hyperreality_Perspectives_on_income_and_capital [accessed Dec 09 2017].
B. Macintosh, Norman & Shearer, Teri & Thornton, Daniel & Welker, Michael. (2000). Accounting as simulacrum and hyperreality: Perspectives on income and capital. Accounting, Organizations and Society. 25. 13-50. 10.1016/S0361-3682(99)00010-0.
[3] Jean **Baudrillard w**as a French sociologist, philosopher, cultural theorist, political commentator, and photographer. He is best known for his analyses of media, contemporary

> status of information in accounting reports. It draws on Baudrillard's concepts of simulacra, hyperreality and implosion to trace the historical transformations of the accounting signs of income and capital from Sumerian times to the present. It posits that accounting today no longer refers to any objective reality but instead circulates in a "hyperreality" of self-referential models. The paper then examines this conclusion from the viewpoint of recent clean surplus model research and argues that the distinction between income and capital is arbitrary and irrelevant provided the measurement process satisfies the clean surplus relation. Although accounting is arbitrary and hyperreal, it does impart a sense of erogeneity and predictability, particularly through the income calculation. Therefore, it can be relied upon for decisions that do have real, material and social consequences. The paper ends with some implications of Baudrillard's theoretic for accounting, reflections on accounting's implications for Baudrillard's theoretic and suggestions for future research.

Though Whittington (2010)[4] comes to the rescue by placing this within the context of individual decision making, and the theory of capital markets. He claims that much of the current thinking of accounting standard setters about measurement seems to be based on an idealised view of markets as being complete and in perfectly competitive equilibrium. In such conditions, there is a unique market price based on full information for every asset and liability, and there is an obvious attraction in using this price as the measure for accounting. This explains the apparent enthusiasm for single ideal measurement methods based on market price, such as fair value, defined within IFRS, as a market selling price.

But, Whittington, goes to say that in reality, markets are imperfect and incomplete, so that ideal unique market prices are not available for all assets and liabilities. This is why SFAS 157 (FASB, 2006)[5] has to resort to a Fair Value Hierarchy, the lower levels of which require estimation of what a market price might be if one existed. The liquidity problems evident in the Global Financial Crisis have demonstrated the limitations of markets and the difficulty of estimating market prices, even for financial instruments.

He notes that an important source of imperfection in markets is the existence of information asymmetry, which means that not all market participants are equally well informed. The alleviation of information asymmetry through the exercise of accountability is the principal reason why accounts are needed. As such measurement methods should be selected with the market context in mind. Having a single preselected measurement method may not best reflect market conditions or meet users' needs. Accounting provides information as input to users' own decision models, rather than providing a decisive valuation.

culture, and technological communication, as well as his formulation of concepts such as simulation and hyperreality.

[4] Measurement in Financial Reporting, Geoffrey Whittington, Abacus, Vol , No 1., 2010

[5] FAS 157. In September 2006, the Financial Accounting Standards Board (FASB) of the United States issued Statement of Financial Accounting Standards **157**: Fair Value Measurements), which "defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP),