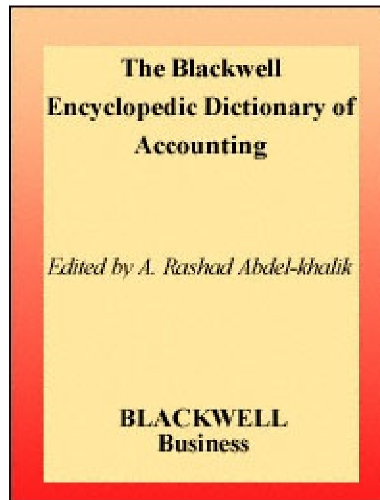

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Preface

In any group or organizational setting, having access to information facilitates the process of management and control. Although it is not the only source of information, accounting has been the basic conventional business activity that drives the formal information structure within organizations. Measurement and evaluation of performance transcend all business activities from the level of individual responsibility, to divisions, to the entire firm. Many of these methods appeal to some theoretical reasoning, while others are governed by pragmatic criteria. Whereas the criteria for revenue recognition have withstood the test of time, novel and new transactions create new challenges for which no theoretical support exists. In those situations, professional accounting rule-making bodies promulgate stop-gap rules that would help serve short-term needs. Accounting for new financial instruments, swaps, and derivatives has come to the forefront and is the most formidable task facing accountants in the late 1990s.

In past years, accounting for transactions such as debt defeasance was considered too complex for the traditional accounting model to handle. But in more recent times, the ingenuity of capital market participants in creating new financial instruments for which no known accounting treatment exists continue to pose challenges to accountants. Even some familiar types of executory contracts such as leases continue to frustrate rule makers as they vacillate between well specified criteria that can be evaded in writing lease contracts and professional judgments that allow more freedom for accountants. Accounting for leases join other executory contracts such as pensions and post retirement benefits in their being measured by accounting standards that could end up providing more garbled than precise information. Many users of financial information do not have a reasonable appreciation for the degree of latitude allowed accountants in the measurement and reporting of financial information. Indeed managers are often assumed to use the accounting flexibility allowed them to manage

earnings. The complexity of the business has created diversity within and among different nations. Accounting for goodwill and foreign currency translations are good examples of this diversity. Because of the high degree of judgment involved in the measurement and reporting of information, international harmonization of accounting is not likely to materialize in our lifetime.

In addition, many of those pragmatically driven rules become accepted as a common body of knowledge merely because accountants and users of financial statements have grown accustomed to them. Accounting for inventory valuation is one example. Although lacking theoretical support, it enjoys unusual longevity in the field. In many countries, it is the lower-of-cost or market rule that perpetuates the conservative mind set of accounting policy makers. The conservative policy-making posture has led to other accounting problems for activities such as research and development that essentially ignore the investment nature of the activity. Conservatism and adherence to historical cost has reduced the interest in alternative valuation models such as current cost or other market valuation basis. In some countries, the accounting profession allows asset revaluation to reflect market prices, while in most countries the revaluation is allowed only for conditions of asset impairment. Because investors and other external users make use of the publicly reported accounting information, understanding these concerns is important in making ratio analysis and other uses of financial reports.

Because acounting is a process of mesurement and reporting that is subject to a great deal of judgment, independent accountants (i.e., auditors) must assess the extent to which the reported

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information *faithfully represent the economic conditions of the firm.* The process of auditing financial statements has thus become an important function. First, because of the complexity of business and the cost, auditors must sample transactions for verification and audit sampling has become more specialized. Second, the audit sampling as well as other evidence-generating processes is subject to certain levels of risk. Auditors are required to follow a particular audit risk model. Third, undertaking the audit process requires analysis of trends and analysis of deviations of information from their expectations, an area known as analytical review. Fourth, in searching for evidence, auditors exercise judgment on what processes to use and what information cues are relevant. Fifth, in making those judgments, auditors apply various technical as well as rules-of-thumb methods and use different approaches to testing audit evidence. The final outcome of an audit is a report that must state whether or not the disclosed financial statements are prepared in accordance with accepted methods and whether or not they reflect the underlying economic conditions within the accepted bounds of audit risk. The format of the report, but not the substance, differ slightly among different countries.

Accounting information is used not only by capital market participants who continue to monitor the information content of different signals, but also by insiders who manage the firm. Planning and budgeting for normal operating activities as well as for capital projects are major functions that require use of and generate accounting information. Analysis of deviations from cost standards and budgets constitute important input for managerial decisions. Evaluating divisional performance requires identification of the managerial unit, perhaps setting a set of transfer prices, as well as devising allocation schemes for the cost of shared resources. Much of these activities are dependent on the level of technology employed by the firm. Integrated manufacturing technology and strategic cost analysis are elements of a new perspective on accounting for internal purposes.

The level of technology employed by the firm has a pervasive effect on all of these elements of the accounting domain. Management information systems, database management, technological auditing are all

manifestations of the effect of technology.

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