

# **The Economic Social Merits Of Accounting & International Implications**

**Or**

**“Yes Virginia, Accounting Has Social Value”**

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**Abstract**  
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This paper examines the role of accounting in society from the micro-to-macro context. The authors trace the contributory and ultimate effects of accounting on societies. This paper characterizes the impact of accounting within an economy and across economies. In the process, the authors:

- < Define Economic Social Merit (ESM) in the context of a society(s).
- < Characterize the creation of value within an economy and relate value generation to ESM.
- < Explain how the standard of living enjoyed within an economy stems from this value cycle.
- < Identify the role and importance of accounting in this value cycle.
- < Illuminate the resultant critical linkages between the micro of accounting and the macro of society.
- < Chronicle important inter-relationships of accounting with components of the markets for capital and the markets for goods and services.
- < Relate specific and important factors in accounting to society.
- < Expose critical links between accounting, an economy, and ultimately the standard of living enjoyed in an economy.
- < Contend that accounting and its derivative benefits to society are of particular and disproportionate import for lesser-developed, emerging, and transition economies.
- < Declare that recent turmoil in global markets signal both the great need for and importance of leadership from the profession.
- < Propose avenues for additional research.

The authors also advance a prescription for the accounting profession that will enhance the economic benefits realized by members of society. They accentuate the importance of leadership in the accounting profession. They suggest several areas of focus that will enhance social benefits while at the same time will promote the accounting profession.

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**Premise:** “Society” is the aggregation of all individuals who enjoy (endure) membership in a common economic system. <sup>1</sup>

**Definition, Social Merit:** Contributing to the standard of living (SOL) and/or quality of life (QOL) enjoyed by one or more members of society without the degradation of standard of living and/or quality of life earned and enjoyed by others.

**Economic Social Merit (ESM):** Actions that employ resources to fulfill human needs and that earn economic rewards in a competitive and free society.<sup>2</sup>

## Introduction

**Overview.** The notion that actions should result in social merit seems relevant and consistent with the social desire to use resources wisely. In free and competitive markets, the generation of economic returns and the potential to create value are very consistent with the wise use of resources. *Indeed, in competitive markets, attractive economic returns that provide rewards to providers of financial capital are possible only as a result of the fulfillment of the needs of individuals through the use of resources – a critical concept we will illustrate.*

Earned economic value derives from the utilization and transformation of resources to meet human needs. In a competitive market, need fulfillment is a necessary but not sufficient condition to result in earned value. The more effective and efficient the process, the higher the level of fulfillment of human needs and, the greater the ESM.

Regrettably, economies endure “extracted income” which we define as unearned benefits accruing to certain parties as a result of the unwise use of resources and one or more of the following: non-competitive offerings, waste, fraud, theft, and other criminal activity. In competitive markets, the

availability of information developed through application of accounting standards can reduce and possibly effectively eliminate extracted income. This benefit stems from accounting providing transparency of information. In competitive markets, transparency provides the opportunity for market participants to avoid letting parties extract unearned income at their expense.

Actions of organizations and individuals can result in ESM if:

- < The wise use of resources enhances the lives of people through need fulfillment and
- < The economic system creates value or, at the margin, just preserves value.

ESM is useful in analyzing various aspects and decisions that involve the allocation of resources within a society. Accounting has impact on the generation of ESM.

In this paper, we examine critical issues in the value creation process in an economy and the role of accounting standards in the context of its contribution to economic social merit (ESM). We use accounting standards in a broad context: the underlying principles, application, presentation, dissemination, availability, acceptance, enforcement, and perceived efficacy of accounting information. Ethics and moral standards are necessary and add to efficacy. We review relationships integral to a functioning economy that generates value for its people and the contributory role of accounting standards to ESM.

**Perspectives.** The “economic” standard of living enjoyed by members of a society serves as one measure of benefits realized by the use of available resources. Separate from direct economic benefits in the classical sense of standard of living, others and we assert a cause-effect relationship between economic social effects and “non-economic” merits. Examples: an improved standard of living enjoyed by a greater proportion of the population likely results in reduced crime and child-family abuse, greater opportunities for education, and other favorable outcomes most would accept as social merit.

The availability and cost of capital committed to an economy influence the development of the economy. In turn, capital relationships affect the availability and costs of goods and services available and accessible to fulfill human needs within an economy.

Accounting provides information that influences the behavior of people who:

- < Make decisions about capital. Capital availability and costs are sensitive to perceived risks and alternative opportunities for the employment of capital. Consequently, accounting affects the social realizations within an economy. These are external users of accounting information.
- < Use information within a company to make decisions about product development, investment in assets, the operations of assets, and other decisions related to taking factors of

input and converting them to products and services that fulfill customer need. We term these internal users of accounting information. Internal use includes pricing and marketing strategies. Decisions in this context influence the availability of products and their prices to segments of the market – thus influencing the population’s ability to fulfill needs through the purchase of products and services.

The efficacy of accounting information affects broad categories including:

- < The efficiency of capital markets in allocating resources.
- < The willingness of investors to provide capital to economies.
- < The cost of capital offered to an economy.
- < The efficiency of the production elements of the transformation cycle, i.e., the availability, readability, and usefulness of information within a company.
- < The financial market’s perception of how well the company manages the production cycle.
- < The social market’s (customers’) perception of the results of the production cycle, e.g., the quality of product produced and the relative value of the product compared to other available products.

The net effects of how external users in capital markets digest and use available information depend on critical factors, including the availability of relevant and reliable accounting information. The subset of information most transparent to market participants takes the form news releases, public reporting, and financial statements provided by firms to investors and lenders.

Internal accounting influences the management of the production function. However, “internal accounting” for an organization is also important in terms of its impact on perceived risk and capital availability and costs. Knowledgeable market participants recognize that internal accounting that supports logical and informed analysis, decision making, and management reduces the risk of the operation and increases the chances of attractive economic returns.

The presence, application, and perceived efficacy of accounting information that meet the desired standards of the providers of capital affect the economy. Highly developed accounting standards yield economic social merits in terms of the development and the improvement in the standard of living. Shortfalls in this regard are detrimental to the economy and society. Increased leadership in the accounting profession to insure the effects of accounting are favorable will add to the efficacy of accounting information and perceptions of such by capital market participants.

**The resource-transformation-need fulfillment process** provides the opportunity for the fulfillment of human needs. This process also is the foundation of the creation of economic value. Factors affecting the availability, allocation, choice, and use of resources and the efficiency of the

“production” process influence the nurture and harvest of economic social merit for an economy(s) and society(s).

**Lesser developed, emerging, and transition economies** suffer from shortages and high costs of capital. The high cost of and limited availability of financial capital inhibits the efficient use of human and tangible capital. The relative lack of efficacy in accounting standards (using our broad definition) results in financial capital shortages/high costs. Consequently, within lesser developed, emerging, and transition economies (LD-E-T), the absence of accounting standards has disproportionate and significant influence.

The improvement of accounting standards is one factor of import in generating economic social merits in LD-E-T economies. We offer that improved standards (adoption, application, disclosure, enforcement, . . .) of accounting and disclosure in countries serve as positive examples of the social merits of accounting. Indeed, even in well developed countries such as Germany, we have witnessed increased attention to accounting issues and disclosure. In various countries, companies have accepted that accounting and disclosure issues, increased availability, and reliability of information lowers perceived risk to providers of capital. These changes have attendant increases in access to capital markets with available capital at lower costs.

Improvements in LD-E-T economies also influence extant economies and capital markets in a variety of ways including reduction in global credit risk, reduced political risk, greater opportunities for efficient global trade, and increases in the efficiency of resources on a global basis.

At this stage in global economic development, our success as leaders in the accounting and related financial professions can profoundly and favorably influence the lives of many people. That prospect offers challenge, attendant responsibility, and motivates our interests in this important area. We have no doubt our colleagues are ready to commit their talents with the intent of improving the standard of living for people.

## **Background**

### **Literature**

The literature offers an array of related and important papers. The references provide a minute sampling of significant contributions. We collectively recognize the important works of others and thank them for stimulating thoughts. In respect of the patience of the reader, we cite only a few papers particularly germane to our effort.

Toms (1998) provides an interesting viewpoint in his examination of the effects of the supply and demand for accounting information in an unregulated market in particular market segment in the period 1855-1914.

Hopwood has given diligent attention and offers a number of insights on accounting and society (e.g., 1987, 1994). Thinking of the contributions in a collective sense provides important perspectives. One particularly insightful comment by Hopwood (1994, 299) asserts that

“Accounting is increasingly seen as a pervasive and highly generalized technology that can contribute to the functioning of a very wide range of organizations and socio-economic processes.”

We could not agree more. Accounting clearly provides social benefits that accrue to individuals and society.

The literature addresses the gains to firms within a society that result from a reduction in perceived risk resulting from reliable accounting practices and disclosure. These studies persuasively argue that shareholder wealth increases and the cost of capital decreases as a result of measures that enhance the accounting disclosures. Lower cost of capital supports the delivery of goods and services to a population at lower costs, ultimately delivering a higher standard of living. Lower cost of capital is also likely to increase the total capital available to an economy.

Watts and Zimmerman (1986) and Easterbrook and Fischel (1984) examine information asymmetry between managers and investors through accounting disclosure and conclude improved availability have favorable wealth effects for firms. Managers’ disclosure policies affect stock prices (and the cost of capital) because the information asymmetries between informed investors and less informed investors raise the transaction costs and reduce liquidity for a firm’s shares trading in a secondary market.

Diamond and Verrechia (1991) reveal that a commitment for future disclosures favorably influence the long-run price of a firm’s shares. We would add that the commitment to and assurances of efficacy of accounting disclosure is disproportionately important in emerging and transition economies since they often suffer from the perceived lack of assurances in disclosure.

Welker (1995) provides an excellent summary of the recent literature on information asymmetry and market liquidity. Welker also reports an inverse relationship between a firm’s bid-ask spread and the quality of accounting disclosure policies.

In an empirical study looking at the choice of functional currency as required by SFAS No. 52, Bartov and Bodnar (1996, 415-16) conclude that “managers wishing to maximize the value of their firm will have incentives to reduce the degree of information asymmetry among market participants by switching to new accounting techniques that make financial statements more informative to investors.”

We also recognize the impact of accounting on management decision making. Chow, Kato and Shields (1994) address the impact of culture on management controls. Their study provided some evidence that national culture exercises some control over management control preferences.

## Definitions & Relationships

An understanding of the concepts presented in this paper is enhanced through short definitions of selected terms. The terms presented focus on recognizing factors that add to the standard of living in an economy.

- ⟨ **Economic Social Merits (ESM).** The value, *as perceived by members of an economy(s)*, of need fulfillment resulting from the availability of goods and services and their acceptance. Collective economic social merits (CESM) are the aggregation of ESM across each member of an economy.<sup>3</sup> Since the focus of this paper is on the effect of accounting on ESM, we defer a discussion of details of ESM and CESM to another occasion.
- ⟨ **Types of Capital.** The customary trichotomy yields tangible, financial, and human capital. We dichotomize human capital into physical and mind capital.
- ⟨ **Resources.** Resources include inputs of production (labor, material, energy, ...) as well as invested capital, such as working capital, capital assets including land, and intellectual capital.
- ⟨ **Social markets.** We define social markets as those markets for goods and services that offer opportunities to fulfill the demand for need fulfillment.
- ⟨ **Competitive markets.** Our definition is simplified compared to the more classic definition. Markets in which the customer has a choice of products/services.
- ⟨ **The transformation process.** The cycle that converts resources from one form(s) to another form (product or service) offering the prospect of human need fulfillment. This cycle seeks to connect the markets for input resources, production, and invested capital with social markets. The acceptance of goods and services in a competitive market and the payment for products/services by customers allow completion of the cycle.
- ⟨ In competitive markets, completing the cycle offers the prospect of creating value *as a result of fulfilling human needs*. Completing the cycle is a necessary, but not sufficient condition to the creation of value.

Figure 1 provides a simplified portrayal of the scheme. The cycle does not “complete” unless a customer accepts a product or service and pays for it. The cycle repeats and possibly grows in size and ability to deliver need fulfillment when the providers of capital allow their invested capital to continue circulating through the cycle. The cycle will grow if providers of capital make additional investments in the cycle, either by investing the net margins and/or investing fresh capital into the cycle. This reinvestment with the expectation of growth in the cycle will occur when the providers of capital expect attractive returns on flowing and invested capital.

(Insert Figure 1 about here)

## Value Creation In An Economy

The delivery of a good/service that fulfills human needs creates social value. In an economic sense, if market participants view that need fulfillment resulted from the wise use of resources, then the process creates value.<sup>4</sup> The creation of value as a result of need fulfillment results in economic social merit.

The cycle in Figure 1 characterizes the conversion-transformation-fulfillment-recovery process in an economy. The cycle reveals how organizations potentially can employ resources to provide need fulfillment, hopefully realize recovery of financial capital, and – potentially and importantly – derive net economic returns that exceed the cost of capital. Success at delivering need fulfillment and earning a net return exceeding the cost of capital:

- ⟨ Signals that market participants for goods and services *and* providers of capital view that the company used resources wisely to create value.
- ⟨ Provides the opportunity to employ the capital again to transform resources into the fulfillment of human needs.

The flow and transformation of capital in this cycle to fulfill human needs are essential for the generation of economic social value. In competitive markets, providers of capital can not realize value unless the people in the economy realize need fulfillment.

## Value Cycle: Basic Relationships

Since the focus is on the social merits of accounting, we will present a summary of key relationships for the cycle and defer full illumination of the relationships of the cycle to another occasion. In our presentation, we assume *free and competitive markets*.

- ⟨ Cycles for individual organizations within an economy aggregate to the cycle for the economy.
- ⟨ Capital will flow into the cycle from extant economies if providers of capital expect the cycle to create value for them.

- 〈 Capital exists in a variety of forms as it flows through the cycle. Capital (cash) enters the cycle and a company converts financial capital into the inputs of production, which results in raw materials inventory. Production alters the form of capital into a useable product. Sale of products to customers fulfills human needs and creates a receivable. Collection of the receivable converts this form of capital back to cash. If the cash coming out of the cycle exceeds all costs including the cost of capital, the providers of capital are generally willing to reinvest their cash in a second circulation through the cycle – based on the assumption that the cycle will continue.
- 〈 As capital flows through the cycle, the risk exposure tends to fluctuate. Work-in-process is of greater risk than raw materials or finished goods; achieving finished goods status results in a reduction in risk since production risk is over; selling the product reduces risk since the product has passed customer acceptance; collecting the cash for the sale eliminates the risk of collection.
- 〈 In competitive markets, the providers of capital recover and potentially realize a net return on capital in excess of the cost of capital. These economic returns generate value derived by producing products that result in delivering need fulfillment to people in the economy. ***Thus, potentially attractive economic returns are only possible through the fulfillment of human needs with attendant improvement in standard of living. Consequently, in competitive markets, the creation of economic social value must precede the creation of economic financial value.***
- 〈 Attractive relationships will prompt providers of capital to leave recovered capital and net returns on capital in the cycle. This behavior keeps capital in the economy and allows future turns through the cycle. The original invested capital plus the net returns on capital support continuation of and growth of the cycle. Growth of the cycle promises increased need fulfillment for a greater number of customers in an economy.
- 〈 Future need fulfillment for members of society requires continued circulation or reinvestment of capital through the cycle.
- 〈 Unattractive relationships as perceived by providers of capital will prompt them to remove the capital from the particular cycle (for a company) or from the economy itself. If not reinvested, the results are disastrous for an economy. Providers of the initial capital harvest extract capital (the margin on sales) from the economy and take this capital to other economies. The export of capital and resultant scarcity of capital remaining in the economy drives up capital and goods costs. As a consequence, fewer people are able to obtain products/services to fulfill human needs. The continued extraction and export of capital from an economy decimates the economy and standard of living.

- ⟨ Attractive returns in a time-risk-return context compared to other alternatives in the world stem from the use of resources to fulfill human needs. Economic returns precipitate following the point of value.
- ⟨ The provision for and preservation of rights of ownership of capital as well as assurance of free capital flows are important if an economy is to attract and retain capital.
- ⟨ The earning of economic returns that add value for the production agent may result in economic social efficiency (ESE). ESE results if the aggregate of society would objectively view that production agents utilized resources wisely to fulfill human needs.<sup>5</sup>

## **Standard Of Living Enjoyed**

Growth in the delivery of need fulfillment and attendant improvement in the standard of living result from one of the following:

- ⟨ Improvements in the efficiency of the cycle allow for more need fulfillment with equal or less resources. A reduction in the variable costs of fulfilling a need is an example of increased efficiency. Using fewer resources to support the operation of the cycle is another.
- ⟨ The expected returns on incremental investments above pure reinvestment appear attractive compared to other opportunities in the world. This relative attractiveness spurs increased commitment of capital to the value cycle. The incremental investment spurs growth in the economy.

In the short term, the creation of social value does not necessarily create economic or financial value. A production agent can deliver goods and services and fulfill needs within society but in the current period not create value for a firm. Production agents sometimes are willing to endure unattractive short-term returns anticipating that the development of markets and the economy will offer sufficient future returns to compensate for short-term losses of capital.

Delivery of need fulfillment to an individual(s) is not a sufficient condition to result in the optimal use of resources for the aggregate economy. Social market efficiency occurs if, from the aggregate view of the economy, production agents use all resources wisely to fulfill human needs and not destroy economic value. Financial capital is a resource of an economy. In the longer term, adding economic social value also requires the wise use of financial as well as all other forms of capital.

## Economic Social Merits (ESM) & Firm Value

The scheme in Figure 1 reveals that in competitive markets, attractive economic returns could potentially accrue to the production agent through need fulfillment. The value of a firm:

- < Increases if net economic returns realized are attractive.
- < Decreases if net economic returns offer insufficient value, or does not meet the expectations of providers of capital.

Importantly, the efficient use of assets (resources) as viewed by people in the economy (“social efficiency” in our view) requires that a production agent earn as a minimum, the required rate of return on capital employed. Earning returns less than this minimum:

- < Destroys value for the production agent’s owners.
- < Destroys value for society since the production process did not earn the minimum required returns “society” wants thereby resulting in the inefficient use of society’s resources.

Those resources used in an inefficient manner are wasted and not recoverable, resulting in capital lost from the company’s cycle. The company or society can not salvage destroyed value that results from the inefficient and loss of resources. Wasted or lost resources represent a one-time event from which the portion of capital lost is never recovered.<sup>6</sup>

The inefficient use of resources does more than destroy capital. The damage extends – in a present value sense – to the present value of all future returns that could have resulted from the preservation and successful use of capital to fulfill human need. To reiterate a crucial point:

In competitive markets, the earning of economically attractive returns that create value for production agents is possible only when need fulfillment to people occurs.  
***Attractive economic profits are a confirmation of the creation of value for society – not at variance with the interests of society.*** Economic profits are essential and indicators of success in employing resources to enhance the living standard enjoyed by members of society.

## Accounting and Economic Social Merits

Accounting has impact on the financing and operation of the cycle illustrated in Figure 1 by influencing need fulfillment and a host of related issues. Our interests ultimately distill to the influences of accounting on the availability and cost of capital to the cycle, and consequently on the economy and the manner in which those costs affect the standard of living enjoyed or endured by the society.

We summarize the influence of accounting on the cycle and then focus on how accounting causes the impact.

## **Accounting and the Value Cycle**

At the micro level, managerial accounting attempts to measure the effects of many decisions and actions on the operations of an organization. The aggregation of the managerial accounting measurements yields reports used by management. Relevant accounting policies adopted by individual organizations enhance (or, diminish) the efficacy of decision making by managers. Managerial decisions based on the accounting system thus influence the economic outcome of the company.

At the macro level, external constituencies – including investors, creditors, regulators, and consumers – generally do not have access to information generated by the managerial accounting system. These groups do receive or have access to financial information provided by management. However, the availability of and access to information varies among the groups.

In addition to voluntary disclosure, regulators and taxing authorities by statute can require information relevant to compliance. Creditors can require information relevant to the credit decision as well as ongoing reports relevant to credit worthiness. Although financial reporting standards vary between countries, investors and the public have access to accounting information provided by management and the financial press in varying degrees.

In this paper, our discussion centers on the accounting information contained in financial reports available to investors, creditors, and the public. Financial accounting information available to taxing and regulating authorities awaits another occasion.

Financial accounting affects society by having an impact on the availability, cost, and allocation of resources necessary for the need fulfillment of people. Interrelationship between financial accounting and the markets for capital, goods, and services ultimately influences the operation of the value cycle. For example, an accounting principle that results in the reduction of the perceived risk of capital employed in a cycle reduces the cost of capital. A reduction of the cost of capital causes value through the increased availability of resources for alternative uses.

Accounting information has several important roles in supporting the creation of economic social merit including:

- ⟨ **The efficient allocation of capital to the firm.** Accounting information assists investors in assessing risk/return opportunities and allocating capital. Assessment of risk requires relevant information that is reliable. If information proves unreliable (e.g., too optimistic or too pessimistic, potentially fraudulent), providers of capital will demand a higher return as compensation for greater perceived risk. Poor information drives up risk and consequently the cost of capital.

- < **The allocation of resources within a firm requires reliable financial information.** In some instances, accountants have been slow to make improvements in managerial accounting information available to decision-makers, precluding them from making informed and logical decisions. For example, the use of the “full-cost model” for product costs often unpredictably distorts the accounting information available to the decision-maker. The arbitrary allocation of many indirect costs often misleads managers and causes them to drop certain products, submit unattractive bids, and even make economically unattractive decisions about capital projects. Regrettably, this failure of managerial accountants to devote more attention to economic issues and the valuation process results in the continued use of inappropriate measures in decision making.
- < **The availability of fresh or incremental capital to support new ventures.** An infusion of capital is necessary to support the exploitation of new ideas for social benefit. Providers of capital must assess the risk associated with the incremental venture. The assessment process requires information about the nature of the venture, the individuals responsible for managing and attaining success, and the financial needs of the venture.
- < **The providers of capital recognize the importance of leadership in the area of accounting and information.** The accounting profession can play a leadership role in the development of reporting procedures that result in relevant information for making decisions relating to investment decisions.
- < **The providers of capital consider ethics important.** The level of acceptance created by a code of ethics for those preparing accounting information may favorably or unfavorably affect the reliability of the information and, in turn, the expected risk-return relationships associated with investments. In this context, the acceptance of ethical standards within the framework of leadership is of great import. A dedication to and enforcement of ethical behavior in arenas of interest to investors and customers – including accounting information – are of import.

## Social and Professional Impact

Enhancing the efficacy of accounting is consistent with:

- < Nurturing an improvement in the lives of individuals in terms of need fulfillment.
- < Fostering an increase in the standard of living within an economy.
- < Providing for the efficient use of limited resources for the benefit of individuals and society.
- < Adding to the prospect of economic social efficiency.

## Basic Relationships

The development of relevant accounting standards contributes to society.<sup>7</sup> Such standards result in a reduction in perceived uncertainty associated with information regarding the value cycle. A brief review of important issues centers on several key areas.

- ⟨ **Uncertainty and capital.** Increases in uncertainty usually:
  - ▶ □ Increase the cost of capital.
  - ▶ □ Decrease the availability of capital.
  - ▶ □ May result in break points in terms of the “chunks” of capital available.
  - ▶ □ May increase the price of bearing a unit of risk and accentuate increases in capital costs.
  
- ⟨ **Product/service cost.** The cost of a product or service includes the cost component traceable to the cost of capital employed in the transformation-need fulfillment- recovery of capital cycle.
  
- ⟨ **Origins Of Uncertainty.** Uncertainty stems from several sources including:
  - ▶ □ The process.
  - ▶ □ The behavior of people within the cycle.
  - ▶ □ Relationships of people and events to and within the cycle.
  - ▶ □ The behavior and perceptions of people external to the cycle.
  - ▶ □ Conditions extant to the cycle, e.g., the price of bearing risk in markets.
  
- ⟨ **Unnecessary uncertainty.** Uncertainty that one can eliminate or avoid without a reduction in expected potential benefits is unnecessary uncertainty. For example, internal to a firm, better accounting can reduce uncertainty about the identification of significant events and their measurements. This notion is one of the benefits of activity based costing.

An acceptance by external parties that accounting standards are reliable should cause a reduction in unnecessary uncertainty. An example in this vein is that clear and effective communications with stockholders and the investment community can reduce unnecessary uncertainty without adversely changing any of the levels or risks of underlying variables influencing value.

## Accounting, Error, and Uncertainty

Actual and perceived uncertainty in accounting information stems from different sources, varies in type, and can have various causes. The motivation for error can be intentional (fraud) or stem from negligence. The effect(s) of uncertainty can be temporal or permanent.

Errors of different origins influence actual as well as perceived uncertainty traceable to accounting. Human behavior rests on perceived uncertainty regardless of the convergence or divergence between actual and perceived uncertainty. Perceived uncertainty stems from a variety of sources: accounting is one and a loci of this paper.

Agents of various forms (management, external reviewers, e.g., auditors, professional boards establishing standards, regulators, market mechanisms, e.g., a stock exchange) generate, interpret, and report accounting information.

Figure 2 portrays a broad scheme of error classification. Broad classification of accounting's effects on uncertainty arises according to the origin of perceived errors and include:

- ⟨ **Measure:** The measure or statistic is deficient in that it does not fully reflect the information of interest. The errors may be known or unknown. The magnitude and/or frequency of the error also may vary with time or circumstance. One may recognize the shortfalls in a measure and yet still derive value from the summary statistic.
- ⟨ **Application:** Actual or perceived errors that stem from the practice or usage of an accounting measure(s) can be separate from shortfalls in the measure itself. Concerns that parties are not properly applying a measure precipitate increased uncertainty.
- ⟨ **Reporting:** Errors in reporting that add to actual or perceived uncertainty.
- ⟨ **Interpretation:** Uncertainty arising from reported accounting measures independent of measure, application, or reporting effects.

The effects of errors take two basic forms:

- ⟨ **Accounting.** The errors that affect the reports and perceptions but do not directly result in economic loss within the organization subject to the reported accounting. These errors can result in direct economic consequences extant to the organization, e.g., an investor in the company's stock suffers a loss. Accounting errors may also result in adverse indirect effects, e.g., uncertainty in the application of accounting measures results in an increase in the cost of capital to this firm as well as to other participants raising money in capital markets. An increase in the cost of capital adversely influences the creation of value for customers, the company, the economy, and society. An increase in the cost of capital also detrimentally influences the standard of living by influencing capital as well as product availability and costs.
- ⟨ **Economic.** Errors that do result in direct economic consequences within the organization. Example: manipulation of accounting numbers to conceal the theft of assets or cash flows.

Errors relative to these categories take these basic forms:

- < **Disparity.** The measures, methods and/or application that do not and structurally can not yield the appropriate information. Disparity may be known or unknown. Thus a user of information may think she is measuring or reporting a particular variable when in fact the accounting does not reflect the underlying reality.
- < **Omission:** The provider of accounting information fails to measure and/or report the event(s) subject to accounting measurement. Omission may be intentional or unintentional.
- < **Commission:** Agents measure and/or report erroneous accounting measurements.
- < **Oversight:** The unintentional failure of an agent to measure and/or provide an accounting variable.

The cause(s) for errors are:

- < **Unintentional:** The agent(s) behavior does not stem from conscious effort.
- < **Intentional:** The agent(s) purposely commits omissions or errors.

Errors have duration effects that are either:

- < **Temporary.** The impact of the error disappears with time. This type of error causes distortions when evaluating and comparing accounting information over time.
- < **Permanent.** A residual effect of the error remains.

The forms of error result in two categories for fraud.

- < **Accounting or Indirect Fraud.** The perpetrator derives benefits by manipulating accounting information and/or issues related to disclosure. The perpetrator derives benefits indirectly – e.g., by taking a long or short position in a stock – rather than directly – e.g., by using accounting fraud to hide the theft of assets. The benefit of fraud might appear somewhat direct, e.g., the manipulation of earnings to qualify for a bonus. However, the benefit of the fraud results from the accounting rather than being the benefit itself.

- ⟨ **Economic or Direct Fraud.** The perpetrator manipulates accounting information to conceal or make the theft of assets possible. Creating an account to hide expenses used to cover non-business costs of travel for his family or college expenses for his son or hiding the unauthorized use of an automobile for personal use represent examples.

(Insert Figure 2 here)

## Special Interests

Special interests can derive benefit from unnecessary uncertainty and from the absence of transparency in the production-need fulfillment-recover cycle. We would identify these individuals or organizations as extractors because they extract unearned benefits without creating value. Extractors can not exist in markets efficient in information, process, access, and opportunity.

The interests of individuals and society are adversely affected by “extractors.” Voluntary participants who engage in activities on an equal footing with others are not extractors. For example, those who speculate on residual (as opposed to unnecessary) risk are not extractors; they perform a service by standing willing to bear risk others wish to avoid.

## Lesser-developed, Emerging & Transition Economies

Accounting and its derivative benefits to society are of particular and disproportionate importance for lesser-developed, emerging, and transition economies for several reasons including:

- ⟨ The proportion of total population requiring basic needs for survival and a rudimentary standard of living is high.
- ⟨ Accounting in practice remains at a rudimentary stage and/or the levels of uncertainty stemming from the concern about a host of accounting practices including outright fraud are high compared to developed economies.
- ⟨ The typically high risks of these economies restrict the availability of financial capital and increase its costs. Accounting (or lack of) and accounting practices are a relatively large contributor to uncertainty compared to the contributions in well developed economies.
- ⟨ Financial capital is essential to the efficient functioning of the value cycle. The restriction of the availability of financial capital inhibits the use of human and tangible resources in a value creation cycle. Human resources often having low unit labor costs remain dormant because

of a shortage of financial capital at attractive rates. As a consequence, those eager to work and generate value waste away. Similarly, tangible resources remain dormant or are exported at prices that do not reflect the true opportunity costs for the local economy.

- ⟨ Though not generally accepted, one of the authors asserts that an increase in perceived uncertainty that results in an increase (decrease) in the required rate of return in an economy also causes an increase (decrease) in the price of bearing risk *as well as* the risk-free rate of interest.

These factors collectively make accounting disproportionately important in lesser-developed, emerging, and transition economies.

## **The Role Of Leadership**

In developed economies we have enjoyed the benefits of leadership that has resulted in the evolution of accounting standards, practices, review, and enforcement. Accounting in these economies is one of the factors that have favorably affected capital availability and costs with attendant positive influence on the value generation cycle and the advancement of an improved standard of living.

Leadership that successfully develops accounting practices and standards within and for the benefit of lesser-developed, emerging, and transition economies will create social value within those economies. Furthermore, given the interdependence of economies and the influence of all economies on perceived risk, developed economies also will benefit from improvements within lesser-developed, emerging, and transition economies.

Special interests will seek to block or inhibit changes that limit their ability to garner unearned benefits from these economies. On the other hand, recent turmoil in global markets signals both the great need for and importance of leadership from the profession.

## **Additional Research**

We initially ignore the potential benefits of improvement in accounting measurers. LD-E-T economies can benefit from application of existing if not perfect accounting. Hence research efforts that center on “improved accounting” by focusing on the application, reporting, and the enforcement of standards will reduce perceived risk and favorably affect the cost of capital to an economy and economic entities within the economy. Several separate but related research efforts examine:

- ⟨ **The effects of a decline in average required rates of return** in LD-E-T economies on the annual costs of capital to those economies. First cut efforts ignore the influence of a

reduction in required rates of return on the availability of capital to respective economies. Instead, this effort estimates the dollar effect of a reduction in capital costs of one percent to an economy.

- < **The reaction of capital markets and economies** to countries that have adopted in full or a variation of accounting principles developed by the International Accounting Standards Committee (IASC). The research focuses on many aspects related to the adoption of International Accounting Standards including the effect of increased compliance and enforcement, as well as, the effect of strengthened license requirements, ethics rules, and stature of accounting and related professions.
- < **The market's reaction and residual effects** within LD-E-T countries in which companies have deliberately provided false, misleading, or intentionally deficient accounting information.
- < **The apparent differences in summary ratios** for market-wide performance across LD-E-T economies for those that do and do not require audited reports.
- < **Within an economy, differences in apparent capital costs** for those companies that do and those that do not provide audited statements.
- < **Within an economy, differences in various measures related to stock and debt instruments** such as price-earnings ratios, returns to share holders, debt default to various coverage ratios (since these ratios stem from good or bad application of accounting).
- < **Net capital investments** (private, not World Bank etc.) prior and after the adoption of higher accounting standards in an economy.

## Summary

Economic social merit results when people employ resources efficiently in an economy to fulfill human needs and consequently create net additions to economic value. The operation, growth (or decline), and efficiency of the value creating cycle in an economy determines – to a great degree – the standard of living enjoyed by people.

In this paper we have illustrated the impact of accounting on the evolution of economic social merit within an economy. We characterized accounting in a broad context to include the development of an appropriate framework of accounting principles and standards, their application in the presentation and dissemination of reliable financial information, and the development of procedures for enforcing adherence to accounting principles and standards.

At the macro level accounting standards significantly affect ESM because of their influence on the availability of capital and the cost of capital to the value cycle. Within a firm, the accounting policies influence operations during the value creating cycle by influencing managerial operating decisions.

An array of research possibilities exploring relationships between ESM and accounting exist. The perceived deficiencies and lack of efficacy in accounting practices in less developed, emerging, or transition economies suggest that improvements in accounting standards would result in substantial benefits to these economies. Consequently, the thrust of our first empirical efforts in this area will focus on estimating “capital cost dollar effects” that would result from improved accounting in these economies. We suspect that the value of the benefits to an economy will greatly exceed the cash costs of upgrading accounting standards and practices.

Last – and most important – is our acceptance of the notion and commitment to a philosophy that seems appropriate in all areas of human endeavor. We should – whether accountants or other professionals – find purpose and motivation in the desire to achieve results that add to the quality and meaning of life enjoyed, rather than endured, by those with whom we share this planet. Providing a safe and fertile opportunity for each person to achieve purpose forms the basis for the aggregation of the contributions of individuals to society. Using resources wisely and carefully to this end seems consistent with the talents and capacities of humans – and in their interest.

Economic social merit is a concept applicable to all economies. In developed economies, our profession has and continues to respond by providing the type of financial and managerial information necessary for orderly capital markets. The net result: a relatively low and reasonable cost of capital in amazing abundance that supports the economic cycle. To be sure, many other contributing factors provide for these developed and relatively efficient markets that provide for economic social merit. However, we would argue that accounting is a major contributor to ESM.

Our profession and related professions should continue our good and well intentioned efforts to enhance the accounting standards in all economies. However, we should recognize that our efforts will have proportionately greater and significant effects in lesser-developed economies. Our profession can assist others in efforts to provide economic opportunities for people in these economies.

Transforming this ideal into reality calls for leadership. A commitment by our and related professions to improving accounting standards in all economies will yield economic social merit. Our profession should openly profess, declare, commit, and pursue actions that we know will make a significant contribution to both preserving existing, as well as developing additions to economic social merit. The benefit accrues to each person, to the society in which they live, and to the world society. The favorable reach and influence of accounting goes far beyond the numbers – to the lives and quality of life enjoyed by people.

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Figure 1

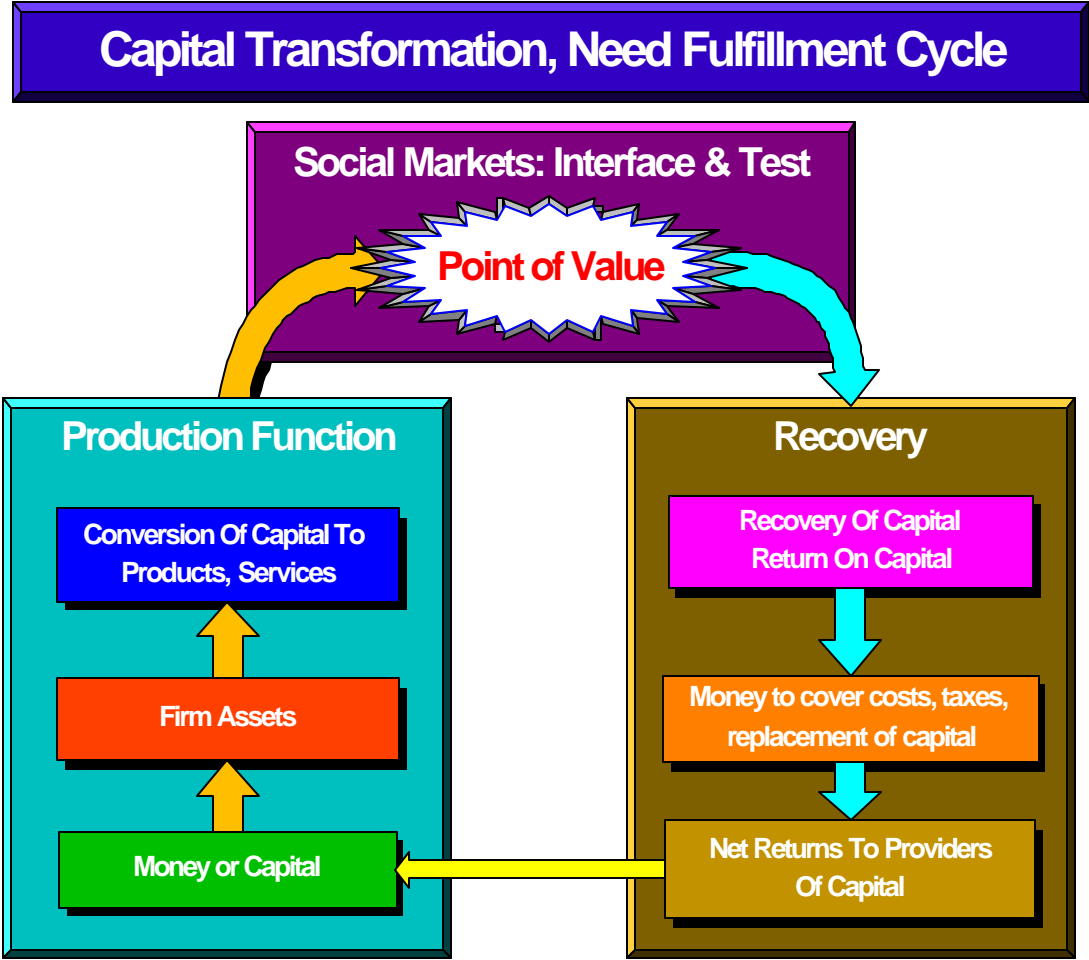
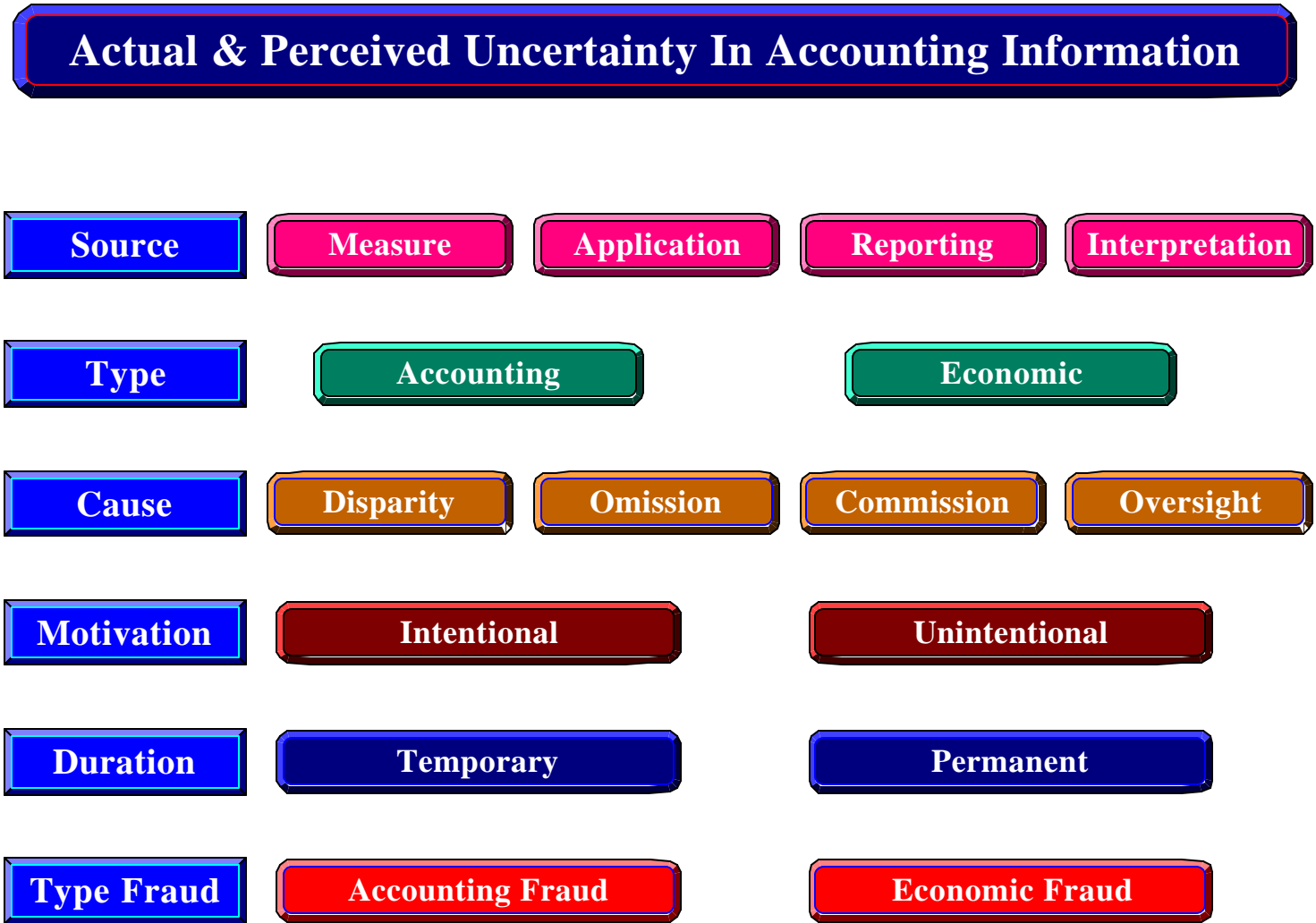


Figure 2



esmf2new

## Endnotes

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- 1 We recognize that this definition has numerous implications, especially given the interaction of and movement towards shared if not common economies. The exploration of a host of related issues awaits another occasion.
  2. Net additions to social merit can occur if an individual suffers a decline in standard of living while others enjoy an increase in SOL/QOL. Examples: a drug dealer suffers a loss in income and decline in life style; a decrease in the ability of a person to engage in financial swindle; a decrease in returns and life style enjoyed by individuals (an organization) that uses resources less efficiently than others.
  3. Collective economic social merit takes account of the collective effects of the marginal ability of each person in an economy to enjoy the benefits of need fulfillment through the purchase/use of products/services. CESM reflects the ability (availability and financial ability) of individuals to realize the need fulfillment. Example: The availability of pharmaceutical products to a few wealthy people in an economy is not the same as practical availability to many within the economy. CESM reflects these differences.
  - 4 Actions could fulfill needs but result from the unwise or inefficient use of resources as viewed by market participants.
  5. The notion of economic social efficiency (ESM) suggested by Groth (1997) is akin to the concept of *Pareto Optimality*. ESM requires that resource use not only fulfill human need without adversely affecting the well being of others – but that resource utilization pass the test of attractive returns on capital. ESM requires the attractive return on all forms of capital: human, tangible, and financial. Certain unique factors hold attention in this regard including the time-expiration of individual human capital.
  6. Some would argue that one can replant a forest – and hence, that timber is a renewable resource. In the local context, this notion has merit. In the aggregate sense, relationships accepted as “laws” asserting, e.g., the preservation of mater-energy seems to contradict this viewpoint. However, we cast this destruction as within an economy. Preserving energy-matter in the universe is an important perspective but not germane to someone trying to feed their family in Iowa.
  7. A separate research effort concentrates on examining and estimating the economic value measured in dollars of “good accounting” on an economy and the world.