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# BUSINESS OBJECTIVES :

# IMPLICATIONS FOR ACCOUNTING

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## INTRODUCTION

As the real world changes, so does its defintion of values and its prevailing ideologies. Today, business firms are no longer seen b society as the instruments of their shareholders alone. Rather, they are composed of a coalition of participants, each of whom have their own interest and motives. It is a long held view that objective of business enterprises is to earn profits. In the past the emphasis has been placed upon earning profits for the benefit of owners.

As a result, the conventional view of the aim of published financial reports was expressed by the Institute of Chartered Accountants in England and Wales (ICAEW) in Recommendation N. 15 issued in 1952 (Withdrawn in 1974). This stated : «The primary purpose of the annual accounts of a business is to present information to the proprietors, showing how their funds have been utilised and the profits derived from such use». This statement was no doubt correct at its time of issue, but with the passage of time it has become increasingly clear that it is incomplete and unsympathetic to modern needs. Currently, business enterprises recognise wider responsibilities. It follows that published financial reports should be of interest to a wider andience than shareholders alone.

It is the author's opehion, that the function of published financial reports is dependent on business objectives. This relationship is rarely discussed in the accounting literature.

The aim of this study is to clear up some of the misunderstanding relating to assumed business objectives and to outline contemporary thinking bearing on this paramount subject.

Findings of this study should be of significant interest to both the financial accounting policy-making bodies, and the financial accounting legislative authorities. Such findings may be considered as a necessary precedent before taking any major accounting policy decisions.

**Business Objectives :**

**Theory and Concepts**

Organisational goals are fundamental to the question of the functions of published financial reports. As Tom Watts, Chairman of the Accounting Standards Committee (ASC) wrote recently.(1).

«We can't really determine what financial».

statements are for until we know what the company is for. We once knew the answer : It was to maximise the cash return to the shareholders....., that seems an anitque idea in our present society».

This dilemma, which is more apparent than real , stems from a confusion of theoretical assumptions with reality or, more precisely, behaviour in organisation. The acknowledgement that the function(s) / objective(s) of the corporate report are interwined with the goal(s) of organisations raises problems that are rarely discussed in the accounting literature. Organisational goals, however, are a problem with which organisation theorists have grappled for several decades.

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(1) T. Watts, «Chairman Watts' Account», Accountants Weekly (21 September, 1979), P. 18.

A basic assumption in the traditional economic theory, accounting and finance is that organisations have one goal, namely that of the hypothetical entrepreneur, which is profit **maximisation.** This assumption was consistent with the self-interest axion, because the profits of the **firms were the main** incomes of their owners(1).

Furthermore, traditional economic theory postulates a relationship between «input factors» — labour and capital on the one hand, and physical output on the other, through the medium of a «production function». The theory also postulates that owners, who are assumed to be managers at the same time, manipulate input factors under their control in a way which maximises the profits of the firms.

We can restate the basic concepts of traditional economic theory, accounting and finance in the following objective function:

$$\max \Pi = PQ - WL - rk,$$

where

- $\Pi$ = Profits per unit of time
- $Q$ = Output per unit of time and $Q = Q(K, L)$ in the production function.
- $L$ = Labour input
- $K$ = Capital input
- $W$ = Market wage rate
- $r$ = User cost of capital
- $P$ = Market price of output.

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(1) See, Louis A. Pondy, «Toward a theory of Internal Resource Allocation», in J. Livingstone and S. Gunn (ed.), **Accounting and Social Goals** (Harber and Row, 1974), PP. 49-68.

**Assuming product price to be a parameter,** the first-order con-**ditions for optimality yield.**

PQ = W and PQk = r; i.e. to maximise profits the business firm, according to this theory, should hire factors and expand production until the marginal value product of each factor is equal to its market price.

This formulation has been the only theoretical description of the behaviour of business firms for a very long time.

Recently, however, numerous economists and organisation theorists have questioned both the existence of an organisational goal and its nature. Silverman, for example, claims that «to say that an organisation has a goal may be to involve onself in some of the difficulties associated with reification — that is, the attribution of concrete reality, particularly the power of thought and action, to social constructs».(1) The orgument essentially being that organisations, as artificial bodies, cannot have goals except in the form of the goals of persons (or groups) connected with the organisation who can influence decisions to commit resources to achieving certain ends. Thus, on organisation's goal may be that of some dominant group or groups,(2) a consensus that results from, bargaining among participant groups,(3) or one

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(1) Silverman, **The Theory of Organizations,** Heinemann, London, 1970.

(2) H.I. Ansoff, «Toward a strategic theory of the firm», in H.I. Ansoff, (ed.), **Business Strategy** (Penguin Books Inc. 1973), pp. 11-40.

(3) H. A. Simon, «On the Concept of Organisational Goal», **Administrative Science Quarterly,** 1964.

which satisfies a given set of constraints in the form of the indirect demands that various groups, such as shareholders and employees, make on the senior management of a company(4).

As the question of whether organisations are profit maximisers as suggested by traditional theory, Simon(1) argues that « (1) the theory is ambiguous whether it is short-run or long-run profit that is to be maximised. (2) Under modern conditions, the equity owners and the active managers of an enterprise are seperated and distinct groups of people, so that the latter may not be motivated to maximise profits. (3) the entrepreneur.... may simply want to earn a return that he regards as satisfactory .... Man is a **satisficing** animal whose problem solving is based on search activity to meet certain aspiration levels». Ansoff(2) has pointed out, as well, that the concept of profit maximisation is incorrct both descriptively and normatively. Descriptively, because, he argues, the empirical studies of business firms show that while firms do seek profit, they also appear to seek other objectives. Normatively because of a growing opinion that the firm should accept other goals for its behaviour in addition to profit.

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(4) R. M. Cyret and J.G. March, **A Behavioural Theory of The Firm,** (Englewood Cliffs, N.J. : Prentice-Hall, Inc., 1963.

(1) H.A. Simon, «Rational Decision making in Business Organisation», **The American Economic Review** (Septempr, 1979), pp. 493-513.

(2) H.I. Ansoff, «Toward a strategic theory of the firm», in H.I. Ansoff, **Op. Cit.,** pp. 11-40.

(3) Accounting Standard Committee, **The Corporate Report,** ICAEW, London, 1975.

## Business Objectives :

### Empirical Evidence

This view of business firms being «satisficers» is further reinforced by emporical evidence, such as in the **Corporate Report**(3) which has conducted a survey of corporate objectives amongst the chairman of 300 of the largest United Kingdom listed companies. In fact only 58% of respondents linked primary objectives to profit and only 23% of the total number of respondents (and included in the 58 above) narrowed this to profits available for distribution to shareholders. **The corporate Reports** states that :

> «The majority view of those replying to the survey was that their primary objective was to make a profit for the benefit of a number of groups. It was not the majority view that the maximisation of shareholders profit was the primary objective».(1)

The respondents' typical replies included such phrases as «satisfactory rewards». An example of the majority view was «to operate a well-managed, efficient and profitable business; one which yields a proper return to shareholders.. and pays careful attention to the wishes of the employees, customers, suppliers and the community». Various other business objectives mentioned in **The Corporate Report** include survival, growth, customer service, employee welfare, and responsibility to the local community and to the national economy. It could be argued, however, that, given prevailing social values about «the unacceptable face of capitalism», respondents were not likely to admit to being maximisers. However, there is other emirical evidence

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(1) Accounting Standards Committee, The Corporate Report, Op. Cit., p. 38.

that many firms are in a position to increase their profit, but do not choose to do so(1).

The consensus of popular opinion on the question of organisational goals thus seems to be on the following lines. While shareholders may be wealth maximisers, this conflicts with the company director's responsibility to provide for the continued existence of the business. The pursuit of a policy of profit maximisation may result in :

1 — greater risk,

2 — high wage claims,

3 — irreversible customer dissatisfaction because of high prices or poor services,

4 — government intervention,

5 — an irresponsible attitude by managers to safety, minority groups, the environment, etc....

Thus, and since the power of shareholders is diffuse, company management will tend towards a policy of earning a level of profit that will be just sufficient to dissuade shareholders from disposing of their shares, enable the company to raise additional capital if necessary, and avoid the potential threat of a takeover. A manifestation of this policy is the use by companies of a target profit rate of return on capital.

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(1) See, for example, A.E. Senoun, **An Investigation into the Uses of Value Added Concept as a Basis for Improving the Economic Performance of British Industry,** unpublished Ph. D. Thesis, City of London University Business School, 1981.

The above also fits the traditional economic view of capital as a resource, like labour and land, that must be rewarded (i.e. with normal profits), as well as certain contemporary economic theories. Galbraith, for example, suggests that enterprises pursue a policy of profit «satisficing» and growth in sales because this ensures the continued existence of an organisation and enables managers to achieve their personal goals.(1) In short, profits may represent a necessary but not a sufficient definition of the goal structure of business firms.

One must admit, however, that in the discussion of whether firms are maximisers or «satisficers» — as outlined above- we have compared a predictive model of economic theory with organisational behaviour. As Machlup explains, traditional price theory «is not .. designed to serve to explain and predict the behaviour of real firms; instead, it is designed to explain and predict changes observed prices as effects of particulas changes in conditons. In this causal connection, the business firm is only a theoretical link, a mental construct, helping to explain how one gets from the cause to the effect». (2) Whether the assumption of profit maxmisation is realistic or true is thus irrelevant. What matters is the predictive value of the theory. If the theory has predictive ability (relative to the accuracy required), its assumption are valid in the sense that theory presumably approximate sufficiently (real world) characteristics. Friedman,(1) for example, also argues that the value of traditional theory does not depend on the realism or otherwise of the

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(1) J. K. Galbraith, **The New Industrial State**. Penguin, 1972.

(2) F. Machlup, «Theories of the Firm : Marginalist, Behavioural, Managerial», **American Economic Review**, March, 1967.

(1) M. Friedman, **Essays in Positive Economics**, Essay 1, University of Chicago Press, 1953.

profit maximisation assumption. For the crierion to be used to judge asumptions is not their realism, but the predictive capacity of the theory that is based on them The realism of the traditional assumption is, on this thesis, irrelevant, so long as the theory provides us with accurate predictions which could be verified through empirical testing.

The queston of whether firms are maximisers or «satisficers also prevails in the study of finance. On the one hand, there are extreme views such as those of J.C. Van Horne, who argues that it is «society acting through government that should determine social and environmental goals, leaving corporations to engage in wealth maximization, thereby efficiently allocating the resources of the corporation».(2) On the other hand, J.M. Samuels and F.M. Wilkes have expressed different views by sayng «One way to look at the objectives of a company would be to say that it should seek to maximise the shareholders' wealth, subject to a growing contraints .. If the management of a company fails to recognise that, in the long-run, it is in competition for shareholders' funds with other companies and other forms of investment, it can, particularly at certain times, put its own positon, and possibly those of the employees of the company, in danger.(1)

It is important to notice that both these quotations include the world «should», that is to say, they are both normative the-

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(2) J.C. Van Horn, Financial Management and Policy. Prentice-Hall, 1977.

(1) J. M. Samuels and F. M. Wilkes, Management of Company Finance, Nelson, 1975.

ories that claim what is necessary for the efficient allocation of resources and continued existence of the firm. Like classical economic theory, they do not purport to describe organisational behaviour and, as in the case of traditional price theory, if theories in finance provide «accurate» predictions of, for example, the behaviour of share prices, then they are useful. In some instances, they do not, in which case other assumptions or consraints need to be included. Unfortunately, in its present state, the subject seems unable to deal adequaely with more complex assumpions, such as «satisficing» behaviour, but possibly, as mathematical techniques are developed, these can be used.

One could argue, however, that unless we can attribute a single, consistent set of objectives to the firm, it will be difficult, if not impossible, to say what would be an optimal decison in any given situaton. The above discussion suggests that the business firms should be viewed as co-operative efforts or coalition wth continung responsbilities to the coalition members. It follows that firms objectives should be unifying, for the whole team of co-operaing groups which contribute to the firm s performance, and not divisive, that is, to create more weaith by avoiding conflict and mobilizing the firm's resources to enlarge the joint wealth rather than maximising one party's share. That is to maximise value added(1) without decreasing shareholders' profits, or what Handriksen calls «Pareto optimality of value added».(2) Such objective seems to be consistent with both

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(1) Value added is defined in this study as the wealth created by a business firm measured in monetary terms and for a particular period of time.

(2) E. S. Hendriksen, «Comments on Morley's Book», The Accounting Review (January 1979), p. 259.

theoretical and empirical evidence cited above. This objective may be shown symbolically as follows :

maximise $VA = W + I + X + D + \Pi t$

subject to $\Pi t + 1 \geqslant \Pi t$

where

VA = value added

W = the accounting period's wage cost

I = The interest payable for the period

X = The corporate taxes

D = The depreciation charge for the period.

$\Pi t$ = total profits for the period t.

### Implications for Accounting Reports

Having discussed business objectives, we shall return to our main concern in the present study, namely, the functions of published financial reports. Given the relevance of modern organisation theories on organisational goals, these can provide us with the main implications for financial reporting. Business enterprises are composed of a coalition of participant, each of whom have their own interests and alternative opportunities. Their continued participation in an enterprise will depend on the alternatives available to them and their perception of whether or not the inducements offered to them by the enterprise (including non-monetary inducements such as social status, companionship, etc.) are

equal to, or greater than, the contribution required from them(1). This situation is depicted in Figure 1. Each point in the Figure represents a productive possibility- that is, a particular combinaton of (participants). However, only those productive possibilities withn the feasible set or «F. set», will ensure the continued existence of the organisation. The funciton of management is thus to maintain the firm within the «F-set» by offering participants the inducements necessary to obtain their contribution.

Taking the foregoing perspective, in which shareholders are only one of a number of groups who provide resources or contribute towards the continued existence of an organisation, and business objective is to maximise the ioint wealth, i.e. value added, rather than maximising shareholders share, i.e. profit, we can conclude that the function (or the objective) of published financial reports should be to provide information that enables existing and potential participants to decide whether or not they wish to (participate) in the organisation. The contents and presentation of published financial reports should thus enable them to attach values to the inducements offered. Bearing in mind The Corporate Report's definition of objectivity which says «the information presented should be objective or unbiased in that it should meet all proper user needs and neutral in that the perception of the measurer should not be biased towards the interest of any one user group»(2) We suggest in this study a

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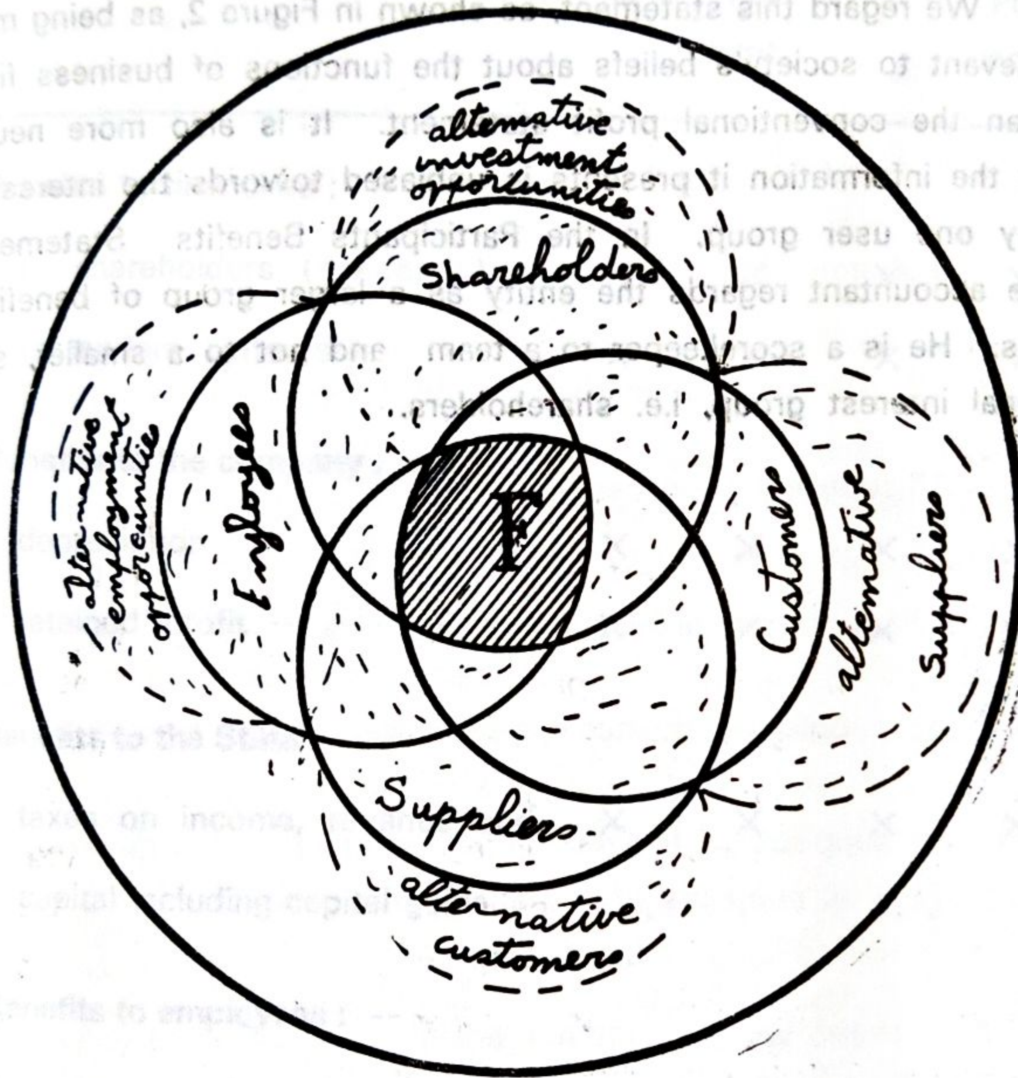
(1) See, for example, D. McDonald and A. Puxty, «An Inducement Contribution Approach to Corporate Financial Reporting», **Accounting, Organizations, and Society,** Vol. 4, No. 1/2, 1979; and G. J. Staubus, «An Induced Theory of Accounting Measurement», **The Accounting Review,** (January, 1985), pp. 53-74.

(2) The Corporate Report, Op. Cit., p. 29.

**Figure 1**




Source: Adapted from D. McDonald and A. Puxty, " An Inducement Contribution Approach to Corporate Financial Reporting", Accounting Organization and Society, Vol. 4, No. 1/2, 1979.

Source : Adapted from D. McDonald and A. Puxty, «An Inducement Contribution Approach to Corporate Financial Reporting», Accounting Organization and Society, ol. 4, No. 1/2, 1979.

financial report that accords with the coalition perspective. This statement is called (Particpants Benefits Statement «PBS») and illustrated in Figure 2.

We regard this statement, as shown in Figure 2, as being more relevant to society's beliefs about the functions of business firms than the conventional profit statement. It is also more neutral as the information it presents is unbiased towords the interest of any one user group. In the Participants Benefits Statements, the accountant regards the entity as a larger group of beneficiaries. He is a scorekeeper to a team and not to a smaller, sectional interest group, i.e. shareholders.

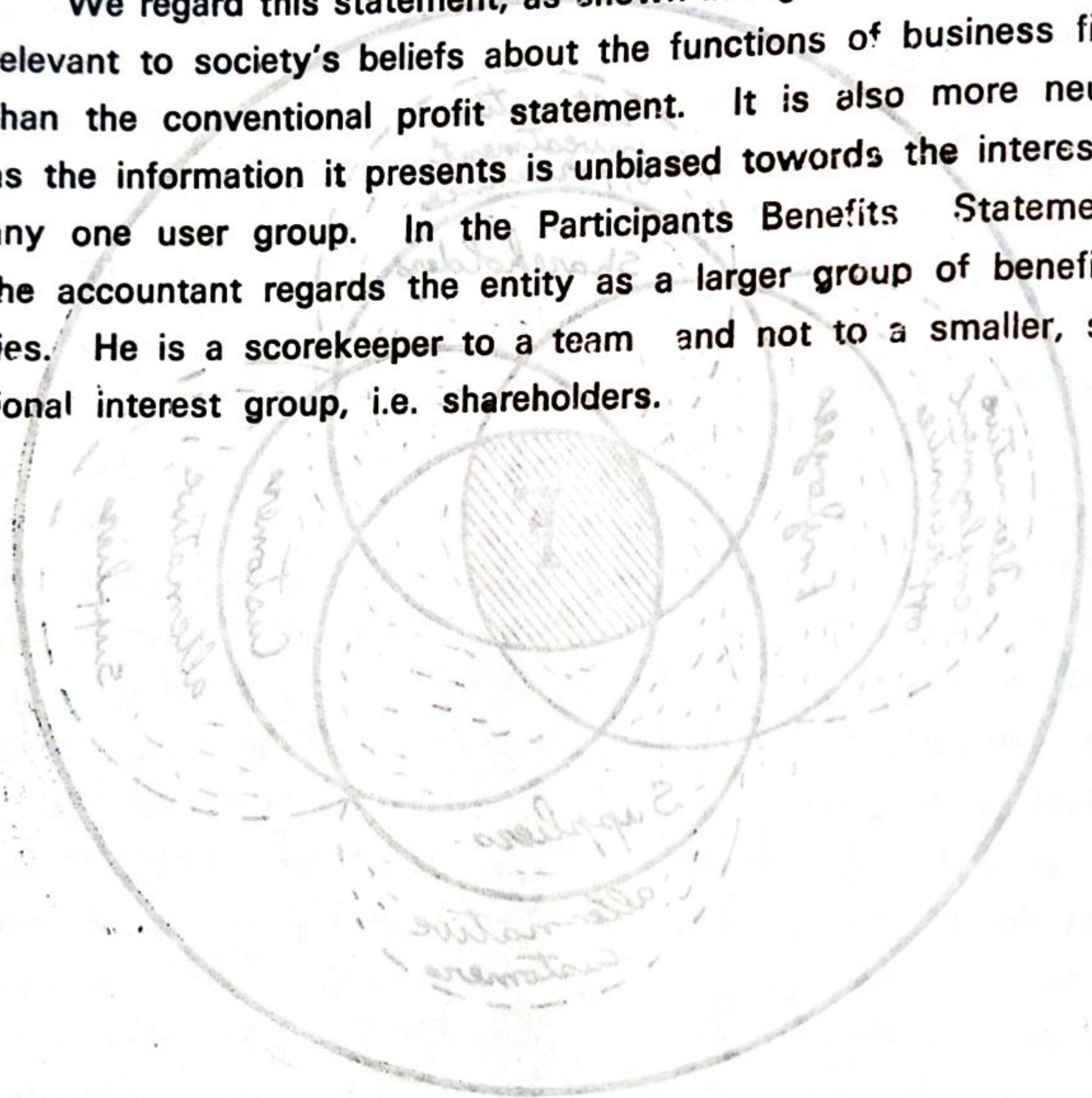


**Figure 2**

**Participants Benefits Statements**

| | 1984 | | 1983 | |
|---|---|---|---|---|
| | L. E | Per cent | L.E | Per cent |
| **Benefits to financiers :** | | | | |
| to shareholders (dividends) | × | × | × | × |
| to lenders (interest) | × | × | × | × |
| **Benefits to the company :** | | | | |
| depreciation | × | × | × | × |
| retained profit | × | × | × | × |
| **Benefits to the State :** | | | | |
| taxes on income, revenue and capital including capital gains. | × | × | × | × |
| **Benefits to employees :** | | | | |
| wages | × | × | × | × |
| salaries | × | × | × | × |
| fringe benefits | × | × | × | × |
| pensions | × | × | × | × |
| **Benefits to suppliers :** | | | | |
| bought-in goods and services | × | × | × | × |
| Total benefits | ×× | 100% | ×× | 100% |

Hendriksen(1), for example, has pointed out that the question «Who is the beneficiary of a company's income» is a key one. We could define (income) in many ways using either a narrow or broad group of beneficiaries. Morley(2) listed the condidates for inclusion as beneficiaries of income as follows :

I — Ordinary shareholders, or

II — All shareholders, or

III — All long-term capital providers, or

IV — All suppliers of finance, or

V — All suppliers of finance and of labour, or

VI — All suppliers of finance and of labour, plus the Government,or

VII — All suppliers of finance and of labour, plus the government, plus all suppliers of goods and services.

At present we accountants answer Handriksen's question (Who is the beneficiary of income? ) by using the second possibility above — all shareholders. We give this answer because in current practice the (income) or profit of a company means the profit earned for shareholders. However, the Participants Be—

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(1) E. S. Hendriksen, **Accounting Theory**, third adition, R.D. Irwin, Homewood, Illinois, 1977.

(2) M.F. Morley, **The Value Added Statement, A review of its use in corporate reports**, Gee and Co. Ltd., London, 1978, p. 5.

nefits Statement chooses the possibility (VII) - all suppliers of finance and of labour, plus the government, plus all suppliers of goods and services. It regards them all the beneficiaries of income.

As indicated above, all accounting statements should be relevant for their users. They should bear upon, and be usefully associated with the information needs of those who will be making decisions on the basis of the information disclosed in the accounts. To test the relevance of PBS, however, we first have to face the problem of how to identify those information needs. There are two main alternative ways of doing this : The «positive» and the «normative». A positive approach would involve determining, by questionnaire or observation, what users' information needs actually are. The basic snag with this approach is that users are preconditioned by experience to use, or ask for, «more of the same». In relation to a novel item of disclosure, such as the PBS, therefore (of which users will have little or no previous experience), it is unlikely that useful responses would result.

The alternative, normative approach involve recognising the «conditioning» effect of information in contaminating evidence as to what users need and instead trying to deduce what they should want from knowledge of what they require in order to satisfy their personal objectives, in order to do this, models must be constructed of the information users' decision processes.

This point deserves a detailed study on its own. Hopefully we could carry out such a study in the near future.

Finally, it is important to emphasise that the PBS, as suggested in the present study, should be reported as a supplement

to the profit statement, and not as a replacement for it. To do otherwise would reduce the comparability of corporate reports of different countries — an autcome directly contrary to the objectives of the International Accounting Standards.

**Summary and Conclusions**

Accounting is a responsive subject and research into accounting, when seen in this context, is an essential means of ensuring its adaptiveness to developing needs. Today, few would dispute the view that the business enterprise is an organisation with continuing responsibilities to all participants and not to the shareholders alone. It is evident, therefore, that the present concept of income as it appears on the traditional profit and loss statement is deficient because it assumes that the sole purpose of the enterprise is to maximise shareholders' profit.

If, however, we agree that business firm has to be viewed as co-operative efforts or coalition with continuing responsibilities to all the coalition members, then economic activities of the firm should be assessed in terms of its contribution to all participants' welfare. Using this approach, it is obvious that the wages paid by the company to its employees are of equal significance to dividends that are distributed to the shareholders. The same reasoning applies to income shares received by all other participants in the campany including the portion of the earnings retained by the company itself for reinvestment.

Granding this orientation, we have suggested, in the present study, an improved way of describing and reporting the performance of business firms. A way that accords with modern organisation theories which increase our nuderstanding of the business firm and how it functions, for this is relevant to the deve-

lopment of accounting theory and practice. This was by introducing a new financial statement, we have called it Participants Benefits Statement. Based on a priori analysis, it was concluded that such statement is more relevant and neutral than the conventional profit statement. The PBS reveals, in particular, information which displays how differing interests are being balanced for the benefit of the whole team which contuibutes to the firm's performance.

It was also emphasised that percentage figures showing each group's relative share of the income generated should be presented, and the statement should be reported as a supplement to the profit statement.

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