An Examination of User's Reliance on Financial Statement in Connection With the FASB Conceptual Framework for Accounting

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ABSTRACT

The accounting conceptual framework has been criticized for not providing an adequate basis for standard setting. This inadequacy is evidenced through the FASB's standards becoming more and more rule-based. Nevertheless, no empirical evidence has been gathered to support the criticisms of the conceptual framework. We analyzed the five qualitative characteristics of accounting information from the conceptual framework in conjunction with an individual's intention to use/rely on financial statements. Using structural equation modeling, we found that only one qualitative characteristic, reliability, affected a person's intention to use financial statements. Additionally, it appears that the greatest factor that influences whether an individual rely on financial statements is their familiarity with accounting. Based on our findings, it appears that not only does the conceptual framework need to be altered, but it needs to changed to help create principle-based accounting standards that are useful to all people, regardless of their background.

INTRODUCTION

The Financial Accounting Standards Board (FASB) has been criticized for not requiring firms to report information that is interpretable and useful for financial statements users (CICA, 1980). The FASB's conceptual framework is the core in which all accounting standards are derived. Therefore, the accounting conceptual framework must embody a set of qualitative characteristics that ensure financial reporting provides users of financial statements with adequate information for decision making. The U.S. financial accounting conceptual framework was established in the late 1970's and early 1980's. Statement of Financial Accounting Concepts (SFAC) No. 2 (1980) indicates that there are five main qualitative characteristics of accounting information; understandability, relevance, reliability, comparability, and consistency. The conceptual framework was formed with the intention of providing the backbone for principle-based accounting standards (Nobes, 2005). However, the Securities and Exchange Commission (SEC) has recently criticized the accounting standards setting board for becoming overly rules-based, which paves the way for the structuring of transactions in the company's favor (SEC 108(d)). Critics of the framework have stressed that the move towards rule-based standards are a consequence of inadequacies in the accounting conceptual foundation. Nobes (2005) argues that the need for rule-based accounting standards is a direct result of the FASB trying to force a fit between standards and a conceptual framework that is not fully developed.

A coherent and strong conceptual framework is vital for the development of principle-based accounting standards and the progression towards convergence in international accounting standards. However, we are unaware of any empirical evidence that supports the criticisms of the current conceptual framework. Additionally, none of the critics have looked at the conceptual framework from the most important viewpoint, the user's perspective. Therefore, the purpose of this paper is to empirically analyze the adequacy of the conceptual framework, from a user's perspective, in relation to an individual's reliance on financial statements for decision making. We developed a survey instrument to analyze an individual's intention to rely on financial statements using Ajzen's (1991) Theory of Planned Behavior.

We found that the reliability characteristic of the conceptual framework represented the only significant dimension of a person's attitude affecting their intention to rely on financial statements. However, the understandability characteristic was approaching significance. Within the context of the theory of planned behavior, social pressures was not significant influence on the intention to use/rely on financial statements, yet familiarity with accounting was found to significantly influence intention.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Structured accounting standard setting began in the early 1930's with the enactment of the Securities and Exchange Commission Acts. These acts gave the power of accounting standard setting to the SEC. Nevertheless, the SEC delegated the authority to set accounting standards to the private sector, the American Institution of Certified Public Accountants (AICPA), in 1938 (Wyatt, 1991). Even before the stock market crash of 1929, many in the profession questioned the adequacy of the current accounting model (Previts & Merino, 1998). The solution to the accounting problems prior to the stock market crash was the adoption of Paton and Littleton's (1940) income determination model, which focuses on cost allocation and the matching of revenues with expenses. To facilitate the adoption of Paton and Littleton's historical cost income model, the American Accounting Association (AAA) issued a string of statements between 1936 and 1948 that supported the implementation of cost accounting and acted like a conceptual framework. Despite the efforts of the AAA, there was no true conceptual framework from which standards could be based. In 1939, the AICPA established the Committee on Accounting Procedure (CAP) as the official body for setting accounting standards. CAP was then replaced by the Accounting Principles Board (APB) in 1959 as the authority for standard setting. CAP's failure resulted from its inability to meet the SEC's instruction to limit the alternatives in accounting through its problem-by-problem approach to standard setting (Previts & Merino, 1998). The APB also tried to issue accounting standards in an environment that lacked a conceptual framework. This contributed to a lack of cohesiveness within the standards, since the APB had no basis for their conclusions on each standard. Ultimately, this led to demise of the APB as the Financial Accounting Standards Board (FASB) took over the accounting standard setting in 1973 (Wyatt, 1991). Prior to the establishment of the FASB, the Trueblood Committee was formed to analyze the purpose of financial reporting and develop a set of objectives for financial statements (Previts & Merino, 1998). The FASB followed the recommendations of the Trueblood Committee and established accountings first official conceptual framework in the late 1970's and early 1980's (Wyatt, 1991). This framework, with a few changes, still provides the basis for the FASB's standard setting today.

Statement of Financial Accounting Concepts (SFAC) No. 2 (1980) develops and discusses the qualitative characteristics that make accounting information useful. SFAC No. 2 separates the qualitative characteristics as possessing either user-specific or decision-specific qualities. The overall user-specific characteristic of accounting information is that it must be understandable. For this reason, the FASB has placed understandability at the top of the qualitative characteristics hierarchy. Under understandability within the conceptual hierarchy are the decision-specific characteristics that influence decision usefulness. The primary decision-specific qualitative characteristics identified by the FASB are relevance and reliability. Then, comparability and consistency are considered to be secondary decision-specific characteristics by the FASB.

Today, the accounting conceptual framework is being blamed for accounting standards becoming rule-based, which leads to the structuring of transactions (Nobes, 2005; SEC 108(d)). In fact, FASB has even acknowledged that the conceptual framework might be inadequate for current accounting standards (AICPA, 2002). A conceptual framework that is consistent with principle based accounting is needed to not only for serving as guideposts for standard setting, but also, for the much needed convergence between U.S. GAAP and international accounting standards (Tweedie, 2004; SEC, 2002). Without strong principles-based accounting standards, FASB has to force a fit between the framework and standards (Nobes, 2005) and practitioners end up using their judgment to determine what accounting rule applies rather than using their judgment to obtain the best theoretical accounting application (Shortridge & Myring, 2004).

Despite all the criticisms of the conceptual framework, there appears to be no empirical studies to support these claims. The purpose of this paper, then, is to examine individuals' intention to use financial statements in order to determine whether the qualitative characteristics of accounting information contribute to their reliance on financial statements. We decided to examine the conceptual framework from the user's perspective since the purpose of financial statements is to provide useful information for decision making. Additionally, we chose to focus our empirical examination on the qualitative characteristics of the framework given that they are the backbone of all accounting standards.

We opted to analyze the conceptual framework and potential financial statement user's intentions within the context of Ajzen's (1991) Theory of Planned Behavior. Ajzen (1991) indicates that empirical evidence suggests that we can determine an individual's intention to perform a behavior through analyzing their attitude, subjective norms, and perceived behavioral control. Within this perspective, we adapted Ajzen's (1991) theory of planned behavior to an individual's propensity to rely on accounting financial statements (see Figure 1).

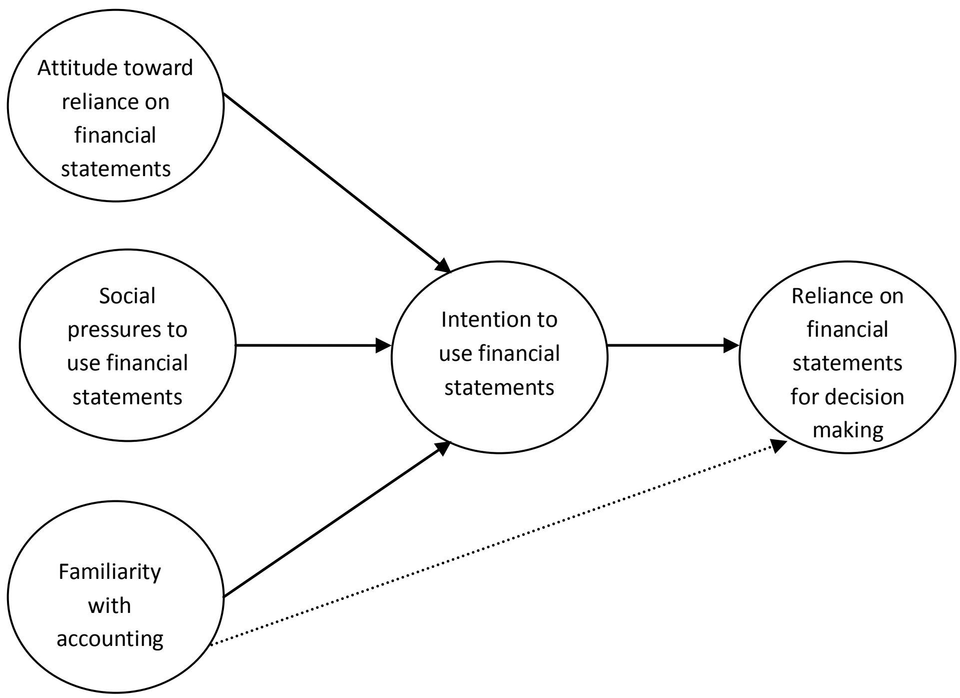

Figure 1: Theory of Planned Behavior Adapted to Financial Statement Reliance

Based on Ajzen's (1991) theory of planned behavior, we propose the following hypotheses for this study:

H1: Financial statements that possess the characteristic of understandability will have a positive association with an individual's intention to use financial statements.
H2: Financial statements that possess the characteristic of relevance will have a positive association with an individual's intention to use financial statements.
H3: Financial statements that possess the characteristic of reliability will have a positive association with an individual's intention to use financial statements.

H4: Financial statements that possess the characteristic of comparability will have a positive association with an individual's intention to use financial statements.

H5: Financial statements that possess the characteristic of consistency will have a positive association with an individual's intention to use financial statements.

H6: Familiarity with financial statements will have a positive association with an individual's intention to use financial statements.

H7: Social pressure on individuals to use financial statements will have a positive association with an individual's intention to use financial statements.

METHODOLOGY

We developed a survey instrument to measure an individual's intention to rely on financial statements by using Ajzen's (1991) Theory of Planned Behavior. We have seven constructs in our model. The first five constructs, understandability, relevance, reliability, comparability, and consistency are the qualitative characteristics identified in SFAC No. 2. According to the work of Huang et al. (1999), these five constructs relate to different dimensions of an individual's attitude toward financial statements. The last two constructs, social pressures and familiarity are included within the context of the Theory of Planned Behavior.

We conducted a pilot study to assess both the reliability and the validity of our survey instrument. A total of 35 completed surveys were collected via an online surveyor. The sample distribution of the pilot study was as follow: 40% female and 60% male; 37% are sophomore, 29% are junior, 3% are senior, and 31% are graduate students. We did not discover any conclusive findings in our pilot study because of the limited sample size. However, we received constructive feedbacks from a group of panelist consisted of nine doctoral students. We refined our survey questions based on their recommendations.

Data was collected online by students enrolled in 10 (5 lower level, 1 intermediate level, and 4 upper level) accounting classes at a large public university in a South Western metroplex. Extra credit was offered to some of the students by their instructors to encourage participation. A total of 245 completed surveys were collected via an online surveyor. All of the responses were usable in our analysis. The sample distribution was as follows: 54% female and 46% male; 1% freshman, 23% sophomore, 35% junior, 24% senior, and 17% graduate students; 48% accounting major and 52% non-accounting major; 56% of the respondents have 0 to 1 year of professional work experience, 27% have 2 to 4 years of experience, and 17% have more than 5 years of experience.

We used the varimax rotation method and suppressed factor loadings that were less than 0.40 in our principal components factor analysis. The factors loaded cleanly except for the comparability and consistency constructs which both loaded on factor 2. After re-examining our survey questions for these two constructs, we found that these questions were too closely related. Thus, we suspect that this is the contributing reason as to why these two constructs fail to load separately. Nevertheless, all of our constructs have above a 0.7 Cronbach's alpha. Nunnally (1978) suggested that a Cronbach's alpha of 0.7 or higher indicates that a construct has good internal consistency. Therefore, our survey instrument demonstrates an acceptable level of internal consistency.

We conducted an inter-item analysis to ensure that there is convergent validity among these constructs. The results indicate that the overall correlations within constructs are greater than the correlations between constructs. Thus, the evidence supports that there is convergent validity among the various constructs. We also performed an inter-factor analysis to ensure that there is discriminant validity among constructs. The results indicate that all of the inter-factor correlations are less than the Cronbach alphas. Thus, it provides support that there is discriminant validity among constructs.

We performed confirmatory factor analysis by using LISREL to run the single factor structure for all of our constructs. We have correlated error terms for some of the factors according to the LISREL modification index before analyzing the goodness of fit statistics. Nevertheless, the NFI and CFI for all of these factors were either one or above 0.90 prior to the correlation of any error items. After the modification process, all of the factors have insignificant chi-squares. Taken as a whole, all of the goodness of fit statistics provide support for construct validity.

RESULTS

We used structural equations model to test the hypothesized relationships among understandability, relevance, reliability, comparability, consistency, familiarity, social pressures, and intention. The inferential results of our proposed model from LISERL are: adjusted Chi-Square = 1.39, RMSEA = 0.04, GFI = 0.87, AGFI = 0.84, Bentler and Bonett's NFI = 0.93, and Bentler's CFI = 0.97. According to Bentler (1990), CFI is the index of choice. Thus, our model represents an adequate fit to the data. The results indicate that only two of our seven hypotheses are being supported.

The results of our hypotheses testing are summarized as follow:

H1: Financial statements that possess the characteristic of understandability will have a positive association with an individual's intention to use financial statements
Result: Not supported (but close to significant) and positive
H2: Financial statements that possess the characteristic of relevance will have a positive association with an individual's intention to use financial statements
Result: Not supported and negative
H3: Financial statements that possess the characteristic of reliability will have a positive association with an individual's intention to use financial statements
Result: Supported and positive
H4: Financial statements that possess the characteristic of comparability will have a positive association with an individual's intention to use financial statements

Result: Not supported and positive

H5: Financial statements that possess the characteristic of consistency will have a positive association with an individual's intention to use financial statements

Result: Not supported and negative

H6: Familiarity with financial statements will have a positive association with an individual's intention to use financial statements

Result: Supported and positive

H7: Social pressure on individuals to use financial statements will have a positive association with an individual's intention to use financial statements

Result: Not supported and positive

In other words, only the hypothesized relationships between reliability and intention as well as familiarity and intention were statistically significant. The other hypothesized relationships were not statistically supported. We also notice that both relevance and consistency have a negative relationship to intention. This finding is contrary to our arguments that all of these factors will have a positive relationship to intention.

DISCUSSION AND CONCLUSION

The purpose of our study is to provide an empirical analysis to the criticism against the FASB's conceptual framework. Our overall results suggest that the current conceptual framework does not adequately align the objectives of financing reporting with the users of financial statements. Nevertheless, our findings have some interesting implications for the conceptual framework and future standard setting.

Reliability is the only qualitative characteristic that has a positive statistical significant relationship with intention. The accounting profession is facing a choice between reliability and relevance in financial reporting, as there is an inherent tradeoff between reliability and relevance (Paton and Littleton, 1940; Vatter, 1947). Reliable information possesses the characteristic of objectivity and verifiability, which is associated with historical cost accounting. Relevance, on the other hand, pertains to any information that will influence the users' financial decision. Many times the most relevant information is often current or prospective in nature. Thus, we cannot have accounting information that maximizes the characteristics of both relevant and reliable because relevant information is not always verifiable.

We would have expected to see relevance as a significant factor in users' intention to use financial statements since the recent accounting standards have moved toward fair value accounting measures, which are considered to be more relevant than reliable information (Ciesielski & Weirich, 2006). However, our results show that reliability is a significant factor. The current accounting curriculum could be the cause of our results since it is rooted in Paton and Littleton's historical cost approach, which focuses on reliability of information.

In the context of the Theory of Planned Behavior, we found that familiarity to be a statistically significant factor to an individual's intention to use financial statements. Thus, as an individual becomes more familiar with financial statements, he or she is more likely to have the intention to use or rely on them when making decision. An ANOVA analysis provides further support for this as it indicates that intention to use or rely on financial statements is significantly different between accounting majors and non-accounting majors. This provides evidence that accounting could be becoming too difficult for individuals who are not proficient in accounting to understand. It appears that the movement towards rule-based accounting standards could be a contributing cause of this disparity in intention. That is, the accounting standards have become so technical upon their execution that the average reader of accounting can no longer discern the main objective of each financial statement element. This finding is troubling to accounting since it contradicts the primary objective of accounting, which is to provide useful accounting information for decision making. Accounting information should be useful for all people who want to use it rather than only being useful to those who understand it. Additionally, under no circumstances, should accounting information provide an advantage to individuals who happen to be experts within the field. Accounting should be a tool and not a barrier.

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