
Original Article

Financial statements are messages that need a context to be better understood

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ABSTRACT In an increasingly complex and shifting economic environment, financial statements have lost a measure of their ability to inform their various constituents, for example, investor and creditor. The shift can be seen in the movement from a producer-dominant market to one that is customer centered. In the previous setting, historically based financial accounting classes and measurements that are principally devoted to conveying the financial status in an enterprise-centric manner were sufficient to achieve the objectives of financial statements. In the current setting, financial statements have to be broadened to take account of the transformation in the economy owing to significant changes in technology. For financial statements to achieve their purpose to be an informative message they need an explicit context, whereas in the previous, more slowly evolving economy – a world without social media, for example – an explicit context was not necessary; it was left to the user to interpret the financial statements of the enterprise through a user-supplied context.

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INTRODUCTION

The proposition that will be advanced and addressed below is that financial statements are incomplete messages, in that additional information in the form of a context is needed in order for the receiver of the message to 'understand' the message. To understand implies that the receiver of the message grasps and comprehends its meaning. Meaning, as it relates to financial statements, implies something more than just the

numbers by themselves; it is a report on how well the enterprise is achieving its goals. An enterprise does not exist in isolation; accordingly, financial statements acquire their meaning in terms of how well they are doing in their chosen environment – their context. Context is defined as the circumstances that form the setting for an event, statement or idea and in terms of which a message can be understood and assessed. In a given situation, there can be multiple contexts, but the one that is chosen should be that one that is consistent with the needs of the receiver to comprehend the purpose and intention of the sender; if the wrong one is selected it can easily confuse or misdirect the receiver.

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In general, the goal of an enterprise's management is twofold: to develop value propositions that the enterprise's customers will buy in growing numbers, while making a sufficient profit so that the return to capital is commensurate with the risk and uncertainties the enterprise has assumed.

Value comes in two flavors: exchange value is defined as the ability of the good to obtain other goods in exchange, and use value is defined as the gratification derived from the use of the product or service. In a monetary economy, an exchange transaction generally involves the tendering of an amount of money to acquire a product or service. Money is an intermediate stage between ultimately two transactions that entail goods or services. The exchange value of the product or service is usually measured in terms of money. In essence, exchange value can be seen as 'how much someone is willing to give or pay for this good or service'. Use value and exchange value do not necessarily have to coincide. In a rational exchange it is assumed that the use value is either equal to or greater than the exchange value.

An organization's success or failure is a consequence of how well it navigates in its operating environment(s). Navigation infers the production of value propositions. Operating environments are the source of opportunities and threats. Accordingly, an organization can be judged on the basis of how well it is satisfying the needs and wants of its customers, and doing so in a profitable manner. Knowing how well an organization is accomplishing its objectives foretells, all things being equal, how well the organization will fare in the future.

An analogy can be drawn between an enterprise and a sea voyage; both share the general objective of safe travel. Management and the ship's captain are tasked with the goal of safely navigating through their respective environments. Before the invention of the barometer, the ship's captain had to use a variety of heuristic to achieve the goal of safe travel.

However, the likelihood of finding themselves in a major storm was substantial. With the advent of the barometer, captains were able to avoid severe storms. To achieve its objective, barometers measure the atmospheric pressure: low pressure is associated with major storms. Barometers provide a quantitative leading indicator.

The question that needs to be answered is: What is the enterprise's equivalent to a barometer? In the current business environment it has become manifest that the emphasis has shifted to the customer. The measurement of the enterprise's relationship with its customers is the equivalent of the measurement of atmospheric pressure.

Continuing with the analogy, the ship's log is the counterpart of financial statements. The log memorializes the results of decisions made by the captain to date. In a setting where the seas have been calm the log records a pleasant voyage, whether the captain did or did not have a workable barometer. The log and financial statements are at best information sources that lend themselves to being used by the reader to generalize the future from the past. Obviously, the reader of both the log and financial statements would be better informed regarding the future if they were benefited by the readings of the relative 'barometers'.

Accounting is limited in that it quantifies *ex post* (the results of) management's *ex ante* decisions (plans) solely in financial (monetary) terms and omits the factors that ultimately produced the financial outcomes, namely, the enterprise's ability to successfully fulfill its purpose to profitably create and sustain value propositions as measured by its relationship with its customers.

The current accounting regime focuses on the future financial-based implications of past transactions and events. Accounting, operationally, is a classification scheme and is coupled with a set of measurement protocols. From a financial statement point of view, enterprises are systems through which there are flows of cash. Balance sheets are static representations, at a point in time, of the various phases in



which the flows of cash are situated. Income statements are actual and accrued potential cash flows for a given period of time.

In addition to the fact that financial statements are historically oriented, financial statements are problematic due to the issues that flow from class membership and measurement difficulties making context necessary for the financial statements to be understood. Accounting classifies and measures transactions and events, and transactions and events do not necessarily fit neatly into a given class, nor are they readily measurable. Derivatives are a good example of an accounting object that can have both of these difficulties.

To achieve the existing objectives of financial statements requires that a multitude of estimates and judgments be made relative to the cash flows; they do not formally measure and report on the critical factors that involve the enterprise's value-creating activities. An example of accounting judgments would be the method of depreciation and amortization; an example of an estimate is the reserve for uncollectible accounts receivables. Given that an organization is in substantial part assessed through its financial statements, management undertakes judgments, in the form of decisions that will present the organization in a financially favorable light. However, the latter type of judgments usually has short-term superficial consequences and invariably has long-term damaging effects.

In the realm of public companies, the Securities and Exchange Commission (SEC) mandated that the management of the reporting company provide a financial narrative in addition to the financial statements. In an SEC Release (Interpretation)¹ the Commission spells out the requirements of an MD&A:

The purpose of MD&A is not complicated. It is to provide readers information 'necessary to an understanding of [a company's] financial condition, changes in financial condition and results of operations.' MD&A should be a discussion and analysis

of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present.

It could be conjectured that the reason behind the MD&A requirement is to address the informational deficiency of financial statements with respect to the issues discussed above in addition to the lack of information that is future oriented.

It is generally understood that an MD&A is reviewed and scrubbed by the reporting company's attorneys, leaving it, generally, a bland and minimally informative document. By its very definition MD&A is not an unbiased message; it is management's view of the world. Furthermore, the basis that the auditor requires to be associated with the MD&A is that of reasonableness and not verifiability.

The purpose of the Status of Customer Relationship (SCR) – presented below – is to provide information beyond that which is contained in the financial statements. It is a concise, verifiable, formal report that reflects the conditions that are in place that will impact the entity in the future. The SCR embodies in one succinct report the goals of the Enhanced Business Reporting Consortium (EBRC) as described in the AICPA_ASEC Whitepaper²: (i) tied to company-specific mission, vision and values; (ii) factors critical to success; (iii) decision reflective; (iv) real-time/future; and (v) company related and forward-looking.

In light of the above, it is submitted that a statement that reports on the enterprise's relationship with its customers provides the necessary context for the comprehension of the financial statements. The combination of financial statements and the SCR gives the reader the sense of what the entity's potential future will be and its past performance, alongside the state of its financial liquidity and resources as displayed in the balance sheet. The report adds a critical dimension to the financial reporting. The important contribution that the SCR makes is, as noted above, that Generally

Accepted Accounting Principles (GAAP) at its basic level is the future realization in cash, of previous transactions and events. Being able to anticipate the future, in some measure, gives the financial statement user the ability to assess the likelihood of the realization, for example, of long-term assets.

Financial statement users rate organizations, in part, through their financial statements. It is assumed that the financial statement reader is able to rate an organization on a scale ranging from -3 to 3 , in the following way: -3 = maximally negative, -2 = moderately negative, -1 minimally negative, 0 = Indifferent, 1 = minimally positive, 2 = moderately positive and 3 = maximally positive. It is assumed that a model of enterprise context, namely, the SCR, discussed below, will also be rated using the same scale. The distance between the two ratings reflects the degree of dissonance between the message and the context. For example, a rating of 3 for the financial statements and a -3 for the context would result in a distance of 6 would reveal a complete disconnect between the message and the context, whereas a distance of 0 says that message and context are in harmony. It is posited that the combination of the rating scores will enhance the reader's understanding of how well the organization is fulfilling its purpose.

The article is organized in the following manner: the next section talks about Communication, the subsequent section Context, the penultimate section Enterprise and the final section Adjoined Accounting model.

COMMUNICATION THEORY

The following notions are central and essential to the communication process:

Accurate = free from error. Decode = to convert a coded message into a comprehensible and intended form. Context = the circumstances that form the setting for an event, statement or idea and in terms of which a message can be understood and assessed; a message without a context can possess various degrees of ambiguity. Ambiguity = capable of being

understood in two or more different ways. Message = a structured set of symbols, images and sounds (SIS) that is intended to convey a whole or a partial thought. Conceptual meaning = the concepts that are attributed to a word, image or sound; for example, the word 'foot' has multiple conceptual meanings, for example the lower portion of leg, a unit of length, the lower edge of a sail, to pay or stand credit for, and to add up a list of numbers. Associative meaning = the conceptual meaning attached by an individual to a particular word, image or sound; different individuals could associate different concepts with a word, image or sound based on their culture, experience and education. Comprehension = the attachment to or construction of meaning to one or more symbols, images or sounds by the receiver.

Information is intended to affect the behavior or state of mind of the receiver. Information is knowledge that is produced either through reason or sense making or through both. For the purposes herein, reason is structured and logical thinking processes (for example, mathematics and formal logic), and sense making is thought that involves the comparison and application of judgment and discernment to the present object with an individual's stored experience that has been experienced personally or through an educational process that acquires the experiences of others.

Financial statements are the vehicles used by an enterprise to communicate to its various constituencies. The issue to be raised is: What information should the financial statements convey? The need to verify the elements of the statements has limited the kind of information that is being conveyed by them, and hence the reliance on past transactions and events. Nonetheless, financial statement users are primarily focused on the futurity of the enterprise. Financial statements need to be expanded to address the needs of the users. In that connection, the SCR presented below satisfies the joint requirement of a verified message and one that is meaningful to the reader of the financial statement.



Communications theory can be divided into two schools: the process school 'sees communication as the *transmission of messages*' and the semiotic school 'sees communication as the *production and exchange of meanings*' (Fiske, 1982, p. 2).

The process school is identified with Shannon/Weaver, who are concerned with the efficiency of the communication channel. They are interested in establishing the ways to transfer a message from A to B such that the message is minimally corrupted by noise and relatively free of error. Noise is anything that is added to the message that is not intended by the sender. The solution to the transmission problem involves the idea of redundancy, that is, the repetition of signal elements increases the likelihood that the received message comports with that which the sender intended. Let us assume that the sender sends a message in English that is very accurate when received by a Japanese receiver. The message satisfied the Shannon/Weaver criteria but fails at the level of meaning. Another example would be that the sender sent the message 'I footed the bill' and this was received by the receiver in a veritable manner. Absent the additional information that context could provide, the message is ambiguous, that is, subject to multiple meanings: in the context of a restaurant it usually means that the sender paid the bill; in the context of auditing it means that the auditor added up the items on the bill. Thus, it can be seen that the accurate transmission of a message alone is insufficient to inform the receiver.

In the semiotic school '... the emphasis is not so much on communication as a process, but on communication as the generation of meaning' (Fiske, 1982, p. 39). The idea behind the semiotic school is that the message should stimulate the receiver to create a meaning close to the meaning intended by the sender. The fundamental question that has to be answered is: What is 'meaning' in the context of financial statements? Here financial statement 'meaning' is intended to be the degree to which the organization has achieved its purpose.

'For communication to take place I have to create a message out of signs. This message stimulates you to create a meaning for yourself that relates in some way to the meaning that I generated in my message in the first place' (Fiske, 1982, p. 39). 'A sign is something physical, perceivable by our senses; it refers to something other than itself; and it depends upon a recognition by its users that it is a sign'. Moreover, 'The sign relates to reality only through the concepts of the people who use it' (Fiske, 1982, p. 41).

An SIS takes on meaning through its semantics: 'A semantics is described as a mapping from the expressions to a conceptual structure. This mapping can be seen as a set of *associations* between words and meanings – associations that have been established when the individual learned the language' (Gardenfors, 2000, p. 15).

'Since both linguistic expressions and their meanings are in the head of an *individual*, a semantics for a language is primarily connected to a single speaker (or listener). Prima facie, this appears to be an enigma for the cognitive approach to semantics: meanings are things that are *common* to the language users' (Gardenfors, 2000, p. 155). Gardenfors offers a solution to this problem: 'The idea is that the conceptual structures of different individuals will become *attuned* to each other, otherwise linguistic communication will break down. Thus, for practical purposes, cognitive linguists often write as if every (adult) speaker of a language is endowed with the same conceptual structure' (Gardenfors, 2000, p. 155).

'Expressions do not mean; they are prompts for us to construct meanings by working with processes we already know. In no sense is the meaning of [an] ... utterance "right there in the words". When we understand an utterance, we in no sense are understanding "just what the words say"; the words themselves say nothing independent of the richly detailed knowledge and powerful cognitive processes we bring to bear' (Turner, 1991, p. 206).

It follows from the above that absent an equivalence of conceptual structures between the sender and receiver communications cannot occur. Beyond that, if there is partial equivalence between the conceptual structures there is a probability that the receiver will arrive at conclusions different from those intended by the sender. It could be proffered that the previous comments, in part, explain why it is that two individuals looking at the same thing 'see' different things. Context provides cues to the receiver to comprehend the message as the sender intended.

A major objective of financial accounting is the achievement of a shared conceptual structure. This is expected to be accomplished through conventionalized concepts that are attached to financial statement SISs. It is assumed that users of financial statements have the requisite knowledge of accounting, business, economics and finance, and a command of the accounting conceptual structure.

The question to be asked is: Does the current accounting model address the various needs of the readers of financial statements? The answer is twofold. First, the current model is excessively complicated in that there has been an exponential growth of concepts comprising GAAP, thereby making financial statements very difficult to decode; in communications a simple meaningful message is more effective than a complicated and ambiguous one. Second, the more recently added concepts depart from clear concepts that lend themselves to the ready inclusion and measurement of past transactions and events to concepts that are not easily classified and measured. Furthermore, the accounting model is very much the captive of the notion of conservatism that emphasizes the recognition of apparent losses and the deferment of gains. The rationale for the asymmetry is the greater ability to verify losses and the lack of verifiability of gains.

Moreover, decision making is forward looking; the current accounting model is the past interpreted in terms of the future. In essence, it is an arrangement that embodies the notion of extrapolation rather than anticipation.

A remedy for the expansion of concepts and their related amorphousness, and the need for a future-oriented dimension that can be verified, is a future-oriented verifiable context. Context reduces the ambiguity that surrounds the message. Additionally, if the context also provides a futuristic feature, then the context clarifies and gives meaning to the message. It is claimed below that the SCR developed here satisfies the three aforementioned criteria: clarifying, future focused and verifiable.

CONTEXT

Context is made up of (i) decoding assistance and (ii) situs clarification. Decoding assistance can be implicit or explicit. 'Decoding is as active and creative as encoding' (Fiske, 1982, p. 42). If the sender assumes that the receiver of the message is attuned to the sender regarding the concepts to be evoked by the SIS then there is the beginning of decoding: the way the SIS are arranged and presented produces an implicit decoding; that is the benefit of convention, for example a shared pattern. If the sender cannot assume that the receiver is on the same 'page' to achieve concordance, the sender must deliberately explain which concepts the receiver should associate with the SIS. In essence, the sender has to educate the receiver.

If a new concept is fashioned from existing concepts such as the word 'blog' in the early use of the word, until such time as it has become conventionalized, the sender has to elaborate on what the new word means. In the instance of the word 'blog' the receiver would be benefited by including a description of the word, such as: a website on which an individual or group of users record opinions, information and so on on a regular basis. In the case of the phrase 'quantum foam', a phrase originated by the Nobel Prize winner John Wheeler through which he introduced the concept to describe what space-time 'looks like' at scales of 10^{-33} cm. The introduction of a new concept, as is the case of 'quantum foam', requires the sender to explain what is intended by the words used. The explanation must be tailored



to the intended audience given that it is a very technical concept; the explanation might be less explanatory to a group of physicists than to a group of accountants.

Context is audience related in that a message that is sent to a particular audience presupposes that the audience will select the same concepts of those that are related to the signs. In the instance where a message, without a particular audience in mind, could be misinterpreted, that is, different concepts associated with the signs causing the receiver to gain, in whole or in part, a different meaning from that which the sender had intended. The latter instance imposes on the sender a burden to clarify what the intended concepts are.

Situs clarification is the implicit or explicit conveyance of the situation in which the message is to be decoded. If the situation is known by the receiver then the intended concepts can be associated with the SIS; if there are many situations in which the message can be interpreted then the receiver has to be given the intended situation so that the message will be interpreted as the sender had intended. Gardenfors (2000, p. 128) argues that 'Sometimes the mere *context* in which a concept is used may trigger different *associations* that lead to non-monotonic inferences'. Barsalou (1987, p. 106) gives the following example: 'When *animals* is processed in the context of milking, *cow* and *goat* are more typical than *horse* and *mule*. But when *animals* is processed in the context of riding *horse* and *mule* are more typical than *cow* and *goat*'.

The previously stated proposition that financial statements need context is consistent with the FASB (Financial Accounting Standards Board)'s (1978, p. 3) assertion that that financial statements in and of themselves are incomplete messages: 'Although financial reporting and financial statements have essentially the same objectives, some useful information is better provided by financial statements and some is better provided, or can only be provided, by means of financial reporting other than financial statements'. The need for context

was explicitly stated as a justification for the MD&A as an instrument to help the reader to decode the financial statements. But as previously discussed, the MD&A falls short of the target. It can be assumed that the shortcomings of the MD&A were the underlying motivation for the EBRC.

There is a difference between a context and additional information, that is, additional detail: the MD&A adds detail not context. For example, let us attempt to grasp the meaning of the statement 'I saw John drive into the bank'. The word 'bank' has a number of different meanings, for example a financial institution, a stretch of rising land at the edge of a body of water, a place for gathering and distributing blood and blood products and the sloping of a road or a racing track ... Let us pretend that the statement had an additional detail such as 'I saw John drive into the bank wearing a green shirt'. The additional detail 'wearing a green shirt' does not disambiguate the message. It adds nothing in terms of clarity. The meaning of the statement standing by itself cannot be discerned; it needs a context to be apprehended.

Contrast the meanings from the following two statements: 'I was on my boat when I saw John drive into the bank' and 'I was watching the race when I saw John drive into the bank'. Even though the additional information seems to be informative, it can be misleading. For example, in the first case the statement could be extended to 'I was on my boat that was docked alongside Citi Bank when I saw John drive into the bank'. In the second case it could be expanded to 'I was watching the race on my television set when I saw John drive into the bank'. Clearly, the meanings of the latter messages are different from the previous ones, but they are not conclusive; they still lend themselves to multiple meanings.

The meaning of the previous messages would become more focused if the following additional facts were disclosed: 'The bank was robbed' or 'John works at the bank'. These additional statements are the contexts in which the words of the aforementioned statements

acquire their meaning. It should be noted that the statements with fewer words can induce meaning, assuming they are contextual, in contrast to statements with more words that are detail oriented.

The breadth and depth of the context that is needed to disambiguate a message flows from the meaning the sender seeks to convey. As was argued above in the circumstance of financial statements are the means through which an enterprise communicates the degree to which it has successfully fulfilled its purpose and the concomitant risk and uncertainty.

ENTERPRISE

Drucker (1974, p. 61) offers, 'To know what a business is we have to start with its *purpose*. Its purpose must lie outside of the business itself. In fact, it must lie in society since business enterprise is an organ of society. There is only one valid definition of business purpose: *to create a customer*' (italics in the original). He goes on to ask, What is value to the customer? His response is: 'The customer never buys a product. By definition the customer buys the satisfaction of a want. He buys value. Yet the manufacturer, by definition, cannot produce a value. He can only make and sell a product' (Drucker, 1974, pp. 83–84).

Drucker goes on to say, 'With respect to the definition of business purpose and business mission, there is only one such focus, one starting point. It is the customer. The customer defines the business' (Drucker, 1974, p. 79). It follows from Drucker that central to the assessment of an enterprise is the evaluation of how successful it is in carrying out its purpose – creating and satisfying customers.

Kay (2011, p. 30) reports on a study conducted by Collins and Porras, who concluded that 'The company that put more emphasis on profit in the declaration of objectives was less profitable in its financial statements'. Kay (2011, p. 28) cites Collins and Porras again, who in turn quote George Merck: 'We try never to forget that medicine is for people. It is not for profits. The profits follow, and if we

have remembered that, they have never failed to appear. The better we have remembered it, the larger they have been'. Essentially, what is being proffered is that profit is a measure of how well an organization has achieved its purpose; it is not a goal in and of itself.

It is important to emphasize Drucker's point that the purpose of a business lies outside of itself. Management decision-making must take on a 'Janus'-like posture, that is, being focused externally and internally at the same time. As a general proposition, an organization chooses its mission and the operating environment(s) in which to fulfill its mission. For example, one organization chooses to be a retailer, another to be a manufacturer. The retailer may choose high-fashion products for the young in contrast to selling having a relatively regular demand items, for example food. One further distinction can be made in the latter choice: one organization chooses to market healthy and natural food products as against the standard bill of fare.

Enterprises operate in one or more operating environments (a general model of environments is presented below). An operating environment is briefly defined as that portion of the social scene that is represented by the combination of particular customer needs/wants/desires and products/services that are presumed to satisfy the former. From initiation and on a day-to-day basis, organizations make decisions regarding which customers' needs/wants/desires to address and which products/services to produce that are supposed to be of value.

Following Knight (1971, p. 20), risk is that portion of uncertainty that can be measured, that is, functionally related to a number system; the remainder is taken to be uncertainty. Number systems are the embodiments of patterns, and predictability implies a discernible pattern. Predictability can take the form of either deterministic or probabilistic. In the first case, there is a one-to-one relationship between the preceding and the subsequent. In the second case, there is a one-to-many relationship between the preceding and the set



of succeeding outcomes. The relationship can be evenly weighted or differently weighted between preceding and succeeding. In the latter case, statistical methodology is appropriate to determine the weightings.

The specific environments in which enterprises operate in range from stable to unstable. Long-term decisions tend to expose the enterprise to uncertainty; time and uncertainty are inclined to be positively related, whereas short-term decisions tend to fall into the risky range. That being said, the degree of stability and instability in an organization's environment influences the organization's ability to measure the uncertainty. Accordingly, stable environments are inclined to measurement regardless of the time horizon for the decision to be realized in cash; in contrast, instability reduces the organization's ability to measure the uncertainty to the point where it is immeasurable. While uncertainty appears to have an ordinal scale of more or less uncertainty, risk can be represented by cardinal numbers, that is, ten is twice five; a 10 per cent probability is twice as risky as a 20 per cent probability.

The theory of the management process put forth herein is that management has to optimize the enterprise performance results at a chosen risk/uncertainty level while resolving the tension between various constituencies such as customer and shareholder, management and employee, government and private interests.

Customers seek the greatest satisfaction from their purchases for the least price whereas shareholders seek the largest profit, which can imply the highest price. Thus, management is in a Scylla and Charybdis type of dilemma: having to choose between two competing ends. When management's self-interest is added to the situation there is a three-sided game. The problem is that the overall process is circular in that management's compensation is usually determined by the profit generated by the enterprise; however, more profit can result from lower customer satisfaction per dollar. Accordingly, if management emphasizes self-interest then it does so at the risk of losing customers to com-

petitors, and in the end the enterprise will lose money, resulting in a situation where management's self-interest will be moot. Therefore, it appears that all benefits flow from the greatest customer satisfaction at the lowest price such that it generates an optimal profit.

In general, management has two strategies: lowest price producer and product differentiator. Each of these pure strategies has associated dangers. In the case of lowest cost producer, the enterprise's competitors may devise ways to lower cost, thereby taking customers, and causing management to undertake risky and uncertain actions. These actions can require the expenditure of effort and resources to stay ahead of the game, failing which, the organization can find itself in a perilous condition. In the instance of product differentiator, the enterprise may have to undertake risky and uncertain activities such as research, development, marketing and promotion, which if they do not pay off can lower or eliminate profit. Thus, it can be asserted that the management process involves the safe steering of the enterprise through the vagaries that exist in its environment(s).

The measures of how successful an enterprise's strategy is, on the one hand, the degree of customer satisfaction and, on the other, the amount of profit that has been generated at what level of risk and uncertainty.

Decision-making entails four elements: (i) an expectation regarding the relevant future, (ii) an estimate of available resources, (iii) the set of desired objectives and (iv) the actions taken to achieve the objectives. The ultimate decision must harmonize these four considerations. The approach taken herein is that management of an enterprise is in a contest between itself and the portion of the economy in which the enterprise is engaged – its operating environment(s).

Critical to management expectation formation, consistent with Drucker, is a twofold analysis: What is the future of our customer? and Which customer does the enterprise want as its customer? The collateral questions are: What

products and services will our customers value? and Does the organization have the competitive advantage to produce the required products and services?

To respond to these questions there is a joint need to assess the external environment(s) in which the entity operates or expects to operate alongside a judgment of resources available to the enterprise. To understand a particular external environment there is a need for a lens through which environments can be comprehended. In that connection, a general description of external operating environments follows.

A 12-class scheme is offered through which the external environment can be grasped and represented. The 12 classes are collected into three groups: resources, setting and influentials. Resources are: raw materials, financial and human capital. Setting is: legal, political, economic, technology, product\service market and industry. Influentials are: demographics, cultural and historical. Needless to say, each one of these classes can take a work the size of a substantial book just to provide introductory coverage. That notwithstanding, a limited sketch of each class will be presented. Clearly, these classes are not independent of each other; however, they can be differentiated along the dimension of time. Resource availability tends to have a short-run nature, for example weeks and months; setting tends to be an intermediate-run phenomenon, for example months and years; and influentials tend to evolve over the long term, for example years and decades. A particular organization's external operating environment can be captured in substantial part through the application of these classes to their given circumstance. If each one of these 12 classes is considered a dimension in a mathematical space the enterprise's typical customer can be viewed as a point in that space.

Resources – Raw materials

Raw materials are considered to be any material input into the production of a product; these inputs can range from iron ore to completed components, for example hard drives for

personal computers. Product producers at all levels, for example mineral miners to assemblers, require inputs of a lower converted level to add inputs to, for example, labor and additional materials, to produce more converted marketable final or intermediate products. The availability and pricing of these inputs can be a constraint or concern to the product producer.

Resources – Financial

All organizations, to survive and grow, must have adequate available financial resources. These available financial resources permit the organization to maintain current operations, invest in new capabilities or to expand its activities. Availability encompasses the organization's own financial resources as well as that which it can tap from either equity or credit sources. Availability is a composite function of the organization's performance, financial state, and the supply conditions in the credit and equity markets.

Resources – Human capital

Organizations by definition require, to a greater or lesser degree, humans. This need occurs at all levels of the organization, from top management to those who are performing the most menial tasks. Human capital availability entails the quantity and quality of the individuals who are accessible to the organization. The optimal combination of quantity and quality of human capital makes possible effective and efficient operations.

Setting – Legal

Berman quoting Fuller (Berman, 1983, p. 4) defines law as 'the enterprise of subjecting human conduct to the governance of rules'. Berman offers, 'Law in action consists of people legislating, adjudicating, administering, negotiating, and carrying on other legal activities' (Berman, 1983, p. 5). It is usually the case that a particular body of law reflects a variety of forces, such as the history, traditions and culture of the people who are governed by these laws.



As the definitions indicate, law conditions what activities an enterprise can and cannot engage in, and that law is not fixed but something that evolves with the needs of the governed society.

Setting – Political

According to ‘Political theory is, quite simply, man’s attempts to consciously understand and solve the problems of his group life and organization’ (Sabine and Thorson, 1973, p. 3). Furthermore, they state that ‘Political institutions and political theories merge into one another in the sense and to the degree that both aim to relate people, objects, and happenings under some notion of common good or common interest’. It is the common good or the common interest that is the predicate of an enterprise’s activities.

Setting – Economic

An economy emerges from the interactions of its participants. ‘A society is held together by the mutual advantages its members find from exchanges with one another, from collaborating in production and trading the products. A society’s economy is the meeting ground for such exchange’ (Phelps, 1985, p. 3). Phelps goes on to offer, ‘A society’s economy, then, operates by presenting the participants with a structure of opportunities which determine, given people’s goals and capacities, who does what’. It should be noted that economic opportunities reside in the economy and are there to be found; they are not to be found in the wishes, hopes and desires of the individual participant. Conversely, the individual participant’s economic wishes, hopes and desires can in part or in whole be fulfilled through active participation in the economy.

Setting – Technology

Technology is understood to be ‘... the corpus of knowledge and the set of techniques by which we manipulate and control the physical world to satisfy human wants. Technological change generally focuses on the techniques,

their attendant devices, products, and processes, and the effects of these on individuals and society’ (Girifalco, 1991, p. 1). Technology is a double-edged opportunity presenter in that, on the one hand, it may be capable of satisfying existing human wants and, on the other, it may produce or evoke new human wants; the iPod is a recent example. Technology is, in and of itself, a valuable economic good; this circumstance underlies intellectual property law.

Setting – Market

The notion of market is one that is deployed to analytically organize the characteristics of the demand and supply and their interactions. Markets are regarded in the following manner (Abell and Hammond, 1979, pp. 55 and 57).

An analysis of the demand side of the market should include:

1. a delineation of market boundaries and how they are changing
2. assessments of present and future buyer concentration.
3. projections of demand for the total market and for major segments.

An analysis of the supply side of the market should include:

1. assessments of present and future supply structure (in terms of supply concentration, product differentiation, and entry barriers.)
2. a description of the character of competition both present and projected.
3. an analysis of cost structure and cost behavior.

Understanding these elements individually and their interactions equips management with a lens to optimize an organization’s performance.

Setting – Industry

Industry differs from market : ‘An industry is a collection of firms producing a homogenous product’ (Ferguson and Gould, 1975, p. 226).

Analytically, industry structure can be characterized as one of five different types: competitive, monopolistic, monopolistic competition, monopsonistic and oligopolistic. The differences between these types are related to such factors as pricing power and the time to adjust supply.

Influentials – Demographics

The composition and age structure of a population is a significant factor for an organization to take account of: ‘Demography, the study of human population, is a field whose major impact on the understanding of everyday society has yet to be fully realized’ (Pol, 1987, p. 1). More specifically, demography deals with fertility, mortality and migration rates, and the changes in these rates. ‘The demographic perspective is simply a manner in which the surrounding world can be viewed. It is “a way of relating basic information to theories about how the world operates.” For persons interested in business issues, it means understanding how the population processes ... affect the business environment and thus help determine opportunities and problems’ (Pol, 1987, p. 3). Enterprise-operating environments are in large part collections of humans in all their varied roles; accordingly, knowing how these collections are changing in terms of age, size and ethnicity is essential to the management of an enterprise.

Influentials – Cultural

What is meant by the word ‘culture’? ‘What do I mean by “culture”? I mean community-specific ideas about what is true, good, beautiful, and efficient. To be “cultural,” those ideas about truth, goodness, beauty, and efficiency must be socially inherited and customary; and they must actually be constitutive of different ways of life’ (Shweder, 2000, p. 163).

Alternatively stated, culture refers to what Isaiah Berlin called “goals, values and pictures of the world” that are manifest in the speech, laws, and routine practices of some self-monitoring group’ (Shweder, 2000, p. 163). It is the habits that individuals acquire from their

regnant environment; it is the ideas, customs, skills, arts and science of a sociological group that is communicated from generation to generation. The communication processes can either be formal, for example education, or informal, for example experience.

Influentials – History

The history of a society plays an important part in its functioning (Commager, 1984, p. 3): ‘Clearly the concept of history set forth here embraces rather more than most historians would claim: the total record of the past – literature, law, art, architecture, social institutions, religion, philosophy, all indeed that lives in and through the memory of man. We need not embrace this imperial definition of History in order to agree that man without memory would be bewildered and bereft. But memory, as we all know, is fitful and phantasmagoric. History is organized memory, and the organization is all-important. As organized memory, history takes almost innumerable forms, serves almost innumerable purposes’. Carrying this definition a bit further, it could be said that to be human implies having memories, and moreover, that normal behavior rests on memory.

ADJOINED ACCOUNTING MODEL

The current accounting reporting paradigm emphasizes the past, a lagging indicator. Clearly, to be useful for decision-making, information must be predictive or indicative of a future-relevant state of the object of interest, and is transmitted to affect the behavior or state of mind of the receiver in whatever way that is perceived by the receiver to be beneficial.

The view presented above is that financial statements are incomplete messages. As stated previously, this view is consistent with the FASB: ‘Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions – for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities. Thus,



the objectives set forth stem largely from the needs of those for whom the information is intended, which in turn depend significantly on the nature of the economic activities and decisions with which the users are involved'.

As previously pointed out, the MD&A, and thereafter the EBRC, attempted to ameliorate the recognized failings of the current accounting model. Current financial statements do not take account of how well the organization is accomplishing its primary goals, that is, production and sale of profitable value propositions. The current accounting paradigm reports on the historic results of an organization in accordance with GAAP, which is a set of conventions that is intended to facilitate inter-entity financial comparison: it is essentially one size fits all. It is accepted that GAAP is a history-grounded approach to financial reporting. Additionally, GAAP-based financial statements can be influenced by random effects and more importantly by managements' estimates that have been known to cause the financial statements to provide a questionable message; it is known that managements have exercised their discretion to 'window dress' the financial statements.

Accounting systems comprise a classification scheme and a set of measurement protocols. For example, unsold product is classified as 'inventory' and is measured by applying the rule 'cost or market whichever is lower on a first-in first-out basis'. What is chosen to be classified and measured is determined based on what is thought to be verifiable and informative to the generic financial statement user. The current collection of accounting data is organized into reports, that is, income statement, balance sheet and statement of cash flows.

The income statement is a reflection of an organization's financial performance over a period of time, whereas the balance sheet is a reflection of the degree of risk/uncertainty that the organization's cash flows are exposed to at a point in time. An additional criterion used in the development of the balance sheet is the expected time of the class to be real-

ized or paid in cash: the rule is that the item should be classified as current if it is projected to be converted into cash or satisfied within the organization's normal operating cycle or a year, whichever is longer. Overwhelmingly, the 1-year condition is used. The balance sheet reflects the time-related cashness of the classes comprising the balance sheet. The cash flow statement is designed to transform the accrual basis of accounting used in the income statement and balance sheet back to a cash basis; it was motivated by the view that knowing from where and to where the organization's cash flows traveled is important to the financial statement user. The flows are reported in three segments: operating, investing and financing activities.

The posited objective of accounting should be the conveyance of the degree to which the enterprise has achieved its purpose as stated above – the creation of value in a profitable manner and at what risk/uncertainty exposure.

If the current reporting scheme is expanded to include, for example, the size and change in size of the number of customers and the aggregate customer satisfaction among other customer-centered metrics, the latter being leading indicators, the addition would make the reporting model more informative; the state of an organization's customer cohort envisages, in part, the organization's future. It also provides a context for the traditional financial statements. This information is collected and presented, below, in a statement entitled the Status of Customer Relationship.

The reporting organization's relationship with its customers is used as a surrogate for how well the organization has chosen its environment(s) given its resources, and how well it is faring, and is evidence as to how well it will probably perform in the future. The reporting organization's relationship with its customers is communicated in the SCR statement.

The enterprise's claimed customer cohort should be in harmony with the enterprise's mission, vision and values. Vision is usually the mental image of an individual who envi-

sions a potential state of the external environment in which the organization can have a fruitful future. Mission is an expression of the organization's unique purpose that brings to life the vision. Values are a preference-ordered set of norms that an individual, group or society uses as standards to evaluate the behavior of a person, an organized collection of people and the assemblage of people at large. The organization's typical customer and the cohort in general should reflect the organization's vision, mission and values. The customer is the manifestation of its purpose of being. The questions that are used to survey the customers should exemplify the organization's vision, mission and values. Thus, if the customer cohort, when surveyed, reports that it is generally unsatisfied, it could be that the enterprise either has pursued the wrong customers or it has not been successful in fulfilling its mission, vision and values. In either event, a poor showing foretells trouble for the enterprise; conversely, a good report indicates a salutary future.

It is patent that a strong customer relationship for an enterprise is a major if not the major critical success factor. A strong relationship is an indicator of customer loyalty that gets transmitted, partially, through word of mouth. A good example of a strong customer relationship would be Apple; its products have become more than just cell phones; they have become 'cultural' artifacts that individuals acquire to be in fashion – they are a signal. Conversely, unhappy customers tend to express their dissatisfaction openly, setting in motion a deterioration of the enterprise's future prospects; an example of a weakening customer relationship is the Blackberry.

The selection of the desired customer coupled with the products/services that the enterprise produces taken together with the internal structure and resources is a materialization of the entity's decision process. The SCR and the income statement report on how well the decision process is achieving its joint purpose of value proposition creation and the generation of sufficient profits.

The SCR is a real-time report that indubitably anticipates a significant part of the enterprise's future. It is a forward-looking document that is based on actual enterprise data.

The SCR is made up of two parts: internal and external. The internal reports on the number of customers, the change in the number from the prior period, the mean, median and mode, and the standard deviation of the distribution of the size of sales; the external reports on the level of customer satisfaction as measured through a scientifically based survey. The survey would be undertaken by the entity's external auditors. During the period that is being reported on by the financial statements, similar to the standard confirmation process undertaken during the course of an audit, the auditor sends a questionnaire to a randomly selected group of the organization's customers with the reply sent directly to the audit firm. Given that the SCR is verifiable, the auditor would be able to issue an opinion regarding the SCR. The opinion would mimic the current audit opinion in that it would state that the SCR 'fairly presents ...' and is in 'accordance with generally accepted survey methods'.

An organization's strategy and tactics should operationalize its mission. The survey should focus on those central aspects of the organization's strategy regarding its customers, for example price, innovation, quality, service, timeliness and functionality. The choice of aspects also signals to the financial statement users what management deems to be important to carry out its purpose. Thus, the survey should present an idiosyncratic image of the organization's business model. Overall, the SCR becomes the unique context in which the traditional financial statements can be more clearly read and understood.

The external part of the SCR does not have to be conventionalized; it should be reflective of the enterprise's unique nature and it should have a clarity and completeness that conveys the critical characteristics of the entity's value proposition that management deems to be essential to its future success with its cus-



tomers, for example on-time delivery, durability of product and style. As shown above, context does not have to be wordy; in the world of financial statements it has to have the capacity to transport the user into the organization's decision-making framework vis-à-vis its customers. This can be achieved through a description of the growth, size and distributional attributes of its customer cohort, as well as through direct consumer survey responses to the selected attribute. In essence, the SCR is a portrait of the enterprise's customer population and, as such, it should be individualistic, in contrast to the financial statements, which are uniform.

Both the internal and external parts of the SCR are verifiable at the same of attestation as the financial statements.

The Adjoined Accounting Model includes the additional report: The Status of Customer Relationship statement alongside the traditional financial statements.

In support of adding the SCR to the reporting scheme, Kaplan and Norton (2004, p. 105) offer the following important insight:

The new economy has heightened the importance of customer relationships. Whereas innovation and operation management processes remain important for strategic success, the evolution of computer and communications technology, particularly the Internet and database software, has shifted the balance of power from producers to customers. Customers now launch transactions. They lead rather than reacting to marketing or sales calls.

They go on:

Customer purchases, recorded at point-of-sales terminals at Wal-Mart, trigger production runs at vendor locations.

They conclude:

Customer management processes must help the company acquire, sustain, and grow long-term, profitable relationships with

targeted customers. (Kaplan and Norton, 2004, p. 107; italics in the original)

The important notion that has to be appreciated is that the economy has shifted from one where the producer had a dominant role to one where the customer holds sway. This change can be seen by the shift from caveat emptor (buyer beware) to caveat venditor (seller beware) in the world of jurisprudence.

Drucker (1974, p. 84) makes the important contribution:

The customer never buys a product. By definition the customer buys the satisfaction of a want. He buys value. Yet the manufacturer, by definition, cannot produce value. He can only make and sell a product. What the manufacturer considers quality may, therefore, be irrelevant and nothing but waste and useless expense.

He goes on to state that (Drucker, 1974, p. 91):

Finally, management has to ask which of the consumer's wants are not adequately satisfied by the products or services offered him today. The ability to ask this question and to answer it correctly usually makes the difference between a growth company and one that depends for its development on the rising tide of the economy or the industry. But whoever contents himself to rise with the tide will also fall with it.

Paraphrasing the advice 'Deep Throat' gave Woodward and Bernstein in the Watergate saga, the financial statement user should 'follow the customer'.

NOTES

- 1 Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities and Exchange Commission, 17 CFR Parts 211, 231 and 241 [Release Nos. 33-8350; 34-48960; FR-72].

- 2 http://www.aicpa.org/Research/Study-sandPapers/DownloadableDocuments/AICPA_ASEC_Whitepaper_Final_20082008April_2008.pdf.

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