

A Free-Market Perspective for the Preparers and Users of Financial Accounting Information Today

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Abstract

This paper explores both academic and professional literature, published over the past few decades, addressing the proliferation of accounting standards and the imposition and increasing burden that has been placed upon the preparers of financial reporting information. The 'pro' argument for increased reporting regulation and disclosure has been the protection of stakeholders; however, recent experiences suggest that this approach has not been entirely successful. A significant number of unexpected corporate collapses have continued to occur. The suggestion is made that, in addition to improved corporate governance and regulation, the interests of stakeholders may be better served through efforts to promote a culture of ethical conduct within the wider business community.

Introduction

Since the late 1960s there has been a considerable amount of literature devoted to the informational needs of the users of financial statements. Over the same time period there has been significant growth in the disclosure requirements of accounting standards. This review takes a free-market perspective and will examine the literature in the context of contemporary accounting theory and practice.

The early work of Ball and Brown (1968) and Beaver (1968) established the relationship between accounting numbers and price responses from securities market trading. The 'information perspective' examined empirical evidence that accounting numbers matter to capital markets. Traditional Positive Accounting Theory (PAT) developed primarily by Watts and Zimmerman (1986) seeks to explain the behaviour of firm managers when faced with the economic consequences of their accounting policy choices. The PAT perspective on owner-manager firm relationships, therefore, has contributed significantly with an explanation of management motivations in the accounting regulatory environment.

An excellent quote from Adam Smith's (1776) *The Wealth of Nations* was presented by Jensen and Meckling (1976) in support of their precursor agency theory work. It addresses the problem of the gap between firm level ownership and management:

The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery [sic] frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company (p. 700).

Jensen and Meckling (1976) identify ten key firm relationships which agency theory helps to explain. Three of these are directly relevant to the current free-market perspective of evaluating accounting regulation and are presented here for your information:

Our theory helps to explain:

- (6) *Why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports;*
- (7) *Why lenders often place restrictions on the activities of firms to whom they lend, and why firms would themselves be led to suggest the imposition of such restrictions...*
- (9) *Why highly regulated industries such as public utilities or banks will have higher debt equity ratios for equivalent levels of risk than the average non-regulated firm (p. 306).*

The relationship in (6) identifies that preparers of accounting information will consider self-regulation if faced with pressure from stakeholders that provide internal and external financing to the business operations. It also proposes that managers will extend this self-regulation to voluntary engagement of external auditors who can attest to the accuracy and validity of the accounting preparation process. The considerable power that external financiers have upon firm managers is explored in (7) where the authors consider the self-regulation of debt covenants in agreements with external lenders. In (9) the authors consider that some industries are highly regulated and that these industries will have a higher debt to equity ratio than non-regulated firms with the same risk. All of these firm relationships have a high degree of explanatory power for why accounting regulators place importance on control and regulation.

This paper comprises five sections. Following this introduction is a brief summary of the changing perception of published financial report users. This is followed by a discussion of the changes in reporting and disclosure obligations and comment on the added benefit to the users of that information. This is followed by a section which reviews some recent opinion on the importance of corporate governance and ethics within business. The paper concludes with a summary of the main points.

Financial Accounting Information Stakeholders

Exactly who uses financial accounting information is at times difficult to define and has tended to change over time. In the early 1960s the common view was that the primary users of accounting information were business managers and the main functions of accounting were to provide historical information and prevent fraud. There was reference to external users but the needs of these users were considered secondary to those of the business manager (Fraser & Bell, in Fraser & Nobes, 1985).

By the 1970s this view of the stakeholder had changed to a more forward-looking perspective and there was increased recognition of external users. An American Institute of Chartered Public Accountants (AICPA) study released in 1973 entitled *The Accounting Scene* (Anonymous, 1973) suggested that financial statements should serve the needs of users, specifically the 'general investing public' (p. 44). Regazzi (1974) quoted from the same report (Report of the Study Group on the Objectives of Financial Statements) that:

No valid users' needs should be ignored. Information that can be understood, and is needed, by sophisticated users should not be diluted to eliminate what less sophisticated users cannot understand. Instead, it should be ordered and arrayed to serve a broad range of users. Nor should accounting information be limited only to the interest of the average investor.

Even at this early stage, there was no indication of any recognition of the different sizes and types of entities and differing abilities to prepare increasingly complex statements. As one writer suggested, the profession in the United States (US) had tended towards producing reports which were 'useful only to the most sophisticated readers' (DuPree, 1985). The new Australian Accounting Standards Board (AASB) *Framework for the Preparation and Presentation of Financial Statements*, implemented to aid the Financial Reporting Council's transition of new International Accounting Standards, has the following to say about the complexity of financial reports:

An essential quality of the information provided in financial reports is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial report, because of its relevance to the economic decision-making needs of users, should not be excluded merely on the grounds that it may be too difficult for certain users to understand (para. 25).

Over a period of some 20 years opinion changed from the early 1960s view of financial reports being a 'scorecard' for management to a more forward-looking document. The US-based AICPA Study Group on the Objectives of Financial Statements stated: 'The basic objective of financial statements is to provide information useful for making economic decisions' (quoted by Benis, 1978: 34). The same study group recognised the varying 'power' of different users, also stating that an objective of financial statements was 'to serve primarily those users who have limited authority, ability or

resources to obtain information and who rely on financial statements as their principal source of information...' (quoted by Benis, 1978: 34).

Other recognised users of financial statements by this time included 'stockholders, creditors, potential stockholders and creditors and others outside an enterprise' (Financial Accounting Standards Board, quoted by Benis, 1978: 34); 'banks and credit grantors and credit rating agencies'; and 'individuals, pension funds, mutual funds, insurance companies, bank trust departments, labour unions and others' (Benis, 1978: 34). Benis recognised the impact that the growth of generally accepted accounting principles and reporting standards had on 'small and/or closely held business enterprises' (p. 34) and, in particular, the fact that those entities did not possess the technical expertise to implement the new requirements.

From the above historical overview, the reader should perceive the urgency with which regulators have sought to broaden the responsibility of management to various stakeholders of reported financial information. It would be reasonable to assume that the aims of regulation were to protect stakeholders from the effects of significant corporate failure (Clarke, Dean & Oliver, 2003), although the frequency of recent corporate collapses would cause us to question whether this has in fact been the end result of the process. Should we question the efficacy of a burgeoning regulatory environment that has not protected tens of billions of dollars of investor funds in the past two decades alone?

The Growth of Reporting Obligations

The 1980s saw considerable discussion regarding the difficulties being faced within both the accounting profession and also in commerce as a result of the growth of accounting standards, particularly in the US where there was regular discussion of 'standards overload' and possible remedies. Even at that stage, there was a concern in the US that standard setters were reacting more to the requirements of the large corporations and thereby imposing an unnecessary burden on smaller entities and their external accountants.

A study in 1983 (Nair & Rittenberg) investigated the issue of standards overload by way of a questionnaire sent to experienced CPAs from both large and small firms, senior executives of privately held businesses and bankers who made loans to small and private businesses. The results of the survey were quite interesting in that both business people and CPAs believed the main reason for businesses using audit, review or compliance services was for bank loan and credit arrangements, rather than to provide assurances to shareholders. The article recommended, amongst other things, the Financial Accounting Standards Board (FASB) should look at simplification of rules and suggested the trend towards increased complexity may be creating a situation where the costs outweighed the benefits. The researchers also found that there was widespread belief that small businesses paid a relatively higher cost for compliance with General Accepted Accounting Principles (GAAP). All three groups in the survey strongly agreed that accounting costs were disproportionately higher for small businesses. This view was also supported by a Financial Accounting Standards Board (FASB) research report quoted in the *Journal of Accountancy*, which suggested that: '...bankers and practitioners agree that the cost of

providing financial information to external users is relatively higher for a small company than a large company...' (Larson & Kelley, 1984: 82).

There is little value in a business preparing technically correct financial reports which comply with the letter of the law if the preparers are more focussed on legal compliance than they are on the major business considerations. The reports may, in fact, be excellent in technical terms but the recipients of them may not be pleased with the story they tell.

A report issued by the American Institute of CPAs in 1983 included the following recommendations:

To the extent that simplicity and flexibility [in new and existing standards] are not feasible, the FASB should explicitly and specifically consider the information needs of the users of the financial statements of small non-public entities and the costs and benefits of developing the information with the objective of providing, within the framework of a unified set of generally accepted accounting principles, differential disclosure principles... (Larson & Kelley, 1984: 78).

Research by the FASB indicated that many bankers share 'a notable misconception... the equating of GAAP financials with audited financial statements' (Larson & Kelley, 1984: 79). Friedlob and Plewa (1984) suggested that while accountants place importance on standards, many of the users place more importance on the reliability that an auditor adds to the statements. This is, of course, not to downplay the importance of GAAP and standards generally but rather to suggest that other factors may have an equal weighting in terms of the usefulness of financial statements to the users.

An article by Jan McCahey (1989) of the Australian Accounting Research Foundation refers to studies which provided some but not conclusive evidence that accounting standards overload existed in Australia at that time. McCahey also referred to the fact that financial reporting requirements were being increasingly specified at law which, together with what she referred to as 'institutional arrangements covering financial reporting...' (McCahey, 1989: 85), would compound standards overload if it in fact existed in Australia.

Similar problems and solutions have been reported in New Zealand (Callaway, 1994; Campbell & Rainsbury, 1995) and in the United Kingdom (UK) (Anonymous, 1995a: 37). There was further discussion of underlying concepts in the 1990s and the notion of professional judgement began to be more recognised. For example, an article by Schwartz (1991) referred to the use of an underlying conceptual framework when the accountant is making decisions as to the treatment of an item. There was also some differentiation between what the accounting standards required in terms of the treatment of transactions and how this was reported in the subsequent financial statements (Anonymous, 1995b: 100). There appeared to have been recognition in the US at least that standards only caused part of the additional workload as greater disclosures could also be quite onerous, particularly for the small preparer (Anonymous, 1995c: 9).

Dissenting opinions notwithstanding, it appears reasonable to accept that the existence of standards overload was a problem, particularly in the small business sector in

the US. What were the more specific consequences of this very broad problem? The first and most commonly cited was the increasing cost of compliance. This would be of concern to any entity; however, the impact is greater in the small business sector which bears a disproportionately higher burden than very large businesses. In the view of some writers, not only was the burden higher on smaller firms, it was a cost which was not relevant to that business. As Lowe (1987: 57) expressed: 'The more complex GAAP requirements are not relevant to small private companies and their financial statement users. Any cost of irrelevant information is excessive'.

While most comments appeared in the US, it was by no means exclusive to that country. A 1987 article, concerned mainly with UK standard setting, made the observation that the long-term outlook for small companies could be quite bleak given the overbearing nature and complexity in development of new accounting standards (Hopwood & Page, 1987).

A further concern is the possibility that the greater burden being placed on smaller practitioners may bring about non-compliance: 'A potential consequence of the growing burden on small CPA firms is the insidious creep of non-compliance with GAAP standards. This has serious implications for legal liability, erosion of professional ethics, loss of public support and dissonance within the accounting profession' (Mosso, in Nair & Rittenberg, 1983: 92). Mosso also suggested that an increase in the number and complexity of standards was seen as a major contributor to time pressure in small CPA firms and a possible cause of 'substantial diversity in practice' (Mosso, in Lowe, 1987: 59). In the same article, Lowe quotes from a report by the AICPA's Special Committee on Accounting Standards Overload which stated: '...the evidence indicates the silent disregard of standards and abandonment of GAAP are clear and present dangers' (Lowe, 1987: 59).

A recent article by Russell Craig entitled 'A Case of Accounting Overkill' makes some interesting observations about the growth of reporting requirements in the public sector, starting with the comment: 'Our disciplinary mantra invites belief that we exist to provide financial information to help users make informed decisions' (Craig, 2002: 46). The subject of Craig's article is the annual accounts of a very small government agency with a turnover of AUD\$700,000 and a staff of four. To comply with the requirements of the *Financial Management Accountability Act*, the annual financial statements of this agency comprise 23 pages of a 73 page annual report and are, in Craig's words, 'unedifying' (p. 46).

A Canadian article, while generally very positive about new employee benefits-related disclosures, expressed concern about the growth of disclosure overload (Estey, 2004). Other specific concerns expressed included considerable compliance costs, limited value in some of the proposed disclosures and some which 'could even be confusing in some situations' (Estey, 2004: 52). While deliberating the proposed additional disclosures, a member of the Canadian Accounting Standards Board had asked, 'What do we really need?' (Estey, 2004: 52). Possibly this question should be asked more often and of the wider group of users of financial information.

The continual development and enhancement of standards, reporting and disclosures is intended to have many benefits for the various stakeholders in these entities as well as for the entities themselves. These are said to include better information for decision-making, comparability across entities and countries, better access to financial markets and greater transparency. Since the most recent series of financial disasters there has been increased significance placed on corporate governance by directors and managers. The increased levels of regulation have not always been given the force of law by direct legislation. In Australia, the Australian Stock Exchange Corporate Governance Council developed ten key principles which are obligatory for public companies under the Australian Stock Exchange (ASX) listing rules. In addition the Corporate Law Economic Reform Program (CLERP) 9 was used to amend company law addressing issues related to auditor independence. In the US, the *Sarbanes-Oxley Act* was very quickly promulgated by legislators to protect company stakeholders. In Australia the reaction was more focussed on corporate governance with the formation of a corporate governance council by the ASX as well as the amendments to the corporations' law enacted in the CLERP 9 legislation.

What Do Users Really Need?

From this brief review of the literature, there appears to be an on-going concern in the US, at least, that there is a problem with an overload of accounting standards and reporting requirements. There have been committees and task forces looking into this since at least the mid-1980s but the concerns still appear to exist. Further, the compliance burden seems to have a disproportionately greater impact on businesses which are considered 'small' (at least by American standards). At the same time, however, the supposed benefits for the stakeholders are not being realised, at least in terms of protecting their financial interests.

If the growth of financial reporting requirements is still not meeting the needs of users and, in particular, not protecting against unexpected failures, it is probably reasonable to suggest another underlying problem. The early years of this decade provided clear evidence of some managers' ability to avoid 'inconvenient' rules where a quick profit was to be made. The situation in the US at the time was well summed up in the following comment made by a US Fund Manager, Jim Cramer:

We have a corporate governance problem in this country. We are in a period where there are two tiers of people; those who obey the law and those who don't (Clarke, 2004: 161).

The collapse of Enron, WorldCom and Global Crossing in the US all demonstrated the extent to which the safeguards for stakeholder may be circumvented by a management which has scant regard for what might be considered ethical conduct (Berenbeim, 2002; Greer & Tonge, 2006). Corporate collapse was not restricted to the US, with HIH, One.Tel and Harris Scarfe providing ample evidence that an Australian corporation can fail in the same fashion as an American one.

A number of common factors frequently exist in relation to many of these high profile collapses. In the Australian cases just mentioned, these include 'inappropriate

management compensation, creative accounting, failure of directors to exercise due diligence, lack of adequate regulation and lack of independence in the audit function' (Leung & Cooper, 2003: 506). Other 'key factors' cited as the causes of unexpected corporate failures are fraud, greed and a lack of corporate governance and ethical failures...' (Mak, Deo & Cooper, 2005: 111).

With the possible exception of 'lack of adequate regulation' (Mak *et al.*, 2005: 111), no amount of accounting standards and disclosure requirements will protect the stakeholders from a combination of the other factors mentioned above. With particular reference to the HIH collapse, Westfield (2003: 24) writes: 'The executives involved knew what they were doing was wrong, yet they did it. No system of regulation can rule against behaviour like this'. This is by no means a solitary opinion as another Australian article in 2002 shows: 'You cannot legislate against a breakdown in corporate governance, poor management or greed' (Larson, 2002: 12). Presumably, if legislation is insufficient, accounting standards and disclosure requirements are not likely to be any more effective.

If rules and standards do not protect the stakeholder, one may ask 'What will?' The answer may lie in the more recent attempts, both through legislation and other regulation, to bolster corporate governance, although as one writer has pointed out: 'detailed black letter law, or rules, are often only a road map for the unscrupulous, as was demonstrated in the Enron off-balance sheet transactions' (Bosch, in Leung & Cooper, 2003: 512). Some writers suggest that the principles-based approach adopted in Australia and the UK is more likely to prove successful than the US legislative regime (Groom, in Bruce, 2002; Leung & Cooper, 2003).

Clearly the common threads in these unexpected corporate collapses is the human element; deliberate actions taken to gain an illicit advantage for the individual with no regard for the negative affect this may have on the various stakeholders in the corporation. A number of contemporary writers refer to the importance of the human and cultural dimensions to an organisation, citing undesirable characteristics and behaviours such as declines in corporate morality, people thinking of themselves first and others second (Charles & Murphy, 2002), an 'unethical corporate culture' (Mak *et al.*, 2005: 111), opportunistic behaviour by directors and managers, declining ethical standards and the new religion of materialism (Leung & Cooper, 2003).

Unlike ethics, corporate governance may more readily be defined or at least described in terms of rights and responsibilities or codes of practice which are said to constitute 'good' corporate governance (Shailer, 2004; Greer & Tonge, 2006). However, as seen with the collapses discussed, any system of corporate governance can be ignored, avoided or waived by a management lacking in the necessary ethical or moral standards to honour their obligations to the stakeholders. Perhaps an answer may lie in the development of a culture of ethical conduct within the business community as some writers are now starting to suggest.

A recent European paper suggests that for companies to evolve into ethical entities, action is required both at the individual level and collectively to eliminate practices which are unethical (Wood *et al.*, 2004). As information systems researchers have found in the past, change within a company needs a senior sponsor or champion and cultural change

would be no exception. This must mean action by the most senior management to ensure codes of ethics are created and made part of the culture of the company. The absence of a code of ethics could be taken by potential investors and other stakeholders as one indicator that they may be facing a higher risk in their dealings with that company.

While most of this discussion has centred on the needs of the users of financial reports, they are not necessarily the only losers in the large scale corporate collapses referred to above. A further negative outcome of these corporate collapses was the effect on the reputation of the accounting profession and on auditors in particular, as details of Arthur Andersen's conduct (amongst others) became apparent. Conceivably, a greater focus on ethics may, over time, help to avoid the situation of the '...auditor caught in the middle and hapless' (Greer & Tonge, 2006: 264). For a profession which relies on a reputation for honesty and objectivity these situations do substantial harm which takes considerable effort to overcome. Further, as the American legislators have shown, if the accounting profession cannot meet society's needs and expectations of its own volition, governments will attempt to ensure this through legislative controls.

The Way Forward

What can be drawn from this discussion? The burden of regulatory and related compliance has grown and continues to grow. This burden appears to be particularly onerous on smaller entities and their external accountants and this burden is certainly consuming resources which could be better utilised improving business operations. Clearly, the increased number of corporate collapses has led to the burgeoning regulation of financial reporting in Australia and world-wide but, despite this, large corporations continue to collapse unexpectedly causing substantial loss to investors and other stakeholders. In the aftermath of the high-profile collapses in the early part of the decade, it is not clear whether the information needs of users of general purpose financial reports are being met. It could be argued that no amount of regulation will protect investors and other stakeholders from unethical or dishonest management and substantial proof of this lies in the market capitalisation lost with these recent corporate collapses.

Within the growing paradox of over-regulation and increasing significant corporate collapses, investors and other stakeholders can gain some solace in the belief that the promotion of corporate governance and ethics will create an alternative culture within organisations otherwise focussed on the bottom-line. As with any cultural change, the development of corporate governance and ethics which actively discourage unethical or dishonest conduct is a substantial and long-term undertaking. It is a change which is required if corporations are to maintain the necessary relationship with the societies in which they operate.

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