Accounting theory and practice flashcard

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1. Introduction

Recent years have saw that listed firms, especially the large organisations, voluntarily disclose their Social and Environmental issues in their annual reports. As a result, a question was come up with by researchers: why managers would choose to undertake the voluntary activities?

Although there is no consensus being reached about what perspective theories should be used to explain the Social and Environmental Accounting, and moreover critique voices are from the works of Marx or by the deep-green or feminist literatures (Deegan, 2002), to some extent, systems-oriented theory and Positive Accounting Theory can list some hints.

This essay will seek to explain the reasons why firms voluntary disclosure information by referring to Legitimacy theory, Stakeholder theory, institutional theory, and lastly Political Costs hypothesis respectively.

2. Legitimacy theory

As asserted by legitimacy theory, organisations are pursuing for activities that are within " the norms and bounds of their respective societies" (Deegan & Unerman, 2006, P. 217). However, these norms and bounds are changing all the time and this requires firms keep pace with the moral environment in which they operate. Some researches indicated that the public disclosure of social and environmental information, such as through annual reports, is for legitimising purpose.

2. 1 Legitimacy, Public Expectation and the Social Contract

Legitimacy theory relies on the notion that there is a “ social contract” between organisation and the society in which it operates. (Deegan & Unerman, 2006, P. 217) The social contract is not easy to define but it implies some expectations that the public has on the organisations. Traditionally, profit maximising is considered to be the optimal measure of corporation performance, however, in recent decades, the public expectation has gone through significant changes. Heard and Bolce (1981) note the expansion of the advocacy movement in the United States during the 1960s and 1970s, and the significant increase in legislation related to social issues, including the environment and employee’s health and safety, which are enacted in the United States within the same period.

Consistent with Heard and Bolce, another argument states that the public increasingly expect the business to “… make outlays to repair or prevent damage to the physical environment, to ensure the health and safety of consumers, employees, and those who reside in the communities where products are manufactured and wastes are dumped…”(Tinker and Neimark, 1987, P. 84)

Legitimacy theory highlights that organisation must pay attention to the rights of the public at large, not only of those of the investors. And the organisation can continue operation only if it meets the generally accepted social expectations. “ Failure to comply with societal expectation may lead to sanctions being imposed by society.”(Deegan & Unerman, 2006, P. 272) for example, legal restriction on organisation’s operation, difficult to obtain necessary resources (financial capital and labour), and/or decreasing in demand for products (for example, consumer boycotts).

2. 2 Legitimacy and changing social expectations

As community expectations change, organisations should also voluntarily disclosure information about what is changing (or explain why their operations have no changes). According to Lindblom (1994, P. 3) with respect of changing expectations: “ Legitimacy is dynamic in that the relevant publics continuously evaluate corporate output, methods, and goals against an ever evolving expectation.”

While Dowling and Pfeffer came up with strategy of ‘ communication” to legitimate organisations’ activities, Lindblom (1994) identified four actions that organisations can use to obtain or maintain their legitimacy. All these methods need firms to disclosure information that the public most expect to know, and through this way firms can show the society their efforts to change.

2. 3 Legitimacy and Reputation Risk Management

A good reputation, to a company, is very important, as it can generate profit in the future.

“ The reputation risk management perspective on voluntary social and environmental disclosures in annual reports assumes that threats to corporate legitimacy can result in damage to the value of a company’s reputation, and such risks to reputation need to be minimized through active management.” (Deegan & Unerman, 2006)

As said by Jonathan Symonds, the Chief Financial Officer of AstraZeneca’s Risk Advisory Group, Failure to deliver our core value could seriously impact

out reputation. While the core value is something like social responsibility, environmental policy, and so on, it is those that company should communicate with the public to protect their reputation as legitimate.

For example, after the Brent Spar oil rig dumping, Royal Dutch/Shell voluntarily prepared reports about its people and profits in order to repair its image for its failure to deal with the execution by the Nigerian government of an anti-Shell activist (Livesey & Kearins, 2002).

3. Stakeholder theory

As both legitimacy theory and stakeholder theory belong to “ political economy theory”, they have some overlaps (Gray, Kouhy, and Lavers, 1995). However, compared with legitimacy theory, which mainly discusses the social expectation, stakeholder theory presents a closer view with particular groups in society. That is, legitimacy theory concern about the society as a whole, while the stakeholder theory merely discuss particular groups. There are two branches using to explain why firms voluntarily disclosure information.

3. 1 The Ethical Branch of Stakeholder Theory

Under this normative perspective, all stakeholders have the rights to be treated fairly by the organisations. That is, as Hasnas (1998, P. 32) said “ firms are not a mechanism for increasing the stockholders’ financial returns, but as a vehicle for coordinating stakeholder interests”.

The broader ethical perspective states that all stakeholders have a right to be informed of the information by the firms about how they are affecting

them. With respect of “ right to information”, “ accountability model” was come up with by Gray, Owen and Adam (1996). As it means by accountability model, reporting should be “ responsibility” driven rather than “ demand” driven (1996. P. 38). Using the accountability model to explain corporate social reporting, Gray, Owen and Maunders (1991, p. 15) argue that:

“…the role of corporate social reporting is to provide society-at-large (the principle) with information about the extent to which the organisation has met the responsibilities imposed upon it”.

That is, the social reporting is to inform the society about how well the firms have fulfilled the responsibilities.

3. 2 The Managerial Branch of Stakeholder Theory

The managerial perspective of stakeholder theory tends to be more “ organisation-centred” (Gray, Owen and Adams, 1996). That is, the organisations will pay more attention to the powerful stakeholders, for example, the owners, creditors or regulators (Ullman 1985), who have a significant influence on the organisations’ successfully operation. As Roberts (1992, P. 598) states:

“ A major role of corporate management is to assess the importance of meeting stakeholder demands in order to achieve the strategic objectives of the firm. As the level of stakeholder power increases, the importance of meeting stakeholder demands increases also.”

As indicated above, form the managerial perspective, the public activities taken by organisations including the voluntary disclosure social and environmental information are to gain the stakeholders' supports and approval, or even more, to distract their opposition and disapproval (Gray et al., 1996, P. 46)

4. Institutional Theory

Compared with legitimacy and stakeholder theories, institutional theory provides a complementary rather than competing perspective in explaining the voluntary corporate reporting practices. It encompasses two dimensions: isomorphism and decoupling.

4. 1 Isomorphism

Isomorphism refers to the adaptation of an institutional practice by an organisation (Dillard, Rigsby and Goodman, 2004, P. 509). DiMaggio and Powell (1983) came up with three different isomorphic processes: coercive, mimetic and normative isomorphism.

Coercive isomorphism is similar to the managerial branch of stakeholder theory. It concerns that the organisations' voluntary reporting including economic, social, environmental and ethical issues is to satisfy the expectations and demands of powerful stakeholders.

Mimetic isomorphism states that " organisations emulate or improve on the institutional practices of other organisations often for reasons of competitive advantage in terms of legitimacy". (Deegan & Unerman, 2006, P. 297) It links to coercive isomorphism, as Unerman and Bennett (2004) said that

without coercive pressure from stakeholders, organisations would unlikely to mimic the social reporting practices of other companies.

Normative isomorphism relates to “ the pressures arising from group norms to adopt particular institutional practices” (DiMaggio & Powell, 1983). As to voluntary information disclosure, the pressure could arise through less formal group influences from a range of both formal and informal groups to which managers belong.

4. 2 Decoupling

Decoupling implies that what the voluntary social reporting shows to the public can be very different from what the organisations actually do. In other words, the social reporting practices might only “ one of the social and environmental responsibilities while the actual managerial imperative is maximisation of profitability or shareholder value” (Deegan & Unerman, 2006, P. 298). As Dillard, Rigsby and Goodman (2004, P. 510) said:

“ In essence, institutionalised, rationalised elements are incorporated into the organisation’s formal management systems because they maintain appearances and thus confer legitimacy whether or not they directly facilitate economic efficiency.”

5. Political Cost Hypothesis

High corporate profitability may potentially trigger political cost for a firm. This happens when representatives of interest groups use the profit as a justification for particular actions. Especially for the large organisations, they are under more social pressure. As Watts and Zimmerman (1978, P. 115)

state that " by avoiding the attention that high profits draw because of monopoly rents, management can reduce the likelihood of adverse political actions and, thereby, reduce its expected costs".

For example, the high profits of banks in the UK are linked to excessive levels of consumer debt, which lead to negative social effects, what is worse, the employees complain about their status quo because of no rising wage. All these factors push greater regulation or higher tax for banks.

In consistent with banks' situation, Ness and Mirza (1991) states that compared with companies in other industries, oil companies provide greater proportion of environmental disclosure in their annual report, because they have more potentially adverse wealth transfers at stake.

By showing the social and environmental engagement in the annual report can thus reduce political attention and eventually avoid the political costs.

6. Conclusion

This essay has examined the voluntary social disclosures from two broad aspects: Systems-oriented theory and Positive Accounting Theory. In sum, firms, especially large listed firms, voluntary disclosure information is for their managerial purposes, either to meet the social expectation and in line with the norms (legitimacy theory), or to respond to their powerful stakeholders' demand (stakeholder theory), or to institutionalise social and cultural values (institutional theory), or to avoid potential political expenses (Political Cost Hypothesis). Although these theories may somehow overlap, they also complement each other.