Business entities and the environment: the role of financial communication

Prof. Pierre Di Toro
Director of Department in
Business, Statistical & Technological Studies
University Full Professor in
Corporate Governance and Business Ethics

Dr. Alessandra Stefanoni
Researcher in Business Administration

1. Business entities–environment interactions and related financial communication issues.

During the last decades, profound changes in the environment where the firm operates (market globalization, technological progress, increase in consumer needs and in the number of stakeholders) have enhanced the role of communication and the importance of fair relations between each “business entity” and its global/local area.

Development of any business organization depends on its interaction with the external environment; therefore, the study of any business entity cannot ignore the interdependencies between an organization and the society.

To survive, an enterprise has to cope with and react to the changes of its environmental context; therefore, it needs enough information to take timely decisions and adopt appropriate behaviours.

Business organizations also need to spread information about their activities, financial conditions, and decisions to gain credibility and stakeholders' confidence.

Widespread, exhaustive information is, therefore, a necessary condition for building a long-lasting relationship between a firm and its interlocutors.

As a matter of fact, in national and international economic debates, the firm is often conceived as a relational system, a social network.

Business organizations develop multiple information flows to communicate with the “players” acting in the social environment.
The internationalization of business and of financial and trade markets has intensified global relations and economic exchanges and enormously enlarged competitive spaces. Communicational exchanges among economic operators have also increased: as a result, there is now a clear need for business people to use even the same accounting language.
The aim of this paper is to analize the pros and cons of a «global» financial communication system *based on shared accounting standards* as a key tool for building effective relationships between the firm and its wider business environment (market, technological, financial, social and cultural context).

2. The relations between a “business entity” and its environmental context: an Italian historical perspective

The Italian Business Administration tradition is rich in scholar contributions trying to define the concept of business entity (“azienda”) emphasizing its relations with its social/cultural/technological environment.
According to Fabio Besta (1845-1922), who is considered one of the master of Italian Accounting tradition, a business entity is a “sum of phenomena, of business activities and *relationships* which are managed on the basis of an amount of capital”.
Clearly, it is remarkable that - at the dawn of XX century - a scholar considered business relationships as a significant feature to be unitarily managed and interpreted.
In Amaduzzi’s view (1904-1991) the “azienda” is “a system of economic forces developing a consumption or production process in the *environment to which the firm belongs* (...)”: the business entity is *complementary to its environment.*
This approach is strengthened by Ceccherelli (1885-1958) who believes that a business organization is “the elementary natural organism of the economic society” deriving its life from a wider organism: the environmental context. The interaction with the *environment is a vital factor* for the business unit survival and development.

Riparbelli (1907-1971) has a similar view: his analysis focuses on interdependencies and correlations between a single business entity and the other actors in the same environment. He maintains that companies are “autonomous organisms which do not live isolated from their environment”. The firm is not an independent entity but an economic unit living and operating in their environment.

Also Giannessi (1908-1982) conceives a business organization (“azienda”) as an entity located in a specific “milieu” affecting it: its behaviour depends on both internal and external “sources”. Indeed, he states that the enterprise is "a system […], combining special factors and *composing internal and external forces”*.

Ponzanelli’s definition (1910-1984) of the enterprise relies on the metaphor of a “living organism” that on one hand, like natural organisms (humans, animals and plants), has organs working harmonically and cooperatively to assure its survival and, on the other hand, *is an organ of the wider social environment.* The similarity between corporations and “living organisms” emphasizes the fact that a business entity and the environment are strongly tied: they interact and affect each other generating inflows and outflows of qualitative and quantitative nature.

Therefore, every firm influences a socio-economic environment and is influenced by the same context.

Thus, the continuous and complex interactions with the context stimulate a bidirectional transformation process which affects the firm and the environment (Normann, 2002). This process is characterised not only by the transfer of goods or money, but also by an exchange of values and meanings, in other words, by a cultural exchange.

Every enterprise is a separate, autonomous and unique entity. However, it is also an actor in the socio-economic system and it plays a very specific role in the territory where it works (Catturi, 2003).

As stressed by the literature review, the change generated by continuous and complex interactions with the environment is essential to the development of the “business entity”.

In nowaday’s ever-changing context, which requires fast responses, adaptiveness is a necessary condition for business development: if a business entity wants to survive, it must be able to forecast changes and timely react to them (Ferraris Franceschi,1995).

In such a frame, economic and financial communication plays a significant role: it enables companies to successfully manage the relationships with their macro-environment.

3. The financial communication process between a business organization and its environment

A company's ability to communicate and disseminate clear and reliable information plays a paramount role for the development of profitable commercial relationships and for savers' and institutional investors' trust: it enhances the business organisation ability to rase financial means necessary for its further development. As a matter of fact, financial markets reward companies that guarantee transparent information, which makes them trustworthy for investors.
The transformation of the economic community and its orientation towards the creation of an integrated, competitive market creates an urgent need for a common language: this language may be based on a set of shared accounting "rules", representing an essential requirement for clear business reporting and transparent circulation of comparable data.

Every business organization generates multiple information signals that are disseminated in the economic environment and that create a communication process with other "organisms" living in the same context. Thus, a business organisation is able to communicate with other entities by using a shared code of symbols constituting a common language.
Accounting data may represent a significant tool of communication since they exemplify and simplify the "communicative action" occurring between an business enterprise and other organisms: in other words, accounting data may provide the codified documentation of financial flows generated by business life.
Therefore, the enterprise communicates with its stakeholders even by using, among others, the "accounting language".
Before investigating the role of this language, let us briefly look at the main elements involved in every communication process.
According to Jakobson's model (see Sebeok, 1960), a well-known interpretative model of interpersonal verbal communication highlighting

the importance of so-called codes in the social context, communication is based on six elements/factors:

- *context* (the co-text and/or the reference world where the message takes place);
- *sender* or addresser (who starts the communicative process by sending the message);
- *receiver* or addressee (receiving and decoding the message);
- *message* (the encoded text that is transmitted by means of a specific channel);
- *code* (a conventional set of signs and rules governing the communication process);
- *contact* or channel (the physical channel used to send the message and/or a psychological connection between the participants in the communicative event).

CONTEXT

SENDER ⟶ MESSAGE ⟶ RECEIVER

CHANNEL – CODE

In the economic world, senders and receivers are represented by business units which communicate with other entities operating in the same context.

Therefore, financial external communication can be seen as a process initiated by a business organization that encodes a message, sends it to one or more receivers who will decode it and send an explicit or implicit reply. The addresser will be able to assess the effectiveness of the initial message on the basis of this feedback.

It is obvious that communication is effective when both participants share the same code and are able to encode/decode figures describing financial trends.

4. A shared “accounting language” for financial communication

In today's globalized context, which is more and more competitive and characterized by greater interaction between the enterprise and the environment, there is an increasing need for new shared rules to facilitate comparison between competing business organizations belonging to different national markets.

This means that business units have to apply policies and use communication tools which "fit the situation". That is to say, they must find the appropriate tools to meet stakeholders' expectations.

In order to satisfy this need, the European Union has endorsed the adoption of international accounting standards for the preparation of financial statement: this document is considered the main source of information and principal tool for financial communication.

It is not only a set of documents that must meet legal requirements but is also the main source of information on the economic condition of the company.

It is clear that the information obtained from the balance sheet must be understandable to its users so that they can take rational and informed decisions.

Therefore, there is a greater demand for new accounting rules that fit the current economic environment: in this context, the financial statement aims at reaching the greatest number of users and at internationally providing relevant information.

A business organisation that intends to survive on international markets must be able to communicate effectively with a multitude of foreign interlocutors whose decisions may affect its work.

If a company starts a relationship with different stakeholders, it must satisfy stakeholders' expectations. A business ability to survive depends on its ability to assess stakeholders' expectations and to meet them while generating (economic) value.

This explains the importance recently gained by financial communication and statements: compared to the past, this communication is no longer seen as a burden to bear or as something that requires formal compliance but as an opportunity, a factor that makes information available about the economic value produced and that generates further value by starting new relations and strengthening old ones.

As a matter of fact, a corporation communicates with the market to gain credibility, commitment, and rewards. These goals can be achieved in an international context if financial communication is true and fair, and

produced by applying shared/uniform accounting principles to the preparation of financial statements.

5. The role of a “global” financial communication

In the last few years, the socio-economic system has undergone radical and profound changes due to scientific and technologic progress and to the growth of financial markets which have affected business *modus operandi.* As already said, every business unit can develop and survive only if it follows the dynamics of the environmental system, which is increasingly complex and multidimensional.

Since geographical and institutional boundaries are progressively overcome, it is a common belief that business units need to interact by exchanging standardized information that presupposes the knowledge of a common accounting language. The European Union has taken steps in this direction by starting an accounting harmonization process within the community, aimed at fostering a progressive internationalization of economic and financial information exchanged between main capital market operators.

This process has received a remarkable boost by Regulation (EC) no. 1606/2002 of the European Parliament and the Council, which has obliged listed companies to apply the accounting principles issued by the *International Accounting Standards Board* (IASB) when preparing their consolidated accounts.

The Regulation has also enabled Member States to permit or require companies trading securities on a regulated market to adopt international accounting standards for the preparation of their balance sheet and to permit or require unlisted companies to prepare their consolidated and/or individual accounts in accordance with adopted IAS.

The European Commission had already shown great consideration towards companies operating in the global marketplace by adopting accounting directives which allowed Member States to choose the method of implementation. As a consequence, non-comparable accounts have been produced in different Member States. This situation has determined a need to improve business communication by adopting a common accounting language that can be understood only if the

accounting data are codified according to accepted global accounting standards.
The application of IAS/IFRS represents not only an “accounting revolution” but also an epochal change: these rules are no longer technical regulations that interpret or supplement the law but are the only guidelines for a shared “language” that must be followed when preparing financial statements; according to Regulation (EC) no. 1606/2002, international accounting principles are intended to be binding.
Generally speaking, we can say that the transition from national to international accounting principles allows a greater comparability of the financial status of European companies. This is a definite advantage to the receivers of financial information and a crucial stage in the inevitable process of business internationalization.

6. Discussion and further development

Because of profound transformations impacting on business life, the application of a common accounting language is a prerequisite for the correct distribution of trustworthy data that contribute to the creation of a transparent economic and cultural environment.
In this context, the application of international accounting principles allows companies to encode accounting data in clear and reliable information, which is a necessary requirement for building profitable commercial relations, gaining savers’ and institutional investors’ trust, and finding the necessary financial means and the best allocation for the economic resources available.
Markets reward business organizations that guarantee highly transparent information: they are considered “trustworthy”. That is to say, these entities enjoy public approval deriving from the availability of data and information that allow the assessment of the business ability to generate value.
From a practical point of view, the adoption of a common financial language based on shared accounting “codes” must aim at disseminating high-quality and fully comparable information in the

European Union, in order to create the ideal conditions for a unique, efficient and competitive market. This goal can be achieved by preparing balance sheets/accounts according to homogeneous and generally accepted accounting principles.

The application of IAS/IFRS within the European Community transforms accounting principles from mere technical provisions - interpreting and/or supplementing the law - into binding rules. This is a significant change for countries like Italy having a Civil Law system, because it brings it nearer to the Common Law system where laws are based on judicial precedents. Therefore, when the balance sheet is prepared, it is likely that the customary law system will be preferred to the “Roman Law” tradition. This evolution will make the rules for balance sheet preparation more adaptable to environmental changes affecting business development and work.

The transition to *International Accounting Standards* offers advantages in terms of uniformity and comparability of the financial report used by companies operating in the European Union. However, it also has potential disadvantages such as a tendency towards differentiation between business organizations that apply the international accounting standards and those that do not.

Thus, the national accounting scenario will increasingly reveal the application of two accounting models deriving respectively from:

- companies applying international accounting principles;
- business organizations resorting to national principles and laws.

The two legal sources create two different accounting systems and two types of “accounting language” that imply a very different balance sheet preparation.

In the Civil Law model, the purpose of a balance sheet is to show corporate assets and performance results by using criteria that most of all protect creditors thanks to the adoption of the prudent accounting principle to evaluate assets.

On the opposite, the IAS balance sheet is meant to provide information about corporate prospects and, therefore, is addressed to current and potential investors. The focus of accounting information is on a business ability to generate its own funds.

A balance sheet prepared on the basis of national standards is a trustworthy document, while a balance sheet prepared in accordance

with IAS keeps the same function but pays more attention to corporate and investors' perspectives and is a powerful tool for their assessment.
This difference is clear if we consider the fact that a Civil law-based balance sheet focuses on costs, while an ISA balance sheet highlights "fair value".
A cost is the value attributed to goods and their function in relation to their ability to contribute to production and revenue generation. At the same time, it is an easily applicable criterion which allows no room for discretion.
The "cost" criterion tends however to be replaced by "fair value" which represents the price to pay for assets or debt settlement during free transactions between well aware and willing subjects.
By placing more emphasis on current valuation of assets and liabilities rather than on historical cost price, the application of the fair value principle tends to narrow the distance between a business book value and its economic value in order to provide international analysts and investors with increasingly useful and commonly understandable information.

On the other hand, as in the last few years the fair value principle has been applied to numerous stocks, we learned more about its potential and actual threshold: it has often led to uncontrolled volatility in balance sheet items.
The point to underline is that alternative criteria used to determine "current value" are not neutral . Some of them, such as future cash flow prediction, sort option pricing, and replacement cost, may vary on the basis of the assets to be valued.
As a consequence, the application of these different criteria causes a high degree of subjectivity in asset valuation and affects comparability, neutrality, intelligibility, and reliability of the financial statements. It is clear that the extent to which the fair value can avoid distortions and ensure homogeneous accounting values depends on the field of its application.
A widespread use of a common accounting language and common criteria for the assessment of balance sheet items is a precondition for distributing correct and reliable data and business information while helping the creation of a transparent socio-economic environment.

Using a “common” accounting language does not mean to standardize business performances nor to equalize their differences by applying rigid rules and regulations, but to replace national dialects with a “global language” (based on international accounting standards) in order to coordinate different accounting practices with flexible rules.

However, the existence of changing rules guarantees the survival of business entities able to adjust their workability to socio-economic environmental needs.

It is therefore necessary to provide accounting information that does not only meet stakeholders’ perspectives but is also prepared on the basis of flexible rules.

International Accounting Standards (or International Financial Reporting Standards) are valid principles, but not be rigidly applied to every case because every business organization has its own distinctive features.

The two languages – the global one and the local one – do not reciprocally contrast, one with the other: they are complementary. Of course, there is a need for a common accounting language that can be used in any socio-economic context. However, while complying with the international accounting principles, this language should be flexible enough to allow some rational discretionality in the application of the different rules, in order to protect and stimulate specific business features and national economic culture.

International accounting principles should not be applied unquestioningly to local realities but they should be the framework for the definition of national accounting rules that do not ignore different socio-economic environments, nor the “uniqueness” of every business organization and its communication needs.

It is necessary to acknowledge that the new international accounting principles can harmonize accounting practices but risk leveling business stimuli and differences that define the external environment. It is obvious that IAS/IFRS are valid principles but they cannot be a valid model for every business organization.