Contemporary Issues in Accounting M

1. Introduction to Financial Accounting Theory

Theories

- A belief or principal that guides actions or behaviour
- An idea or set of ideas that is intended to explain something
- Developed as a result of applying various value judgements and that acceptance of one theory, in preference to others will in part be tied to one's own value judgements
- Should critically evaluate theories before accepting them

Accounting Theory

- A description, explanation or a prediction based on observations (positive accounting theory) and/or logical reasoning (normative accounting theory)
- Logical reasoning in the form of a set of principles that:
  - Provide general framework reference by which accounting practice can be evaluated
  - Guide the development of new practise and procedure
- Considers:
  - People's behaviour with accounting information
  - People's needs for accounting behaviour
  - Why people elect to supply particular information
- Accounting theory is necessary to:
  - Understand the world we live in
  - Provide a basis for decision making
  - Remove bias

Accounting theories:

- <u>Prescribe</u> how assets should be valued (positive/normative)
- <u>Predict</u> why managers choose a particular accounting method
- <u>Explain</u> how an individual's cultural background affects accounting information provided
- <u>Prescribe</u> what accounting information should be provided
- <u>Predict</u> <u>or</u> <u>explain</u> how accounting disclosures might be used as part of a strategy to legitimise the operations of an organisation
- <u>Provide principles</u> for decision making
- <u>Identify problems</u> and <u>offer solutions</u>

MANY THEORIES OF FINANCIAL ACCOUNTING EXIST, HOWEVER NONE ARE UNIVERSALLY ACCEPTED

Role of Theory in Financial Accounting

- Provide an explanation of what is happening
- Help predict what will happen
- Partial or inaccurate theories can be of <u>some</u> use

positive accounting theory

Why Study?

- Need to consider the implications of accounting information
  - Implications for organisation and stakeholders if one accounting method is chosen over another
- Shows how elements of accounting should be measured
- Motivation for organisations to provide certain types of accounting information
- How and why capital markets react to particular information
- Without a theoretically informed understanding it will be difficult to:
  - Evaluate the effectiveness and suitability of current accounting practices
  - Develop improved accounting practices

Positive Accounting Theories

- About the world as it is. They:
  - Describe what is happening
  - Explain what is happening
  - Make predictions about what will happen
  - Are based on hypotheses
  - Make value judgements
- Begin with assumptions and through logical deduction allow predictions to be made
- If predictions are sufficiently accurate when tested against observations of reality, they are regarded as having provided explanation of why things are as they are

Criticism:

- Positive theories don't provide prescription

Normative Accounting Theories:

- Make suggestions about:
  - What should happen
  - What ought to be

"Should" not "Will"

- Observation and/or facts are considered (only considered)
- Based on what researcher believes should occur in particular circumstances
- Should not be evaluated on whether they reflect actual accounting practice

Criticism:

- Lack of empirical observation
  - Personal opinion about what should happen
  - Positive theorists argue they prefer to give expected implications of actions and let others decide themselves what they should do

Evaluating & Testing Theories

- A good theory should:
  - Be logical in its construction
  - Be clearly articulated
  - Be testable
  - Be consistent with observation
- A theory can never be tested true – but can be made closer to the truth
- A single observation can prove a theory false

2. Normative Theories of Accounting – the case of accounting for changing prices

Measurement in Accounting

Conceptual Framework Definition: *the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried*

- Need to figure out the monetary impact of every action

Benefits of measurement:

- Makes financial statements decisions useful – gives meaning
- Allows users of accounting information to:
  - Assess an entity's financial performance and position
  - Compare the entity's performance and position over time
  - Compare entities within the industry

Limitations of measurement:

- Little agreement on what measures should be used
- Mixed measurement reduces comparability
- Can be subjective
- Additivity problem (adding together assets purchased at different times)

Historical Costs
Assets:

- Recorded at the amount or cash or cash equivalents paid or the fair value of consideration given to acquire them at time of acquisition

Liabilities:

- Recorded at the amount of proceeds received in exchange for the obligation, or the amount of cash or cash equivalents expected to be paid to satisfy liability

Limitations of Historical Costs:

- Assumes money holds a constant purchasing power i.e. $1 today = $1 tomorrow
- Economic factors make them less valid
  - Specific price level changes (shifts in consumer preferences)
  - General price level changes (inflation – for all)
  - Fluctuation in exchange rates
- Lack relevance in times of rising prices
- Additivity problem (assumes constant purchasing power)
- Can overstate profits in times of rising prices, distribution of profits can lead to erosion of operating capacity
- Are reliable but not relevant

Support for Historical Costs:

- Predominant method used for years so has support of profession
- Even as 'fair value' methods become more used, some assets are still measured at cost

Current Purchasing Power Accounting (CPPA)
Based on the view that in times of rising prices if an entity were to distribute unadjusted profits based on historical costs, in real terms the entity could be distribution parts of its capital

- Adjusted on price level index/CPI
- If not
  - Can overstate; profit, earnings, dividend payouts
  - Will effect operating capacity and operating capital

Advantages of CPPA:

- Relies on data that is relatively available under historical cost accounting
- No costs involved in getting asset values
- CPI data also readily available

Disadvantages of CPPA:

- Movements in the prices of goods and services not included in index (e.g. CPI) may not reflect price movements in different industries
- Information generated by CPPA may be confusing

Current Cost Accounting (CCA) – Replacement Cost
Assets:

- Carried at the amount of cash or cash equivalents that would have been paid if the <u>same or equivalent</u> asset was <u>acquired currently</u>

Liabilities:

- Carried at the undiscounted amount of cash or cash equivalents that would be required to <u>settle the obligation currently</u>

Advantages of CCA:

- Increase usefulness of information provided by differentiating operating profit from holding gains and losses
- Better comparability to previous performance

Disadvantages of CCA:
- Replacement costs of assets may not be the same for all firms
- Replacement costs do not reflect what the asset would be worth if sold
- Can be difficult to determine replacement costs

Fair Value
Assets:
- Carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal

Liabilities:
- Carried at their settlement values
- The undiscounted amount of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business

Present Value
Assets:
- Carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business

Liabilities:
- Carried at the present discounted value of the future net cash outflows expected to be required to settle liabilities in the normal course of business

Deprival Value
- The loss that would be suffered if an entity was deprived of the asset
- May incorporate:
    - Present value if the item was held for use
    - Net realisable value if item was held for sale
    - Replacement cost associated with replacing the item

Decision Criteria for Choice of Measurement Approach
- Needs of potential users of financial statement
- Practical considerations – costs vs benefits
- Management motivations and objectives – impact on incentives, reputation etc.

Needs of Users of Information
Existing and Potential Investors:
- Concerned with the risk inherent in and the return provided by investments
- Need information that:
    - Assists in deciding to buy/hold/sell shares
    - Enables them to assess entity's ability to pay dividends
- Need forward looking information – FAIR VALUE

Creditors/Lenders:
- Interested in information that enables them to determine whether amounts owing to them will be paid when due
- Interested in net position
- FAIR VALUE would be most useful if can be reliably measured

	Current Cost	Historical Cost	Present Value	Deprival Value	Fair Value (for)	Fair Value (against)
Relevance	**HIGH**: Indicative of future potential	**LOW:** Especially as time passes	**HIGH**: Indicative of future potential	**LOW:** Not related to business case	**HIGH**: Focuses on future potential	**LOW:** Hypothetical & not relevant to specific entities
Faithful Representation	**HIGH:** Determined by reference to actual costs	**HIGH:** Measures objective transaction	**LOW:** Can be subjective	**LOW:** Can be <u>very</u> subjective	**HIGH:** Determined using objective market prices	**LOW:** Highly subjective if no objective market prices
Understandability	**LOW:** Can be subjective	**HIGH:** Is well known & understood	**MEDIUM:** Assumptions can be complex	**LOW:** Assumptions can be complex	**HIGH:** Represents current market value **As long as active market*	**LOW:** Often based on complex assumptions and calculations
Comparability	**MEDIUM:** Can be subjective	**MEDIUM:** Purchasing power of money changes	**MEDIUM:** Involves many different assumptions, is subjective	**LOW:** Involves many different assumptions	**HIGH:** Focus on market value not individual entity	**LOW:** Different models lead to very different results