INTRODUCTION TO FINANCIAL ACCOUNTING THEORY

What is a theory?

- A coherent set of hypothetical, conceptual, and pragmatic principles forming the general framework of reference for a field of inquiry

Why is it important to study accounting theory?

- To aid in the analysis of financial statements
- To aid in decision-making

Brief overview of theories of accounting

Early development of accounting theory

- Relied on the process of induction
  - The development of ideas or theories through observation
    - The number of observations forming the basis of a generalisation must be large; and
    - The observations must be repeated under a wide variety of conditions; and
    - No accepted observation should conflict with the derived universal law
  - In generating theories based on what accountants do, it is assumed that what is done by the majority of accountants is the most appropriate practice (accounting Darwinism)

Modern development of accounting theory

- Started to develop theories using deductive reasoning
  - Started to describe what accountants should do
  - Start with a general proposition and reason down

Normative theory

- Concerned with what should be done (policy prescription)
- Derived from the notion of a norm, standard, or an ideal model
- Seeks to provide guidance to select appropriate accounting procedures
  - Focuses on deriving an ideal accounting system by inductive reasoning

Positive theory

- Explains and predicts by searching for reasons why an event occurs
  - Aims to explain current practice
  - Aims to predict the role of accounting and associated information in decision-making
- Does not seek to tell us that what is being done in practice is the most efficient or equitable process
- Process
  - Begins with assumptions and, through logical deduction, predictions are made (generate a hypothesis)
  - Predictions or hypotheses are tested by empirical evidence using the scientific method

The scientific method

- Identify and define the research problem
- Develop theoretical structure
- State hypotheses to be tested
- Construct the research design
- Gather data (sampling)
- Analyse observations and evaluate results
- Consider limitations and constraints

THE FINANCIAL REPORTING ENVIRONMENT

Reliance on double-entry accounting

- Many criticisms including:
  - Not taking into account the various social and environmental consequences of a reporting entity's existence

Rationale for regulation financial accounting practice

- Parties who argue that regulation is necessary give the following reasons:
  - Markets for information are not efficient without regulation a sub-optimal amount of information will be produced
  - Although some people argue that the free market *on average* is efficient, on average arguments ignore the rights of individual investors, some of whom can lose their savings as a result of relying on unregulated disclosures
  - Some parties who demand information about an organisation can obtain their desired information due to the power they possess as a result of their control over scarce resources required by the organisation. Conversely, parties with limited power will generally be unable to secure the information about an organisation
  - Investors need protection from fraudulent organisations that may produce misleading information, which, due to information asymmetries, cannot be known to be fraudulent when used
  - Regulation leads to uniformity which leads to comparability
- Parties who argue against regulation give the following reasons
  - People are willing to pay for accounting information which will lead to an optimal supply
  - Any organisation that fails to provide information will be punished by the market; an absence of information will be deemed to imply bad news
  - Regulation will lead to an over-supply of information (at a cost to the producing firms as users will tend to overstate the need for the information
  - Regulation typically restricts the accounting methods that may be used
  - Performance of managers impacts on remuneration they can command in the market for their services
    - Incentive to adopt strategies to maximise value of firm and provide information about performance
    - Poor performance can increase the likelihood a firm will be a takeover target
    - Accounting information can minimise cost of capital and increase firm value

Three theories

Public interest theory

- Regulation be introduced to protect the public
- Protection may be required as a result of inefficient markets
- Assumes that the regulatory body is a neutral arbiter of the 'public interest' and does not let its own self-interest impact on its rule-making process

Capture theory

- Although regulation is often introduced to protect the public, the regulatory mechanisms are often subsequently controlled (captured so as to protect the interests of particular self-interested groups within society, typically those whose activities are most affected by the regulation

Private interest theory

- Relaxes the assumption that regulations are initially put in place to protect the public interest, as well as the assumption that government regulators are neutral arbiters not driven by self-interest
- Governments are made up of individuals who are self-interested and seeking re-election, so those which an interest in particular legislation are more likely to get it if they can form themselves into large organised groups with strong cohesive voting power

The role of professional judgment in accounting theory

- At the core of the accounting process is an expectation that accountants should be objective and free from bias when performing their duties
- Some accounting methods may be selected at different times, such as those that best reflect their underlying performance (efficiency perspective) or designed to serve a self-interest (opportunistic perspective)

How powerful is the accountant

- The output of the accounting process impacts on many decisions
- Accountants can transfer to interested parties a source of power to drive changes in a corporation's behaviour
- Accountants can give legitimacy to organisations but emphasising particular performance attributes

Regulation and accounting standards

- The view that financial accounting should be objective, neutral and apolitical can be challenged
  - Standard setting is a political process because it affects wealth distribution
  - Proposed regulation may be technically sound and logical, but not implemented due to political power or influence of affected parties
- Standard-setters encourage parties to make submissions on proposed standards
- Accounting standards and financial reports are the result of various social and environmental considerations
  - Tied to the values, norms and expectations of society

NORMATIVE THEORIES OF ACCOUNTING – THE CASE OF ACCOUNTING FOR CHANGING PRICES

Measurement in accounting

- Accountants measure the elements of financial statements
- Elements have various measurable properties
- Property reported is to AASB Framework
  - Provide financial information about the reporting entity that is useful in making decisions about providing resources to the entity
  - Represent faithfully the most relevant information about resources, claims, and efficient discharge of management responsibility over resources
  - Be justifiable on analysis of costs and benefits
- Examples of properties that are measured in AASB standards
  - Historical cost
  - Net realisable value
  - Fair value
  - Present value

Historical cost

- Measurement technique that uses acquisition cost as evidence of the value received
- Measures sacrifice, rather than future benefits
- Defined as cash or cash equivalents paid or the fair value of other consideration given to acquire an asset (AASB 116, [6])

Advantages

- Argued to be more reliable than other measurement techniques
- Adjustments may need to be made if accounts are to reflect value over time
- Associated with financial capital maintenance

Limitations of historical cost accounting in times of rising prices

- One assumption of historical cost accounting is that the money holds a constant purchasing power
- However, three components of the modern economy make this assumption less valid than it was at the time the model was developed
  - Specific price level changes, occasioned by such tings as technological advances and shifts in consumer preferences
  - General price level changes (inflation)
  - Fluctuation in exchange rates for currencies
- Historical cost accounting information may suffer from problems of irrelevance in times of rising prices, as it may not be useful to know what something cost years ago when its current value may be considerably different
- Historical cost accounting can tend to overstate profits in times of rising prices, and that distribution to shareholders of historical cost profits can actually lead to an erosion of operating capacity
- Historical cost accounting distorts the current year's operating results by including in the current year's income holding gains that actually accrued in previous years

Current purchasing power accounting

Calculating indices

- When applying general price level accounting, a price index must be applied
- A price index is a weighted average of the current prices of goods and services relating to a weighted average of prices in a prior period, often referred to as a 'base period'
- Associated with maintaining present level of operating capacity

Performing current purchasing power adjustments

- When applying CPPA, all adjustments are done at the end of the period, with the adjustments being applied to accounts prepared under the historical cost convention

- When considering changes in the value of assets as a result of changes in the purchasing power of money (due to inflation) it is necessary to consider monetary and non-monetary assets separately
  - Monetary assets are those assets that remain fixed in terms of their monetary value (such as trade debtors and investments that are redeemable for a set amount of cash)
  - Non-monetary assets are those assets whose monetary equivalents will changes over time as a result of inflation (such as plant and equipment)
  - Monetary liabilities are fixed in term (such as an obligation to pay a fixed amount)
  - Non-monetary liabilities include obligations to transfer goods in the future
  - Net monetary assets = monetary assets – monetary liabilities

Current cost accounting

- CCA differentiates between profits from trading and those gains that result from holding an asset
- Holding gains can be considered as realised or unrealised

Exit price accounting

- A form of valuing assets at their net selling prices at the reporting date and on the basis of orderly sales
- The present selling price is the proper and correct valuation coefficient for the measurement of wealth at a point in time and income is the difference between dated wealths so calculated

Multiple measures

- Multiple measures have been applied as a solution to the measurement problem
- Movement away from strict historical cost to a mixed measurement system
- Standard-by-standard consideration of the appropriate measurement approach

What is value?

- Not a clearly defined concept so measurement can be difficult
- AASB Framework defines assets in terms of those future economic benefits, therefore value should be ascertained by measurement of these benefits
- Value in use = benefits from use; value in exchange – benefits from sale
  - Value-in-use > Value-in-exchange = retain asset
  - Value-in-exchange > Value-in-use = sell asset

Value in use

- Difficult to measure and often entity specific
- Can be measured by determining the PV of future economic benefits
- Used in practice when cash flows, discount rate, and horizon are known

Value in exchange

- Net market value is an objective measure of an asset's true value
- Market is a conglomerate of firms and individuals, so each may place a different value on an asset
- Information asymmetry leads to imperfect markets

Deprival value

- Value to owner, or amount an entity should receive for loss of the asset
- Could be
  - Current replacement cost
  - Net market value
  - Present value of future economic benefits (value in use)
- Cannot be
  - > current replacement cost
  - < net market value

Measurement research

- Research to date suggests that current cost disclosures have no incremental information content over historical cost disclosures
- Beaver and Landsman (1983) examined the value of current cost information:
  - Current cost numbers did not add significantly to regressions of share returns on historical cost numbers
  - Historical cost numbers did add significantly to the regressions of share returns on current cost numbers
- Studies have also considered whether current cost information increases the predictive accuracy of statistical models of economic events
  - Generally, the addition of current cost information does not add predictive power to the models
- Attitudes of individuals to current cost disclosures was surveyed by Madison and Radig (1983)
  - Managers of 229 'Fortune 500' firms
  - Concluded the data were perceived by managers to be of low relevance to internal-decision making
- Barth (1994) noted that current cost research results are possibly due to a lack of reliability in current cost measures
- Research suggests that provision of fair value information is useful
- Studies by Eccher (1996) and Barth (1994) suggest that provision of fair-value information has incremental information content for share prices relative to historical cost information

FOREIGN CURRENCY TRANSACTION

- AASB defines 'exchange rate' as the ratio of exchange for two currencies'.
- Where debts, receivables, or other monetary items are denominated other than the domestic currency they are converted into a single currency
- Examples of foreign currency
  - Acquisition or sale of goods from or to a foreign supplier where the transaction is denominated in a foreign currency
  - Loan from foreign lender denominated in a foreign currency
- A foreign currency transaction initially recognised in the functional currency by applying to the foreign currency amount the spot exchange rate at the date of the transaction (AASB 121, para.21)
- Functional currency is the currency of the primary economic environment in which an entity operates