THEORETICAL PERSPECTIVES ON THE PURPOSE OF ACCOUNTING

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Abstract: *The paper aims to reveal some contradictions that are inherent in present-day theoretical outlook on the purpose and object of accounting. Accounting has exchanged the systemic approach to economic phenomena for a process-oriented one, which can be observed in the increasingly common use of current value in assessing fixed assets. This, however, leads to distortions in the information supplied by accounting information systems, providing space for creative accounting practices. The paper presents examples of partial contradictions in the conceptual framework of accounting that have a common origin in perceiving productive capital through the prism of financial capital. This condition can be traced back to the intrinsic propensity of financial capital to keep looking for new ways to generate returns. The new approach to accounting certainly helps attain this goal at the macro-economic level. The new objects and uses of accounting hence result in deepening the dichotomy between its theory and practice.*

Keywords: *net assets, financial capital, productive capital, historical cost, creative accounting, current value, fair value*

JEL Classification: *G32, M41, P12, P16*

1. INTRODUCTION

In recent years, accounting has completely overhauled its measurement system in an attempt to address investors' requirements for extended information. What kind of theoretical reflection has driven these changes? What are the outcomes of the new information input that accounting has offered to the business community? These are the key questions that have inspired the authors in crafting this paper and shaping its contents. They found that it was by no means easy to answer these questions. To be able to tackle them, one needs to take a different outlook on the object and purpose of accounting; it also involves a good awareness of the theoretical foundations of accounting, and a firm grasp of the relationship between accounting theory and accounting as a measurement system. The paper sets out to voice some profound criticism of the trends that appear to prevail in current thinking about accounting.

2. THE NATURE OF TODAY'S ACCOUNTING

Over the last few years, we have seen a major change in outlooks on the purpose of accounting. It is now believed that accounting cannot perceive reality in a static manner, which was the case with approaches built around the popular application of historical cost. Employing different available forms of valuation, accounting should not be limited to describing facts only; it should aim to support decision making processes and produce information that is useful, in the first place, to investors. Since investors are interested in prospective returns on their capitals, they demand insights and projections into the future and relevant information that helps predict future trends. It is the pressure from investors that has forced accounting to focus on economic processes described by such variables as, primarily, fair value.

"The goal of accounting theory is to provide a set of principles and relationships that explains observed practices and predicts unobserved practices" [1]. Predictions of unobservable practices are supposed to primarily forecast future cash flows and are based on the quantity of wealth, interpreted as a sum-total of assets that are assessed via fair value. Fair value is conceptualized as either (a variety of) current price quoted on an active market or, alternatively, as estimated current price in case an active market (i.e. one where the law of supply and demand is valid and operational) does not exist.

As long as it is possible to price assets using fair value that is only estimated, one should not wonder that assets tend to be commonly overvalued. Advocates of the application of fair value in accounting argue that the more such wealth, conceived in these terms, is worth, the greater cash receipts can be anticipated in the future. Once the fair value of our assets is known and the assets are thus priced, we can make informed decisions on whether a particular asset should be sold or retained. Future cash receipts are, consequently, forecast based on a higher asset price.

To a similar extent, predictions of future cash receipts are based on an enlarged valuation of net assets. The value of net assets can be inflated by two factors: revaluation reserve and financial profit, the latter including e.g. unrealized gains. Unrealized gains represent short-term assets that are fair valued. An increase in net assets, which corresponds to an increase in equity capital, leads to an increase in the company's share price. As a result, the price-earnings ratio rises, which happens to be the ratio that most influences the perceptions of the company's standing in the capital market. This, in turn, boosts anticipated cash flows. Hence, the application of fair value in asset pricing can be seen as an attempt to challenge the category of book profit and a move toward the primacy of economic profit.

This line of thinking results in the emergence of many contradictions in accounting theory. The key ones are as follows:

– Being a non-cumulative aggregate, the total price of a business entity's assets does not stand for its wealth. It cannot be treated as an arithmetic sum. Fair value, on the other hand, corresponds to economic relations from a number of markets. The qualitative aspect of these

relations is radically different, as the law of demand and supply responds differently to the same commodity in different markets. To elect the right (fair) value for asset pricing purposes is a major methodological challenge, since fair value assumes potentially different economic content in different markets. For this reason, asset prices must not be added up arithmetically.

– The application of expected fair value for asset pricing while at the same time abandoning the transaction-based approach is inconsistent with the central category of market economy – value. It is through market transactions that society establishes an acceptable level of capitalization and approves a specific distribution of value, thus determining the current level of consumption. The transaction-centeredness of accounting makes value structurally transparent in the process of its creation and distribution. The use of fair value in fact waives the category of value. The very notion of fair value introduces volatilities into the accounting system, notably currency volatility which is seen by monetarists as the prime mover of economic growth processes. This illustrates the extent to which accounting is indebted for its theoretical underpinning to modern monetarism. Admittedly, the monetarist idea that money plays a key role in driving economic processes is transposed by accounting to the micro-economic level. This condition is clearly associated with the common use of currency volatility to achieve ample returns on financial capital.
– The understanding of capital as equivalent to net assets contradicts its very nature and denies the theory of value. Under the theory of value, capital is identified with capitalized savings that the society invests in a subsequent value generation process. Within the residual approach, capital (assets vs. liabilities) comprises capitalized values as well as expected ones. Information on the amount of such capital should be of interest to potential investors since it is indicative of the earnings that can be derived from capital invested and its multiplications attributable to asset pricing procedures.

This perception of capital may encourage motivation schemes where managers are rewarded for maximizing their net assets rather for sustainable and economic use of resources. It is small wonder then that event management has been accordingly replaced by value management.

3. HISTORICAL COST AS OPPOSED TO FAIR VALUE

Historical cost is among the central notions of accounting. One of the key principles of accounting posits that assets be recorded at the cost of purchase, i.e. the cost borne by the business. Historical cost represents the value offered in exchange for an item that has been acquired by the business. At the moment of purchase the market value and the cost are identical. The assumption of monetary units, inherent intrinsic to which is known in accounting, makes it possible to quantify economic facts and record them in measurable terms. This assumption is a prerequisite for the application of historical cost. Historical cost represents value that is brought forward into the process of value creation. The application of historical cost in asset pricing is objective in nature – the value of each purchased item has been acknowledged through real business transactions, confirmed in the melting pot of an economic society; a society that has chosen to expend some of its income on the purchase of capitalized wealth, i.e. assets. In this way, divisible and distributable forms of value are involved in another value creation process. The purchase of goods is an insufficient but necessary condition for turning capital into productive potential. Capitalized asset value stands for nothing but savings that have been transformed into investments. The extent to which a business contributes added value (on top of the inherited value represented by the historical cost) reflects the productive potential of the capital employed in the business.

The application of historical cost in asset pricing accounts for cumulative expression of wealth. The value offered in exchange is represented by the purchase price. Historical cost emerges at a particular time from the relations of value distribution that were shaped under particular economic conditions and governed the society at the time. The use of historical cost reveals the way in which values arise at the level of micro-economic capital allocation. As long as accounting sticks to historical cost, it is possible to trace capital flows behind input-output relations [2]. What matters the most, however, is that an approach based on historical cost supports the structural outlook on value.

The application of historical cost is essential to the ability of controlling resources. It provides information on what resources were purchased and at what price. The role of historical cost is not, however, confined to looking after resources. Capital resources that are valued at the price of their purchase reflect a sacrifice on the part of their owners – a commitment that is made in the hope of obtaining a reward. They hence represent legitimate claims on the division of profits. When assessed via historical cost, business profits will not raise controversies in the society. They will not result in conflicts relating to the forms of profit distribution, since the society itself has authorized the economic relations embodied by the capitalization of wealth.

Value is of systemic nature because so is the nature of organized work. The application of historical cost makes it possible to trace capital flows within input-output relations [2]. These relations are observable in the double entry system – a central principle of accounting. Historical cost accounting allows us to capture the structural aspect of value and, given the systemic nature of value, provides a basis for systemic representation of economic processes in accounting. Historical cost hence warrants the systemic character of accounting as such. Although historical cost has been much criticized for recording values as static phenomena, these criticisms have been mostly off-target. It is the static representation, along with the structural perception of value, that provides a true picture of the driving forces behind the creation of a society's wealth. After all, this wealth generation has been validated by the society's income power. This is how the society assesses work, the work whose utility is rated and conferred by the society itself. This assessment constitutes the ultimate purpose of accounting as a system of measurement. The

system must therefore remain a static concept once the society has accepted the directions of capital allocation.

By recording economic transactions, accounting highlights the static nature of value, which is of utmost significance for the ability to track the processes of economic growth and, most of all, to reveal the dynamizing power of value creation observed in proportions of prior and new work. If this is the case, accounting appears reduced to its true purpose – that of showing the structure of value throughout the process of its creation and distribution. It does not then get involved in making decisions on resource allocation – decisions that should only be made by the society itself. The input-output relations recorded in the historical cost permit one to analyze the way resources are managed as well as to interpret the utilization of resources vis-à-vis capital allocation, as reflected in the generation of some added value. The double entry system of accounting offers insights into effective meaning of this relationship.

Historical cost accounting is criticized by the so-called "academic accounting" community for the static nature of values it records. It is obvious that value is a dynamic category. Yet, it is not the role of accounting to project future values, which nevertheless contemporary accounting systems attempt to do. Any such value needs to be endorsed by the society. Assets are not purchased in order to be sold but in order to be incorporated into the organized whole of capital at work. In specific justified uses, this capital contributes to the creation of new value. Historical cost accounting allows us to trace what results were produced and what resources were used to obtain these results. The application of historical cost thus helps identify the processes of value creation at the level of micro-economic capital allocation.

Critical attitudes toward the category of value based on historical cost, showing it as a static concept that challenges the dynamic nature of value, stem from the fact that the time factor is not taken into account. Based on this criticism, historical cost is rejected as a parameter in asset pricing. However, within the structure of value the transition from a static system to a dynamic one is explained by the operation of a subjective factor – that of human activity, and of innovation thus brought by humans into the transformation process of society's work. What is at stake here is not time in a purely mechanical and quantitative form. System dynamics do not stem from the system's structure. The dynamics of the system as a whole is driven by the evolution of the society's work and of the way the work is organized within each socio-economic formation. Transformations of work relations in a given society dynamize the structure of value created by the society, allowing the fusion of static entities with the dynamics of economic processes, and the combination micro- and macro-economic processes [3]. The measurement system of accounting, founded and focused on the recognition of the contents of the underlying economic processes (transformations in the work of a particular society), makes it possible to properly represent the structural aspect of value. Since value is intrinsically open to such transformations, an accounting system based on historical cost is not an entirely static concept. An obvious conclusion that follows from this discussion is that fair value, although its supporters argue to the contrary, cannot guarantee an adequate process-based representation of economic facts by accounting systems.

4. CONCLUSIONS – A GENERALIZED OUTLOOK

Changes in contemporary accounting do not occur in isolation from changes affecting economic processes and relating to the global character of today's economies. An accelerated expansion of financial capital is observed. There are increasingly significant barriers to obtaining traditional returns on financial capital as long as financial capital has to be transformed into productive capital. The participation of financial capital in the distribution of added value cannot be increased beyond the capacity to increase added value itself. Looking for new sources ways of capital gains, financial capital has received substantial support from monetarist theory in its current, widely popular variety. The pivotal proposition is that money should be seen as a commodity. Once money is recognized as a commodity, the law of supply and demand assumes a regulatory function with regard to the value of money. Hence, it becomes easy to control and adjust the volatility of prices, interest rates and currency exchange rates. The law of monetary circulation has always related the supply of money (being the effect) to an increase in the real value of products and services (the cause). Under the monetary approach, the equation reflecting the quantity of money in circulation expresses this same relationship. This, however, does not prevent contemporary monetarists from interpreting the relationship the other way and putting up money as the original driver of economic growth. Simultaneously, the volatility of money has come to be taken advantage of with a view to garnering profits from financial capital. It is possible to earn profits on interests, differences in exchange rates or, last but not least, on inflationary price increases. This of course does not involve participation in the distribution of added value by employing financial capital in areas where productive capital is normally used. All this is just about redistributing added value through such forms of involvement that do not entail the transformation of financial capital into productive capital. Accounting has been exposed to immense pressure from investors. In an effort to meet their expectations, it has developed an alternative to traditional accounting, with its own theoretical apparatus on which to build its measurement system. The key step was to introduce variability into accounting systems via the notion of fair value. Fair value is, broadly speaking, such a current value that can be determined in the so called active market or that can be estimated (computed) in case an active market does not exist, i.e. there is not a market in which the law of demand and supply is fully operational. Fair value offers a way to reflect such variabilities within accounting system.

Asset pricing based on the concept of fair value leads to a situation where one is allowed to revalue assets, i.e. to put a higher value on capital assets that are brought into the business from the outside. This possibility is in fact frequently used by managers. To practically apply fair value to asset pricing and thus introduce volatility into accounting systems, it was necessary to redefine some basic categories, such as capital, revenues, and costs. Capital is perceived in residual terms as net assets (i.e. assets less liabilities), while

revenues represent an increase in net assets, and costs correspond to a decrease, in net assets.

Being closely linked to increases in net assets, the categories of revenues and costs have been completely stripped of their transactional nature. Not only can revenues be received as a result of the sale of products and services but they can also be derived from an increase in the value of capital assets. They thus represent a promise or belief that the revenues may be obtained in the future in the form of cash receipts. This is also the case with costs. Costs are no longer solely defined as a financial representation of the consumption of factors of production. A mere drop in the value of assets is regarded as a cost, too. Costs are therefore not identified any longer with the value of capital assets brought forward into another circulation phase, which means that they do not convey information about the value of capital reproduced in an ensuing value creation process.

Proponents of the new approach in accounting generally conceive the categories of capital, revenues and costs as carrying promises or prospects for the future. As such, these notions introduce a degree of subjectivity into the science of accounting. Consequently, accounting has lost much of the objectivity that can be duly expected of a scientific domain. The application of fair value in the measurement system of accounting undermines the category of value – a key category of market economy. Fair value relies on estimated and subjective figures, clearly infringing on the neutral character of accounting. Although the adoption of fair value in accounting has been motivated by efforts to enhance information provided to investors, it is in fact much more likely to distort investor information, even if its supporters will claim the opposite.

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