Current purchasing power accounting accounting essay

Accounting theory is a set of basic assumptions, definitions, principles, and concepts surrounding the accounting rule. It includes the reporting of accounting and financial information to relevant or interested parties. There are several approaches that are used in the development of accounting theory. The two main ones are normative theory approach and the positive theory approach.

Normative theory approach is a theory that is not based on observation. It is based on how things in the accounting process should be done. This approach comprises of different approaches to have a single but effective accounting approach (Khandelwal, & Jain, 2008). This kind of approach uses a formula to come up with an income based on value, not costs.

On the other hand, positive or descriptive theoretical approach to accounting theory is a set of theories that is concerned with what accountants actually do (Rosenfield, 2006). These theories rely on a process of inductive thinking, which involves making observations and drawing inferences from them. The main purpose of making observations is to identify certain similarities, identify the number of instances that the similarities are actually observed to deduce a certain degree of assurance necessary to set up a theory about all the similar instances (Ackert, & Deaves, 2009).

Each of these accounting theoretical approaches are applicable in any business today. However, it would be difficult to apply them together at the same time, since each of them has different objectives (Ackert, & Deaves, 2009). It is therefore up to an accountant to decide what approach is most accurate or best suited for what situation. This calls for the right judgment of accountants to be able to make the right decision in every situation or challenge that a business entity is faced with.

Normative Theory Approach

There are several approaches covered in this approach. Each of these theories is best suited for a different situation (Belkaoui, 2004). Below are these different theories and various situations where each theory is best to be applied.

Historical Cost Accounting

This theory is applied in times when the costs or prices for things are on the rise (Murphy, 2008). The Historical cost accounting theory is based on the assumption that money holds a constant purchasing power. The main challenge with this theory is that it assumes that the monetary unit is fixed and constant over time.

This theory is however based on three components. One is that there are specific levels in price levels, which may be characterized by technological factors and changes of consumer demands. Another component is that there is usually a general change in price levels, which is what is known as inflation (Murphy, 2008). The third component is fluctuation in the exchange rates for different currencies. Due to these three components, the book value of a business should show the current value of assets when preparing financial reports (Murphy, 2008).

As stated earlier, historical cost accounting is used when a company is experiencing rising prices. Prices are expected to raise every now and then, and this may render the approach useless in most of these situations. Companies that make use of this approach are safe from overstating profits especially in times when prices are on the rise (Whittington, 2007). Distribution of profits in such situations can affect the purchasing power of a company.

This kind of approach may not be viable to use since it affects the operating results of the current year as it includes gains asserted in previous periods of the company′s existence. More to that, capital maintenance depends on maintaining an intact financial capital and purchasing power (Murphy, 2008). Using actual current values as they are presently in the market may give a certain measure of profits which should be well distributed to maintain a physical operating capital.

Current Purchasing Power Accounting

This theoretical approach is best suited in situations where accountants need to maintain capital and the purchasing power of a company. The Current purchasing power accounting theory was developed on the basis that if a company distributes its profits as is required by historical accounting, then the real value of a company has to be reduced (Murphy, 2008). This means that the company would have to distribute a certain amount of its capital.

This approach applies indices and is hence easy and cheaper to apply when in such a situation (Rosenfield, 2006). This is because any adjustment that needs to be done is done at the end of a period, and on records made from historical cost accounting.

Under this approach, non-monetary assets are termed as assets that monetary value may change overtime due to inflation. Such assets include the machinery in a factory. On the other hand, net-monetary assets are defined as monetary assets minus the monetary liabilities.

With this theoretical approach, changes in the purchasing power of a company are not attributed to the non-monetary assets. The loss of purchasing power comes about as a result of holding net-monetary assets (Murphy, 2008). In general circumstances of price level accounting, non-monetary assets are listed to the current purchasing power and as thus, no profits or losses are recognized. This theoretical approach is not reliable when making decisions for the company.

Current Cost Accounting

This approach is best suited when trying to maintain the purchasing power of a company during times if inflation, or fluctuation of exchange rates of currencies, because it is based on actual valuations. This theoretical approach cuts a clear line between profits that are made after sales, and the gains that come with holding an asset, be it a net-monetary asset or a non-monetary asset (Murphy, 2008).

Scholars have argued that a physical or real approach to maintaining capital yields the best results in any business entity, especially in terms of income. This approach values as asset on the basis of replacement costs (Murphy, 2008). Operating income of the asset is valued as realized revenue, minus the replacement costs of that particular asset.

This approach of calculating replacement costs is best for calculating operating profit. This makes it possible to maintain the operation capacity of the business at a constant level. The current cost operating profits before absorbing gains and losses, and the realized gains of holding an asset are both counted as revenues, and thus the sum of the two equates to historical cost profit (Rosenfield, 2006).

Gains of holding an asset are different from gains after making sales (Porwal, 2001). This is because are the two are dependent on differing factors in the market, most of which are beyond the control of the management in a business. There is an uncertainty surrounding the prevalence of replacement costs though.

Current cost accounting is founded on two business concepts; current operating profit and realizable cost savings. Current operating profit is defined as the excess of the present value of the output sold, over the cost of related inputs. Realizable cost savings, also termed as the holding gains or losses, are the increase of the present cost of assets that the company is holding in a given period. Holding gains or losses of an asset can be realized or unrealized. For example, the holding gain of an excess in revaluation in unrealized, but is still considered as part of the business profit in the income statement (Whittington, 2007).

In the event that there are two companies that were started at different times, the company that was started earlier will have a larger operating profit. This is because it has less depreciation costs. Any one would think that this company has a more efficient system of running its operations in the current years than other companies that were started later. The actual case is that the management made a wise decision when starting the company. The fact that they bought their assets back in time is a contributing factor. This is a good illustration of the concept of realizable cost savings.

Exit Price Accounting

This approach argues that assets should be valued as per their exit or market prices, non-marketable reproducible assets at replacement costs, and seasonal no marketable, non-reproducible assets be valued at the original cost (Rosenfield, 2006). The theory also argues that financial statements should be structured in a way to show how much a company is able to adapt to different situations and environments, and that income should be inclusive of all profits and losses, those that have been realized and those that have not been unrealized.

This approach is suitable especially when the management has to make decisions about the future of a company. The fact that it gives a straight on focus on the adaptability of a company, makes it stand out of other theories (Whittington, 2007). The adaptability of a business entity is based on how liquid or sellable its assets are. This kind of approach would come in handy at a time when a company is considering to sell some of its assets to counteract inflations in the market.

Positive Theories Approach

As defined earlier, positive theories are used to explain and predict a phenomenon after making observations (Deegan, & Samkin, 2011). Positive theories are based on the assumption that if one makes a series of observations on a behavior, they are able to develop a certain patter which they use to make conclusions and predictions. Examples of positive theories include the stakeholder theory and the legitimacy theory (Deegan, & Samkin, 2011).

PAT is mainly involved with relationships between people or entities that provide resources to a business organization (Deegan, & Samkin, 2011). For instance, the relationship between the management of an organization and its owners. The main elements of most of the relationships according to this theory involve the delegation of decision making from one party (possibly the owners or management who act as the principle) and the agent (second party). If the principle makes wrong decisions, then the two parties are likely to suffer losses, and increased costs due to inefficiency. Such expenses are known as agency costs.

The Positive Accounting theory seeks to find a way to reduce agency costs by use of contractual arrangements. It is thus based on the assumption that stakeholders will act in favor of their own interests, and will therefore grab any opportunity available to increase their wealth (Deegan, & Samkin, 2011). With this assumption, morality and loyalty are definitely not characteristics of this theory (Ketz, 2006).

The positive accounting theory states an organization is usually a collection of people who have individual self-interests, but are willing to cooperate to achieve collective goals, while at the same time, working on their personal goals (Alexander, Brittan, & Joseen, 2007). One prediction of the PAT is that organizations will execute measures that align the interests of the whole organization to self-interests. Most of these measures are based on the output of the accounting system, where the stakeholders get to share the excesses of the organization. Such mechanisms need to be backed up by financial statements.

According to PAT, managers should commit themselves to preparing the financial statements (Freedman, & Jaggi, 2010). This is an expensive activity and the costs incurred are known as bonding costs. Bonding costs can therefore be defines as costs incurred to relevant authorities or agents when establishing means to communicate to the principals, so that they may act in a way that will not affect goals of the organization or the individuals involved.

Being part of the stakeholders, the management officials too, have their own self-interests. Based on this assumption, PAT states that the financial statements that are prepared by the management should be audited (Alexander, Brittan, & Joseen, 2007). This would help avoid possibilities of the agents to act or manipulate figures in the financial statements to suit their interests. On this note, PAT assumes that not all opportunistic actions can be controlled by contractual arrangements such as the auditing exercise, therefore, there will always be residual costs. Costs incurred during the auditing exercise are known as monitoring costs.

Decisions or investigations that are based on the Positive accounting theory adopt an efficiency perspective or an opportunistic perspective. The efficiency perspective seeks to find mechanisms that can be executed so as to reduce agency costs (Freedman, & Jaggi, 2010). A good example of this is that when companies produce financial statements that have been audited, they reduce real costs since there are no hidden figures that are not well accounted for. The audited financial statement therefore serves as an efficient perspective, and thus the organization can be termed as efficient (Deegan, & Samkin, 2011).

Still from the efficiency perspective, accounting practices of an organization should reflect the underlying financial performance of the organization. Organizations adopt different accounting methods, which can be explained by various organizational characteristics. A good example of this is goodwill. If a company is able to provide reliable information about its performance, potential investors will not need to go out looking for more information from other sources. This saves time and reduces costs (Schroeder, Clark, & Cathey, 2011).

A company will pick an accounting method that will best show its underlying performance. This means that placing certain limitations or regulations on how companies prepare their financial statements can lead to a company incurring more costs than necessary, and probably not achieve their goal. Based on this, this theory recommends that companies should be allowed to prepare their financial statements in a way that best suits their operations, and that will show their underlying performances well (Deegan, & Samkin, 2011).

As for the opportunistic perspective, PAT seeks to explain and predict opportunistic behavior likely to happen after getting into a contractual agreement. For example, when trying to minimize agency costs, the management of a given organization can negotiate a contractual arrangement to increase their bonuses on profits made. This would align the interests of the managers with those of the owners of the business entity. With the agreement in place, the management can then find other mechanisms to ensure that more profits are generated (Freedman, & Jaggi, 2010). The more profits are made, the better the bonus that both the management and the owners will enjoy. These mechanisms that the management adopts may not be reflected on the set up of the organization or its assets.

The opportunistic perspective assumes that owners of an organization predict that managers will at some point act opportunistic (Deegan, & Samkin, 2011). The principles are therefore likely to set what accounting methods should be used. For instance, a bonus plan agreement may have a stipulation that a depreciation method be used to calculate income inform of bonuses. The management may find it a bit costly to stick to the stipulated plan, and may seek an alternative method. Following such a possibility, PAT states that agents will always have an upper hand in deciding what accounting method to use.

Conclusion

The above theories are applicable in different situations. According to the analysis put above, the two theories address different issues, and thus, it would yield contradicting results to combine them. For instance, normative theories are best applied when a company is faced with various externalities like fluctuations of currencies and inflation of prices. These affect the purchasing power of a company and thus, the theories come in handy to help the management to make decisions on how to survive such challenges.

As for the positive theories to accounting theory, these come in handy when dealing with issues that affect the relationship between the major stakeholders of any business; the owners and the management. The two parties may have contradicting interests, and the positive theories come in handy best in such situations.