Is accounting profit figure a measure of true profit of an organizations

Accounting rules and regulations are a 'mish-mash of rather conflicting concepts'(e. g. relevance and neutrality), giving managers discretion in deciding which principle to and not to apply(1). Profit is no simple figure which can be computed easily(2), infact it is a thorough process of naming and counting(3); identifying, calculating and summarizing many references generated. Some of these items donot exist, and hence are brought into existence by identifying and assigning monetary values, some involve quantifying the qualitative, while calculation of others may involve managers choosing between different rules and methodologies(revenue recognisation, inventory, depreciation calculation using different techniques), all of which are accepted, by providing a simple reasoning or justification for the choice. Hence, earning management itself is allowed in the profession giving managers the discretion to twist and turn certain figures to meet their criteria, provided a proper reasoning is given.

Prudence-an important rule in history, guiding managers that should a conflict arise, a conservative approach to be adopted, as not to be over-optimistic about performance. But now, it is a mere subset of reliability, replaced by faithful representation by IASB, following FASB(4). Should we now expect more use of creative accounting? Given the current credit crunch is it fair to follow USA? Does this mean that instead of using a careful approach as to which colors to use, managers are free to paint the picture in any way they like? Similar implications apply for the use of fair value accounting (driven by Hick's, 1975, income and opportunity cost theory), affecting asset valuation and income recognisation. Also given diverse and conflicting rules, what maybe true for one company or country, maynot be

true for another(due to different accounting bodies). Therefore profit is merely 'creating rather than reflecting reality'(5).

Another point to discuss is PAT(positive accounting theory); based on unrealistic assumptions as long as they are a good prediction, and underlying hypothesis are never rejected if proven wrong(6). The diagram below shows that in every step of PAT methodology there is a lot of subjectivity, and half of the time they donot tell what assumptions have been made.

PAT is based on Adam Smith's rational economic man stating that 'all choices are based on self interest and accumulation of private wealth; hence accounting methods will be chosen to mislead and disguise performance'(7). " Agency theory" (Jensen & Meckling, 1976) is closely related to this, displaying conflict of interest amongst shareholders and managers, which justifies why managers may resort to earning management, especially if performance-based salaries are used (management compensation hypothesis, Watt and Zimmerman 1986).

Shareholders appoint auditors as a protection of their rights and assurance that managers are managing the company to the best of their ability, to maintain decision making efficiency, but auditors donot have access to all the information, and only base their decisions on the information provided by managers and given accounting regulations, does this information asymmetry means that auditors really provide a fair and truthful analysis of company reporting? Given the limited figures that auditors are given, can they analyze that profitability as shown by the company is actually correct?

The answer is NO, and we have many examples such as Enron, Sunbeam, which despite been given unqualified audit reports, failed ultimately.

Furthermore, as Watt and Zimmerman argue that PAT only gives a prediction of which method managers might use, but doesnot tell which accounting method should be used, for example a large company is likely to use income reducing methods to avoid political attention (political cost hypothesis), debt hypothesis states that a company which is close to breaking its debt covenants will choose policies to ensure such covenants are not violated(8).

Also, it is too simplistic to state that it is the only truth. Infact even if profit figure is aligned with company's actual performance, according to coherence theory it is 'just a truth'(9), and not the ultimate reality. Although some might claim the contrary, as the media only compares the profit figures and doesnot refer to the variety of accounting policies that can be adopted(10).

My argument ends with the viewpoint, that although accounting policies and audit reports are designed to protect stakeholders from false reporting, but due to gaps in rules, managers still maintain the discretion to choose policies, which is exploited to meet their objectives, hence shareholders and auditors should use a pool of resources, such as return on investment(11), key performance indicators, share price and economic profit (bank interest and return on other assets-12) to assess performance. Information is not stable, clear and self-evident(13), it is subject to constant change, and can be generated and interpreted in different ways. Truth is not in the numbers, it is only constructing reality using 'space, time and value machine'(13), therefore users of accounting information should use their own judgment,

knowledge and opinions before reaching any conclusion and not base decisions blindly on profitability alone.

NOTES:

Rhoda lecture notes: 'The Growth of regulation: International standards and conceptual frameworks of accounting.

My first reflective piece

Lecture notes Ann-Christine Frandsen: 'Where do we find accounting'

Lecture notes Dr Fiona Anderson Gough: 'Early standards and normative theory, the influence of past on present'

Hines 1988

Friedman, The methodology of Positive Economics 1953

Adam Smith, The wealth of nations, 1776

Lecture notes, Rhoda, Positive accounting theory (PAT)

Lecture notes, Dr Fiona Anderson Gough, Portraying success

Deegan and Unerman, 2006

Lecture notes, Ann Christine Frandsen

Ball and Brown, 1968

Frandsen A-C (2009), Information Organisation