

Financial statements
are important for
investors and
creditors accounting
essay



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You are required to discuss and comment on the above statement with reference to academic books, papers, and other published sources that you have read. Consider all the following in your response:

Critically evaluate financial statements in terms of its importance, reliability and relevancy to the key users.

Response:

As stated by Atrill & McLaney, the financial statements objective is to provide a snapshot of the financial position and performance of a business (Atrill & McLaney, 2008).

The Financial Accounts of a company describe the performance of the company in financial terms. They are summary of the extensive activities of a business designed to provide true and accurate pictures to stakeholders (Woelfel, 1994).

In today's world, the financial accounts of a company will be of interest to wide variety of users called stakeholders (DL MBA Material, 2003).

As discussed in DL MBA material, some of stakeholder of a company can be owners, lenders, investment analysts, managers, employees, customers, suppliers, competitors and government agencies. The following briefly discuss characteristics of financial reports which would be interested to each party (DL MBA Material, 2003).

Owners - The shareholders of company's are ultimate owners. The shareholders invest their money into company & hence they are concern with profitability, dividend and future prospects of the company. Their main

concern is reliability of information available to them to decide their future expectations or course of actions (DL MBA Material, 2003).

Lenders - They are the financial institutions who lend money to a company for its regular operation or business expansions. They perform detailed analysis of company accounts and make decision to lend money. It helps them to understand the financial leverage of the company by analysing the different leverage ratios like debt-to-equity ratio etc. They determine the fixed assets of the company in order to cover up any eventuality. They decide the repayment ability of companies towards borrowings (DL MBA Material, 2003).

Investment Analyst - They are risk-appetite traders, individual investors, and financial institution looking for business opportunity to invest money into a company. They often use company's account to evaluate the future growth and profitability of a business. One of their main concerns is growth potential of the company & their share price performance in stock market (DL MBA Material, 2003).

Managers - A companies managers' intention is to analyse the financial accounting and find the direction of the efforts being put to achieve corporate objectives. They usually determine the company performance based on exhaustive internal accounts. Their individual performances get judged by the producing good accounting figures (DL MBA Material, 2003).

Employee - They would be concern about future of company & stability and would be looking at accounts from company profitability, growth, long term business and truthfulness of information (DL MBA Material, 2003).

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Customers- They often see company's account to determine the strength of the potential vendor to satisfy their commitments (DL MBA Material, 2003).

Supplier- They often see company's accounts to determine the credit facilities & payment terms (DL MBA Material, 2003).

Competitor- will be interested to see the accounts to gain any advantage which they can make use of (DL MBA Material, 2003).

Government agencies- Tax authority will take closer look into a company's account to identify any discrepancy in the account by overstating or understating profits. Hence the key criteria would be to check accuracy, verifiability & truthfulness (DL MBA Material, 2003).

The different users of accounts got different motives to look at it and they got different requirements like fairness, truthfulness, performance, repayment capacity, financial leverage, liquidity and cash flow of a company.

Question 2 : Review the shortcomings of HCA model when prices are rising and explain why financial reports under the HCA are subject to some major limitations (e. g. inventory is undervalued, the depreciation charge to the income statement is understated, balance sheet values are understated, and periodic comparisons are invalidated).

Response:

The historical cost accounting is a convention in which asset values are based on the actual amount paid for the assets with no inflation adjustments. The historical cost conventions mention that the value of assets should be accounted on their acquisition cost (Atrill & McLaney, 2008).

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It does not take into account inflation though there are certain adjustments like depreciation, depletion and impairments (www. money terms. co. uk, 2010). It relies on an assumption that the purchasing power of money is constant through out and does not change with time. Under historical cost approach, the inventories are reported in balance sheet at cost. However, there may be reduction in realisable value of the inventories due to obsolescence, deterioration or saleable price changes; hence historical cost approach does not account for this change (Hawawini & Viallet 2007).

It is often said that the weighing assets at their current value would provide a more truthful picture of the financial position of a company and would be more meaningful to wide range of audiences for decision making. But at the same time it has got reliability problem (Atrill & McLaney, 2008).

With rise in price, HCA will not be able to capture the change in valuation of underlying assets as it records the value of assets as historical cost. Hence, increase in the value of assets will not be reflected in a company balance sheet. Due to this the balance sheet will not present the true financial position. As a result, in the time of high inflation, profits will be overstated and tax liability will increase.

Again with price fall, similar problem will be observed but this time real asset value will be less than the historical cost hence overstating the assets on the balance sheet & undermining the profits & the tax liability will decrease.

The depreciation adds more complication to the problem. The cost of assets generally spread out over a number of years of its usability life time at the price paid at the execution of a transaction. The depreciation affects the <https://assignbuster.com/financial-statements-are-important-for-investors-and-creditors-accounting-essay/>

carrying value of the asset. HCA does not consider the real value and hence depreciating original value does not show true picture.

Question 3: Why has the HCA model survived in spite of its limitations in times of inflation?

Response:

The HCA model is traditional accounting model and there are many reasons for its survivals. It is straightforward, simple and reliable. There are certain limitation with net market value, depreciation, price rise & fall and inflations but at the same time other accounting systems largely faces concerns around reliability, appropriateness, quality & truthfulness of information (Johnson, 2005).

As per Johnson, the historical costs though not fair but much more reliable. Hence many instances, the importance is given to trade-off between historical costing and other advanced fair value practices in much larger perspective (Johnson, 2005).

The foundation of HCA is a real transaction which has happened and the money has been paid for that transaction. Hence the cost value is a real & not fictitious and has its root in that transaction. It is not about calculating somewhat imaginary or hypothetical cost. The main advantage of using historical cost accounting is simplicity and certainty. The other advantage is it gives managers ability to forecast future operational costs. Hence in spite, many experts argue that the fairness of the method is far from real value, it still continue to dominate the accounting world.

Question 4: Discuss the features of current income and value models (e. g. Current Purchasing Power Accounting (CPPA) and Replacement Cost Accounting (RCA) models) that have been suggested to replace or operate in tandem with the HCA convention.

Response:

As per Nobes, current purchasing power or general purchasing power accounting systems are based on historical cost accounts adjusted with general price index numbers (Nobes, 1992). In case of current purchasing power accounting, the original purchasing costs are corrected by correction factor based on some general index like retail price index. The corrected purchase cost is then used to calculate the balance value of the assets in order to record in the balance sheet for that year. Hence it represents more realistic value for non-monetary assets.

Ahmed argues that the replacement cost accounting measures replacement cost in units of money. He argues that the replacement cost income is equal to the difference between realised revenues and their corresponding replacement costs in units of general purchasing power (Riahi-Belkaoui, 1996). As per Drummon & stickler, the replacement cost is the amount of cash or cash equivalent that would be needed presently to acquire equivalent assets which can provide same function as the original asset. The method consists of estimating the cost of a new asset as argued by Christina (Drummon & stickler, 1983). The important characteristic of replacement cost accounting is to capture the effects of changing prices and ultimate changing value of the items.

The key feature of both techniques is to capture the loss or gain in the value of non-monetary items such that the effects of inflation or deflation can be captured in the balance sheet to make it more accurate.

Question 5: Critically evaluate the virtues and defects of these alternative models.

Response:

The main characteristic of the alternative models like current purchasing power accounting or replacement cost accounting is a mechanism to capture the loss or gain in the value of non-monetary items on the current valuation basis. It helps to record assets on the balance sheet with realistic values. The balance sheet can portrait true picture of financial position of an organisation (DL MBA Material, 2003). It can accommodate the effects of inflation or deflation & make financial statement more economically relevant.

The main drawback of the alternative models is changes in the prices are captured but these are not based on actual real transaction. These models are complicated and values are subjective. It may happen that the general Consumer Price index or inflation has gone up but the impacts on assets have been reverse or not that significant. In such case, the resultant value will be erroneous. Hence they lack in reliability.