

Financial accounting is subjective not objective accounting essay



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This essay is to discuss how financial accounting information is objective in a true accounting sense. Some accountants base information on subjectivity. But in the true sense of accounting, accounting information is said to be objective due effective evidence and facts that are used to back up the information. Relevant quotes will be used in order to support each arguments illustrated.

“ Objectivity in accounting is largely a myth” (Morgan, 1988 pp 477). It refers to how future expansion can be regulated in terms of building alternative perspective in accounting. And how accountant can approach different situations using different methods.

Accountants and economists define financial accounting in different ways, but the most acceptable way of referring to accounting can be “ Financial accounting can be defined as a process of designing and operating an information system for collecting, information in order to make financial decisions” (Andrew, 2009 p33). All financial data and other financial information gathered are organised in an efficient way in order of accounting principles for reporting purpose and also financial or economic decisions.

Financial accounting is said to be “ objective in the sense that it is not biased which means it is true and fair” (tutor2u 2010) in review. The purpose of financial accounting is to provide information about the performance of a company to external stakeholders and internal bodies such as managers and directors within the organisation. The external stakeholders can be in form of shareholders, creditors, suppliers, tax authorities etc. The financial

information gathered will help external investors to make the right investment decisions in such an organisation.

Objectivity in accounting is essential for accountants of an organisation when reporting the financial worth of the business. The set value of a final accounts presented to managements depends heavily on basic assumptions which are been presented by the accountant. " Accounting is like any other form of human activity is governed by different principle" (Edward 1964). Likewise accounting is governed by concept and convention e. g. IFRS. It is assumed that accountant must show accurate accounting information. In most cases the fairness of disclosed information are been judged by external auditors. However, evaluators may point out that this is sufficient reason why accounting cannot be objective. Agreeably a wide range of basic assumptions and forecasts may be made when preparing the economic information and the emotional factors which may determine an observer's attitude do create difficulties. However for objectivity to be valuable, difficulties have to be overcome by investigating all evidence without bias prior to addition in the accounting system.

Objectivity as a property of accounting measurement does have an appeal. It is a complex concept to explain, in some cases it leads to confusion and disagreement. " It is far more realistic to define objectivity simply as the consensus among a given group of observers" (Yuji Ijiri, 1967 p133).

Objectivity depends mainly on the measurer. For instance, measuring the net profit of an organisation, accountant will have to produce a high level of consensus rather than evaluating through a layman's point of view or economist.

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Fairness is closely related to reliability. Objective evidence consists of anything that can be physically verified such as a receipts, cheque, invoice, or bank statement. In a situation whereby information or assets cannot be verified objectively, a number of subjective techniques are used to develop an estimate. The determination of items such as depreciation expense and allowance for doubtful accounts are based on subjective factors, at a halt even subjective factors are influenced by objective evidence such as past understanding.

Management accounting allows for a great deal of subjectivity when creating metrics and methods for measuring business performance. This is difficult in the sense that accountant's individual beliefs and biases can have an impact on the way performance is measured. For instance- if the productivity of workers was to be measured, the accountant may focus solely on the output and not consider the inputs. This will later have a knock on effect on overall productivity and also employees will feel that they have not being evaluated fairly due to how information was generated.

Subjectivity can be used in evaluating the bonus scheme of an organisation..

" Subjectivity can take the form of flexibility in weighting quantitative performance" (Christopher, 2003 p726) when measuring a managers bonus within a particular period. Subjectivity plays an important role in analysing an employee's incentive; this is because it helps to reduce employees risk and also maintains the difference between the employees and employers.

However, the advantage subjectivity can lessen managers' motivation by allowing assessors to ignore certain types of performance measures that

should have being included in the bonus plan; this will alter the payout
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measure making it change at a particular period, and also establish “favouritism and bias” into the reward system among other employees (Prendergast and Topel 1993). As a result of favouritism, managers will be less able to differentiate what constitute a performance. Despite its importance, subjectivity is still largely an unexplored happening,

Net income is the result from an investment within a particular period in time. This is released from business risks and is accredited to the owner's entity, expectation of investment results are specified by uncertainty; the results are released from risks when they become facts. What are the expected result and the facts in each investment? For business investments, whether the results of investments have been released from risks is generally determined based on whether assets that are not subject to business risks have been obtained in exchange for assets that are subject to business risks. When investment activity continues as it is, the assets are measured at historical cost. Historical cost is objective it allows for all assets to be recorded at their acquisition cost before depreciation. However, historical cost does not record opportunity cost of older acquired assets which therefore leaves room for subjectivity.

Subjectivity tends to have an advantage on financial accounting in regards to goodwill. Goodwill is assumed to be the difference of the value in use and the market price. Value in use is a present value of the future cash flow expected from the best use of the asset, discounted by the discount rate as of the measurement date, while a market price represents a price quoted in the distribution market for an asset. Goodwill is an important asset but subject to suspicious since evaluation depends on the measurer. Therefore, <https://assignbuster.com/financial-accounting-is-subjective-not-objective-accounting-essay/>

meaning the values placed on goodwill cannot be exact. However, accountants recognise the objectivity of goodwill only when it is purchased.

Subjective goodwill can also be the difference between value in use and the market price of the asset. Future cash flow is realised from the best value of an asset which is has already being discounted by using a discount rate as at date. Value in use reflects the subjective value estimated by the reporting entity, and it consists of a market price and intangible subjective goodwill, which is defined as the excess of value in use over the market price²³.

Subjective goodwill is not included in a financial report because its earning and reports cannot be verified and accounted for. Subjective goodwill can only be included in the financial income report of a firm as long as it is calculated on the bases of depreciation.

Conclusion

In conclusion, different researchers such as “ Shapiro believes that financial statements can be objective, in the sense that they may be true or false in virtue of the “ facts of the matter” (John, 2007). Referring to Searle theory he also recognizes that the objectivity or subjectivity of judgement tends to be a “ matter of degree” (Searle, 1995 J. Searle, *The construction of social reality*, Penguin Books, London (1995). Searle, 1995), This means there is a degree to subjectivity in terms of information because not all opinion is fully objective.

Objectivity principle simply entails that accounting data should be able to be verified and free from any form of bias, basically accounting information must be reliable to all accounting user. Historical cost information and other

accounting entries are recorded on the basis of original documents which have not being influenced by personal unfairness and objectivity. Therefore, historical cost accounting is still referred to be objective inspite of its limitations.

However, the degree of objectivity extremely varies because it recognises what intangible assets that cannot be included in a balance sheet. This is ‘ because the judgement involved in determining whether it is probable for future economic benefits will surge leaving it too subjective to result in similar accounting under similar circumstances’ (IAS 38. BCZ38)