

Could the Suitability of the Existing Accounting System be Argued?

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Accounting is a process of recording and studying financial data related to company's operations. Its aims are above all to provide information about the events in company business life in an agreed language comprehensible to accounting information users and to provide information which is vital to business decision-making. If we consider the above mentioned aims, we can establish that it is not easy to reach them. Accounting is not an exact science, which means that approximations or planned amounts are very often used as its tool. In addition, as the future is uncertain, we cannot determine the exact value an asset is about to achieve when converted into a monetary form, neither can we define the amount which is to be required to discharge a certain liability. And so we can ask ourselves if the existing accounting solutions enable us to create suitable accounting information. Our paper deals with the problem of the existing accounting system's suitability. Four questions are investigated, namely the question of accounting solutions consistency, reality of financial statements, capability of creating accounting information which provides an optimal management of the elements of the business process and accounting solutions' objectivity.

Key words: classical accounting approach, consistency of accounting solutions, objectivity of accounting solutions, reality of financial statements, business decisions

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Introduction

Accounting is a process of recording and studying financial data related to company's operations. Its aims are above all:

- to provide information about the events in company business life in an agreed language comprehensible to accounting information users and
- to provide information which is vital to business decision-making.

The first aim of accounting relates to the past, the second to the future. However, reaching the above mentioned aims is not easy. Accounting is not an exact science, which means that approximations or planned amounts are very often used as its tool. As the future is uncertain, we cannot determine the exact value an asset is about to achieve when converted into a monetary form, neither can we define the amount which is to be required to discharge a certain liability. Therefore, the practice of accounting has some objective limitations. However, it can be questioned whether the existing accounting solutions provide the creation of suitable accounting information.

Our paper deals with the problem of the suitability of the existing accounting system. Four questions are investigated, namely the question of accounting solutions consistency, reality of financial statements, capability of creating accounting information which provides an optimal management of the elements of the business process and accounting solutions' objectivity. Finally, some possible solutions are provided.

Suitability of the Existing Accounting System

The suitability of the existing accounting system, the so called classical accounting, is assessed in this paper on the basis of four criteria by establishing:

- if the existing accounting system is consistent,
- if it provides the creation of accurate financial statements,
- if it provides accounting information that enables their users to manage the elements of the business process optimally,
- and if the accounting solutions are unbiased towards business entities.

CONSISTENCY OF ACCOUNTING SOLUTIONS

Are the solutions of classical accounting consistent, in other words, is it possible to use them consistently to disclose accounting events? Let us take a look at the following example.

The aim of the business process is creating output. However, the business process is not possible without the necessary elements which are equipment, materials, services and labour. These elements are being consumed in a business process. By valuing the expenses of those elements, the costs are obtained.

The costs are thus the expenses of business process elements expressed in price. They are defined by the following five conditions which are to be met simultaneously:

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- when one of the business process elements is considered,
- when a particular element is being spent in the business process,
- when a particular element can be expressed in price or when money is needed to obtain it,
- when expenses expressed in price are logically related to creating output and
- when expenses expressed in price do not exceed reasonable amount.

According to the third condition, we can use the term costs only in cases when the depreciated element is monetized.

The elements of the business process include employees and their working abilities. Their presence in the business process is associated with labour costs. However, the value of employees is not shown among assets, which means that their value as a business process element equals zero. However, the question is how it is possible to discuss the costs of an element whose value equals zero. If we multiply any quantity of this element's expenses by its price per unit (zero) we always obtain the same result.

It can be established that classical accounting considers various elements of the business process in a different way, which means it is inconsistent. Furthermore, the labour costs occur regardless to the fact that the depreciated element has no value.

The method of treating the investments in employees, which is discussed in the following chapter, also points at the inconsistency of the existing accounting solutions.

REALITY OF FINANCIAL STATEMENTS

Do financial statements based on classical accounting approach provide true and real picture of the company's business life? Francis and Schipper (1999) established that financial statements had significantly lost their credibility. The same was established by Collins, Maydew, and Weiss (1997), Ely and Waymire (1999), Lev and Zarowin (1999) and Chang (1999). Some other authors approached the problem indirectly. For instance, Kanodia, Singh, and Spero (2005) established that the accounting disclosure of company investments is often inaccurate, which puts the reality of financial statements under the question and Himick (2015) exams the 'conditions of possibility' for workers to be considered depreciable assets. On the other hand, McCarthy and Schneider (1996), Francis and Schipper (1999), Goodwin and Ahmed (2006), Ji and Lu (2014) and

Goebel (2015) express the opinion that the value of intangible assets is shown reliable and relevant. And finally, Lev (2008) expressed criticism towards the method of valuing and disclosing intangible assets. Our own response to this question is demonstrated through an example that shows different methods being used by a certain company to treat particular investments. We disclose the method of treating the investments in tangible fixed assets and the method of treating the investments in employees.

Let us suppose that a company purchases a machine whose purchase value is sixty monetary units and whose useful life is five years. The company pays the supplier by the due date, but the payment is not directly associated with the costs as the company depreciates the purchased machine in sixty months – e.g. one monetary unit per month.

However, the situation is rather different if a company provides education and training for its employees. In this case, the company discloses the relevant costs as soon as it receives the invoice from a training provider. Would it not be more suitable to raise the value of the employee by the amount of the invoice and to depreciate this investment during the entire useful life of their acquired knowledge (e.g. within three years)? It may be assumed that due to their newly-acquired knowledge, employees will perform their work better.

Obviously, the classical accounting employs different methods to treat the investments in tangible fixed assets and different methods to treat the investments in employees. Our question is if there are any sound professional reasons for justifying the different methods in treating the investments.

In our opinion, the classical accounting approach obviously exaggerates in applying the principle of prudence in accounting, which leads to a rather high amount of hidden reserves on the balance sheet. Hidden reserves are especially present among assets. The presence of hidden reserves is useful for the long-term existence and development of a company and therefore the company owners are interested in it. Hidden reserves decrease business success which leads to a lower tax burden for the current period.

To sum up, classical accounting does not disclose investments in employees as a raised value of employees, on the contrary, those amounts are disclosed among the costs immediately as they occur. Classical accounting justifies this approach by the principle of prudence. In other words, classical accounting does not include the investments in employees into the costs because it considers them as high-risk. However, are the investments in employees in fact so risky

that they need to be treated this way? Our opinion is that the classical accounting's supposition regarding the high-risk of investments in employees has completely no ground and is very disputable from a professional point of view. In addition, investments in employees have the highest long-term return of all investments. It is also known that output with a small share of knowledge in its price are increasingly difficult to market. Knowledge is the only good that will always be in great demand and it will always be possible to market it at a reasonable price. Moreover, a company that does not invest enough in its employees risks a relatively rapid collapse.

An investment is the most common way of the transformation of assets that does not affect the value of liabilities. However, investments in employees do not lead to the transformation of resources as the reduction of one resource (e.g. money) does not result in the growth of the other resource (investments in employees are not disclosed among assets). Consequently, investments in employees knock off the equilibrium of the balance sheet in classical accounting because a shortage of resources with regard to the value of liabilities occurs. The knocked off equilibrium of the balance sheet due to the lack of assets can only be regained by reducing the capital (or by its smaller increase in comparison to disclosing investments in employees among assets).

In classical accounting, investments in employees can be compared with spending money irrationally, e.g. for lottery tickets that will not be in for the draw or similar; in other words, accounting records do not show that there are any benefits to be expected from these investments. Reduction of one asset (e.g. money spent on investments in employees) does not result in the growth of the other asset or in debt reduction (e.g. loan repayment, payment to the supplier, etc.). Furthermore, if non-disclosure of investments in employees among assets leads to capital reduction, should its disclosure lead to capital growth? The question might be absurd but it clearly illustrates the inconsistency of classical accounting regarding the disclosure of investments in employees.

It should also be noted that some authors express no doubt regarding the adequacy of the existing approach towards the question of financial statements' reality. In other words: some authors are convinced that classical accounting makes it possible for financial statements to show true, real, objective and not very distorted picture of previous business life of a company (e.g. Core, Guay, and Van Buskirk 2003; Penman 2003; Skinner 2008) and they even promote conservatism of accounting solutions (Salama and Putnam 2015).

Also other opinions could be found. Dumay (2009) for e.g. talks about 'accountingisation of intellectual capital,' Chiucchi and Dumay (2015) use the term 'intellectual capital lock-in' and similar. The main question is how to make intangible assets tangible to improve the reality of accounting statements. See also Guthrie, and Ricceri (2006), Dumay (2014) and Massingham and Tam (2015).

PROVIDING ACCOUNTING INFORMATION THAT ENABLE THEIR
USERS TO MANAGE ALL THE ELEMENTS OF A BUSINESS PROCESS
OPTIMALLY

Does classical accounting provide information that enable their users to manage all the elements of a business process optimally? Let us demonstrate our response to this question through the following example regarding employees.

It can be established that classical accounting does not provide the information on the value of employees and investments in them. This information affects:

- human resource management,
- importance of human resource management and
- planning the future value added.

Let us focus on those questions in details.

Human Resource Management

Not knowing the information about the value of employees and investments in them negatively affects human resource management: it is easier for the management to make staffing decisions on the basis of costs and value factors. The estimates of employees are only exceptionally based on quantitative methods. Therefore, not all the information needed for efficient recruitment, employment, utilization, evaluation and reward of employees are at the management's disposal. It is also more difficult for the management to establish the success of human resource management.

In short, information on the value of employees and investments in them are very important for the management of employees. However, the experts in this area obviously do not share the same opinion. There is no mentioning of the value or valuing of employees in numerous records on the human resource management, even though their value has a key role in managing employees. How can we even manage someone (or something) without knowing their value? On what basis can we decide how much to offer to an expert that wants to leave the company in order to keep him?

Importance of Human Resource Management

Not knowing the information on the value of employees and investments in them, negatively affects the management of employees. The role of human resource management is small in today's companies. Its operation is usually considered as unproductive and expensive, therefore, the companies aim to minimize it. In some cases, human resource management is regarded as a luxury that only the most successful companies can afford. This attitude towards the human resource function is due to the fact that it is very difficult to assess its impact on business performance.

Since human resource management is considered to be unproductive, its budget gets reduced first when a company performance decreases. Under such circumstances, the value of investments in employees gets reduced as well, which has a negative influence on a company performance in the long run. The amount of the damage caused by doing this remains hidden.

Planning the Future of Value Added

Not knowing the information on the value of employees and investments in them makes it difficult for the management to plan the amount of value added in a company. Namely, the term employees is closely related to the term of value added.

Value added is defined as the increase of the market value of output caused by the increase of their quality. It is assessed by calculating the difference between the market value of output and the purchase value of consumed elements. Value added is considered as wealth – it is a unit of measurement for the achievements realized by the investors, management and employees.

The amount of value added in a company otherwise depends on technical and technological equipment, however, it depends even largely on the value of employees and investments in them.

We are aware of the fact that evaluation of employees is a very complex issue and that searching for an acceptable professional solution would require great efforts. According to Steen, Welch, and McCormack (2011, 300):

Numerous authors establish that evaluation of employees includes a greater degree of subjectivity than evaluation of tangible assets; this is also true for reporting on employees.

Although the solution of this important professional issue requires great efforts we should not be discouraged from trying to solve this issue. Furthermore, numerous authors establish that the informa-

tion on employees is very important for the users (Barth, Beaver, and Landsman 2001; Schiemann and Gunther 2007; Wyatt 2008; Gammerschlag and Moller 2011; Mention 2011; Vafei, Taylor, and Ahmed 2011; Abhayawansa and Guthrie 2012; Uyar and Kilic 2012; Gammerschlag 2013).

BIAS OF ACCOUNTING SOLUTIONS

Are the solutions of classical accounting unbiased, in other words, do they provide an equal treatment of individual economic agents according to their operating characteristics? Hereby, we define operating characteristics as:

- composition of assets and
- possibilities of debt financing.

Composition of Assets

The question regarding the influence of the composition of assets of a company on their value disclosed on financial statements is related to the previously discussed question of the reality of financial statements. Let us observe this on an example of intangible assets.

An intangible asset can be disclosed among assets only if it is separately identifiable (it can be separated from the company, sold, transferred, rented, exchanged and similar) or if it arises from contractual and other legal rights. At the same time, there must also be a probability of future economic benefits related to it and a possibility to accurately measure its purchase value (Mirza, Holt, and Orrell 2006). For better understanding of the existing accounting system in relation to the discussed question, we demonstrate a simplification through an example.

A company has two basic options to obtain an intangible asset. The first option is to purchase it, which means, for example, that a company purchases knowledge that is protected by a patent. This way, the purchase value of the intangible asset is disclosed among the assets. The second option is that a company creates the knowledge by itself, e.g. in its own laboratory or similar. In this case, disclosing these items among the assets is associated with numerous limitations.

For example, the research costs that occur inside a company do not have the characteristics of intangible assets. This also applies to internally generated brands, goodwill and similar items. However, the development costs that occur inside a company can be disclosed among intangible assets if several conditions are cumulatively ful-

filled. In short, the disclosure of intangible assets that occur inside a company is regulated in a very conservative way.

We are not familiar with the results of the research on this topic but we are convinced that most part of the necessary intangible assets are created by the company itself. It is hard to imagine a global company, operating in the area of pharmacy, microelectronics or similar, buying essential knowledge to be able to perform its activities. This means that the share of intangible assets acquired by a company through purchasing is materially less important. The result of the before mentioned conservative regulation is that most part of these assets in companies is not disclosed among assets.

It can be established that the composition of assets significantly influences their value disclosed on financial statements. If an important share of company's assets is intangible, it is very likely for their value not to be disclosed on the balance sheet or to be disclosed only to a lesser extent.

The experts in this field do not provide a unanimous answer to the question regarding the influence of the composition of a company's assets on their value disclosed on financial statements. Lev (2008, 210) cites a number of studies which prove that the influence is significant and that the book values of technology companies (companies with a large share of intangible assets among assets) are much undervalued. This option is recognized also by Skinner (2008, 7). On the other hand, Penman (2007) believes that classical accounting provide the disclosure of the total value of intangible assets on the balance sheet.

Possibilities of Debt Financing

Do classical accounting's solutions provide equal possibilities of debts financing for all companies? Let us observe this on the following example.

Company A and Company B dispose of the same asset value but significantly differ by the composition of assets. The assets of Company A are mainly tangible while the assets of Company B are mainly intangible. Both companies have the same value of debts. Do they have similar possibilities to obtain debt financing sources, in other words, can they borrow in a comparable way?

Capital is a positive difference between assets and debts. Considering the fact that both companies have the same value of debts, the value of their capital depends only on the value of their assets (disclosed on the balance sheet). In this respect, there is an important difference between the companies. The assets of Company A

are mainly tangible, which means that almost total value of their assets is disclosed in the balance sheet. On the contrary, the assets of Company B are mainly intangible, therefore, only a small share of them is disclosed in the balance sheet. The threshold of technological feasibility that enables the capitalization of the research and development costs is set to a very high level. This also means that that the value (disclosed on the financial statement) of the capital of Company A is much higher than the one of Company B.

Capital is a means of protection for creditors, therefore, it is obvious that Company A has better possibilities of debt financing than Company B. In short, the classical accounting solutions do not provide equal possibilities of debt financing for all companies. The advantage is obviously on the side of the companies that have a large share of tangible assets and a small share of intangible assets among their assets. On the other hand, micro and small innovative companies are disadvantaged as they have almost no tangible assets; therefore, their possibilities of debt financing are low.

However, some authors do not share the same opinion. Skinner (2008, 15), for example, mentions several cases of successful technological companies with a larger share of intangible assets, which can be in his opinion considered as a proof that money (lending) market works well. Furthermore, in Skinner's opinion, the cases of companies like Microsoft, Intel, Cisco, Dell and Google clearly show that all companies are treated equally in the money market.

Conclusion

Are the solutions of classical accounting suitable, in other words, do they reflect economic reality? Do they provide the necessary accounting information for users?

In our opinion, classical accounting is in a serious crisis. It is not just the crisis of the process of implementation; the true crisis of accounting arises from its basic assumptions. Accounting has become a strictly rational and increasingly technical activity with very little space for new ideas. In comparison to the 50's and the 60's of the previous century, the decades that follow seem to be in a deep stagnation. The origins of almost all the ideas realized in the last few decades can be traced back to very old records. This situation is most likely due to a general belief that the accounting profession has already reached its peak and that all we need is just technical upgrading of the established ideas. Cost hierarchy, triple-entry bookkeeping and similar ideas are simply neglected by most accountants. The same is true for human resource accounting.

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