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A review of accounting theories on asset valuation

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Abstract
This paper which adopted a descriptive methodology looks at the importance of theories in the development of professions generally. However, it specifically examines the historical attempts of the accounting profession at developing generally accepted accounting theory. The attempts made towards realization of the above objective were captured in the inductive, normative and the corporate report approaches with their major pitfalls. In spite of these attempts, accountants still differ in their opinions about some theories especially asset valuation models. Some accounting theories implicated in the disagreement were highlighted. The paper, in conclusion, stresses the need for accountants to adopt a common stand on theories of asset valuation and income determination so as to ensure public reliance on accounting information both for investment decision and other purposes. The paper recommends the need to restructure existing models or even develop new ones to harmonize accounting thoughts on asset valuation and other related concepts.

Introduction

Professions of diverse nature are built upon two foundational elements – the theory and the practice. While the theoretical principles provide the logical basis or reasons for action, the practical aspect puts these principles into use to ensure uniformity of results. The two elements inevitably, compliment each other in the overall development of professions.

Generally speaking, some people in the practice area tend to see theories as the stock in trade of academics. They also tend to believe that theories stand in the way of the actual job. However, those who take this view are probably ignorant of the role that theory can play in practical matters and do not realize that an absence of theory does give rise to many real and practical difficulties (Lewis and Pendrill, 1996).

Many professions passed through different stages, sometimes with unimaginable challenges, in order to develop theories that would guide their practice. Development of acceptable theories by professions, no doubt, helps issues obviously made any anticipated consistency inherent in behaviour of accountants difficult to be noticed. It is therefore, not surprising that the attempt failed.

(b) ***Normative approach:*** Following the failure of the first attempt, anxious accountants came up with another attempt, known as the normative approach in the 1950s. The second attempt was normative in that it aimed to improve accounting practice (Wood and Sangster, 2008). The approach considered some of the defects of the inductive approach. For instances, it looked at what accountants should be doing instead of what they did in their various areas of practice. Lewis and Pendrill (1996) observed that the normative approach theories basically consisted of a mixture of deductive and inductive principles, the latter being used to identify the basic objectives. They also noted that this attempt at theory construction was extremely valuable in that it generated a number of books and papers which have had profound effect in the development of accounting practice, particularly in the area of current value accounting.

The contributions of the normative approach not withstanding, it did not pass the simple test of general acceptance. In fact, Wood and Sangster (2008) argued that the main problem of normative approach has been a lack of a general agreement as to the objective of accounting. This is against the background that there are many users of accounting information with various accounting/financial information needs.

The mixture of deductive and inductive principles opened a wide gate for criticisms, and the failure of the second attempt was overtly rooted in the inductive component of the approach. The major criticism of the approach which centred on lack of a general agreement as to the objectives of accounting was the domain of the inductive element.

(c) ***Corporate report approach:*** The collapse of the second attempt based on the diversity of the information needs of users of accounting information, gave rise to the third attempt, generally called the corporate report approach. The Financial Accounting Standard Board (FASB) in the USA suggested that accounting theory should be developed by first identifying the users of accounts and then finding out what information they require (Lewis and Pendrill, 1996). The FASB's suggestion was in line with the submission of Hendriksen and Van Breda (1992) on how prior identification of information needs of different users of accounting information would help to satisfy the objectives of accounting theory. This approach was seen as being practically – oriented and many people believed it would help judge current accounting practice and guide the development of new procedures. Earlier on, Carsberg *et al* (1974), noted that usefulness for specified purposes would be the criterion by which the merits of accounting practice must be finally judged.

This approach has been endorsed by a number of significant British and international studies, including · ***The Corporate report;*** the International Standards Committee publication, ***Frame-work for the preparation and presentation of financial statements,*** Professor David Solomon's report to the Research Board of the ICAEW ***Guidelines for Financial Reporting Standards; Making Corporate Reports Valuable,*** a discussion document published by the Research Committee of the Institute of Chartered Accountants of Scotland, as well as the ASB Draft Statement of Principles (Lewis and Pendrill, 1996).

In spite of the apparently large scale endorsement, the approach ran into difficulties which necessitated the abandonment of work on the project in the mid 1980s, even though it is believed to have had reasonable influence on accounting thoughts and developments across the world (Lewis and Pendrill, (1996). They further stated that one of the major criticisms of this approach is whether it is possible for accountants to produce one 'all – purpose' form of report for all user groups of accounts always. Some argue that information needs of different user groups might be so disparate that it would be difficult for one report to address.

Another limitation of the corporate report approach is how to handle conflicts of interest among group members while attempting to satisfy all users of the report. A typical example could be seen when employees demand information shareholders would not want them to have.

Since to produce special reports tailored to every possible group of users would be not only time-consuming but also costly, producers of accounting information appear hesitant to embrace the approach. The absence of general acceptance and legislation on the corporate repot approach has continued to strengthen the cost averseness of producers of accounting information in this regard.

Theoretical Framework

The theoretical framework upon which this study is based are:

(1) Theory of measurement of income:

Adeyemi (2008) states that lack of consensus on the theory of measurement of income gives rise to the use of two models in the determination of wealth of a business. The models are:

(i) Net asset model: This involves subtracting the value of individual liabilities from the value of individual assets. The resultant figure becomes the net asset value.

(ii) *Expected future value model:* This model entails the use of the present value of expected future net cash flows to determine income of a business. It obviously recognizes the 'loss' in value of money over time but determination of cash flows may pose difficulties.

(2) *Theory of asset valuation:*

Anderson (2009) contends that a wide range of methods exist for asset valuation due to the divergent views of accountants on the subject matter. These methods include:

(i) *Historical method:* Under this method, an asset is valued at what it costs to procure it less an amount attributable to effect of usage of the asset over a period. The quantification of the effect of usage or 'wear and tear' in monetary terms may be arbitrary.

(ii) *Adjusted historical cost method:* This method takes into account changes in the value of money from the date of purchase to the balance sheet date. The calculations are effected by using a price index (Wood and Sangster, 2008). They are of the opinion that this method does not remove the problem of the 'true' cost; all it does is to assume the original historical cost is accurate and then adjust the value of the business (and, hence, the owner's wealth) to allow for different timings.

(iii) *Replacement cost method:* Advocates of replacement cost method believe it is better to use estimated amount it would take to replace an asset being valued at the date of valuation. They believe the method indirectly and more reasonably addresses the issue of asset depreciation and effect of inflation.

(iv) *Net realizable value method:* Net realizable value represents the difference between the sale proceed and the cost of disposal of an asset. Some accountants believe that this method would give a fair value of an asset.

(v) *Present value method:* This method values an asset as the sum of the future expected net cash flows associated with the asset, adjusted to its present (today's) worth. The adjustment to present worth is believed by many to remove inflationary bias.

(vi) *Deprival value method:* Wood and Sangster (2008) state that deprival value method was propounded in USA by Bonbright in 1930s and later developed in the

UK for profit measurement by Baxter. The method is based on the concept of value of an asset being the amount of money the owner would have to receive to compensate him exactly for being deprived of it.

(3) ***Theory of capital maintenance:*** Just as the opinions of accountants differ over the theories of measurement of income and asset valuation, they also differ over methods of calculating capital maintenance. Capital maintenance is concerned with measuring the sustenance of wealth over a period of time as opposed to only a particular date. Smith (2008) states that controversies surround the concepts of capital maintenance. The approaches to the theory of capital maintenance are:

(i) *Money capital maintenance:* This concept follows the normal accounting procedure to arrive at the value of capital maintenance. Put differently, it disregards changes in the value of money over time.

(ii) *Real capital maintenance:* Wood and Sangster (2008) state that this concept is concerned with maintaining the general purchasing power of the equity of shareholders. It takes into account changes in the purchasing power of money (i.e. inflation) as measured by the retail price index.

(iii) *Maintenance of specific purchasing power of capital:* This concept is similar to that of real capital maintenance, except that the price index for use here is related to the specific price changes of the goods in which the firm deals. The use of specific price changes makes the model more objective.

Discussion

Limitations inherent in some of the accounting theories tend to underline the reasons for their non-universal acceptance and application. The import of this is the preference of some asset valuation models to others by some accountants. These limitations are model – dependent.

While the expected future value model of the theory of measurement of income has difficulty of determination of cash flows, the net asset variant ignores effects of depression. Those opposed to this model argue among other things, that it neglects depreciation in value of assets and liabilities occasioned by inflation (Adeyemi, 2008).

The determination of the effect of usage of assets in the historical method of asset valuation is a common area of disagreement. Anderson (2009) states that the contentious issues in this method are how to arrive at the effect of usage in terms of value, effect of inflation on asset value, as well as the useful life of the asset.

The adjusted historical cost method which was introduced to remedy the deficiencies of the historical method has its own limitations. The drawback of this method is lack of precision in determination of the value of the price used to adjust the historical cost figures.

The replacement cost method which some people believe is superior to both historical and adjusted historical cost methods because it accommodates asset depreciation and inflationary effects is widely criticized. While Young (2010) argues that the exact value of a similar asset in the market could be influenced by inherent market indices, such as grade of the asset, discounts, model, etc, Wood and Sangster (2008) contend that technological changes could occasion non availability of a similar asset in the market.

Under the net realizable value, it is believed that the disposal value of an asset contains some elements of changes in value of money due to inflation. However, Wood and Sangster (2008) and Young (2010) believe that the limitations of the replacement method also apply here.

In spite of the adjustment for inflation in the present value method of asset valuation, some criticisms still trail it. Davidson (2009) states that lack of certainty in the forecast of future net cash flows and the choice of correct discount rates are part of the complexities of the method.

The deprival value method which gained prominence in the 1930s gradually declined in popularity. The major limitation of the method is that the replacement cost, net realizable value and present value methods which are the primary indices for its calculation are already over-burdened with disagreements.

The money capital variant of the theory of capital maintenance, not withstanding its wide application, has its short falls. Its major limitation is that it fails to adjust assets to the current values (Nobes and Parket, 1995).

Even though the real capital maintenance method recognizes changes in the purchasing power of money, it still falls short of the general expectation. Smith (2008) captures this in his contention that the process of choosing the rate of inflation, as measured by the retail price index, is imprecise.

Regardless of the objective nature of the maintenance of specific purchasing power of capital, it still lacks acceptance. The argument on the imprecise nature of the price index still holds.

Consequent on the above, it is likely that accounting reports prepared with some of these models may be associated with some prejudices. There is therefore the need to for concerted effort to remove some of the limitations to make accounting reports more acceptable.

Conclusion

We have seen the various attempts made at developing generally accepted accounting theories without any success. The effect of this is the preponderance of approaches to some concepts in accounting. Even though the scenario provides a healthy environment for a balanced academic development, the effect of the different approaches on the output of accounting reports leaves much to be desired. The situation becomes even more worrisome when we realize that many users of accounting information do not have reasonable accounting background. As would be expected, many of these users often rely on the accounting reports for various financial and business investment decisions.

Recommendations

In the light of the above discussion, the following recommendations are made:

1. Accountants should realize the implications of limitations of these theories on accounting reports and the various decisions that are based on them.
2. There is need to restructure the existing models or even develop new ones to harmonize accounting thoughts on asset valuation and other concepts.

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