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Choice of Accounting Policy: Effects on Analysis and Interpretation of Financial Statements

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Abstract

This paper examined the effect of accounting policy adopted by the reporting entity on the analysis and interpretation of financial statements. It is mandatory according to the Statement of Accounting Standards (SAS NO.1) and International Accounting Standards (IAS 1) for every reporting entity to disclose the accounting policy adopted in the preparation and presentation of financial statement. Accounting policies are very important for the proper understanding of the information provided in the financial statements. An entity should clearly state the accounting policies it has used while preparing and presenting the financial statements. Disclosure of accounting policies is important because many accounting standards allow alternative treatments for a same transaction or item. Users of financial statements will not be able to compare the financial information with other entities if the accounting policies are not cleared outlined. Therefore, by stating the policy adopted, this will make it possible for the readers and users of financial statements to make informed decision. The users will as well be able to see the impact of accounting policies on the income statement and financial position of the reporting entity within the industry.

Keywords

Accounting Policy, Financial Statement, Reporting Entity, SAS, IAS

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1. Introduction

Financial statement is the source of information through which the user groups assess the company. However, the information provided by the financial statement should be useful for its intended purpose. The primary objective of corporate report is to communicate economic measurements and information about the resources and performance of the reporting entity useful to those having reasonable rights to such information. A reasonable right to information exists where the activities of an organization impinge or may impinge on the interest of a user group [1].

Therefore, financial statement is periodic financial information which shows the profit or loss and the state of affairs of the business organization. It is prepared periodically, usually at the end of the year.Accordingto[2] financial statement as an integral and important part of the broad field of business analysis is the process of evaluating a company economic prospects risks. This involves analysis of a company's business environment, its strategies and its financial position as well as performance.In the words of [3] financial statement is the expression of the worth of the company through the end period balance sheet. Hence it is the communication of the activities of the company in a period of year added to the preceding period to give an end of a new period position.

Financial statements provide valuable information for both the owners of the business and for any potential owners/investors. From the users group, it is possible to identify three general areas of interest in which users' needs and objectives may lie:

- Financial status – can the business pay its way, is it in fact liquid?

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- Performance – how successful is the business, is it making a reasonable profit, is it utilizing its assets to the fullest, is it in fact profitable and efficient?
- Investment – is the business a suitable investment for shareholders or would returns be greater if they invested elsewhere, is it a good investment?

2.Purpose of the Study

The main trust of this paper is to theorize that the choice of accounting policy has effects on the analysis and interpretation of financial statements even if the same data is used.

3. Contents of Financial Statements

According to[4] financial statements of a firm is defined to consist of three main accounts: the balance sheet, the profit and loss account and cash flow statement.

3.1. The Statement of Financial Position

This is the statement where the assets and liabilities of the reporting entity are disclosed. Although no prescribed format for the statement of financial position is required by [5], it does set out the minimum information which is required to be presented in the statement, as set out below:

- property, plant and equipment;
- investment property;
- intangible assets;
- financial assets not disclosed in other headings below;
- investments accounted for using the equity method;
- biological assets;
- inventories;
- assets/disposal groups classified as held for sale;
- trade and other receivables;
- cash and cash equivalents;
- liabilities included in disposal groups classified as held for sale;
- trade and other payables;
- provisions;
- financial liabilities not disclosed in other headings above;
- liabilities and assets for current tax;
- deferred tax liabilities and assets;
- non-controlling interest, presented within equity; and
- issued capital and reserves attributable to owners of the parent.

However, amendments may be made to the ordering of items if bysodoing the new presentation provides more relevant information to the users of the financialstatements. Additional line items, headings and subtotals should be added where relevant tothe understanding of the financial statements. [6]*Property, plant and equipment* requires information to be disaggregated into classes of assets, for example freehold buildings, plant and machineryand office equipment.

It is also required by [5] that specific information is presented in relation to the share capital of theentity. These disclosures include identifying:

- The number of shares authorised;
- The number of shares issued and fully paid, and issued but not fully paid;
- The par (nominal) value per share, or that the shares have no par value.

In addition, a full reconciliation of the movement during the year in the number of shares outstanding is required, specifying any rights, preferences and restrictions attaching to theshares. Disclosure should also be made of any shares in the entity, held by the entity or by its subsidiaries or associates and any shares reserved for issue under options and contracts forthe sale of shares.

Where an entity does not have share capital, equivalent information should be disclosed.

3.2. The Statement of Comprehensive Income

It is stated by [5] that, as a minimum, the following information is required to be presented in thestatement of comprehensive income for the period:

- revenue;
- finance costs;
- share of the profit or loss of associates and joint ventures accounted for using the equity method;
- tax expense;
- an aggregate figure for the profit or loss of discontinued operations and the gain orloss in relation to the re-measurement, or disposal, of discontinued operations;
- profit or loss;
- share of other comprehensive income of associates and joint ventures accounted forusing the equity method;

- each component of other comprehensive income classified by nature;
- total comprehensive income;
- the profit or loss attributable to non-controlling interest and that attributable to owners of the parent; and the total comprehensive income attributable to non-controlling interest and that attributable to owners of the parent.

Other comprehensive income comprises items of income and expense which are not required by other [7] to be recognised in profit or loss.

How a choice is to be presented in comprehensive income is permitted by [5]:

In a single statement of comprehensive income; orin two statements: an income statement (which includes only those items which are required to be recognised in profit or loss) and a statement of comprehensive income (which begins with the profit or loss per the income statement and then displays the components of other comprehensive income).

As explained above for the presentation of the statement of financial position, additional line items, headings, sub-classifications and subtotals should be added where relevant to the understanding of the financial statements. If an item of income or expenditure is important to the fundamental understanding of the performance of the entity during the period, this item should be disclosed separately. Examples of such items include a significant write down (a loss in value) of property, disposals of investments or where the entity has discontinued some of its operations during the period.

Entities are required to present an analysis of expenses recognised in profit or loss, but [5] permits a choice as to how the expenses are classified. The classification should be based either on the nature of expenses, highlighting the main types of expenditure incurred, for example staff costs and raw materials, or on the function of expenses. The latter classification presents expenses under headings such as cost of sales or administration costs; this classification generally requires considerable judgment to ensure that allocations of the expenditure are appropriate.

4. Financial Accounting Theory

In financial accounting theory, according to [8] companies choose their accounting methods so as to present truth and fairness on their activities. These choices, however, is employed in the accounting policies of the reported entity. These policies are the bases of drawing up and interpreting their financial statements. From the foregoing, accounting policy is influenced by Normative and Positive accounting theory.

4.1. Normative Accounting Theory

There are five important work on normative accounting theory as carried out by [9,10, 11, 12 and 13]. Normative accounting theory seeks to prescribe some bases of accounting, measurement, particular accounting procedures and the contents of financial reports [13 and 14]. In furtherance of his work[13] differentiate between normative theory and policies. According to him, in normative theory, researcher does not commit himself/herself to the goal assumed but in the case of accounting policy, the researcher is committed to the goal. Hence, normative theory attempts to tell what the people or constituencies should do. Therefore, normative theory is not solely evaluated by predictive value, but is also evaluated by its logical consistency. Hence, normative theory attempts to state what financial information should be collected, analysed and communicated.

4.2. Positive Accounting Theory

This is a positive theory, that aims at predicting action such as which accounting policies firms will choose and how newly proposed accounting standards will cause firms to react. The study carried out by [15] help give an understanding why different companies will choose different accounting policies and why managers may object to changes in these accounting policies. In addition, the study revealed why investors may react to the potential impact of changing accounting policies. Positive accounting policy has three hypotheses around which its prediction are organized namely: the bonus plan hypothesis, the debt covenant hypothesis and political hypothesis.

4.3. Statement of Accounting Policy

Accounting policies are very important for the proper understanding of the information provided in the financial statements. An entity should clearly state the accounting policies it has used while preparing the financial statements. Disclosure of accounting policies is important because many accounting standards allow alternative treatments for a same transaction or item. Users of financial statements will not be able to compare the financial information with other entities if the accounting policies are not cleared outlined.

Therefore, accounting policies are those bases, rules, principles, conventions and procedure adopted in the preparation and presenting financial statements.

5. Choice of Accounting Policy

In the choice and application of the appropriate accounting policies, some fundamental concepts contradict one another. Hence, when choosing application of appropriate accounting policies, the following should be considered:

5.1. Substance over form

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely with their legal form.

5.2. Objectivity

The accountant should be objective when presenting financial information. The preparer of financial information should not be bias or try to favour a segment of users of financial statement.

5.3. Fairness

This is an extension of the objectivity. Accounting information should be prepared not to favour any group or segment of society.

5.4. Materiality

Financial statements should disclose all items which are material enough to affect evaluation of decisions.

5.5. Prudence

Uncertainties surround many transactions. This should be recognised by exercising prudence in preparing financial statements. However, prudence does not justify the creation of secret reserves.

6. Financial Statement Analysis

Financial statement analysis seeks to evaluate management performance in several important areas such as profitability, efficiency and risk. Ratios are usually employed in interpreting and analyzing financial statement. There are limitations within ratio analysis. However, the major limitation is the problem encountered when companies used different accounting policies within their financial statements.

The choice of accounting policy could, however, significantly affect the analysis and interpretation of published financial statements in the following ways:

- Policy on asset valuation particularly regarding land and building. In this situation, historical may or may not be departed from. This will affect profit through depreciation charges and balance sheet structure.
- Depreciation policy of certainty will have effect on profit and assets value.
- The method adopted in the valuation of stock will impact profit, assets value as well as liquidity ratio through the cost flow assumption made (LIFO, FIFO) and also the treatment of overheads.
- Long term contract assumptions, for example method adopted in the recognition of profit.
- Goodwill valuation and method of elimination from the financial statements.
- Leases allocation between operating and finance lease, method of allocating finance charges relating to both lease and lessor.
- Research and development policy regarding possible capitalization of development costs and policy on any resulting amortization.
- Pensions- problems associated with the type of scheme, the valuation of surplus or deficit and the allocation of these and other costs over accounting periods.
- Use of temporal or closing rate method for translation of foreign trading operation.

Consolidation policies that are definitions relating to the distinction between subsidiary and associate, use of acquisition or merger accounting, quantification of fair values will all affect the numbers in the financial statements.

Hence, in analyzing and interpreting financial statements, it is very important to take into cognizance the accounting policies adopted by the reporting entity. This will enable the users to know how the accounting policies impact the items in the financial position and income statement.

7. Conclusion

The accounting policy to be chosen is part of the need for the firm to reduce contracting costs. Therefore, different accounting policies that can be employed by a reporting entity have significant impact on the interpretation of financial statements through ratio analysis. The different accounting policies affect the income statement as well as financial position. This has both direct and indirect impact on all the major ratios like return on capital employed and gearing.From the foregoing, the users of accounting information must peruse the whole information contained in the financial statement. The accounting policies adopted must be understood so as to dictate how to compare one company with another even in the same industry.

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