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The Dilemma of Measurement in Financial Reporting

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The Measurement Problem

Those of us working in accounting realize that the numbers reported in financial statements may not be precise as a result of estimates. But readers of financial statements could be laymen to the accounting profession and would likely construe that these numbers are accurate to the last dollar. The fact that it is not uncommon to see amounts reported in thousands of dollars instead of to the last dollar in financial statements is an indication that to do otherwise could indicate to the readers a degree of precision which is not there.

Examples of estimates include allowance for uncollectible accounts, allowance for depreciation, allowance for warranty, disclosure of contingent liabilities, etc.

Contingent liabilities may or may not have to be disclosed depending on the level of probability that the contingency would materialize. If the probability is remote no disclosure is required and if it is probable disclosure would then take place by means of a footnote, the estimate of which would be based on legal advice. Only when the probability is most likely would journal entries be required hence affecting both the balance sheet and income statement.

The primary culprit of the measurement problem comes from estimated allowances as a result of observing the matching principle under generally accepted accounting principles (GAAP) whereby estimated expenses not

necessarily incurred must be matched with revenues in the same accounting period as these expenses have helped to generate the reported revenues. This paper provides a closer, but brief, discussion of two of such allowances, namely allowance for uncollectible accounts and allowance for depreciation.

The Case of Uncollectible Accounts

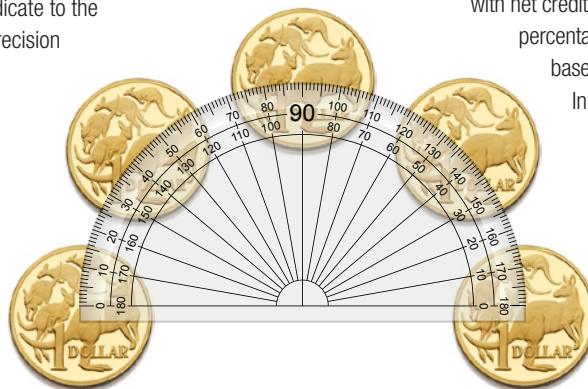
The allowance for uncollectible accounts is estimated in one of two ways, the percentage of net credit sales and the ageing method. Because of its simplicity, the former is used by more companies than the latter. Each method is based on a different philosophy. In the case of the percentage of net credit sales, it is assumed that the uncollectible portion of receivables varies with net credit sales and that this percentage can be estimated based on past experience.

In the case of the ageing method, it is assumed that the longer one waits the probability of the account being a bad debt gets higher and that such probabilities can be estimated for the various

ranges of days outstanding. The method then bears no direct relation to the amount of credit sales although it is conceivable that receivables vary in direct proportion to credit sales.

A superficial comparison of the two methods shows that the ageing method is superior as it is based on past experience pertaining to uncollectible accounts under the assumption that if an account remains unpaid for a longer period of time it is more likely that it will be delinquent. On the other hand, both methods generate inaccurate results as the estimates are based on past experience and past performance is no indication of future performance. We see that in 2008

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Estimates made on a subjective basis create measurement problems in the financial statements

the global financial tsunami caused financial institutions to under-estimate uncollectible allowance causing phenomenal losses in that year. We see also that in the purchase of investment funds there is always a disclaimer indicating that past performance is no indication of future performance. In addition to the aforementioned, the estimation process for both methods is highly subjective resulting in even more measurement problems. As in each year the actual percentage of net credit sales for bad debt is different and the same applies to the percentages used for each category of collection period, there is no consistent method used by companies world-wide as to how the estimated percentages are arrived at.

Another drawback relates to the use of the ageing method when applied to small and medium size enterprises (SMEs) where the customer base is relatively small and is concentrated in a small number of large accounts as in the case of Hong Kong. These customers tend not to pay up when the receivable is due and could drag out payment for another one or two months. However, they always pay their bills. Hence this pattern of payment defeats the assumption underlying the ageing method.

The Case of Depreciation

Depreciation is like the allowance for uncollectible accounts in two ways in that the economic life of the long term asset and its residual value must be estimated, hence its subjectivity and that it is done in observance of the matching principle. However, unlike the allowance for uncollectible accounts, depreciation serves yet another important function in that it is an allocation of the historical cost of a long term asset over its useful or economic life as the economic benefits of the asset to a company are long term. On the other hand, depreciation can be used as a tool for earnings management in that the accounting choice can be legitimately made to suit the aspirations and needs of the company. For stable revenue-generating assets, the use of the straight-line method tends to stabilize

income, while accelerated methods such as the double-declining balance method (DDB) would be beneficial for early tax write-offs and for assets that generate more revenue in the earlier years. It too has an income stabilizing effect in that the repairs and maintenance expenses in the later years tend to offset the decline in depreciation expenses. The units-of-production method is based on the assumption that an asset depreciates in accordance with usage, considering only the physical wear and tear, but not the obsolescence factor. The expenses track the revenues closely and have a stabilizing effect as well.

The earnings management function of depreciation resembles that of inventory methods based on cost flow assumptions. As inflation takes place more frequently than deflation, the use of the first-in first-out method impresses the Board of Directors and aggressive investors seeking significant capital gains in their investments. The use of the last-in first-out method reports less earnings and is a tax-savings device. The use of the weighted average method stabilizes earnings and appeals to investors who wish to see stable earnings growth and to avoid significant fluctuations.

Concluding Remarks

The above discussion shows that estimates made on a subjective basis to satisfy the matching principle create a measurement problem in the financial statements. On the other hand, independent auditors of financial statements never guarantee the accuracy and precision of the numbers presented in these statements. They only vouch for the fairness of the presentation and the consistency of the approach to preparing these numbers. As such, readers should not rely solely on the numbers reported in the financial statements of only one year or one accounting period, but compare the operating results of the company over several years or accounting periods to detect a trend, if any. It is advisable to seek expert advice on computed financial ratios for liquidity, solvency, etc., and to detect a trend as well from these ratios.

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