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ACCOUNTANCY ENTANGLED BY FINANCIAL CAPITAL

Summary

This paper aims at presenting some contradictions that can be found in the contemporary theoretical approach to the issue of accounting. Accounting has changed the systemic perception of economic phenomena into the process related one. This may be manifested in using current value to assess fixed asset component, which results in distortions in the informative system of accounting, thus encouraging application of creative accounting. Partial contradictions demonstrated in this paper are deeply rooted in the theoretical background of accounting and they have one common foundation – seeing productive capital through the prism of financial capital. This approach results from financial capital related tendencies to search for new forms of capital returns. New accounting allows for following such tendencies on the microeconomic level. New subjective interests of accounting deepen the dichotomy between theory and practice.

Key words: *production capital, financial capital, historical cost, fair value, creative accounting*

Introduction

The author of the paper points to theoretical drawbacks of contemporary accounting resulting from the key dichotomy – seeing productive capital through the prism of financial capital. Making money on production capital is a domain of business activity conducted by investors, this domain is conditioned by progressing globalisation processes. Activation of financial capital is forced by the objective barriers and obstacles to generate profit on production capital. The pressure from investors looking for attractive returns on financial capital had a considerable impact on the accounting measurement system.

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Conceptual transformation of the accounting system was based mainly on creating opportunities to use volatility of the value of money.

Theoretical justification for activation of the role of money through impacting the economy is proposed by monetarists. The concept of monetarism, rooted in the current trend of neoliberal economy, forced the necessity of process approach to creation of informative system of accounting. With globalisation came the international accounting which had to redefine its systemic approach in order to open international flows of financial capital, the opening was achieved by introducing a number of changes. The most important changes referred to a new outlook on the role of a business unit and replacing historic cost by current value to price the assets and to change the economic content of capital. In view of the author of the present paper, introduction of the changes aimed at activating the accounting system triggered serious discrepancies rooted in current theoretical layer of accounting.

1. Macroeconomic thought in monetarist version of neoliberalism

The title of the paper which emphasizes the entanglement of accounting by financial capital requires a brief profile of neoliberalism enhanced by a monetarist outlook on the role of money. The development of economic thought abounded in many theories explaining the essence of wealth of a given society. The easiest way to understand the process of wealth accumulation lies in the very logic of rational thinking of societies, who through their labour use the earth's natural resources to satisfy their needs and the kind and scope of the needs correspond to the level of cultural and social development of each respective society. Identification of objectives is rudimentary, it gives sense to social processes of manufacture. Simultaneously, the very same society is aware that in order to fuel their productive force, they have to capitalize on their existing technological, cultural and social developments. In this way, conditions for involvement of new generations in the process of accumulating wealth are created. Reproducing of existing and creating new wealth is a continuum of each society in economic and civilisation spectrum.

Societies functioning in the conditions of market economy require money, a currency. Money serves an ancillary role in the process of accumulating wealth, it is a mean of tangible expression of value, a mean of circulation facilitating the exchange of goods. This basic truth is

expressed by the theory of value, which shows in a synthetic way how labour is applied to satisfy the needs of a society in market economy conditions. According to this theory, the structure of value is expressed by the ratio of capitalized labour to new value manufactured as the result of current labour of the society. Thus, value denotes the creative force of a given society. Of course, the theory of value is far from being perfect as it does not take into account the capital in the form of natural resources. Excessive labour leads to overexploitation of the natural environment and effects of this exploitation are clearly visible.

The development of economic thought was not channelled towards building up on this particular theory which was rejected by neoliberalism as it seemed to undermine the role of labour as the main source of wealth. Contemporary neoliberalism adapted the point of view of monetarists who claim that only money may be the source of wealth. Monetarists are convinced that money is a fundamental and original factor that triggers economic change. For monetarists variables such as: global production, employment and prices are shaped and determined by money which seems to be, in their view, the only meaningful asset.¹

Classic economy, quite rightly, believed that money is a neutral intermediary mean of exchange. The primary reason behind the increase in the volume of money in circulation was the increase of value of goods and services. Money seems to have been the result. This regularity is reflected in the principle of money circulation. Monetarism infringes the principle of money circulation and turns the cause into effect claiming that demand for money is a demiurge determining economic growth.

Assigning an excessive role to money secures economic interests of the banking sector. In this regard the most harmful is issuance of money by the Central Bank to cover public debt. Banks discovered long ago this particular nature of money. Banks can freely increase and decrease the money supply.² Funds generated in this way may not only be utilised as investments but they can also be spent on reckless consumption. Nowadays such phenomena are, unfortunately, quite common. Banks exceed their mandate to create money and generate profit of their own, mainly in the form of interest rates. When it comes to money, scientifically formulated theories seem to be of lesser importance than real life institutions and experiences”.³

¹ P.A. Samuelson, W.D. Nordhaus, *Ekonomia*, Vol. 1, PWE, Warszawa 1995, p.495.

² P.A. Samuelson, W.D. Nordhaus, *Ekonomia*, Vol. 1, op. cit., p. 153.

³ J. K., Galbraith, *Ekonomia w perspektywie*, PWE, Warszawa 1992, p.152.

At this point an observation must be made that banks while manipulating the money supply impact price volatility as well as changeability of interest and exchange rates. These three volatilities detached from the real value of provided goods and services create perfect opportunities to make money from the mere changeability of money. The answer to the question why manipulating the changeability of money has become so desired lies in the key contradiction of capitalism. The right to accumulate capital and the related right of maximising profit encounters obstacles. Increased output of goods and services requires increased consumption which, in turn, is limited by the division of added value which is subdued to the principle of maximising profit. Extended consumption is possible through supplying a considerable amount of credit money or increasing the volume of cheap money in circulation. This contributes to increased inflation, which as the result of rising prices leads to unjustified transfers of added value. A similar role in the transfer of the added value is played by changeability of interest and exchange rates.

Expansion of financial capital benefiting from this ‘changeability’ becomes obvious. No wonder then, that nowadays it is more and more difficult to generate profits from value created in reality, it is so much easier to make profit by manipulating the value of money. In recent years there has been considerable intensification of financial capital looking for easy money, which triggers unjustified redistribution of added value on global scale and poses the threat of crisis occurrences. Contemporary economists do not even try to conduct a thorough reliable analysis because proving that neoliberal model is unrealistic is pointless, as this model does not describe the world as it is but as it should be. Neoliberalism is not trying to build the system that is well-matched to the real world; instead it is trying to build a world which would match the system.⁴ Monetaristic outlook on the expansive role of money in economic processes has become deeply rooted in the system of international accounting developed for the purposes of advancing globalisation processes.

⁴ See: S. Clarke, *Neoliberalna teoria społeczeństwa*, [in:] *Neoliberalizm przed trybunałem*, A. Saad-Filho, D. Johnston (eds.), Książka i Prasa, Warszawa 2009, pp. 99-100.

2. Contemporary accountancy versus financial capital

In recent years accountancy has reorganised its measurement system. It has been done with the intention to extend the range of information for the needs of investors who want to earn profit on changeable values of money. But what theoretical thought inspired these changes? What are the consequences for the economic life from the new offer of informative accountancy? It is not easy to answer these questions without revisiting the basics of accountancy, without understanding its theoretical side and grasping the relations between processes underlying a given theory and the accounting measurement system. For the sake of theoretical considerations the author concentrated on three key aspects which have a critical significance in the process of rebuilding the information system of accounting. Namely, a new outlook on the role of a business unit for which this information system is being built, rejecting the principle of historical cost for valuation of assets and replacing this principle by the current value and adopting to accountancy a new concept of capital. The order of the issues listed above marks the sequence of the author's deliberations.

Traditionally accountancy was defined as: information system which identifies, records and informs about economic occurrences of an organisation.⁵ Accounting through its measurement system explained the behaviour of business entities who used limited resources to achieve their economic objectives. The governing rule here was the rule of a business entity. Various social groups are included in activities of business entities, establishing certain relations of social labour participating in the process of creating value. The quality of informative system of accountancy which, at the same time, reflects its theoretical value could be seen in the extent of implementation of proper measures and relations between those labours. The foundation of systemic approach of the development of accounting measures was the theory of creation and distribution of value. Accountancy allows for tracking the circular movement of capital in the process of creating and distributing of value. In its registration system accountancy pointed to internal allocation of capital, waste of capital in different phases of circulation and driving forces participating in accumulation of capital. Financial reporting as the end product of accountancy served a number of various end-users.

⁵ J.J. Weygandt, P.D. Kimmel, D.E. Kieso, *Accounting Principles*, John Wiley and Sons Inc., 2002, p.2.

In the current development stages this approach was rejected. A company is treated as a certain set of contracts between external parties e.g. moneylenders and investors, between internal parties: managers and employees.⁶ The reason behind formally written down contracts is the conflict of interests between the contracting parties which results from their respective economic interests. It is assumed that contract participants are aware of the economic assumptions of occurrences and formulate contracts in a rational manner. Business activity of an organisation with contractual balance of economic forces should find reflection in accounting. In the most current approach accountancy introduced new categories and measures of relations, whose aim is to support decision taking processes of a business unit. From this angle accountancy is nothing more than a kind of language in which the contract is written down. Contractual outlook on a business organisation exposed interests of investors, with a tacit assumption that it also meets the interests of other groups of users. This approach, obviously, cannot be agreed with. The interests of investors and interests of other groups of users of the information provided by accountancy are completely divergent. The level of generalisation thanks to which interactions of various interests would be more or less balanced, has not been found. Accountancy in response to challenges coming from globalisation processes has rebuilt its informative system having in mind the interests of investors eager to make money on financial capital.

Another key problem to be addressed here is the rejection of historic cost principle by contemporary accountancy. In accordance with this principle assets of a business unit should be recorded in their purchase price, i.e. the cost that a business unit must bear. Historical cost represents the value transferred in the process of creating value. Application of historic cost to value assets has objective character, the value of purchased assets was confirmed in business transactions and in the melting pot of social hieroglyphics exposed in trade exchange in a given society. Each society devotes a portion of their income to purchase capitalized wealth – assets. In this way division forms of value were incorporated in yet another process of value creation. Purchase of assets is a prerequisite for creating production force of capital. Capitalized value of assets is nothing more than savings transformed into investments. The degree to which a given business unit will combine

⁶J. Ronen, V. Yaari, *Earnings Management*, Springer, New York 2008, p. 15.

added value to transferred value (represented by historic cost) shows the production force of the capital involved in a given business unit. Application of historical cost for valuation of assets allows for cumulative expression of wealth. Exchange value represents the purchasing price. Historical cost emerges in a given moment from the very same share relations of value which referred to the members of the same society, relationships established in given economic conditions. Application of historical cost reveals the process of shaping value on the level of microeconomic capital allocation. Historical cost allows to show capital flows in input-output system,⁷ and most of all, enables the structural approach to value.

Historical cost is under strong criticism in the circles of the so called *academic accountancy* due to the static nature of value written down on its basis. It was assumed that accounting, by using different measurement methods should not just describe reality. It was argued that the role of accounting is also assistance in decision taking processes, useful most of all for investors who are interested in future returns on their capital. Thus the investors are in need of information about the future. Pressure from investors forced accountancy to become interested in economic processes described by means of variables of value conditioned by changeability of money. A great emphasis was put on the category of fair value which was introduced into the accounting system, this category is of predictable nature. It is in line with the opinion that the aim of accounting theory is to provide the set of principles and relation which would explain what can be observed and foresee what cannot be observed.⁸ Foreseeing of what cannot be observed should refer mainly to future cash flows based on the volume of wealth which is understood as the sum of assets valued in accordance with fair value principle. The fair value is a kind of current price shaped on an active market or predicted current value in a situation when active market, regulated by the principle of demand and supply, does not exist. Thus the accounting system was enriched by measures of future occurrences which operate on the basis of predictable changes in the value of money. The ancillary role with this respect was given to the notion of fair value. However, fair value contrary to what its supporters

⁷ V. Yaari, *A Defense for Historical Cost Accounting*, Accounting Theory vol. 2, SAGE, 2009.

⁸ R.G. Schroeder, M.W. Clark, J.M. Cathey, *Financial Accounting Theory and Analysis*, John Wiley and Sons, Inc. 2001.

claim, does not assure the process approach to economic occurrences in the measurement system of accounting.

The experience up to the present shows that using fair value in the process of asset valuation opens space for creative accounting, which, as it is already known, contributes to crisis occurrences. Creative accounting consists of a selection of accounting principles and such interpretation of transactions and occurrences to allow for manipulation aimed at improving or very often just smoothing the financial result. The term is also used with respect to instances of fraudulent financial reporting.⁹ It is worth recalling the famous Enron scandal of 2001. Mass media all over the world reported on fraudulent 'creative accounting', which made it possible to generate non-existent profits. In a nutshell, negative occurrences at the energy giant were connected with forging financial reports and other frauds, committed by accountants with consent from auditors. Financial results were manipulated and the company value was artificially created in order to satisfy demands of owners and other stakeholders.

Such situations are connected with the development of financial markets attracting investors eager to make money from their cash. The possibility to conduct transactions on the Internet makes the whole thing so much easier. Demand for profits generated by financial transactions triggers reaction from companies. Searching for capital on stock markets businesses try to publish as positive financial results as possible. Using fair value to evaluate assets they fall into temptation to overprice assets which results in overestimation of profits. In some cases these activities go so far that they reach a climax and end in a scandal which then reverberates all over the world. Each scandal means excessive losses for investors. Creative accounting often uses a range of methods of manipulation which mostly refer to revenues and costs.

It wouldn't be possible, if the creators of the new approach did not regard creative accounting as something positive. Creative accounting is the way of keeping track and register of economic occurrences in accordance with regulations in force and appropriately interpreted accounting principles but the method of interpretation is not directly prescribed by the principles and is the result of imaginative and unusual

⁹ M. Kutera, A. Hołda, S. Surdykowska, *Oszustwa księgowe. Teoria i praktyka*, Difin, Warszawa 2006, p. 30.

application of these regulations and principles.¹⁰ The volume of this paper does not allow for a full polemic with such reasoning. It should be noted however, that reliable recognition of economic assumptions in which a business unit operates is not possible in order to apply creative accounting. It should also be mentioned that creative accounting opens space for using derivatives, contractual options for evaluation of which changeability of exchange and interest rates is applied. Creative handling of derivatives, more than once brought considerable losses for business units.

The possibility of practical application of fair value for evaluation of assets and implementation of volatility into the measurement system of accounting required redefinition of some basic categories such as: capital, revenues and costs. Capital is conceived in residual way as net assets (assets less liabilities), revenues is the growth of net assets value, costs, by contrast, the fall in net assets value. Such understanding of capital has absolutely nothing in common with its essence as the notion of capital has always meant transformation of savings into capital resources. The way of expression of capital in contemporary accounting completely rejects the theory of value i.e. the capital stands next to value. From theoretical perspective of the theory of value, capital represented capitalized values which when incorporated into the processes of accumulating wealth conditioned growth of production force of the functioning capital. Capital conceived in residual way consists not only of capitalised volumes but also of volumes foreseen for the future. It is assumed that net assets which represent equity capital are the basis for predicting future cash flows. This kind of information should come in handy for potential investors as it may project potential profits from invested capital. Moreover, maximisation of net assets should trigger increase in demand for stocks and shares of a given business unit. This kind of reasoning motivates managers towards maximisation of net assets. No wonder than, the status of a business unit has been changed. In order to maximise net assets a priority has been given to value management. It cannot escape unnoticed that the volume of net assets does not offer any grounds for foreseeing future cash flows. Such

¹⁰ P. Gut, *Kreatywna i agresywna rachunkowość w kontekście naruszania zasad rachunkowości*, Conference materials of the National Convention of Accounting Departments Pułtusk 2004, p. 7, quoted after J. Samelak, *Co to jest rachunkowość kreatywna?*[in:] *Rachunkowość sztuka pomiaru i komunikowania*, Publishing House of Warsaw School of Economics, Warszawa 2011, p. 459.

situation could take place if assets were purchased in order to be re-sold at profit. But then there would be only particles of financial capital incorporated in various assets, nothing more. In a manufacturing business unit assets are not purchased to be resold but to participate in the process of value creation in an organised way. Capital conceived in residual way represents demandingness with respect to distribution of added value but says nothing about input of this capital in the process of creating this value. Such approach is ideologically confrontational and gives rise to unfounded ripping off of equity capital from the capital of function. The accounting assumption on a business unit has not been officially waived but it may not be based solely on the function of equity capital. This function is characterized by the division of value not by its creation process.

3. Contradictions in contemporary accountancy

Development of informative system of accountancy although it serves the needs of practice and is rooted in real life business experience, may not be independent beyond the understanding of economic content of the same observations of real life. Today's globalised economic world is full of intensified activities of financial capital. Accountancy is not neutral towards this reality which is proved by its proposal of an alternative system which is in opposition to reality. This alternative system introduces a series of serious contradictions, some of these contradictions are presented below:

- accountancy assumed the supreme goal of investors and applied measure procedures for the benefit of this particular group of users, at the same time causing a shift of criteria for rational conduct of managers. Reasonableness in resource management no longer is the most important thing for managers, it was replaced by reasonableness of creating the value of the company, the capital volumes of a business unit. That explains why managers every so often turn to creative accounting in order to fulfil the criteria;
- creative accounting was meant to serve a worthy goal – economising on accounting profit. This assumption is, inherently, false. The managers may be aware of economic assumptions for internal allocation of capital in the business units under their jurisdiction, but they cannot know the assumptions for capital allocation on macroeconomic scale;

- theoretical accountancy rejects the value principle because it comes from the abundance of occurrences in the business practice, occurrences provoked by the expansion of financial capital. There is no evidence that the value principle contradicts the practice of business life. Current trends in economy do not offer an alternative theory which would consistently contradict the value principle. It does not mean, however, that the value theory cannot be improved and better adjusted to rapidly changing times. Attempts of partial theoretical corrections made by narrow specialists will not be sufficient. What is really needed is a macroeconomic theory with a fresh outlook on the new market reality, a theory synthetically expressed in the value principle. In contemporary accounting, interests of investors are excessively glorified and the theoretical aspect of accounting is being ripped off the necessary objectivism. Theory must not be a direct transformation of empirical experiences. If a theory concerns social processes of wealth accumulation in which various social groups participate, it must take into account usefulness for all participating groups not just one. Otherwise, the theory ceased to be scientific and becomes a part of utilitarian knowledge.

In the contemporary accounting system one may point to many other, more detailed, contradictions, however, it is impossible to discuss them all in a study of this volume. But it must be emphasized that detailed contradictions in contemporary accountancy stem from one elementary contradiction i.e. looking at production capital through the prism of financial capital.

Conclusions

The author of this paper points to deficiencies of contemporary accounting measurement system. The main reason behind these deficiencies is the absence of solid theoretical background. Looking at production capital from the angle of financial capital poses a serious ontological error which deforms the nature of the research object of accountancy. It must have resulted in misshaping of the category of capital, revenues and costs. These categories are not of transactional nature, they do not emerge from social character of market relations. The measurement model of profit is based on the concept of nominal capital behaviour and application of current prices together with predicted value; it reveals the impact of the changing value of money regardless of real

content of economic processes. Theoretical error of contemporary economy which sees money as a commodity and monetaristic assumption about superior role of money in economic processes was fortified by contemporary accounting which loosened its assumptions making space for creative accounting and its tools related to changeability of money. The concept of contemporary monetarism overtook the intellectual, political and economic awareness of establishments as well as those who create the information system of accounting.

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