ISSN : 2350-0743

www.ijramr.com

International Journal of Recent Advances in Multidisciplinary Research

Vol. 03, Issue 06, pp.1538-1543, June, 2016

RESEARCH ARTICLE

EFFECTS OF ACCOUNTING CONCEPTS' APPLICATION ON THE FIRM'S PERFORMANCE

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ARTICLE INFOABSTRACT

Article History:
Received 20th March, 2016
Received in revised form
18th April, 2016
Accepted 27th May, 2016
Published online 30th June, 2016

Keywords:

Accounting Concepts,
Bookkeeping,
Business Entity Concept,
Objectivity Concept,
Performance,
Records Management.

This study examines how the theory and application of Business Entity and Objectivity Concepts influence the performance of a firm. It highlights on how these fundamental concepts, under Accounting Concepts, influence the activities and the performance of an organisation. To achieve the objective of this study, comprehensive literature and industrial observations are used. The study finds direct relationship between proper application of business entity and objectivity concepts and the performance of an organisation. It concludes that proper business activities must ignore favouring family and friends (business entity concept) and must be supported with relevant source documents (objectivity concept). Further observation reveals that most family and small-scale businesses (especially owner-managers) do not strictly comply with the two concepts and this normally retards their business operations at the long run. Therefore policy and decision makers, especially owners and managers, of such businesses must strictly apply business entity and objectivity concepts if they want to grow and sustain their businesses at the long run. This paper adds to the existing body of knowledge and serves as a precursor for a future research.

INTRODUCTION

Accounting is the language of businesswhichhelps to communicatefinancialinformation to users for informed decision making (Deegan &Unerman, 2008). Accountinginformation can makesenseifitisbasedonprinciples (Ehow.com, 2014). Managers need accurate accounting information to make accurate decisions. "Accounting information provided by accounting entities is used by various users with different interests. For the information to be useful, it should be relevant, reliable, comparable, understandable and timely presented to the user. Businesses operate in different environments and therefore are prone to produce different accounting information. This has led to the development of generally accepted accounting principles and procedures to guide the preparation of the information so that standard results can be achieved. They prescribe how different accounting situations should be treated to achieve standardized information beneficial to all users" (Stacey, 2014). This study is consistent with the study of Atrill&McLaney (2008).

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Bookkeeping and Accounting is a process of chronologically capturing daily financial dada in the books of accounts with reference to source documents, processing data into information, storing and retrieving the information for economic decision making. Proper financial statements are mostly financiers' requirement for accessing credits (Saleemi, 2008; Williams, Susan, Haila, Bettriel&Carcello, 2008; Larson, Wild &Chiapetta, 1999). Good financial statements influences profitability and ensure fair assessment of the firm's performance. However, improper and inadequate financial records management enhances business failure (Maseko &Manyani, 2011; Peacock, 1985,1987,1988). Nevertheless, there is no proper record keeping without following guiding principles.In proper records management, accounting and bookkeeping provide relevant basis for tracking historical financial records. All financiers require, among others, good financial statements as a criterion to offer credit facilities (Pandula, 2011; Bass &Schrooten, 2005; Amonoo *et al*., 2003; Williams, 2003). Another basis could be the profitability of the business (Pandula, 2011; Abor &Biekpe, 2009; Tetteh&Frempong, 2009; Topalova, 2004). A major purpose of accounting and bookkeeping is to provide relevant information to stakeholders for economic decision making (Deegan &Unerman, 2008).

To provide acceptable information for relevant decision making, sources and principles for deriving the information must be reliable and acceptable. Therefore, accounting concepts are generally accepted assumptions and principles that guide the preparation of financial statements. There are many accounting concepts; yet, the choice of any one concept depends on the nature of business activities and polices. The concept judged to be better-off and adopted by a firm (called accounting policy) becomes the standard of measurement and auditing. There is no good information without using good guiding principles. With keen observation of industrial practice relating to accounting and bookkeeping over the years, especially among small and family businesses, application of accounting concepts are given little focus, if not ignored. This means that the value creation in using the concepts is also missing. A business unit is regarded as “artificial person” whose activities must be independent of the owner and employees (business entity concept), and that all transactions in the name of such a firm must be supported with relevant source documents to enhance proper bookkeeping and accounting (objectivity concept). This would enable ‘free and fair’ assessment of the financial performance of the business per time (periodicity concept). In view of this, the researchers are motivated to present a research paper on Objectivity Concept and Business Entity Concept under Accounting Concepts. The study aims at examining how the theory and industrial application of Business Entity and Objectivity Concepts influence the performance of a firm. The subsequent sections will provide descriptions of the study, general analysis, actualisation, conclusion and general recommendations of the study for policy decisions.

TheoreticalBackground

This main section discusses the Objectivity Concept and Business Entity Concept under Accounting Concepts. It will climax on how these fundamental concepts influence the modern industrial activities and the performance of an organisation. This is illustrated in a model below.“Accounting concepts define the assumptions on which the financial accounts of a business are prepared. Financial transactions are interpreted in the light of the concepts which govern accounting methods” (Glautier&Underdown, 2001:38). The authors add that accounting concepts serve as guideposts that emphasise the reliability and usefulness of the information. “Accepted accounting principles are represented by rules and conventions.

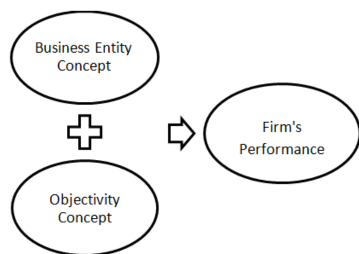

Fig. 1. Research Model

These principles contribute to the likelihood that a company's financial statements provide reliable information about its operating results and financial position, each of which is useful in decision-making processes. It is therefore essential that the information presented is objective, meaning that it is impartial, unbiased and free from subjective valuation”(Nordmeyer, 2014). The expression of "true and fair view" opinion by auditors and accountants on accounting information relates to the accounting policy adopted by an organisation (Gray& Manson, 2008; Woolf, 1994). The policy helps to ensure that accounting information is presented to meet the users’ needs. (See also Albrecht, 2008; Ralph, 2007).

Objectivity Concept

“Objectivity Principle states that accounting will be recorded on the basis of objective evidence. Objective evidence means that different people looking at the evidence will arrive at the same values for the transaction; that accounting entries will be based on fact and not on personal opinion or feelings” (Ventureline.com, 2014).It is also confirmed that “accounting methods used should be generally understood and agreed to and can be verified. It insists that all the financial transactions should be supported with relevant evidence - documents or receipts. This avoids personal judgment of records. It adds to the reliability and usefulness of accounting information, and ensures the need for credible source documents” (Wojdak, 1970).

According to Nordmeyer (2014), “objectivity requires that measurements presented in financial statements be based on verifiable evidence such as an electronic or paper trail that supports the transactions represented in the statements. In practical terms, an essential attribute of each measurement in the statements is that an identical result would be obtained by two independent observers, not influenced by personal views or perceptions”.Accounting is generally regarded as a measurement discipline and all measurements must be objective with uniform results. Accounting concept of objectivity is fundamental to measurement. However, an individual’s measurement and interpretation of accounting information may vary according to his/her knowledge, experience and circumstances per time. Hence, accounting measurements are subjective based on experimenter’s perception (Opetd, 2014).

The authors’ views above are consistent with the application of Objectivity Concept. The common insight from the authors focuses on relevant source documents as evidence and measurement issues that avoid undue biases in preparing financial statements. This ensures neutral and uniform judgement by accounting professionals overtime. Recording and reporting financial data or information must be based on facts, figures and evidence of truth, not personal assumptions, preferences and interests that can lead to misapplication of funds and conflicts. That, two or more professionals preparing and assessing financial statements from the same source data must come up with similar results that will ensure true and fair state of affairs.

Relevance of Objectivity Concept

Objectivity concept helps to produce uniform information/result, which makes it possible to compare financial statements of different firms over a period of time. According to Nordmeyer (2014), the reliance on verifiable evidence (source documents) during the measurement of financial results makes it possible to compare the financial

statements of more than one period and more than one firm. This is possible only if information presented in financial statements is objective, which, in turn, provides assurance that the data is reliable and uniform. Nordmeyer (2014) adds that objectivity requires the accountant to remain impartial in decision-making processes that lead to the documentation of transactions and the creation of the financial statements, which means that financial facts reported must be free from personal prejudices. Objectivity also requires the preparer of financial statements to remain intellectually honest and interprets accounting policies in a truthful manner. In addition, an accountant must avoid any conflict of interest in dealing with a client. Proper records management with relevant source documents will help the accountant to fairly separate business transactions from personal transactions under business entity concept. Again, the proper record keeping helps to build track records of the business that could help to access external finance. However, financial and trade track records for assessment are missing in most family and small businesses. Supply and demand sides of finance do not know much about each other, hence a complicated problem of information asymmetry (Deakins*et al*. 2008; Burns, 2007; Wattanapruttipaisan, 2003; Glautier&Underdown, 2001). Nevertheless, Burns (2007) suggests that good working relationship can help reduce information asymmetry problems.

Business Entity Concept

Relevant source documents must support financial records management (objectivity concept). While accountants are observing objectivity concept, they must be aware of legal existence of the business that is distinct from the owner. Business Entity Concept treats business entities as artificial persons or separate legal entities (or economic unit) distinct from their stockholders and stakeholders so that accounts are prepared to show all transactions that only affect the operations of the firm. The business unit and its owners/managers are treated as separate and independent beings. Staubus (1985) argues that "entity" concept is a theory which suggests that accounting activities are specific to an entity and an economic unit under a single management. To have legal personality means to be capable of having legal rights and duties within a certain legal system, such as to enter into contracts, sue, and be sued (Atrill&McLaney, 2008; Martin, 2003;Glautier&Underdown, 2001; Bryant, 1928).

Accountants are concerned about transactions relating to the business only; hence, treat the firm as separate entity from their stock/stakeholders. They prepare accounts to give information about the business, not on the owners. Likewise, owners are treated as creditors to the extent of capital invested. The owners are independent personalities and regarded as providers of loan capital for interest. In this case, any drawings and losses by the business will reduce owners' capitals while profits/interests and additional capital will increase the loan capitals. To ensure that financial records provide the true view of the enterprise, private transactions should be completely divorced from that of the firm as much as possible. All transactions must be done in reference to the policies of the organisation. All businesses, irrespective of size, must keep to this concept to enable them enjoy its value. However, the case is complex among family and small businesses; that most of them ignore the entity concept. They use the business resources (cash and /or kind) anyhow they like. Owners most at times mount undue pressure on the accountants/cashiers to release funds to them which they will never account for or reimburse to the business. Despite unlimited liability clause against sole traders and partnerships, the benefits of business entity concept compliance cannot be ignored (Accounting-Simplified.com, 2013; Victor, 2009; Atrill&McLaney, 2008; Glautier&Underdown, 2001). Glautier&Underdown (2001:39) add that "the accounting and legal relationship between the business and its owner is shown on the balance sheet, which states the firm's assets and liabilities and hence indicates its financial position and well-being.

Relevance of Business Entity Concept

The knowledge about the distinction between the owner and the business unit helps accountants in reporting the true profitability and measuring the overall performance more objectively and economically (Lewis &Pendrill, 2000). Application of entity concept helps ensure that tax calculation is accurate and audit opinion on the financial statements is really true and fair. Though the owner enjoys all profits and bares all losses, the concept draws a line between resources of the business and that of the owner. The concept gives a warning signal, especially to owner-managers, to keep-off all business resources. The concept helps the accountant to protect the interest and resources of the business and that of the owner. Nevertheless, entity concept does not limit the owner from bearing all liabilities, risks and defaults from business operations; but it enables proper bookkeeping and accounting. In general, application of business entity concept, especially among small and family businesses, is always a big challenge. Some of these challenges are due to limited knowledge in financial records management and the concept by owners, owner-managers and managers.

General Analysis and Discussion

This section briefly presents the case of owner-managers and external managers in relation to the application of entity and objectivity concepts.The argument whether family firms managed by family members are more likely to apply the concepts or not as compare to management by non-family members is not developed so much in literature. Keen observation of industrial practice and the literature debates show that owner-managers are more likely to default in applying the concepts than external managers. However, irrespective of who manages the firms, if the leadership quality of "fair and firm" is lacking, more conflicts are bound to emerge (see Chu, 2011; McConaughy*et al*., 2001; McConaughy, 2000; Morck*et al.,* 2000).

Actualization

This section focuses on the application of business entity and objectivity concepts in relation to performance: the case of family and non-family business ownership. All businesses were once small businesses. "Small businesses have been linked to the flowers in the spring: rich in diversity, often colourful, full of the promise of better things to come"

(Chadwick, 1978:85). “A business is normally created to enhance the wealth of its owners” (Atrill&McLaney, 2008:17). The studies of Chu (2011) and Wilson *et al.* (2013) provide a good basis for family and non-family business management and respective performance. Whether family firms perform better than non-family firms or not is the question passionately argued in the literature (Gedajlovic*et al.,* 2012; Wright &Kellermanns, 2011). The strategic management and control of family and non-family firms are relatively different (Bammens*et al.,* 2011; Gersick&Feliu, 2013; Goel*et al.,* 2013).

Family firms are proved to be more efficient and survive at the long run than non-family firms because they prefer internal funding to external funding to enable them avoid external interferences according to pecking-order theory (POT) (Brealey*et al., 2009;* Pike & Neale, 2009; Carney, 2005; Anderson &Reeb, 2004). The literature espouses POT for the SMEs’ financial management, suggesting that SMEs prefer internal finance; first from retained earnings, then debt as second and equity as last. This is because the owners are risk averse to dilute their ownership interest and control; and they cannot issue public equity (Abor &Biekpe, 2009; Gregory *et al*., 2005; McMahon *et al*., 1993; Holmes & Kent*,* 1991). In short, POT endeavours to explain why SMEs prefer internal to external finance (Lucey, 2006).

As compare to non-family businesses, family firms engage in fewer diversifications, business risk may also be reduced and survival chances increased (Miller *et al.,* 2010). However, ownership and management conflicts in family firms may be more severe than in nonfamily firms which may affect business growth and survival at the long run (Zahra, 2010; Kellermanns&Eddleston, 2004; Schulze *et al.,* 2003). Human capital limitations and innovation through R&D, and agency problems are likely to be more severe in family firms than non-family firms (Gedajlovic*et al.,* 2012; Villalonga& Amit, 2006; Morck& Yeung, 2003).Empirical studies suggest that family ownership and control is positively associated with the firm’s performance than non-family firms (Dyer, 2006; Villalonga& Amit, 2006; Yammeesri&Lodh, 2004; Anderson &Reeb, 2003; Habbershon*et al.,* 2003; McConaughy*et al.,* 1998; Kole, 1995).

The cue from the above discussion suggests that family firms can only perform better and survive at the long run than non-family firms if there is efficient management and control of resources with less conflicts from family members. Interestingly, no literature was conducted on the application of business entity and objectivity concepts by family and non-family firms’ ownership and control. However, keen observations show that family firms managed by non-family members are more likely to apply the concepts in preparing their financial statements than family firms managed by family members. Likewise, non-family firms are more likely to apply the concepts in preparing their financial statements than family firms due to more external interventions. This implies that the standard of performance measurement between family and non-family firms must be deeply researched into to avoid misleading conclusions.

Conclusion

This paper examines how the theory and application of Business Entity and Objectivity Concepts influence the performance of a firm. To achieve the objective of this paper, literature and industrial observations were used. The study finds that there is positive relationship between the application of business entity and objectivity concepts and the performance of an organisation. Business entity and objectivity concepts help to produce quality accounting information to users for quality decision making. Business entity concept ensures that transactions of the business are totally separated from that of stockholders and stakeholders. Objectivity concept ensures that all transactions are supported with relevant source documents and information measurement must have uniform results. It concludes that proper business activities must avoid favouring family and friends. The study also reveals that despite the size of the business, compliance with the concepts is essential (Atrill&McLaney, 2008). The implication is that, compliance with the entity and objectivity concepts is a pointer to maximising profits of the firm. Better performance of a business is possible when business and entity concepts are strictly applied and observed overtime. It ensures true and fair measurement and interpretation of financial statements that will enhance decision making (Gray& Manson, 2008; Woolf, 1994). However, some researchers argue that subjective views on the choice and application of the concepts cannot be ignored. Others opine that total separation between the business and the sole traders and partnerships is not practicable because of unlimited liability nature of such businesses (Atrill&McLaney, 2008). Nevertheless, policy and decision makers, especially owners, managers and accountants must strictly apply business entity and objectivity concepts to ensure growth and sustainability of their businesses at the long run. This paper adds to the existing body of literature and serves as a basis for future research. However, the study is relatively limited to researchers’ personal observations and literature review.

Recommendations

One major purpose of accounting is to provide relevant financial information for decision making by stakeholders (Deegan &Unerman, 2008). Therefore, the following recommendations are provided to guide policy decision and action:

- Daily sales proceeds must be deposited in the firm’s bank account, not in the owner’s or manager’s personal accounts, within 24hours or as the business policy directs;
- All official expenses on behalf of the firm must the recorded as such with supporting evidence in the firm’s books of accounts;
- All personal expenses by the owner, manager, accountant and other employees must be treated as pure personal transactions, which must not appear in the firm’s books of accounts;
- The firm’s goods and services enjoyed (unofficially) by the owner, manager, etc. and their families must be paid for in full. No free lunch for owners and managers, except the business policy allows it;
- That, there is no special prices or gifts for family and friends, every official transactions are done at arm’s length;
- Personal assets must be separated from business assets and accounted for separately;

- Financial statements and their supporting source documents must be kept safe and must be accessible to the users and decision makers at the right time;
- Firms must employ and train professional accountants and/or bookkeepers;
- Owners must not put undue pressure on the accountants/managers to borrow money (or take goods) for personal use, they must rather allow the normal business process to flow without undue interferences;
- Owners and managers must not use business assets (especially fixed assets such as motor vehicles) for private purposes, for example to funerals, parties, and other unauthorised occasions.
- Future researchers can conduct empirical studies on the impact of these concepts on the firms' performance.

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