Dealing with Corporate Collapses

In the lead up to the commencement of the government’s legislative process enacting the reforms to financial reporting and auditing, no dominant theme has been reported in the media in May and June. However, there have been sufficient articles concentrating on various aspects of the reform process, suggesting that the issue of credible audited financial statements is still of public interest. This edition of Current Affairs in Auditing will discuss some of these articles.

How well does accounting and accounting standards deal with the problems of a collapsing company?

An article written by Tony Harris (2003, p. 9) reviewed the book Corporate Collapse: Accounting, Regulatory and Ethical Failure (revised edition) written by Frank Clarke, Graeme Deane and Kyle Oliver. This book deals with corporate collapses in Australia since the 1960s. The authors adopt the thoughts of Professor Ray Chambers, who devised continuously contemporary accounting (COCOA). This system values assets on their sale price, not at their historical costs or revalued amounts. Accounting justifies valuing assets on historical cost or revalued amounts stating that these are going concern values, whereby these amounts are in the balance sheet waiting to be matched against future revenues. All assets included in the balance sheet are subject to the lower of book value and recoverable value. If the recoverable value is below book value, the asset is then written down. Recoverable value is a future-related value and its measurement involves much subjectivity that may aid preparers of reports in trying to convince auditors that no write down is necessary. When it becomes obvious that the assets’ loss has occurred permanently, large write-downs that shock readers of the financial statements can occur. The authors argue that assets should be valued at their sale values, enabling in our prior example, the assets to be written down over a number of years, giving a better indication of the solvency of a company. Large write-downs that surprise investors will not occur. These losses are large as the decrease in value resulted over many years.

Valuing the assets at sale prices would mean that assets such as capitalised costs and goodwill would cease to be included in the balance sheet. These assets cannot be sold separately and thus are excluded from the balance sheet. Students who grapple with the complexities of tax effect accounting would be delighted to learn that tax effect accounting would cease to exist if COCOA were adopted. A future tax benefit has no resale price, meaning it cannot be placed in the balance sheet.

Another aspect of COCOA is that it simplifies the underlying conceptual basis of accounting. The test for an inclusion of assets in a balance sheet is whether the asset has a resale price. We would thus not have the need for the vast standards that lead to many means by which assets can be placed in the balance sheet.

For a fuller appreciation of the benefits of COCOA you should read the Harris article or the text, Corporate Collapse: Accounting, Regulatory and Ethical Failure (revised edition).

Reference