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Exploration on the Perception of Accounting from an Analytical Perspective

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Abstract: *This study provides a focused and analytical overview of the financial accounting literature, specifically examining accounting valuation. The main areas of interest include the implied costs of equity capital, empirical accounting proxies, and frictions in accounting theory. The author contends that accounting research in these domains often exhibits complacency and a dearth of rigorous analysis. Complacency in the field of financial accounting undermines research innovation and impedes the long-term viability of accounting academia. The examples addressed in this paper encompass various issues, such as structural modelling and model falsifiability. It also examines the problem of determining whether a firm is overpriced or underpriced using valuation models that do not consider such phenomena. Additionally, it discusses the arbitrary combination of two unrelated models, one for valuation and one for the discount rate. Furthermore, it highlights the failure to acknowledge the empirical limitations caused by risk-neutral valuation models when estimating costs of capital. Lastly, it explores the use of the same model for both valuation and discount purposes*

Keywords: Financial accounting, accounting study, cost of capital, perception

I. INTRODUCTION

This paper presents a focused and evaluative overview of the financial accounting literature, primarily focusing on empirical archival research, but not limited to it. Due to the extensive range of financial accounting study, it is imperative to exercise discernment and choose carefully. The field lacks criticality as it is too complacent in its scientific methodology, questionable proxy constructs, and the casual approach of financial accounting empiricists (and occasionally theorists) towards financial accounting theory. To pre-empt any accusations of undue pride, I must acknowledge that my own work is not impervious to the objections presented in this paper. The primary areas of research in financial accounting include accounting valuation, which encompasses the assessment of implicit costs of equity capital, empirical accounting proxies, and the identification of accounting theory frictions.

Due to the firm's conservative approach, a larger amount of its recognized value is assigned to operating assets compared to operating earnings. The problem with valuation is worsened by the ambiguous term "other value relevant information," as these variables will also receive a percentage of the firm's established value allocation. However, how can we determine in advance which additional variables are significant for determining value, considering that the model does not explicitly define them? Moreover, what if these significant variables differ among different companies and industries?

Ohlsonian models are limited in their ability to deliver meaningful valuation insights since they assign the known value of the firm to accounting variables. While I have a different opinion, it is accurate to state that Ohlsonian models are neither suitable for identifying overvalued or undervalued enterprises, nor for estimating intrinsic values using accounting figures that deviate from market prices. The number is 6. If the accounting numbers yield a value different from the market value, it signifies that the firm's recognized value has not been accurately distributed among the accounting numbers. The conceptual flaws arise when attempting to utilize Ohlsonian models to quantify the firm's intrinsic value, or in other words, to determine its degree of under- or overvaluation in relation to its market value. The above discussion fails to acknowledge that most Ohlsonian models operate under the assumption of risk neutrality. Interpreting the empirical estimation of models and their relative popularity is challenging due to the fact that the world

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is clearly not risk-neutral. Feltham and Ohlson (1999) enhance the Residual Income Model (RIM) valuation model by incorporating risk. They propose that the firm's worth is determined by its book value, weighted abnormal earnings (as in risk-neutral models), and a combination of covariance risk-adjustment components. There is a lack of empirical accounting studies that have explored the problem of risk in the context of model estimate. Nekrasov and Shroff (2009) deviate from the norm by evaluating Feltham and Ohlson's (1999) expanded RIM model. However, although they consider the possibility of risk, they fail to consider the factual observation that risk fluctuates with time. In a manner akin to Ohlson's (1995a,b) enlargement of the conventional RIM model, Lyle et al. (forthcoming) integrate an augmented set of dynamics, encompassing risk dynamics, into the Feltham and Ohlson (1999) RIM model. Their dynamic risk structure and empirical results align with the extensive evidence in the accounting and finance literature that costs of capital (anticipated returns) change over time. Furthermore, they provide a closed-form linear solution that can be easily estimated using empirical methods.

Assessment of financial records and determining the cost of obtaining capital

Research on the accounting cost of capital has the potential to be highly significant, both in terms of practical application and motivation. For example, the expenses associated with obtaining cash can be utilized to determine the worth of investments and act as a standard for assessing the CEO's effectiveness. Many studies on accounting disclosure policies are driven by the belief that transparency leads to a decrease in the capital costs of companies.

In accounting research, costs of capital are commonly inferred. This means that they are usually calculated as the internal rate of return, which compares the current known price to the expected future cash flows. The cash flows are analyzed using a typically Ohlsonian model. Most empirical studies make the assumption that the resulting internal rate of return figure represents the company's cost of capital. However, if the cash flows in the numerator are appropriately adjusted for risk, the resulting cost of capital will be equal to the risk-free rate. Nevertheless, what is the objective of such an undertaking? Without adjusting for risk, the estimated cost of capital will only be an approximation, as stated by Samuelson and Ohlson (2021) several decades ago.

Empirical accounting valuation studies often employ Ohlsonian type models to assess the worth of a firm's cash flows. Additionally, a CAPM type model is commonly utilized to empirically ascertain the appropriate cost of capital, irrespective of the valuation model's ability to accurately consider risk. This seeming contradiction arises from the paradox that when an Ohlsonian model is employed to assess the cash flows of the firm, it becomes impossible to deduce an approximation of the firm's cost of capital using the same model. Conversely, if someone analyzes a model to determine the implied cost of capital, they cannot subsequently employ the same model to assess the worth of the company. In order to effectively utilize Ohlsonian models for valuation, it is necessary to have an estimate of the cost of capital. This estimate is crucial for calculating abnormal earnings, among other things. The conventional practice of "merging" two models, where one model is utilized for valuation and the other for calculating capital expenses, has two significant issues. According to the literature on implied cost of capital, the value and cost of capital of a corporation are determined together. Regardless, this literature implies that the price incorporates both future cash flows (profits) and the discount rate. The disregard for simultaneity occurs when calculating company value using one model and cost of capital using another. Assuming that the Ohlsonian-type model and the CAPM-type model are substantially identical when estimating price and cost of capital is incorrect. Each paradigm does not always entail the other.

The concept of financial accounting and its associated obstacles

The purpose of financial accounting theory is to produce hypotheses that can be tested and to provide guidance for empirical research in the discipline. However, there is an unfortunate inclination for theory to overlook the obstacles that provide it with significance. Indeed, the modeling of frictions can be challenging, although there are instances where they play a key role. Theorists have already raised this matter, as evidenced by Hemmer's (2008) analysis of unmodeled frictions in the publication of Plantin et al. (2008). However, I consider it to be important and deserving of emphasis. Two occurrences should be enough.

Gigler et al. (2009) analyze the impact of accounting conservatism on debt covenants in a complex and advanced manner. Within the framework of their model, they make the assumption that the level of debt for the company is both positive and determined by external factors. Put simply, Gigler et al. (2009) does not include a model for the leverage decision. This occurrence is not uncommon and does not inherently pose any issues. It is not possible to incorporate everything into a model, and even important decisions cannot always be incorporated, especially when the model is

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already extensive. However, there is a condition: According to their approach, debt is considered to have no inherent worth. Undoubtedly, debt becomes costly in the absence of any compensating factors. Therefore, under this model, the firm should be composed solely of stock. However, it is not possible to analyze debt covenants for a firm that has just equity. Essentially, it is not reasonable to assume an external level of debt when the model itself finds that the best capital structure consists exclusively of stock. How can the rationalization of debt covenants be achieved in a model that exclusively considers the issuance of debt by irrational firms?

An alternative approach to address this critique would involve expanding the model to incorporate additional factors, such as the tax deductibility of interest. This inclusion would result in the establishment of an ideal level of debt inside the model. However, incorporating taxes into the current model, due to its intricate nature, would probably make it extremely difficult to solve, and it would not change the qualitative outcomes of the model. In my view, this response is insufficient. The authors' conclusions on the impact of conservatism on debt covenants cannot be guaranteed to remain valid if their model were to include tax frictions. It is plausible that the article concludes that accounting conservatism is essentially negative because of the assumption that debt is exogenous, meaning that no firm would hold debt optimally from the start. In my perspective, the model's results should be supported by a proof that takes into account taxes or other frictions.

There are cases where certain frictions are represented while others are not, and it is the unrepresented frictions that are particularly significant. Beyer and Guttman (2012) investigate a compelling framework of voluntary self-generated transparency before a company issues new shares to fund new investment prospects. The issue lies in the fact that new owners are appropriating a portion of the advantages derived from the current assets. This creates a motivation for management to exaggerate the worth of existing assets in order to attract new investors who are prepared to pay a greater price for each new share, thus minimizing share dilution. The concept is quite complex, and its implications for voluntary disclosure are innovative. However, the fundamental underlying assumption of the model is that new shareholders will receive the same advantages from existing assets as existing shareholders. When existing assets create a distortion in managerial incentives, organizations often opt for project financing instead of issuing equity directly. This approach helps to isolate the returns generated by the new investment from the returns generated by the existing assets. Put simply, project financing resolves their problem. Beyer and Guttman fail to acknowledge this alternative or the potential obstacles that could render the project finance approach excessively costly.

II. CONCLUSION

This work presents a focused and critical analysis of the financial accounting literature, specifically examining three research areas: accounting valuation, which includes implied costs of capital, empirical accounting proxies, and unmodeled frictions in accounting theory. The author contends that accounting research in these domains often exhibits excessive complacency, especially in its dearth of critical reasoning. Oftentimes, empiricists neglect to acknowledge the constraints of the existing models and thereby misuse them. The paper examines various examples, such as structural modelling and model falsifiability. It also explores the issue of determining if a firm is overpriced or underpriced using valuation models that do not consider certain phenomena. Additionally, the paper discusses the problem of combining two different models, valuation and discount rate, without acknowledging the empirical limitations caused by risk neutral valuation models when estimating costs of capital. Additional instances of a deficiency in critical reasoning encompass the repetitive utilization of proxies that lack a solid theoretical foundation, the estimation of regressions that inevitably produce biased coefficients despite the availability of solutions in the econometrics literature, and the creation of intricate models that fail to incorporate the necessary frictions relevant to the research topic.

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