Norges
Handelshøyskole

Norwegian School of Economics and Business Administration

PhD Dissertation in Accounting

The Usefulness of the Asset-Liability View

- An Analysis of Conceptual Frameworks and the Implications for Norwegian Accounting Regulation

Steinar Sars Kvifte

The Norwegian School of Economics and Business Administration,
the Department of Accounting, Auditing, and Law,
Bergen, Norway

Reading Committee:

Reading Committee Chair, Professor **Atle Johnsen**, the Norwegian School of Economics and Business Administration.

Professor **Frøystein Gjesdal**, the Norwegian School of Economics and Business Administration.

Professor **Jens O. Elling**, Copenhagen Business School.

ISBN 82-405-107-9

NORGES HANDELSHØYSKOLE BERGEN

Content

Preface and Acknowledgements 7

1. Introduction 10

1.1 Background and Research Questions 11

1.2 The Relevance of the Study in a Norwegian Context 13

1.2.1 IFRS 2005 15

1.3 Chapter Overview 17

2. Conceptual Frameworks 20

2.1 From Accounting Theory to Conceptual Frameworks 21

2.1.1 The Missing Principles 22
2.1.2 Conceptual Framework Approaches 26
2.1.2.1 Descriptive Frameworks 27
2.1.2.2 Normative Frameworks 28
2.1.2.3 Inductive and Deductive Reasoning 30
2.1.3 Descriptive Accounting Research and Theory 32
2.1.4 Concluding Remarks 36

2.2 Content, Benefits, and Authority of Conceptual Frameworks 37

2.3 The Merits of Conceptual Frameworks 46

3. Objectives and Qualitative Characteristics 54

3.1 Objectives of Financial Reporting 55

3.1.1 Decision Usefulness 56
3.1.2 Decision Making Versus Stewardship Demand 60
3.1.3 Primary Users 63
3.1.4 Suggestions 66

3.2 Qualitative Characteristics 70

3.2.1 Reliability 72
3.2.2 Relevance 75
3.2.3 Trade-Off Notion 77
3.2.4 Secondary Characteristics 80
3.2.5 Underlying Constraints 82
3.2.6 Suggestions 85

3.3 Concluding Remarks – Summary of Suggestions 87

4. Recognition 93

4.1 Dimensions of Recognition: Measurement and Definitions 95

4.2 Measurement 98

4.2.1 The Evolutionary Approach 101
4.2.2 A Normative Frame of Reference to Measurement 105

4.3 Definitions of Elements 107

4.3.1 The Effects of Uncertainty 113
4.3.2 Degrees of Probability in the Provisions Standards 115
4.3.3 Examples of Inconsistencies in Accounting Standards 117
4.3.4 Concluding Remarks 118

4.4 Two Perspectives 119

4.4.1 The Shift 120
4.4.2 The Conflict 121

4.5 Income Recognition 129

4.5.1 Revenue Recognition 132
4.5.1.1 Earning and Realizability 133
4.5.2 Expense Recognition 137
4.5.2.1 The Matching Concept 137
4.5.2.2 Matching Versus Smoothing 139
4.5.2.3 The Case of Amortization 145

4.6 The Critics of the A-L Perspective 149

4.7 Concluding Remarks 153

5. The Application and Effectiveness of the A-L Definitions ______ 162

5.1 Methodology ______ 164

5.2 Explicit Application of the IASB Conceptual Framework ______ 168

5.2.1 IAS ______ 169
5.2.2 SIC ______ 177
5.2.3 Summary ______ 186
5.2.4 Concluding Remarks ______ 187

5.3 Effectiveness and Rejection of the A-L Definitions ______ 188

5.3.1 Pension Accounting ______ 189
5.3.1.1 The Method ______ 190
5.3.1.2 The Application of the A-L Definitions ______ 192
5.3.1.3 Conclusion ______ 198
5.3.2 Maintenance Cost Accounting ______ 198
5.3.2.1 The Methods ______ 199
5.3.2.2 The Application of the A-L Definitions ______ 201
5.3.2.3 Conclusion ______ 203
5.3.3 Income Tax Accounting ______ 204
5.3.3.1 The Methods ______ 204
5.3.3.2 The Application of the A-L Definitions ______ 208
5.3.3.3 Conclusion ______ 217
5.3.4 Goodwill Accounting ______ 218
5.3.4.1 The Methods ______ 219
5.3.4.2 The Application of the A-L Definitions ______ 221
5.3.4.3 Conclusion ______ 228
5.3.5 Other Inconsistencies ______ 229
5.3.6 Concluding Remarks ______ 230

5.4 Summary ______ 232

6. A Survey of the Decision Usefulness of the A-L View to Financial Analysts ______ 241

6.1 Introductory Comments ______ 242

6.2 The Survey ______ 244

6.2.1 Test Design ______ 246
6.2.1.1 The Target Population ______ 246
6.2.1.2 Sample Selection, Coverage and Representativty ______ 248
6.2.1.3 Demographics of the Sample ______ 250

6.2.1.4 The Questionnaire 251
6.2.2 Findings 261
6.2.2.1 Objectives of Financial Reporting and Qualitative Characteristics 261
6.2.2.2. The Decision Usefulness of the A-L Definitions 264

6.3 Concluding Remarks 268

7. Summary of Findings 272

7.1 The Conceptual Differences Between the A-L View and the R-E View 273

7.2 The Effectiveness of the A-L Definitions 274

7.3 The Usefulness of the A-L Definitions in Standard Setting 275

7.4 The Decision Usefulness of the A-L Definitions to the Financial Analysts 276

7.5 Other Findings and Contributions 277

7.6 Future Research Opportunities 279

8. Implications for Norwegian Accounting Regulation 282

8.1 Accounting Regulation in Norway 282

8.1.1 The Legal Framework 283
8.1.2 Accounting Standard Setting in Norway 285

8.2 The Norwegian Framework 286

8.2.1 A Conceptual Framework Based on the R-E View 287
8.2.2 The Basic Accounting Principles 290

8.3 Meeting the Challenge of IFRS 2005 297

8.3.1 The Accounting Act Committee 2002 298
8.3.2 IFRS 2005 in Norway 299
8.3.2.1 The Mandatory Scope of the EU Regulation 2002 305
8.3.2.2 The Optional Scope of the EU Regulation 2002 307
8.3.2.3 IFRS Harmonization Outside the EU Regulation 2002 308
8.3.2.4 The Implications of the IASB Hierarchy of Sources 315
8.3.3 A Revised Norwegian Conceptual Framework 319
8.3.4 Concluding Remarks 322

References ____ 325

Appendix A: Analysis of IAS ____________________________ 342

Appendix B: Tables in Chapter 6 __________________________ 350

Appendix C: Cover Letter and Questionnaire _________________ 355

Appendix D: Pre- and Post-Survey Activities _________________ 369

Appendix E: The NYSSA-report ___________________________ 380

Appendix F: Analysis of Norwegian Accounting Standards _______ 398

Figures

Figure 2-1 Conceptual Framework Approaches ____________________ 27
Figure 2-2 The Conceptual Frameworks of the Leading Standard Setters ________ 38
Figure 2-3 The Hierarchy ______________________________ 39
Figure 3-1 Objectives of Financial Reporting ____________________ 70
Figure 3-2 Qualitative Characteristics _________________________ 72
Figure 4-1 Measurement in a Normative Perspective ________________ 106
Figure 4-2 The Asset-Liability View versus the Revenue-Expense View _______ 125
Figure 4-3 Smoothing _________________________________ 143
Figure 5-1 The Analysis Matrix __________________________ 166
Figure 5-2 The Maintenance Cost Example ____________________ 200
Figure 8-1 The Norwegian Framework in IFRS 2005 _______________ 309

Preface and Acknowledgements

I first gained interest in conceptual frameworks and their implications for accounting standard setting and regulation in the Accounting Program at the Norwegian School of Economics and Business Administration (NHH) in 1993-1994. In particular, the role of the asset and liability definitions in the frameworks triggered my curiosity, and in 1997, I published a research paper on the subject (Kvifte 1997). Through research conducted in the preparation of the paper, I learned that several important conceptual questions were unanswered or undocumented in the accounting literature. Later, through my technical accounting advisory experience in an international accounting firm and my involvement in Norwegian accounting standard setting, I realized that application of accounting concepts and principles in accounting regulation and practice is more challenging than it may appear. Thus, when I decided to pursue a doctoral degree in the spring of 2001, conceptual frameworks represented a promising pathway to explore.

I have appreciated the opportunity to research and work solely on issues I have been allowed to define myself, and the challenge embodied in the task of developing a PhD dissertation that hopefully eventually would academically be accepted as such, has been an educating and stimulating experience.

My special thanks are due to Professor Atle Johnsen, NHH. Atle has throughout the whole process enthusiastically contributed with his insightful comments and remarks. His knowledge of accounting standard setting is unique in Norway, and I have greatly benefited from his conceptual and technical competence.

The second member of the Reading Committee, Professor Frøystein Gjesdal, NHH, has given me a better understanding of the field of accounting research. I have benefited from the methodological expertise of Frøystein, and his involvement has been important to the final product.

I am also grateful for the willingness of Professor Jens O. Elling, Copenhagen Business School, to serve on the Reading Committee. Professor Elling is recognized for his expertise in the area of conceptual frameworks, and his advices in the latter phase of the dissertation were useful.

In the early stages of the project, I benefited from meetings and discussions with Professor of Accounting George J. Staubus, Haas School of Business, UC Berkeley. The willingness of Professor Brett Trueman, Haas School of Business, UC Berkeley, to comment on research ideas was valuable, and the empirical contribution in chapter 6 is an indirect result of his influence. In addition, the interest of Professor Xiao-Jun Zhang, Haas School of Business, UC Berkeley, in my research was encouraging.

Furthermore, in chapter 6, I have benefited from the technical assistance provided by Visiting Scholar Michael Knie-Andersen, Haas School of Business, UC Berkeley, and Researcher Kari Hauge Riisøen, FAFO Institute for Applied Social Sciences. I would also like to extend my appreciation to the New York Society of Security Analysts (NYSSA) for kindly consenting to distribute my questionnaire among its members, and thus providing me with an appropriate dataset to draw conclusions from.

The encouragement and support of Arthur Andersen in Norway was important for me in initializing the project, and I am thankful that Ernst & Young in Norway, after the merger between the two companies, let me continue the program under the same terms. Likewise, the financial support of the Norwegian Institute of Public Accountants (DnR) has represented an important contribution. The scholarship I was rewarded from The U.S. – Norway Fulbright Foundation was academically motivating and contributed to making the visit at UC Berkeley possible. Furthermore, I am grateful for the encouragement and support of the Agder University College (HiA) during the whole project. The financial and academic support and flexibility HiA provided me with was one of the most important factors in my decision to enroll in the PhD program.

Last but not least, Lin, my wife, has been a listener and motivator during the whole process. Furthermore, she is the producer of the figures in the Dissertation and she assisted me in carrying out the administrative tasks involved in the financial analysts survey in chapter 6. I am grateful for her contributions and for her being there all the time.

I hope this final product meets the expectations of all the people and institutions that have supported me academically and/or financially through the process.

Oslo, December 2003

1. Introduction

> *"We are driving our own car but are in the middle of a traffic jam caused by other cars that preceded ours. Those cars have either slowed down because they were uncertain about which road to take or have taken a road that proved to be impassable and have returned to the crossroads, adding to the congestion. This scene is further confused by many well-meaning auditors and preparers of financial statements who are directing traffic and giving conflicting stop-and-go signals. It is confused by professors on each corner who are beckoning drivers down their favorite roadways. Users of financial statements are seldom seen. Behind the FASB's car are several very impatient drivers – would-be standard setters – who are honking their horns and frantically gesturing that we should forge ahead in the direction they want to go. The noisiest car is a black limousine with the Washington, D.C., licenses plate "SEC". For several years the driver of that car has been pointing down the road of concepts. (...) The traffic jam of conflicting views on the nature of standard setting and the role of concepts has existed a long time. However, the level of frustration has reached the point that those affected are willing to contribute money to allow the development of a conceptual framework to proceed. The hope is that this effort will clear the roads and reduce the uncertainty about the direction of financial reporting"* (Kirk 1981, 83).[1]

In this introductory chapter, the background and the research questions of the Dissertation will be summarized in chapter 1.1. The relevance of the study in a Norwegian context will be explained in chapter 1.2, and in the final section, chapter 1.3, an overview of the structure and content of the Dissertation will be offered.

1.1 Background and Research Questions

Financial Accounting Standards Board (FASB)[2] in the US initiated in 1973 a conceptual framework project. The last concepts statement, SFAC No. 7, was issued in 2000. The effort has in other words been time consuming, and includes more than 4000 pages and the cost has been significant: *"The conceptual framework project that is being undertaken by the Financial Accounting Standards Board (FASB) is by far the most expensive, time-consuming, lengthy, and profound project ever attempted"* (Schuetze 1983, 254). Other standard setters have engaged in similar projects: *"It is noteworthy that virtually all the standard setting bodies in English speaking countries and the International Accounting Standards Committee are presently in the process of developing conceptual frameworks"* (Sprouse 1988, 127). International Accounting Standards Committee (IASC), later replaced by the International Accounting Standards Board (IASB), issued its framework in 1989.[3] The Accounting Standards Board (ASB) in UK announced in 1991 that a conceptual framework project was on its agenda, and in 1995 they published an exposure draft of "Statement of Principles" (a final statement was issued in 1999). Also other countries, including Canada, Australia, and New Zealand, have issued conceptual frameworks.[4]

The IASB Conceptual Framework builds on the FASB Framework: *"(...), the IASC Framework is largely patterned after the FASB's Conceptual Framework, and there are few fundamental differences between them"* (FASB 1996, 57). Other countries have also designed their frameworks after the FASB Conceptual Framework, and in general there are few significant differences (Elling 1998, 138).

The conceptual frameworks have been criticized both from a theoretical perspective and from a more practical perspective calling the frameworks usefulness into question. Particularly the decision to base the frameworks on the Asset-Liability view (the A-L view) as opposed to the Revenue-Expense view (the R-E view) has fueled many objections.[5]

The New Economy's reliance on high-technology related human capital has led many commentators and analysts to doubt the ability of the accounting rules to capture value-relevant information of reporting entities.[6] Given current accounting frameworks' focus on investor-relevant information, an inability of financial reports to provide investors with relevant information may represent a serious threat to the existence of the frameworks and the current accounting rules.

The pressure on accounting standard setters to continuously deal with new recognition issues in established and emerging industries may to some extent have resulted in unnecessary inconsistencies between generic similar transactions.[7] One may expect that the magnitude of this potential problem has increased with the emergence of the New Economy.

Research opportunities provided by the accounting standard setting process are numerous. Evaluations of shortcomings in the conceptual framework are one obvious avenue (Wyatt 1990, 87). It is this research opportunity that will be addressed in the Dissertation.

The role of conceptual frameworks in accounting theory will be discussed, and the structure of conceptual frameworks will be investigated and evaluated. Four research questions will be addressed:

1. What separates the A-L view from the R-E view at the conceptual level?
2. Do the A-L view and the R-E view produce different solutions to accounting problems?
3. Are the A-L definitions useful in accounting standard setting?
4. What perspective, the A-L view or the R-E view, provides the most decision useful information?

Even though all the research questions are concerned with the A-L definitions, it will be an objective to conduct a comprehensive analysis of the function, the structure, the

content, and the application of conceptual frameworks, not limited to recognition issues. Furthermore, the conclusions drawn will be analyzed in a Norwegian context.

Financial reporting has historically been based on historical cost. However, it is common to associate the A-L view in the conceptual frameworks and value accounting. It is therefore uncertain whether the A-L view and historical cost accounting are compatible. Even if they are, it may not be that the asset and liability definitions add usefulness beyond the traditional revenue-expense view in a historical cost setting. Although value accounting has gained significant support over the last few years, historical cost recognition issues still play and will continue to play an important role in financial reporting. Furthermore, the outcome of the push for value accounting internationally cannot be predicted with certainty.

1.2 The Relevance of the Study in a Norwegian Context

The focus in the Dissertation is the conceptual frameworks of leading standard setters, and in particular, the usefulness of the A-L view will be investigated. The relevance of the Dissertation in a Norwegian context may thus not be obvious. The Norwegian Accounting Act Committee rejected the conceptual frameworks approach after considering the conceptual frameworks of other standard setting bodies in the preliminary works of the current accounting legislation (NOU 1995:30). Furthermore, the Norwegian accounting regulation is based on a transaction-based historical cost model and a R-E view is adopted.

However, the conceptual frameworks and the A-L view have not been fully explored in a Norwegian context. Norsk RegnskapsStiftelse (NRS, "The Norwegian Accounting Standards Board" (NASB)) considered the development of a conceptual framework: *"At inception, the NASB faced some difficult strategic decisions. Ideally, the new body would have to liked to begin by issuing a statement of basic concepts and principles as did the Accounting Standards Board in Britain"* (Johnsen 1993, 623). Because of the pressing need for substantive accounting standards at the time, the NASB chose to focus their

efforts on issuance of specific accounting standards. The Accounting Act Committee conducted an evaluation of the existing conceptual framework, but concluded that the conceptual frameworks of the FASB, the IASB and other standard setters yet had to prove useful, and the conceptual framework approach of these standard setters was rejected (NOU 1995:30). In reaching this conclusion, the Accounting Act Committee relied primarily on secondary sources. Furthermore, one must appreciate the impact of the timing of the Accounting Act Committee conclusion. In the late eighties and the early nineties, the conceptual framework projects of the standard setters had been exposed to severe criticism and the approach was in many regards considered a dead-end by leading commentators. The interest in the conceptual frameworks was little, also among other standard setters. The conclusion reached by the Accounting Act Committee was therefore reasonable.

It was first in the end of the nineties that the conceptual framework approach again received noticeable attention. For instance, as will be further explained in the introduction of chapter 5, the IASB intended to revitalize the IASB Conceptual Framework in 1998. Furthermore, the FASB issued a new Concepts Statement in 2000 (SFAC 7), fifteen years after SFAC 6 had been issued, and thus directed attention towards the FASB Conceptual Framework again. Also, the ASB approach in the UK leading to an exposure draft in 1995 (ASB 1995) received little support at the time, and the ASB soon realized that a revision was in demand (ASB 1996). In 1999, a final British conceptual framework was issued.

More importantly though, in explaining the relevance of the dissertation in a Norwegian context, is the European Union (EU) Regulation that came into force in September 2002 (EU Regulation 2002) requiring all entities in EU listed in a regulated market to prepare consolidated accounts in accordance with IFRS by 2005. Thus, according to the European Economic Agreement (EEA), Norwegian entities will have to implement IFRS by 2005. The EU Regulation 2002 will naturally play a significant role in the development of Norwegian accounting regulation in the future. In the following, the IFRS harmonization

process associated directly and indirectly with the implementation of the EU Regulation 2002 at a national level will for simplicity be referred to as "IFRS 2005".

1.2.1 IFRS 2005

> *"The introduction of the IAS Regulation requiring all listed companies throughout Europe to adopt International Accounting Standards by 2005 is a major achievement. The common basis for financial reporting based on high quality global standards provides a platform for efficient cross border investment both within and beyond the European Union. It can be expected to enhance the efficiency of capital markets and provide an example other countries may wish to follow"* (letter from European Advisory Financial Reporting Group (EFRAG) to EC Commission in June 2002).

The benefits associated with international harmonization of financial reporting requirements are undisputed. Furthermore, when the underlying frameworks are similar, harmonization generally implies little more than elimination of specific differences in certain areas where for one reason, often based on practical arguments, or another, countries have allowed or required different solutions. However, the costs may be high, particularly in countries as Norway where an independent body of authoritative accounting literature has been developed.

The harmonization process is far more challenging when the underlying frameworks are fundamentally different. For example, in certain countries, financial reporting rules and tax rules are closely related, and the financial reporting rules are therefore not always grounded on accounting concepts alone.

In other countries, no conceptual framework, or conceptual frameworks fundamentally different from the IASB Framework, have been developed. The latter situation applies to Norway. A framework for financial reporting, constituted by the implicit framework explained in the report of the Accounting Act Committee and the basic accounting

principles in the Accounting Act, exists, but is fundamentally different from the IASB Conceptual Framework.

In Norway thus, certain new accounting rules in specific areas will have to be adopted. For example, certain minor amendments in pension accounting, in accounting for foreign currency translations, in accounting for business combinations, and in accounting for income tax, to name a few, have to be made. The basic approach applied in the respective international accounting standards and the similar Norwegian accounting standards is generally the same, and the technical harmonization efforts required by IFRS 2005 will therefore be manageable.

On the other hand, the adoption of a new framework for accounting, the IASB Conceptual Framework, may prove to be far more challenging. As explained, except for the evaluation of certain standard setters' conceptual framework made by the Accounting Act Committee in 1995, little research on the purposes, the structure, the content, and the application of the conceptual frameworks have been conducted in a Norwegian context. Thus, it is fair to say that the implication of IFRS 2005 raises conceptually difficult questions, and may represent more of a challenge than one at the outset may think. For one thing, IFRS 2005 most certainly represents a tremendous pedagogical task. The challenges involved in the process of educating the Norwegian accountants under a conceptual framework based on a fundamental perspective (the A-L view) different from the fundamental perspective in the Norwegian Framework (the R-E view) cannot be ignored. Furthermore, the implications of a fundamentally different conceptual framework on accounting practices and the development of accounting regulation in Norway may also prove to be significant. Johnsen and Eilifsen, in their discussion of the A-L view in the IASB Framework and the R-E view in the Norwegian Framework, predicted in 2001 that *"A future change in the EC directives to permit or require IASC standards to be applied for preparation of consolidated accounts for listed companies in Europe will have significant impacts on the development of good accounting practice in Norway"* (Johnsen and Eilifsen 2001, 1316).

The analysis of conceptual frameworks conducted in the dissertation and the main subject of the dissertation in particular, namely the usefulness of the A-L view, will therefore obviously be of relevance in a Norwegian context. Furthermore, the intention is to summarize the findings of the analysis in chapter 7, and to apply these finding to the Norwegian pre-IFRS 2005 setting, and to develop a proposal for the Norwegian conceptual approach to IFRS 2005 in chapter 8.

1.3 Chapter Overview

The Dissertation is divided into three main parts:

1. An Analysis of Conceptual Frameworks (chapters 2, 3, and 4)
2. The Usefulness of the A-L view (chapters 4, 5, and 6)
3. The Implications for Norwegian Accounting Regulation (chapter 8)

In chapter 2 the role of conceptual frameworks for financial reporting in accounting theory is explored.[8] [9] The FASB Conceptual Framework is often termed a "normative and deductive framework". In chapter 2 this approach is explained and supported. However, the deductive-label is questioned, and it is argued that a conceptual framework for financial reporting cannot be free of inductive reasoning. The question "Is accounting an art or a science?" is not by itself considered essential to the problems to be explored, but the question is nevertheless asked in order to explain why the development of conceptual frameworks became an important task to leading standard setters in the last three decades of the twentieth century.

Furthermore, in chapter 2, as a background for the analysis of conceptual frameworks in the following chapters, the content, benefits, authority, and the merits of the conceptual frameworks are explored.

The conceptual frameworks are analyzed and evaluated in chapter 3 and 4. The analysis is based on the FASB Conceptual Framework. In chapter 3, the objectives and qualitative characteristics of the conceptual frameworks are investigated and analyzed. Recognition,

including definitions and measurement, is explored in chapter 4. In particular, the conflicts between the A-L view and the R-E view are analyzed (Research Question 1 and Research Question 2).

In chapter 5, the usefulness of the A-L view in accounting standard setting is investigated. In the first part, the application of the IASB Framework in the accounting standards and interpretations of the IASB is investigated (Research Question 3). In the second part, the application of the A-L definitions in four areas, pension accounting, maintenance cost accounting, income tax accounting, and goodwill accounting, is explored (Research Question 2 and Research Question 3).

Based on the findings in the preceding chapters, a survey among the primary users of financial statements, represented by security analysts, is designed and conducted. The objective of the survey is to gain insight into the decision process of the primary users of financial reports in order to address Research Question 4. The results from the survey are reported in chapter 6, and the implications of the survey on the main topic of the paper, namely the usefulness of the A-L view and the R-E view, are investigated.

In chapter 7, the findings in the analysis in the preceding chapters are summarized. The intention is to collect potential loose ends and to organize the findings. Moreover, chapter 7 acts as an introduction to chapter 8, in which the findings are applied in the assessment of the Norwegian situation.

Thus, the intention of chapter 8 is to assess the implications of the major findings in a Norwegian perspective. More specifically, the analysis and the findings in the preceding chapters are used to evaluate the alternatives available in the development of a Norwegian Framework with future applicability.

---

[1] Donald J. Kirk, Chairman of the Financial Standards Board, tries to explain the situation before the FASB had adopted a conceptual framework in a speech presented at the 1980 annual meeting of the American Accounting Association (AAA).

[2] From 1973, replaced the Accounting Principles Board (APB).

[3] The IASC was the international standard setting body from 1973 to 2001. It was in 2001 replaced by the IASB. For simplicity, the international standard setting body will be referred to as "the IASB" also before 2001. Similarly, the framework developed by the IASC in 1989 will be referred to as "the IASB Conceptual Framework". The IASB decided in 2001 to replace International Accounting Standards (IAS) with International Financial Reporting Standards (IFRS). New accounting standards will thus be referred to as IFRS. However, the current accounting standards will not be renamed. In the following, both International Accounting Standards and International Financial Reporting Standards will be referred to as "IFRS", unless a specific IAS is referred to.

[4] The FASB has issued several Concepts Statements (SFAC). These Concepts Statements make up what here is referred to as "the FASB Conceptual Framework", or simply the "the FASB Framework". Other standard setters' frameworks are referred to in the same manner (the ASB in the UK: Statement of Principles for Financial Reporting (1999), the Australian Accounting Standards Board (AASB)/the Australian Accounting Research Foundation (AARF) in Australia: Concepts Statements (1990), the Financial Reporting Standards Board (FRSB)/the New Zealand Society of Accountants (NZSA) in New Zealand: Statement of Concepts for General Purpose Financial Reporting (1993), the Accounting Standards Board (AcSB) in Canada: Financial Statement Concepts (1990), and the IASB: Framework for Preparation and Presentation of Financial Statements (1989)).

[5] The Asset-Liability view has also been termed the "balance sheet approach" and the "current value view" (Ernst & Ernst 1977, 45), and the Revenue-Expense view has of some been termed the "accruals approach" (Kirk 1998, 14) and the "matching view" (Ernst & Ernst 1977, 24).

[6] "Entities" is here used as a common term for "companies", "enterprises", "corporations" and other organizations preparing financial statements. The International Accounting Standards Board (IASB) decided in April 2001 to replace "enterprises " with "entities" in International Financial Reporting Standards (IFRS, International Accounting Standards (IAS) from 1973-2000).

[7] Jaenicke (1981) found that accounting practices for revenue recognition have evolved for new transactions to be inconsistent in rationale and, often, in outcomes.

[8] "'Financial reporting" will be regarded as a substitute for "accounting" under certain circumstances. For instance, "conceptual frameworks for financial reporting" is not intended to convey something else than "conceptual frameworks for accounting". Furthermore, "financial reporting" may also be substituted by "financial statements" under certain circumstances.

[9] As discussed in chapter 2, conceptual frameworks represent accounting theory. However, the term "accounting theory" is not limited to conceptual frameworks.

2. Conceptual Frameworks

> *"The conceptual framework is a series of Financial Accounting Concepts Statements that provide the foundation for U.S. financial accounting and reporting"* (FASB 2002b, 5).

The analysis of conceptual frameworks in the following chapters will primarily be based on the FASB Conceptual Framework. This approach seems appropriate for three reasons. 1) The FASB was the first standard setter to take on a conceptual framework project, 2) other standard setters have to a great extent patterned their frameworks after the FASB Framework, and 3) the framework literature of the FASB is the most extensive.

Other standard setters have, as commented on in chapter 1, issued conceptual frameworks. Even if these standard setters to a great extent have built their frameworks on the FASB Conceptual Framework, an evaluation and analysis of conceptual frameworks would be incomplete without a comparison between the FASB Conceptual Framework and the frameworks of other leading standard setters (Skinner and Milburn 2001, 573). The current international harmonization effort further supports a comparison. The so-called G4+1 has historically been important in the international harmonization process. G4+1 includes the FASB in the US, the ASB in the UK, the AASB and the FRSB in Australia and New Zealand, respectively, the AcSB in Canada, and the IASB. In the following, G4+1 will be referred to as the "leading standard setters". The conceptual frameworks of these standard setting bodies will be discussed an analyzed along with the different concepts statements of the FASB.

The remainder of this chapter is organized as follows. First, the development that culminated with the introduction of the FASB Conceptual Framework will be discussed in chapter 2.1. Next, in chapter 2.2, the content, benefits, and authority of conceptual frameworks are explored. Finally, as a conclusion to the background analysis, the merits of the conceptual frameworks are summarized in chapter 2.3.

2.1 From Accounting Theory to Conceptual Frameworks

> *"Every science, methodology, or other body of knowledge is oriented to some conceptual strucuture – a pattern of ideas brought together to form a consistent whole or a frame of reference to which is related the operational content of that field. Without some such integrating structure, procedures are but senseless rituals without reason or substance; progress is but a fortunate combination of circumstances; research is but fumbling in the dark; and the dissemination of knowledge is a cumbersome process, if indeed there is any 'knowledge' to convey"* (Vatter 1947, 1).

The term "conceptual framework" was introduced by the FASB about three decades ago.[1] However, Paton and Littleton's monograph "An Introduction to Corporate Accounting Standards", 1940, later said to be one of the most influential accounting texts ever published, was also a conceptual framework.[2] In their own words: *"The intention has been to build a framework within which a subsequent statement of corporate accounting standards could be erected"* (Paton and Littleton 1940, ix).

The term "conceptual framework" was not chosen by incident. The terminology reflects the nature of accounting, and to some extent the lack of scientific foundation. The conceptual frameworks of the leading standard setters appear to be normative frameworks primarily applying deductive reasoning.

2.1.1 The Missing Principles

> *"(...), academicians must abandon the notion that accounting and finance are exact sciences and that accounting theory must be totally logical and consistent and lend itself to statistical proofs of validity. If there is one thing we have learned during the past decade of work on the Conceptual Framework, it is that there is no golden rule or ten commandments of accounting"* (Borst 1981, 15).

Paton and Littleton chose in their monograph to replace the term "accounting principles" as used in "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements" published by the American Accounting Association (AAA) in 1936, by "accounting standards". "Accounting standards" were defined as *"(...) solutions to financial accounting problems"*. This choice of terminology prevailed for decades, and was also used by AAA in "A Statement of Basic Accounting Theory" (ASOBAT) in 1966. Later the FASB chose to replace "accounting standards" with "accounting policies", which is in line with the current international terminology.

Paton and Littleton argued that "accounting principles" implied *"(...) a universiality which obviously cannot exist in a service institution such as accounting"* (Paton and Littleton 1940, 4). Others have supported this view: *"The word "principles" was a slightly pretentious term in accounting. I think we know what principles are in the natural sciences. But accounting arrangements are clearly man-made. There is no one "right" way of proceeding. It isn't anything derived from an inquiry into fundamental truths any more than a decision to drive on the right side of the road is in the United States or on the left side is in Britain. It's just a convenient way of doing things"* (Nolan 1972, 18). Still others have used the term "accounting principles", but acknowledging that the meaning may be different from the meaning of principles in sciences: *"The terms "postulates" and "principles" are used to denote a certain proposition (sentences, assertions) about accounting. "Postulate" is more basic than "principle" both in the sense that "postulate" has a wider range of significance than "principle" and in the*

sense that a "postulate" precedes a "principle" in any discussion which follows the pattern of formal logic. (...) The term "principles" is used to denote those basic propositions which stem from the postulates and refer expressly to accounting issues" (Moonitz 1963, 43).

"Accounting theory" would demand principles, and in recognition of the nature of accounting and the "missing principles"[3], the FASB chose to develop a conceptual framework as opposed to an accounting theory.[4] To reach this decision the FASB learned from the failure of the Accounting Principles Board (APB), the predecessor of the FASB, to develop accounting postulates and principles in Accounting Research Study No. 1 (ARS No. 1) (1961) and Accounting Research Study No. 3 (ARS No. 3) (1962). The term "principle", as used by Moonitz and others, was replaced by "policies" or "standards", while the term "postulate" was replaced by "fundamental assumptions" or "basic assumptions".

One may infer from the above that accounting theory is self-contradictory in that the nature of accounting does not allow for principles. Not everybody supports such a conclusion. Ijiri (1975) claims that accounting theory may be developed, but in order to do so, distinction between theory and policies must be drawn and fully understood. A theory can be scientifically verified. Accounting, as we currently know it, is from this point of view more an art than a science.

The common belief that accounting cannot be a science, is, according to some commentators, a misunderstanding, and stems from certain misconceptions: *"First, the authors have a misconception of the nature of science. They seem to believe that in order for a discipline to be scientific, it must consist of immutable laws and absolute truths. The fact is that laws in even the most exact sciences are mutable. Witness the recent overturn of the Newtonian laws of physics by Einstein. To a scientist, laws are empirical generalizations which must be subject to falsification. If they were immutable, scientists would call them 'definitions', not 'laws'. In direct contrast to scientists, accountants conceive of laws as immutable and seem to believe that there are no uncertainties in*

science. (...) Specifically, the second misconception is that there is something about accounting that makes it inherently unscientific. That accounting is more like an art than a science may been an accurate description of accounting at present, but it is not a necessary condition of accounting" (Sterling 1979, 10-11).[5]

As opposed to theories, policies rely on value judgments and opinions. Standard setting bodies such as the FASB and the IASB perform a policy function. The accounting standards issued by these bodies rely on opinions and judgments, and do not qualify as accounting theory in the strict scientific meaning. Nevertheless, it is common to refer to accounting concepts[6], including conceptual frameworks, as accounting theory.[7] The conflict between this less scientific definition of accounting theory and accounting theory in the strict scientific sense will not be investigated further here. After all, the principal focus is accounting policies, and not "accounting principles". Or, in the words of Bierman: *"Accounting is the art of measuring and communication financial information about economic events in accordance with reasonably well-defined conventions that are intuitively appealing. Once we agree that the tasks of measuring the financial position and income of a period with perfect accuracy are impossible, we can proceed with improving the state of the art"* (Zeff et al. 1979, 56 (Bierman)).

"Accounting theory" may be too ambitious, but some sort of a framework is imperative: *"Accounting is not a science, subject to the same exact rules as counting. On the other hand, accounting should not be without a well-defined structure"* (Zeff et al. 1979, 56 (Bierman)). A conceptual framework is supposed to constitute *"(...) a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements"* (FASB 1976b, 2). Conceptual frameworks are by some commentators defined more loosely: *"A collection of broad rules, guidelines, accepted truths, and other basic ideas about the field"* (Miller and Redding 1998, 109), and *"(...) there are as many views of what constitutes a CF as there are writers"* (Gore 1992, 31). However, here, the definition of the FASB is adopted.

One should note that the conceptual framework approach assumes that accounting standards are necessary. Some commentators, taking a more philosophical approach, claim that this assumption represents a shortcut, and that a scope and method debate is where the discussion should start: *"The Conceptual Framework endeavor presumes that standards are necessary, whereas this is part of what is at issue in the scope and method debate"* (Bell 1997, 3).

Certain commentators seem to find the FASB definition somewhat misleading, and argue that overall, the primary function of a conceptual framework is to facilitate effective communication among the constituents, and that conceptual frameworks provide for a *"(...) rhetorical guide to the policy business of the respective institution and a vehicle for "close-in" policy debate."* (Christensen and Demski 2003, 429). However, the same commentators seem to allow for a somewhat more profound function of the conceptual frameworks, and that the frameworks *"(...) are also essential if society is to maintain relatively stable expectations about how they will manage regulatory issues in the future"* (Christensen and Demski 2003, 429). Thus, Christensen and Demski, does not necessarily reject the FASB definition, but emphasizes that the frameworks can only be given a meaningful interpretation within a regulatory environment.

It has been advocated that even conceptual frameworks for accounting is a too ambitious concept: *"Based on the premise that every financial accounting user wants something different from financial accounting information, it has been logically argued that it is impossible to posit a general theory for financial reporting"* (Aitken 1990, 230). This argument is denied by the FASB and others based on the premise that in spite of different groups having different information needs, there are pieces of financial information common to every user.

As already noted, not everybody supports the view that theory cannot be used to refer to the field of accounting, or that accounting is an art, not a science. To balance the views here expressed, Chambers' comments on the issue in his contribution to the "Essays in

Honor of William A. Paton" may be adequate: *"We are told frequently that accounting is a man-made device, and that its doctrines and rules can never be as precise as those of the sciences. But this is mere excuse, and false in substance. The body of knowledge popularly described as "science" is also man made. It is under constant examination and reconstruction. As for its precision, it is precise only at the level of principles; at the level of technological application it is no more precise or exact than human skill and judgement can make it. We are told that there are no fundamental truths which underlie and which could give firm shape to the practice of accounting. But this is only quibbling. Artisans who have no knowledge of fundamental truths have pursued their work with great skill, simply by observing carefully the outcome of their work and accepting the discipline that the characteristics of their materials impose. We are told that there is no singular concept of income, that no single method of general purpose accounting is "best", and that rules and practices must remain matters of judgement. This is mischievous. Judgement is an element of all technical arts. But if we have no firm idea of what is serviceable in a given setting, we have no way of determining whether a particular judgement is good or bad, and hence reliable or unreliable"* (Zeff et al. 1979, 74).[8]

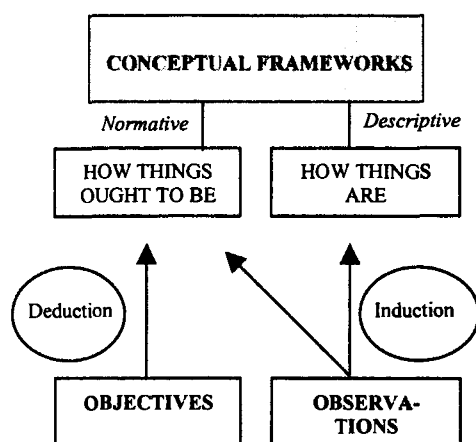
In his "Critique of Accounting", Mattessich explains why his support of the FASB's conceptual framework project is limited. In his view the "postulation approach" has proved to limit the usefulness of the FASB Conceptual Framework (Mattessich 1995, 80), and he argues that a more scientific approach applying more rigorous logical means would have proven to be more successful. Mattessich admits, however, that the very nature of accounting may explain why more scientific approaches traditionally have not been applied: *"Accounting is an applied rather than a pure science"* (Mattessich 1995, 187). He terms the FASB Conceptual Framework a "pragmatic-normative theory", an assessment that the following analysis supports.[9]

2.1.2 Conceptual Framework Approaches

Accounting frameworks may be descriptive or normative. Descriptive accounting theory attempts to find relationships that actually exist. Normative theory employs value

judgments based on premises saying how things ought to be. In addition, frameworks may be classified into deductive and inductive frameworks. However, conceptual frameworks are typically not strictly normative or descriptive, nor do they employ only deductive or inductive reasoning. Nevertheless, classification of conceptual frameworks according to the descriptive/normative and deductive/inductive labels may be useful.

Figure 2-1 ***Conceptual Framework Approaches***



2.1.2.1 Descriptive Frameworks

Descriptive accounting frameworks are recognized by the role given to empirical observations and induction: *"Research methodology involved in developing descriptive models is two-fold, namely, (1) empirical observations and (2) induction. The process of constructing descriptive models starts with observations of empirical phenomena"* (Ijiri 1975, 8).

Up to a certain point, experience may solve accounting problems. However, beyond that point, something more is needed. As long as the conditions giving rise to the accounting problem does not change, experience may work well. When the conditions change the experience alone does not work. This is where the induction is introduced. From experience one may draw inferences, and use those inferences to extend our knowledge to problems beyond experience. In this process experience *"(...) is placed in perspective as part of a broader, more comprehensive framework"* (Moonitz 1963, 43).[10]

Traditionally, up to the 1960s, accounting was primarily discussed within descriptive models. Accounting practice was observed, and hypotheses were founded based on these observations. Accounting policies were developed consistent with the hypotheses explaining the current practice. For example, "A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements" (AAA 1936) was descriptive. The objective was *"To agree upon a foundation of underlying considerations which will tend to eliminate random variations in accounting procedure resulting not from the peculiarities of individual enterprises, but rather from the varying ideas of financiers and corporate executives as to what will be expedient, plausible, or persuasive to investors at a given point in time"* (AAA 1936, 187).

Four years later, Paton and Littleton proposed their descriptive accounting framework. Their ambition was not to reformat accounting practice: *"This discussion of the framework of accounting seeks no extensive reform of corporation practices. The aim has been to present a theory basis by means of which corporation accountants may be helped to make a realistic appraisal of their practices and public accountants may be aided in reviewing corporation reports"* (Paton and Littleton 1940, ix).

The strength of descriptive models is their ability to guide solutions to new accounting issues. However, the informational needs of the users of financial reports are not traditionally given priority, and well established practices, regardless of their consistency with the descriptive models, tend to downgrade the role of these frameworks.

2.1.2.2 Normative Frameworks

Normative accounting frameworks are recognized by the role given to objectives and deduction: *"The process involved in constructing normative models may be characterized by (1) goalassumptions and (2) deduction. Since a normative model is goal oriented, the assumed goals must be clearly stated. In order to say that accounting practices should be such and such, one must state the goals to be served by changing the existing accounting practices toward the normative direction. Then, one must develop a model, deducting from the goals some of the properties that the model must have"* (Ijiri 1975, 9).

Normative accounting frameworks must state a clear objective to be reached by financial reports. From the objectives the users' informational needs, qualitative characteristics of the information, and definitions of the elements of the financial reports are deducted. Based on these concepts, recognition and measurement policies are recommended.

The normative approach in accounting was introduced in "A Statement of Basic Accounting Theory" (ASOBAT) (AAA 1966). ASOBAT was the first statement in which the needs of the users were put ahead of the experts and producers, that is, the accountants who prepare the financial reports.[11] ASOBAT was followed by "A Statement of Accounting Theory and Theory Acceptance" (SATTA): *"The charge was to write a statement that would provide the same type of survey and distillation of current thinking on accounting theory as A Statement of Basic Accounting Theory (ASOBAT) provided in an earlier decade"* (AAA 1977, ix). In Accounting Principles Board Statement No. 4 (APB Statement 4, 1970), "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", the informational needs of the users was put in focus. This statement is still an important document, and parts of the statement are integrated into the FASB Framework. For instance, the qualitative characteristics of the FASB Conceptual Framework are basically an adoption of the *qualitative objectives* of APB Statement 4 in their entirety (Hendriksen and van Breda 1992, 107). The APB Statement 4 represented the attempt of the APB to establish a coherent accounting theory in which critical terms and concepts are defined. In retrospect, one may say that APB did not succeed, even though the APB Statement 4 is still considered an authoritative formulation of GAAP. It was condemned by many because it was, by its own admission, primarily descriptive rather than prescriptive (Hendriksen and van Breda 1992, 108). To blame the disbandment of the APB solely on Statement 4 would be unfair (the issuance of APB 16 and 17 on business combinations and goodwill has in the literature commonly been referred to as the single most important cause of the effort to replace the APB (Zeff 2003, 198)), but, as Hendriksen and van Breda put it, *"The ink was barely dry on APB Statement No. 4 when the APB was disbanded and the Financial Accounting Standards Board (FASB) was formed"* (1992, 109).

Skinner (1987) explains that the use of the term "normative" to describe the FASB's conceptual framework to some extent is deceiving: *"(...), this type of framework is prescriptive rather than descriptive. This does not mean that it is wholly normative. On the contrary, like any good theory, it must be firmly grounded on factual premises. Empirical investigation is required to see that we have our facts straight before any conclusions can be drawn with respect to specific issues"* (Skinner 1987, 629). Skinner is not alone claiming that the prescriptive-label is misleading: *"A Conceptual Framework is a body of propositions describing "concepts", ideas entertained about matters open to observation or experience, and supposed or confirmed relationships between those matters"* (Chambers 1996, 126). The inability to develop normative accounting theory, as an elaborated deductive system, may be another reason for the FASB to introduce the less ambitious term "conceptual framework" (Elling 1998, 136).

2.1.2.3 Inductive and Deductive Reasoning

> *"I don't care whether research is inductive, deductive, or seductive as long as it's productive"* (L. Goldberg, Staubus 2002, 30).

Miller and Redding (1988) argued that the FASB Conceptual Framework is a normative and deductive framework, and that such frameworks will lead to less incoherence between accounting standards and give rise to the possibility of proactive standard setting compared to the more descriptive frameworks of the past.[12]

The A-L view which the conceptual frameworks of the FASB relies on, has been developed in a normative and deductive setting, while the R-E view commonly is referred to in the context of positive or descriptive frameworks and inductive reasoning: *"For reasons that are not entirely clear, some people assume that a logical process must be all one or all the other"* (Moonitz 1963, 45). This is to some extent true, but both perspectives are to a certain degree normative, and the conceptual frameworks of the FASB and the IASB are also using inductive reasoning.[13] [14] The combination of inductive and deductive reasoning in the development of a theory platform is not particular to the

accounting discipline: *"From the above discussion, it is clear that one rarely finds a scientific system which is either purely deductive or entirely inductive. Most systems are of a hybrid nature, that is, they are partially formed and developed under deductive reasoning but also contain a large number of facts which could never have been inferred. In addition, some propositions may have no empirical correspondence but are needed for facilitating the formulation of a theory. On the other hand, complete verification of a generalized statement is not attainable"* (Yu 1976, 20).

The framework of Paton and Littleton (1940) was primarily descriptive based on inductive reasoning. The framework was induced from current practices. However, elements of normative accounting and deductive reasoning were present. The objective in Paton and Littletons framework was to measure "enterprise performance", and the experiences induced from current practices were used to deduce accounting policies.

Skinner developed a framework in a normative setting that relied on both deduction and induction in "Accounting Principles – A Canadian Viewpoint" (Skinner 1972, 304-312). He acknowledged that the deductive approach had to be supplemented by practical concerns, and that a pure normative and deductive approach had its limitations: *"After definition of the users' information needs and identification of observations about the environment which relate to such needs, the next step is to consider how such needs can be met in practice"* (Skinner 1972, 309).

Similarly, the descriptive frameworks may build on deductive reasoning: *"In every case, however, some process of abstraction from the mass of evidence is required, some recourse must be had to the logical processes of drawing inferences from the evidence at hand and deducing further knowledge already established"* (Moonitz 1963, 44). In other words, a framework may involve both induction and deduction. In a descriptive framework general guidelines are induced from experiences, while these guidelines are extended through deduction.

Some have argued in reference to the nontheoretical nature of financial accounting that deductive reasoning has no place in financial accounting. Kirk summarized Kripke's (1989) view on this issue as follows: *"Since theorizing and deductive reasoning will not solve those real-world problems, the FASB should abandon its conceptual framework, follow the ways of the law, and let experience be the teacher"* (Kirk 1989, 84). Kripke supports a pragmatic, more legal structure: *"I believe that accounting must get back to reliance on a pragmatic structure that will develop, instead of being deduced from a structure of definitions, qualitative characteristics, and objectives"* (Kripke 1989, 50).[15]

The normative approach of the conceptual frameworks will be reflected in the following analysis. To further explain descriptive frameworks and to balance the analysis in the following chapters against the most common research approach in current accounting research communities, descriptive accounting theory and associated research approaches will be introduced in the next section.

2.1.3 Descriptive Accounting Research and Theory

> *"Many accountants are more interested in establishing accounting principles than in considering how one goes about doing so"* (Gordon 1964, 252).

Knowing that conceptual frameworks represent the "theoretical" approach of the leading accounting standard setters over the last three decades, one may assume that conceptual frameworks have been of primary interest in the accounting research community in the same period. The assumption does, however, not hold. Descriptive accounting research dominates the field of accounting more than ever.

Descriptive accounting research as we know it today originated in the sixties when research methods from finance and economics were introduced into accounting. Increasingly, particularly in the US, accounting research has been characterized by a preference for empirical research supported by an extensive use of formal mathematical

and statistical modeling.[16] The shift from normative accounting research to descriptive research may be illustrated by the issues dealt with in published research papers in the sixties and seventies. For instance, in the Journal of Accounting Research thirty-five percent of the papers published in 1963 were normative in nature, while only five percent were concerned with empirical testing (Panozzo 1997, 454). Ten years later, in 1972, there was no evidence of normative research in the papers published in this journal, while empirical research based on economic models accounted for sixty percent of the published papers. In 1991, empirical based research accounted for more than eighty percent of the published papers. These findings may to some extent be journal dependent, but a similar trend has been documented for other leading accounting journals as well (Lukka and Kasanen 1996).

Interestingly, the timing of the shift in research focus parallels the timing of the shift from accounting theory to conceptual frameworks explained in chapter 2.1.1. In other words, the accounting standard setters and the accounting profession moved from descriptive frameworks to normative frameworks, while the research community moved from normative theories and methodologies to descriptive theories and methodologies. These concurrent circumstances did not appear by coincidence. As explained in chapter 2.1.1, the shift from accounting theory to conceptual frameworks can be explained by the unscientific nature of accounting. The shift in research focus may be attributed to the very same explanation. Accounting research was not considered to represent scientific research among academicians. The lack of scientifically-based accounting research paved the way for methodology-dominated work and analytical modeling (Lee 1995, Panozzo 1997).

The shifts in accounting standard setting and accounting research has to some degree led to a gap between the two professions that probably does not benefit any of the two. Academicians have moved away from questions of interest in accounting standard setting: *"The extensive use of formal methodologies, the preoccupation with esoteric economics and a frequent reluctance to get involved in actual accounting practices, are probably the most consistent characteristics of mainstream accounting research"*

(Panozzo 1997, 454). Thus, the academicians provide the accounting standard setters with less insight and contributions than what would be ideal to the accounting profession. At the same time, the academicians may eventually be "digging a ditch" for themselves by increasing the distance between their research and the actual accounting questions. If their research becomes more focused on methodological questions and issues of more relevance to other academic fields, for instance finance and economics, than real accounting issues, the validity of their research may at some point be questioned.

As may be inferred from the above, it is somewhat difficult to distinguish current accounting research from research in other academic disciplines, finance and economics in particular. As a rule of thumb, accounting research is research in which accounting information represents a critical variable. For instance, if regression is applied in the analysis, accounting information must be a statistical variable, either the dependent or an independent variable. Empirical tests of the effects of accounting choices on security prices and empirical tests of what motivates managements' choices of accounting methods represent two research opportunities that have been pursued by numerous accounting researchers. For example, tests of how management bonus schemes affect the management's choice of accounting methods under different circumstances are examples of the latter approach.

One genre of empirical based accounting research is often referred to as positive accounting research. Watts and Zimmerman introduced the term in the late seventies in their paper "Towards a Positive Theory of the Determination of Accounting Standards" (Watts and Zimmerman 1978) when they tried to link the empirical based accounting research with accounting standard setting. However, positive accounting research is also often referred to as "the Gordon Approach" or "the Gordon Methodology" after Myron J. Gordon who was the first to formulate a positive accounting research method (Gordon 1964 (Eckel 1981)).

The normative approaches of the conceptual frameworks and the positive accounting theory have one thing in common: Both are directly or indirectly concerned with

accounting choices. However, there is a significant difference in the objectives of the approaches. The positive accounting theory does not present a rule for choosing among accounting policies, but rather *"(...) provides an explanation for accounting and auditing practice"* (Watts and Zimmerman 1986, ix) (Watts and Zimmerman 1990, 148) (Passmore 1953, 676). For example, positive accounting theory explains why some entities prefer accelerating amortization schedules instead of linear schedules, and why many companies prefer pooling to purchase accounting in business combinations. Often, positive accounting theory does not try to explain the preferences, but merely states a relationship. For instance, there may be a relationship between acquisition accounting and subsequent stock prices. Positive accounting theory will typically try to explain the tendency to prefer pooling to purchase accounting by such a relationship, but the research methodology is not always capable of eliminating other possible explanations, and the researchers will thus sometimes have to settle with the evidence of a relationship.

The so-called value relevance research can be used to explain the limitation of descriptive accounting research. Currently, statistical tests of the correlation between accounting information and the value of the underlying security are popular in accounting research. For instance, a regression analysis is designed to capture the correlation between the recognized pension liability and the security price. If a statistical significant correlation is found, recognition of pension liabilities is considered to be value relevant. It should come as no surprise that an economic liability has an impact on the pricing of the underlying security, however, it is not clear from the test described that accounting information about the liability is value relevant. That is, the economic impact of the pension plan may be reflected in the security price even without the recognition of a pension liability in the financial reports. Thus, the test here described really does not tell us anything about the value relevance of the accounting information. In order for the test to have explanatory power, it must be designed so that it captures both alternatives, namely no recognition and recognition of the pension liability.

Positive accounting theory will explain and predict which entities will and which will not use a particular accounting policy, but it says nothing as to which policy the entities

ought to use: *"Such a theory (a theory in social science) will have the limitations characteristic of the physical sciences. It will not tell us what we ought to do, any more than physics tells us whether to build a bridge or to be content with a ferry"* (Passmore 1953, 676). Positive theorists are generally concerned with how the world works, not how it ought to work according to some subjective value standards: *"(...), partisans of positive accounting knowledge only deal with "facts", in contrast with more traditional "normative" views which are concerned with prescriptions about what accounting practices ought to be"* (Panozzo 1997, 455).

The positive accounting theorists' main objection to the normative theorists is that they rely on an objective statement that has to be subjective, and useless in resolving differences in individual decisions (Watts and Zimmerman 1986, 7). Positive theories take the form "If A then B", and can be refuted by evidence. This is in contrast to the normative theories in which the form will be "If A, then B should be chosen".

The positive accounting theory and the research building on the theory represent important contributions to the field of accounting. The positive accounting theory can potentially explain rational and irrational behavior among the users of financial statements, and standard setters in their process of developing new and revised accounting standards can use these explanations. However, this theory's contribution to the technical issues to be dealt with by accounting standard setters is limited. Furthermore, this theory is not necessarily contributing to the development of more informative financial reports. Behavior may be explained, but more often than not, the implications for better financial reporting are subtle or unclear (Skinner and Milburn 2001, 36).

2.1.4 Concluding Remarks

The FASB Conceptual Framework has been developed in a normative and deductive setting. As indicated above, however, the logic underlying this and similar frameworks is not all free from induction and descriptive elements. The FASB Framework apparently deduces guidelines for recognition and measurement from the objectives adopted, but

these objectives are partly defined based on an analysis of accepted accounting practices. For instance, as discussed in chapter 3.3.2, the adoption of the stewardship objective clearly reflects the traditional use of financial reports. Furthermore, the guidelines for recognition and measurement reflect more than the objectives established. Common accepted accounting practices is at work as well. As noted, Mattessich termed the FASB approach a "pragmatic-normative theory". The analysis concluded here supports Mattessich's assessment.

The intent here has been to put the conceptual framework approach into perspective by placing the frameworks within what commonly is referred to as accounting theory. Conceptual frameworks represent one approach to accounting theory, and will as such be further analyzed in the following chapters.

2.2 Content, Benefits, and Authority of Conceptual Frameworks

The FASB's Statement of Financial Concepts, the FASB Conceptual Framework, includes six Concepts Statements: Statement of Financial Accounting Concepts No. 1 (SFAC 1), Objectives of Financial Reporting by Business Enterprises, issued in 1978, SFAC 2, Qualitative Characteristics of Accounting Information, issued in 1980, SFAC 4, Objectives of Financial Reporting by Nonbusiness Organizations, issued in 1980, SFAC 5, Recognition and Measurement in Financial Statements, issued in 1984, SFAC 6, Elements of Financial Statements, issued in 1985 (replacing SFAC 3, Elements of Financial Statements of Business Enterprises), and SFAC 7, Using Cash Flow Information and Present Value in Accounting Measurements, issued in 2000.

Even if SFAC 7 was issued in 2000 and new concept statements may be issued in the future, it may be argued that the FASB Conceptual Framework as such was "finalized" in 1985. SFAC 6 represented the final step in the conceptual framework hierarchy (SFAC 7 adds guidance to the measurement level (SFAC 5)), and the other leading standard setters, with the exception of the ASB in the UK (issued a working paper in 1997 about "Discounting in Financial Reporting"), have not elaborated the guidance on present value measurement beyond general comments in their respective conceptual frameworks, at

least not yet. In the following therefore, the 1985 will be referred to as the issuance year of the FASB Conceptual Framework.

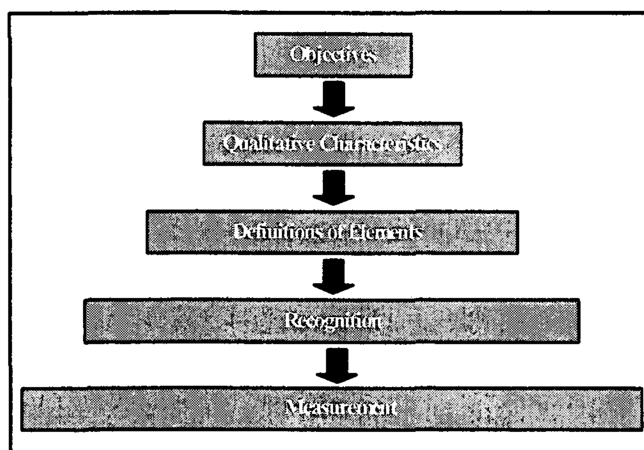
The IASB Conceptual Framework has the following structure: Objectives, Underlying Assumptions, Qualitative Characteristics, Elements of Financial Statements, Recognition, and Measurement. The ASB Conceptual Framework is divided into eight chapters: Objectives, Reporting Entity, Qualitative Characteristics, Elements of Financial Statements, Recognition, Measurement, Presentation, and Accounting for Interests in Other Parties. The AASB Conceptual Framework can be outlined as follows: Objectives, Qualitative Characteristics, Definition and Recognition of the Elements of Financial Statements, Measurement, Display (or disclosure), Standard-setting Policy, and Enforcement, while the NZSA Conceptual Framework is divided into Objectives, Qualitative Characteristics, Underlying Assumptions[17], Definition and Recognition of the Elements of Financial Statements, and Measurement. The AcSB Conceptual Framework has the following structure: Objectives, Benefit versus Cost and Materiality, Qualitative Characteristics, Elements of Financial Statements, Recognition, Measurement, and Generally Accepted Accounting Principles.

Figure 2-2 ***The Conceptual Frameworks of the Leading Standard Setters***

FASB	IASB	ASB	AASB	NZSA	AcSB
Objectives	Objectives	Objectives	Objectives	Objectives	Objectives
Qualitative Characteristics	Underlying Assumptions	Reporting Entity	Qualitative Characteristics	Qualitative Characteristics	Benefits vs Costs and Materiality
Elements	Qualitative Characteristics	Qualitative Characteristics	Definition and Recognition	Underlying Assumptions	Qualitative Characteristics
Recognition and Measurement	Elements	Elements	Measurement	Definition and Recognition	Elements
Present Value Measurement	Recognition	Recognition	Display	Measurement	Recognition
	Measurement	Measurement	Standard-setting Policy		Measurement
		Presentation	Enforcement		GAAP
		Accounting for Interests in Other Parties			

Even if all leading standard setters have chosen to develop their own conceptual frameworks, the structure of the frameworks seems to be similar: *"Following the FASB's lead, standard setters in a number of other jurisdictions have also developed their own frameworks. Canada and the International Accounting Standards Committee (IASC), now the International Accounting Standards Board (IASB) were the first to do so, followed by Australia, New Zealand and, most recently (in 1999), the United Kingdom. (...) Not surprisingly, the conceptual frameworks that were developed are generally similar but not necessarily identical to the FASB's framework"* (FASB 2001, 3).[18] [19] The frameworks are hierarchical in structure and the following elements are common to them all: (1) Objectives of financial reporting, (2) qualitative characteristics of accounting information, (3) definitions of elements of financial statements, (4) recognition of elements in financial statements, and (5) measurement of elements in financial statements. Furthermore, an analysis of the frameworks shows that the leading standard setting bodies have reached basically the same conclusions at the different levels of the hierarchy (Gore 1992; Johnson 1994; Lennard 1994; Gore 1995). However, there are certain differences between them. These differences will be explored in later chapters.

Figure 2-3 ***The Hierarchy***



SFAC 1 represents the top-level of the hierarchy, objectives of financial reporting. SFAC 2 represents the second level of the hierarchy, qualitative characteristics, SFAC 6 represents the third level, definitions of elements of financial statements, SFAC 5 represents the fourth and fifth level, recognition and measurement, and SFAC 7 adds guidance on the fifth level, measurement.

The FASB Conceptual Framework covers business and nonbusiness entities[20]. However, only business entities are of interest here, and SFAC 4 and parts of the other Concepts Statements of relevance only to nonbusiness entities will be ignored. This is in line with the delimitation made in the IASB Framework: *"The Framework applies to the financial statements of all commercial, industrial and business reporting enterprises, whether in the public or the private sectors"* (IASB 1989, 8).[21]

Furthermore, the analysis in the dissertation will primarily be concerned with the financial statements of the annual reports, and disclosures outside the annual reports, for instance the interim reports (however, see the analysis of IAS 34 in chapter 5), press releases and conferences, etc., will generally not be considered. Given the fact that the conceptual frameworks do not include disclosures outside the annual reports, and that the annual reports represent the single most important source of financial information to the users, this limitation should not be critical: *"At the top of every analyst's list (of financial reports used by analysts) is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it"* (Knutson 1992, 7). More importantly, other parts of the annual reports than the financial statements, for instance the management discussion and analysis (MD&A), and additional disclosures (notes) are generally not included in the conceptual frameworks. The AASB Conceptual Framework represents an exception in this regard in that additional disclosures ("display") is covered by the Framework. ASB in the UK has included a separate section on presentational issues. This does not imply that the leading standard setters do not consider the notes an important part of the annual reports (IASB 1989, 21), and it is somewhat puzzling that the disclosures section of the annual reports has not been given more emphasis in the conceptual frameworks. Certain

commentators claim that the lack of due consideration of disclosures limits the usefulness of the conceptual frameworks (Gore 1995). The FASB, the IASB, and the AcSB are currently considering taking on a joint project in which a so-called "Disclosure Framework" is to be developed (the IASB Update, October 2003).

The FASB has suggested the following benefits as a result on achieving agreement on the conceptual framework (FASB 1976b):

- Guide the body responsible for establishing standards.[22]
- Provide a frame of reference for resolving accounting questions in the absence of a specific promulgated standard.
- Determine bounds for judgment in preparing financial statements.
- Increase financial statements users' understanding of and confidence in financial statements.
- Enhance comparability.

Even if these benefits have implications for many user groups, the FASB emphasizes that the standard setters themselves will be the primary beneficiary: *"The Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by the new series"* (introductory paragraphs of the Concepts Statements).

The absence of coherent guidelines before the conceptual frameworks tended to force standard setting bodies to apply an ad-hoc or "fire-fighting" approach to standard setting. The conceptual frameworks are intended to guide the standard setting bodies in their effort to establish accounting standards in that the frameworks provide the broad frame of reference for accounting standard setting, reducing or eliminating the need for "fire-fighting".

The IASB's statement of purpose suggests similar benefits: *"This Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. The purpose of the Framework is to:*

(a) assist the Board of IASC in the development of future International Accounting Standards and in its review of existing International Accounting Standards;
(b) assist the Board of IASC in promoting harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by International Accounting Standards;
(c) assist national standard-setting bodies in developing national standards;
(d) assist preparers of financial statements in applying International Accounting Standards and in dealing with topics that have yet to form the subject of an International Accounting Standard;
(e) assist auditors in forming an opinion as to whether financial statements conform with International Accounting Standards;
(f) assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with International Accounting Standards; and
(g) provide those who are interested in the work of IASC with information about its approach to the formulation of International Accounting Standards" (IASB 1989, 1).

AASB in Australia adds the following benefits (AASB 1995, 7):

- Increased accountability on behalf of the accounting standard setters.
- Enhanced communication between standard setters, preparers, auditors and other parties.
- Less costly accounting standards development process.

The communication effect is also of the FASB considered to be an important benefit from their conceptual framework project: *"The need for improved communication , especially between the Board and its constituents, provides much of the rationale for the whole conceptual framework project and particularly for this Statement. Indeed, improved communications may be the principal benefit to be gained from it"* (FASB 1980, 12).

Without a common language understood and accepted by all parties involved, there can be no "meeting of minds" (Gore 1992, 117).

The above mentioned standard setters seem to view the conceptual frameworks primarily as an aid for standard setters. The New Zealand Society of Accountants (NZSA), on the other hand, presents its framework as a tool that primarily is meant to assist preparers and users, but acknowledges that the framework also will be useful in assisting the New Zealand Financial Reporting Standards Board (FRSB) (NZSA 1993, 1.1).

The frameworks are intended to guide accountants in solving issues not specifically dealt with in accounting standards, and give guidance when recommendations rely on the accountants' judgment. Clearly, one of the benefits from conceptual frameworks is that detailed accounting rules may not be necessary: *"The conceptual framework may reduce the need for some specific standards"* (Pacter 1983, 76). Consistent general principles or policies will to some extent make detailed rules redundant, without eliminating the need for general guidance. Furthermore, the frameworks should be instrumental to investors and others in their analyses of financial statements (IASB 1989, 1). In combination, these benefits should enhance the comparability of the financial statements.

However, the accountability benefit was probably the initiating factor when the FASB took on the conceptual framework project. The FASB was aware that accounting standards had to regain the credibility of public opinion which had been lost as a result of the many perceived abuses of financial reporting during the 1960s: *"Skepticism about financial reporting has adverse effects on businesses, on business leaders, and on the public at large. One of these effects is the risk of imposition of government reporting and other regulatory requirements that are not justified – requirements that are not in the public interest because the perceived benefits do not exist or are more than offset by costly interference with the orderly operation of the economy. Skepticism creates adverse public opinion, which may be the antecedent of unjustified government regulation. Every company, every industry stands to suffer because of skepticism about financial reporting"* (FASB 1976c, 5).

A common characteristic of conceptual frameworks is that the frameworks are not given authority as accounting standards. That is, the compliance requirements associated with accounting standards do not apply to the frameworks. How the guidelines of the frameworks should be interpreted, especially when no accounting standard or other authoritative statements apply to a specific problem, is not always clear. In the case of IAS, for example, the importance of the framework in solving accounting issues in the absence of a specific IAS and interpretations of the IASB (Standard Interpretations Committee (SIC)) is unclear. The framework is only one of several sources that should be considered: *"In making this judgment, management considers: (a) the requirements and guidance in International Accounting Standards dealing with similar and related issues; (b) the definitions, recognition and measurement criteria for assets, liabilities, income and expenses set out in the IASC Framework; and (c) pronouncements of other standard setting bodies and accepted industry practices to the extent, but only to the extent, that these are consistent with (a) and (b) of this paragraph"* (IAS 1.22). This ranking of the different sources' authority in policy selection, is in the following termed "the authority hierarchy" or the "hierarchy of sources". Even if not explicitly stated, one must assume that the first source, a, includes the SIC's. IAS 1 explicitly states that the last source, c, is overrided by the other two, and that the IASB Framework does not override any of the solutions in the IAS': *"Nothing in this Framework overrides any specific International Accounting Standards"* (IASB 1989.2). The IASB may issue accounting standards in the future that do not comply with the Framework, and the consequence will be that entities accounting in compliance with the Framework at the time the new standard is issued, will have to replace policies in accordance with the Framework with policies in conflict with the Framework.

Furthermore, what if the guidance in other IAS' (source a) lead to solutions inconsistent with the IASB Framework (source b))? In the FASB's comparison analysis between IAS and US GAAP this shortcoming is discussed: *"IAS 1 does not state whether any of those sources is preferable to another if one or more sources is relevant to the circumstances or if there is a conflict between two or more relevant sources"* (FASB 1999, 72). In

practice, the Framework seems to be considered the primary source in the absence of specific accounting standards or other interpretations. Acknowledging the dominating authority of accounting standards compared to the Conceptual Framework, it should be clear that one may not depart from the hierarchy of sources in IAS 1.

In the US as well, a hierarchy of sources has been established (FASB 1999, 73)[23]:

1	PRONOUNCEMENTS OF DESIGNATED BODIES (FASB AND SEC).
2	PRONOUNCEMENTS OF OTHER BODIES SUBJECT TO PUBLIC HEARING AND APPROVED BY A BODY AT LEVEL 1.
3	PRONOUNCEMENTS OF BODIES AT LEVEL 1 AND 2, THAT HAVE NOT BEEN EXPOSED TO A PUBLIC HEARING.
4	PRONOUNCEMENTS AND PRACTICES GENERALLY ACCEPTED.

The FASB Conceptual Framework is not considered "pronouncements", and is overrided by all the pronouncements mentioned above. In the absence of any of the above sources, other accounting literature may be considered. Such literature may include *"APB Statements, AICPA Issues Papers, AcSEC Practice Bulletins, FASB Statements of Financial Accounting Concepts, International Accounting Standards Committee Statements of International Accounting Standards, Governmental Accounting Standards Board Statements, Interpretations and Technical Bulletins, Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids, pronouncements of other professional associations or regulatory agencies, and accounting textbook and articles"* (Delaney et al. 1996, 6).[24] In other words, according to this hierarchy, the role of the FASB Conceptual Framework is rather insignificant in interpreting accounting standards and solving accounting problems. This status is also evident from the fact that accounting standards and pronouncements inconsistent with the FASB Conceptual Framework continuously have been issued (chapter 5). Thus, one may expect, as did the Board, that the primary beneficiary of the Conceptual Framework is the FASB itself.

2.3 The Merits of Conceptual Frameworks

Following the failing attempts of AICPA and APB to develop a sound basis for accounting standard setting, the establishment of the FASB was by many commentators viewed as the last opportunity to keep accounting standard setting in the private sector. The FASB saw its conceptual framework project as the means of enhancing the credibility of financial statements in the eyes of the public. The need for public support in their standard setting efforts was thus one of the motivations for initiating the framework project.

DePree (1989) conducted a study to test the logical structure of the conceptual framework, and concluded that the structure of the FASB Framework is logically consistent, and deductively valid. Koeppen (1988) used a four-tier model to represent the conceptual process involved in the selection of accounting concepts and procedures developed by AAA to evaluate the FASB Framework, and concluded that the Framework is consistent and usable in practice.

According to some commentators the project has delivered what it promised: *"At its origins in 1973, the Board was not eager to take on such a project, but many of the Board's publics were, and its own early experience demonstrated the need to define principles or concepts that would result in consistent or similar solutions to similar problems. To achieve that-an implicit expectation when the Board was formed-and at the same time develop a standard of accountability for what was looked upon at the time as the private sector's last chance to set accounting standards, the Board undertook its conceptual framework project. From the perspective of a former insider, it has been useful and, in fact, essential"* (Kirk 1989, 104).

As an answer to the demand for a shift from producer-oriented accounting standards to user-oriented accounting standards, the Conceptual Framework has served a purpose: *"The conceptual framework could be judged to be a great success by a person convinced that the main purpose of a conceptual framework is to raise the sights of a*

significant proportion of the participants in the reporting process by placing more emphasis on decision usefulness and connected concepts" (Miller 1985, 49).

The framework project was a response to a general demand for a cohesive accounting theory, and to some extent it may be concluded that this demand has been met: *"Although each proved to be controversial during the process of issuing Discussion Memoranda, analyzing responses, conducting public hearings, agreeing on an Exposure Draft, and again analyzing responses, the final Statements of objectives, qualitative characteristics, and elements have not been, and are not likely to be, seriously challenged"* (Sprouse 1988, 124). Similarly, Sterling was supporting the FASB approach to objectives, qualitative characteristics, and definitions: *"I am much impressed by the significant accomplishments of the FASB"* (Sterling1982, 104).

The fact that the FASB applies its conceptual framework (see for instance Reither 1997), and motivated other accounting standard setters to initiate similar projects, may be interpreted in favor of the project, and indicates that the potential of conceptual frameworks as a frame of reference is believed to be promising. The Fédération des Experts comptables Européens (FEE) concluded in the "Comparative Study on Conceptual Accounting Frameworks in Europe" that a conceptual framework is a necessary tool in the international harmonization process (FEE 1997, 11).

In spite of the great interest given to conceptual frameworks, many commentators doubted that the profession would gain from these projects: *"Little that is new and little that can be expected to aid in the resolution of accounting issues can be found in the FASB's statements"* (Dopuch og Sunder 1980, 1), and as expressed by Kirk: *"(...), a majority from all areas believe our efforts will lead only to affirmation of the status quo with minor changes"* (Kirk 1981, 84). Wyatt (1991) advocates that the FASB has failed to meet the expectations in two areas, one of them being the conceptual framework.

In retrospect, the critics have raised their voices. Paterson's description of the IASB's framework is illustrative: *"It starts with great promise, it falters before it gets to the end*

(...)" (Paterson 1988, 26). Miller et al. concludes *"(...) that the FASB's Conceptual Framework project did not achieve its original goals"*, and follows up by stating that *"Although it is probably an overstatement to call the project a failure, it is certainly a disappointment* (Miller et al. 1994, 102).

Others have based their critics on the seemingly lack of usefulness of the frameworks: *"But after the immense amount of time and money that was spent on developing the conceptual framework, there is still no agreement on the usefulness of the framework"* (Nussbaumer 1992, 235). Chambers rejects conceptual frameworks altogether: *"These projects have failed through disregard of the role of systematic knowledge in the design of serviceable practical devices"* (Chambers 1996, 119). FEE's comparative study reveals that existing frameworks fail to represent a useful tool to the standard setting bodies: *"In most countries, the accounting solutions to specific issues are difficult to find and are sometimes inconsistent even if there is a conceptual framework"* (FEE 1997, 11). Milburn supports this view: *"In short, conceptual frameworks have been incomplete, and only of limited value in the development of accounting standards"* (Milburn 1991, 43).

It has been advocated that the FASB Conceptual Framework is lacking a formalized approach, and in addition to capture financial accounting issues, should have been concerned with other areas of accounting: *"The FASB's attempt to create a conceptual framework could have provided an excellent focus for integration; but apart from lacking a formalized approach, the exclusion of managerial as well as macro-accounting and outher subareas limited this undertaking to financial accounting"* (Mattessich 1995, 80).[25]

According to Gore the major question in the evaluation of conceptual frameworks is whether the frameworks will enable standard setters to handle recurrent accounting problems more successfully than before the introduction of the conceptual frameworks (Gore 1995, 150). Gore listed six frequently revised accounting issues[26], and concluded that to date the practical use of the conceptual frameworks was only limited: *"Thus, a CF may be said to be of practical use in solving some problems, unhelpful due to*

incommensurability with regard to others, unhelpful due to a lack of firm decisions in respect of others, and unhelpful due to noncoverage of topics that would fit into a CF" (Gore 1995, 170). Gore's analysis shows that it is primarily at the recognition and measurement level that the conceptual frameworks fail to deliver. In addition, Gore argues that the in order for conceptual frameworks to be useful, disclosure issues have to be covered by the frameworks. Davies et al. supports Gore, and conclude that the FASB Conceptual Framework seems to have had little influence on the development of accounting standards: *"Possibly the best example of where the framework has been used as the basis for an accounting standard is in the development of SFAS 95 – Statement of Cash Flows; however, this is clearly the exception. An analysis of the Appendices headed "Basis for Conclusions" in the more recently issued SFASs, reveals few references to the fact that the members of the FASB have used the concepts statements to guide their thinking – and where reference is made it is generally to broad objectives or qualitative characteristics"* (Davies et al. 1997, 63).

Kripke (1989) argued that the Conceptual Framework does not meet any of the potential benefits listed by the FASB at the initiation of the framework project (FASB 1976b): *"For instance, if the question was whether to recognize an asset, the answer might start with an express or implied decision to discuss whether it fits the definition and whether recognition would be useful. It might consider the putative asset's measurability, reliability, and relevance and whether the measure is conservative; or it might choose to ignore the qualitative characteristics, and decide without discussion that historical cost will be the applicable attribute; or it might select an attribute from among the four others presently available (and possibly more in the future). Or it might declare the existence and announce the measure of an asset without any of these processes, as it did in FAS 87. Few will be in an improved position to predict how the Board will come out on any issue, except that it has shown a felt need to assure its constituents that things will continue to be done substantially as they have always been done"* (Kripke 1989, 43).

Nussbaumer found in her study that some of these benefits had been achieved in certain selected cases: *"After looking at the individual statements and specific accounting*

issues, it is clear that the conceptual framework has provided some of its promised benefits and has been successful in some areas. However, these successes have been limited to issues that were not controversial in the first place, and have not been evident in the more complex issues that must be addressed by the FASB" (Nussbaumer 1992, 240). Also, Solomons agreed that some of the benefits had been reaped: "Economizing of effort", "gain in consistency", "improved communication", and "defense against politicization" (Solomons 1986b, 115).

The analysis of the merits of the conceptual frameworks in this chapter has been based on the evaluations and suggestions of other commentators. Different opinions clearly exist as to the usefulness of conceptual frameworks. The idea of conceptual frameworks, however, has potential: *"This is not to say that the FASB's project should be rejected out of hand; it contains some outstanding work, particularly in the area of qualitative characteristics. However, a way must be found to address the fundamental issues, without having to resort to comprise solutions; thereafter, a method of implementation will have to be developed which will make whatever transition is necessary acceptable to both the preparers and users of financial reports"* (Davies et al 1997, 63). The release of SFAC 7 in 2000 shows that the FASB still believes in the projects.[27] [28] Even if some aspects of the Conceptual Framework do not live up to the expectations, the FASB should hesitate to let go of the idea of a conceptual framework: *"It is not to be denied that to some extent the guiding model of the overall order will always be a utopia, something to which the existing situation will only be a distant approximation and which many people will regard as wholly impractical. Yet, it is only by constantly holding up the guiding conception of an internally consistent model which would be realized by consistent application of the same principles, that anything like an effective framework for a functioning spontaneous order will be achieved"* (from Solomons 1986b, 124).

The conceptual framework approach to accounting theory seems to have support, and to some extent merits. A valid question though, is why the critics of the frameworks seem to outnumber the supporters? This question is not answered by adopting or rejecting the

conceptual framework altogether, but rather by a careful analysis of the different levels of the frameworks. An analysis of the levels is conducted in the following chapters.

---

[1] Others had used the term "conceptual framework" before. For instance, Backer and Bell used the term in their essay about income measurement in 1966 (Backer and Bell 1966, 68).

[2] Interestingly, some commentators has claimed that Paton's book on accounting theory in 1922 (Paton 1922) represented a greater contribution to the field of accounting, and that the monograph by Paton and Littleton (1940) more reflected the effects of the Great Depression and the preferences of Littleton, than Paton's ideas (Staubus 2002, 17). However, this earlier work of Paton never received the same recognition.

[3] *"Accounting does not have principles that can be demonstrated or proved or disproved"* (Kripke 1989, 11).

[4] Kripke (1989) discusses the untheoretical "nature" of financial accounting. A more philosophical approach is taken by Gambling in his untraditional book on accounting "Positive Accounting: Problems and Solutions", in which he describes accounting as an "anti-science" (Gambling 1984, 71).

[5] Salvary (1989) is of the same opinion as Sterling, and treats accounting as a science in his book "An Analytical Framework for Accounting Theory".

[6] "Concepts" is here used as an overall label for postulates, axioms, assumptions, doctrines, conventions, constraints, principles, and standards.

[7] *"We define "theory" as a cohesive set of hypothetical, conceptual, and pragmatic principles forming a general frame of reference for a field of study"* (AAA 1966, 1).

[8] Yu (1976) proposes "The Scientific Method" for accounting (Yu 1976, 23).

[9] The pragmatic-normative accounting theories are, according to Mattessich's classification, connected with Chambers, Edwards and Bell, Ijiri, Sprouse and Moonitz, and Sterling, to name a few (Mattessich 1995, 220).

[10] Moonitz discussed the descriptive framework represented by ARS No. 1 and ARS No. 3.

[11] The roots of the normative approach goes further back. Devine advocated a normative approach in his *"Research Methodology and Accounting Theory Formation"* in 1960, and Rappaport elaborated Devine's approach in 1964. However, even Devine was not the first to apply a normative approach. Chambers introduced the decision usefulness approach and thus a normative approach to accounting in his "Blueprint for a Theory of Accounting" in 1955 (endnote 3 in chapter 3).

[12] Gore argued that the major problems of the descriptive approach was that the products (the accounting standards) often lacked coherence and consistency, and that standard setting had been reactive, and that the term "fire fighting" often was adequate to describe the standard setting process (Gore 1995, 151).

[13] Mattessich explains well why the assumption that normative frameworks and descriptive frameworks have to be all deductive and inductive, respectively, cannot be: *"For Hendriksen, as for many other*

accountants, the term "normative" seems to be almost synonymous with "dedcutive" (something to which I object). Even the milder statement by Wolk et al. may lead to misunderstandings: "Although there are exceptions, deductive systems are usually normative, and inductive apporaches usually attempt to be descriptive" (Wolk et al. 1992, 33). First, empirical theories require deductive as well as inductive inferences. Second, conditional-normative theories cannot exist without (at least implied) empirical means-end relations (gained through inductive reasoning)" (Mattessich 1995, 176).

[14] Critics of the R-E view have argued that the descriptive and inductive approach is a core problem of the R-E view: *"Incidentally, surely it is "inappropriate",(...), to appeal to generally accepted accounting practice for support when it is that very practice that is under scrutiny"* (Solomons 1995, 45). However, this problem may not be limited to the R-E view. For example, in the IASB framework references to current practice to support the views taken are numerous.

[15] In this context it is worthwhile to add that Kripke is a Professor of Law.

[16] The empirical research dominance is particularly evident in the US. Panozzo (1997) for example, describe the US research tradition as "mainstream research" implying that alternative research approaches are generally not applied. In contrast, Panozzo described European accounting research as a "fragmented adhocracy" implying that alternative research approaches are considered more favorably among European academicians.

[17] The NZSA lists going concern, period reporting, and accrual accounting as underlying assumptions. The IASB also considers going concern and accrual accounting as underlying assumptions. The concept of accrual accounting is a recognition issue, and a separate discussion of this concept, as an underlying assumption seems inadequate. Furthermore, the discussion of prudence or conservatism as a separate issue from recognition and measurement is somewhat surprising.

[18] See also Gore 1992 and Gore 1995.

[19] *"Throughout the 1980s, each of the other G4+1 organizations developed its own version of a conceptual framework, patterned in most respects after the FASB's framework"* (Monson 2001, 277).

[20] The major characteristic separating business entities from nonbusiness entities is that profit seeking is the principal motivation of business entities, while profitability has no place among the performance measures by which nonbusiness entities are judged. Another major characteristic separating the two is the way in which they obtain resources (Solomons 1986a, 81).

[21] The conceptual frameworks of AASB, NZCA and CICA apply to both business and nonbusiness entities.

[22] In the introductory paragraphs of each Concepts Statements the FASB announces: *"The purpose of the series is to set forth fundamentals on which financial accounting and reporting standards will be based. More specifically, Statements of Financial Accounting Concepts are intended to establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting".*

[23] The GAAP hierarchy is also set forth in Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report.

[24] In debating a principle-based approach to accounting standard setting, the FASB has acknowledged the complexity of the hierarchy of sources: *"After analyzing the structure of U. S. standard setting, the FASB concluded that concern about the number and complexity of sources and forms of financial reporting guidance are valid (...)"* (Herz 2003, 253). The FASB intends to reduce the number of sources and improve the consistency of the sources, and thus clarify the structure of the hierarchy of sources.

[25] The approach of the FASB is by Mattessich termed the "postulation approach", and involves *"(...) the formulation of basic premises and possibly consequences of the theory in a natural language (like English) without demonstrating rigorously the conclusions that follow from the premises"* (Mattessich 1995, 78).

[26] The six issues discussed by Gore are group accounting, deferred taxation, extraordinary items and prior year adjustments, inflation accounting, cash flow statements, and research and development.

[27] By the release of SFAC 7 in 2000 the FASB proved Solomons wrong in his 1986-predictions: *"Though the board has not acknowledged that the statement was its last word on the conceptual framework, it seems unlikely that any further work will be done on it, except perhaps on methods of display of financial information"* (Solomons 1986b, 114).

[28] There is still a significant group that does not support the efforts of the standard setting bodies to put additional efforts into framework projects. For instance, a survey in the UK in 1997 showed that only 39% favored the adoption of a concepts statement (or a "Statement of Principles") (Kirk 1998, 16).

3. Objectives and Qualitative Characteristics

The producers of accounts and the users of these accounts often understand financial reporting and accounting as synonyms for recognition. Questions like "Should a gain on a contract to purchase a certain good lead to recognition?" and "Should a leased asset be recognized in the balance sheet?" are the accounting issues according to these parties. Most of these producers and users will agree that disclosure represents an important part of financial reporting, and disclosure issues are generally regarded as financial reporting and accounting. This is not surprising when a significant number of the current accounting standards deal with nothing but disclosure issues, for instance segment reporting, and the accounting standards dealing with recognition issues without exception also covers disclosure of financial information. However, if you propose "objectives of financial reporting" and "qualitative characteristics" as issues of interest in financial reporting and accounting, a lot of the producers and users will shake their head, signaling that such questions fall outside of what they consider being issues of financial reporting and accounting. The obvious reason for their reaction is that these questions are answered before their involvement in the financial reports start, and thus the average producer and the average user regard the answers to these questions as predetermined. To them there is no alternative to decision usefulness as the overriding objective of financial reporting, and the need for relevant and reliable information in order to meet this objective is almost tautological.

In this chapter financial reporting objectives and necessary qualitative characteristics of financial reporting will not be considered tautological, and different approaches to defining the objectives will be explored. Furthermore, whether relevant and reliable information is obtainable in all situations will be questioned, and the relationship between these qualities will be explored.

The remainder of this chapter is organized as follows. First, objectives of financial reporting will be analyzed, before an analysis of qualitative characteristics is conducted in

chapter 3.2. Certain amendments to the current conceptual frameworks are suggested in the end of each section, and summarized in a final section, chapter 3.3.

3.1 Objectives of Financial Reporting[1]

> *"Many accountants have criticized our literature for its excessive attention to the 'how' and its almost complete absence of attention to the 'why' (see, e.g., Spacek, "Accounting Court", p. 4). We have been busily engaged in perfecting our means, our techniques, with precious little attention and much confusion about the goals or objectives of accounting"* (Sterling 1979, 13).

In a normative model, consensus concerning accounting objectives is imperative for a constructive framework (Rappaport 1964, 107). In order to set accounting standards, the purpose of the accounting standards must be defined. In the opening paragraph of the Trueblood Report the Group explained the need for objectives: *"Accounting is a social system much like language and law. As such, it tends to evolve by adapting to its environment; but evolutionary changes may occur which are incompatible or even in conflict with current notions of what the objectives of this system ought to be. An explicit statement of objectives, therefore, is essential to its rational development"* (AICPA 1973, 13). Sorter and Gans supported the Group, and in their opinion an explicit statement of objectives was crucial to the development of accounting standards: *"No longer should it be possible to legislate accounting standards by fiat; no longer should it be possible to thunder "Thou Shalt" without continuing with "because". (...) In other words, for something to be part of the recognized body of generally accepted accounting principles, it should be demonstrated to be right because it is the best available means for executing the objectives. (...) Accountants now have an agreement that GAAP are generally accepted because they are "right", instead of merely asserting that standards are right because they are generally accepted"* (Sorter and Gans 1974, 2-3).

However, in order to influence the behavior of preparers and users, more than a statement of objectives is needed. As such, the principal beneficiaries of a statement of objectives are the standard setters themselves (Solomons 1986a, 67). In the introductory paragraphs of the Concepts Statements, the FASB emphasizes that objectives *"(...) will not, by itself, directly solve financial accounting and reporting problems. Rather, objectives and concepts are tools for solving problems"*, and acknowledges that the Board itself will be the major user and the direct beneficiary of the guidance provided by the Concept Statement (chapter 2.2).

3.1.1 Decision Usefulness

Financial statements should represent a useful tool for decision makers[2]: *"Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions"* (FASB 1978, vii). Decision usefulness is the primary objective of financial reporting.[3] This main objective has not been regarded controversial (Skinner 1987).[4] Inherent in the main objective are several subordinated objectives proposed in SFAC No. 1:

1. *"Financial reporting should provide information that is useful to present and potential investors and creditors and other users in making rational investment, credit, and similar decisions. The information should be comprehensible to those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence"* (FASB 1978, 34).

The important contribution of this statement is that the FASB explains what level of competence the users of the financial reports should have. The FASB expects the users to have a certain level of financial and technical competence, and uneducated users cannot unconditionally expect to find the financial reports useful (chapter 3.1.3).

2. *"Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the*

amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected by an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations, and to pay cash dividends and may also be affected by perceptions of investors and creditors generally about that ability, which affect market prices of the enterprise's securities. Thus, financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (FASB 1978, 37).

In this second statement the FASB emphasizes the role of cash flows, and explains that decision useful information depend on the timing and uncertainty of expected future cash flows. The FASB acknowledges that information about cash flows is the ultimate goal of an entity's activities: *"The ultimate test of success (or failure) of those activities is the extent to which they return more (or less) cash than they cost"* (FASB 1978, 38) However, mere cash flow information, for instance in the form of a cash flow statement, does not fulfill the demand for decision useful information.

3. *"Financial reporting should provide information about the economic resources of an enterprise, the claims to those resources (obligations of the enterprise to transfer resources to other entities and owners' equity), and the effects of transactions, events, and circumstances that change resources and claims to those resources"* (FASB 1978, 40).

Potential cash flows are of interest, but information about an entity's economic resources, obligations, and owners' equity, is also important to the users in their assessment of the entity's financial strengths and weaknesses, and liquidity and solvency. This information is helpful in predicting the future cash flows. Some of the resources are direct sources of cash to the entity, and obligations are often direct causes of cash payments to be made by

the entity. Information about resources and obligations will thus often represent reliable measures of future net cash flows.

4. *"Financial reporting should provide information about an enterprise's financial performance during a period. Investors and creditors often use information about the past to help in assessing the prospects of an enterprise. Thus, although investment and credit decisions reflect investors' and creditors' expectations about future enterprise performance, those expectations are commonly based at least partly on evaluations of past enterprise performance"* (FASB 1978, 42).

Information about past performance is helpful in order for the users to be able to predict future cash flows. Cash flow information from the last accounting period alone, for instance in form of a cash flow statement, cannot however, adequately indicate whether the past performance of the entity is successful.

5. *"The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information. Their interest in an enterprise's future cash flows and its ability to generate favorable cash flows leads primarily to an interest in information about its earnings rather than information directly about its cash flows. Financial statements that show only cash receipts and payments during a short period, such as a year, cannot adequately indicate whether or not an enterprise's performance is successful"* (FASB 1978, 43).

This fifth statement follows up the fourth statement. Cash flow information is not alone sufficient for the users to predict future cash flows. For example, at any given point of time the entity will have delivered product or services for which it has not yet received

payment. Or, it may have received payment but yet not fulfilled its obligation to perform (deliver etc.). Furthermore, it may have incurred costs (made payments) and acquired rights or objects that may be expected to be rewarded by inflow of cash in future periods. Moreover, the entity may have received goods or services for which no payment is made yet. The emphasis put by the FASB on performance and earnings measurement is of particular interest in the context of this dissertation. In chapter 4.4, the importance of the performance emphasis is further elaborated.

6. *"Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency"* (FASB 1978, 49).

Even though cash flow information alone is not adequate for the users to predict the cash flow potential of an entity, cash flow information is useful as a supplement to performance information. For instance, such information may be useful for the users to understand the operations of the entity, and will be useful in an assessment of financing activities.

7. *"Financial reporting should provide information about how management of an enterprise has discharged its stewardship responsibility to owners (stockholders) for the use of enterprise resources entrusted to it"* (FASB 1978, 50).

This seventh statement introduces the stewardship function of the financial reports. Management is responsible for the operations of an entity, and is accountable for their performance to the investors. The stewardship function of financial reports is in smaller entities often covered through other means than the financial statements, for instance through internal reporting to the board of directors. In entities with a wider ownership

such reporting is not sufficient, and in the FASB's opinion the investors should be able to rely on the financial statements for stewardship relevant information. The issue of stewardship demand is explored in chapter 3.1.2.

8. *"Financial reporting should provide information that is useful to managers and directors in making decisions in the interests of owners"* (FASB 1978, 52).

This last statement further emphasizes the demand for stewardship relevant information. And, as discussed in chapter 3.1.2, the FASB considers the objective of stewardship relevant information equally important as the decision making relevant information represented by the first six statements listed and commented on above.

All the objectives are concerned with decisions, directly or indirectly. In this respect, it is important to emphasize that the role of financial statements in the economy is to provide useful information for decision making, not to determine what those decisions should be.

3.1.2 Decision Making Versus Stewardship Demand

The decision usefulness objective has been criticized for elevating the predictive uses of financial statements above the reporting uses: *"The stewardship function (i.e. assessing the past performance of Directors) has always been the traditional function of financial reporting and there are few objections to its inclusion. However the introduction of decision making is more controversial since this must involve the implementation of more forward looking information into the financial statements such as the adoption of net present values and selling prices"* (Kirk 1998, 12).[5]

According to the FASB the financial statements should meet both demands, and the objectives listed above include both the forward-looking and backward-looking uses. According to many commentators, the approach of the FASB is the ideal: *"Ideally, financial reporting therefore helps the best-performing firms in the economy to distinguish themselves from poor performers and facilitates efficient resource allocation*

and stewardship decisions by stakeholders" (Healy and Wahlen 1999, 366). Other conceptual frameworks try to balance the two as well. Kirk describes the ASB Conceptual Framework: *"Chapter 1 identifies the main objective of financial statements as providing information to shareholders about the financial position, performance and financial adaptability of an enterprise that is useful for assessing both the stewardship of management and for making economic decisions"* (Kirk 1998, 12). AASB in Australia as well as the IASB (IASB 1989, 14) put emphasize on both decision making demand and stewardship demand, while FRSB in New Zealand seems to focus on the stewardship, or accountability, role of financial reports (NZSA 1993, 3.1).

The conflict between the decision-making demand and stewardship demand has been debated for decades: *"During the early stages of the development of accounting rules in the first half of this century, the primary focus of financial statements was based on the principle of "stewardship""* (Davies et al. 1997, 49).[6] Rappaport emphasized the question of stewardship and decision making in 1964 when he was discussing what basic unresolved issues remained: *"What should be the scope of reporting responsibility to investors? Should it comprehend stewardship and/or investment guidance?"* (Rappaport 1964, 95).

Some commentators seem to suggest that stewardship demand in the view of the FASB is met through the decision making demand:[7] *"It is also worth noting that the FASB attempted to subsume the accountability approach or stewardship approach into the adopted decision usefulness approach. An argument running through most of the documents considering objectives was that accountability involved a decision to buy, hold, or sell shares based on the performance of the entity and its management as reported. As such it forms a sub-set of the decision usefulness approach"* (Gore 1992, 33).[8] Gjesdal on the other hand, argued that these two uses require different information in financial reports: *"Two apparently different answers may be suggested to this question. (1) Financial statements may be of value to investors (in a broad sense) making investment decisions. I shall call this, decision-making demand. (2) Investors usually delegate decision making to managers. Then there may be a demand for information*

about the actions that are taken for the purpose of controlling them. This I shall call stewardship demand" (Gjesdal 1981, 208). Ijiri was of the same opinion, and argued that the choice between the two would have a significant effect on the conceptual framework: *"A conceptual framework of accounting can be decision based or accountability based. The choice critically affects the resulting framework"* (Ijiri 1983,75).

Ijiri described the decision making demand as follows: *"In a decision-based framework, the objective of accounting is to provide information useful for economic decisions. It does not matter what the information is about. More information is always preferred to less as long as it is cost effective. Subjective information is welcome as long as it is useful to the decision maker"* (Ijiri 1983, 75). Stewardship demand on the other hand, is explained as follows: *"In an accountability-based framework, the objective of accounting is to provide a fair system of information flow between the accountor and the accountee. It is built upon the accountability relationship between the two parties. Based on the underlying accountability relation, the accountee has certain right to know; at the same time, the accountor has a right to protect privacy. More information about the accountor is not necessarily better. It is perhaps better from the standpoint of the accountee but not necessarily from the overall accountability relation. Subjective information can seriously damage the interest of the accountor, even if it is highly useful to the accountee"* (Ijiri 1983, 75). In other words, Ijiri points out two important differences between the decision making demand and the stewardship demand with regards to the information provided: 1) More information is always better if cost effective in the decision making demand, but not necessarily in the stewardship demand, and 2) subjective information is inadequate in the stewardship demand, but not necessarily in the decision making demand.

Gjesdal shows theoretically that stewardship demand and decision making demand generally are not identical, and that these demands should be distinguished: *"In decentralized organizations there will be a demand for stewardship reporting in the sense that such reporting is ex ante efficient. This demand exists under quite general conditions. The theory of stewardship information then belongs to the same theoretical framework as the theory of decision-making information. In particular, both theories*

spring from the same definition of information. On the other hand, the problem structures are not identical, nor are the criteria of stewardship informativeness and decision-making informativeness. Hence there are reasons for distinguishing between the two objectives, (...)" (Gjesdal 1981, 226). Thus, information preferences will under certain circumstances be different depending on whether stewardship or decision making demand is considered primary. Reichelstein (2000) shows that cash flow matched depreciation is to prefer when performance measures are compared in a principal-agent setting. Whether such matching benefits the decision-making demand of the investors is unsaid.

The FASB admits that the stewardship demand in certain cases cannot be met: *"Financial reporting provides information about an enterprise during a period when it was under the direction of a particular management but does not directly provide information about that management's performance. The information is therefore limited for purposes of assessing management performance apart from enterprise performance"* (FASB 1978, 53). Furthermore, some commentators argue that even if the FASB apparently emphasizes the two equally, the backward-looking uses tend to be downgraded: *"Another example of a single objective overriding all others is the FASB's tendency to put decision-relevant information over other goals such as accountability"* (Mattessich 1995, 197).

3.1.3 Primary Users

The objective of decision usefulness requires that primary users of the financial statements are identified. Identification of the primary users has been the subject of controversies. This should come as no surprise since different users have different informational needs. However, even though the FASB acknowledges the heterogeneity of external user groups, a common characteristic of all outside users is their interest in the prediction of amounts, timing, and uncertainties of future cash flows, or "cash flow oriented information" in the terminology of Staubus (Staubus 1999). Thus, the objectives in SFAC 1 *"(...) are those of general purpose external financial reporting by business enterprises"* (FASB 1978, 13). Among the potential users are *"(...) owners, lenders,*

suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labor unions, trade associations, business researchers, teachers and students, and the public" (FASB 1978, 24).

Investors, creditors, and their advisors are singled out among the external users: *"Investors, creditors and their advisors are the most obvious prominent external groups who use the information provided by financial reporting and who generally lack the authority to prescribe the information they want"* (FASB 1978, 30).[9] By making this choice the FASB has been criticized for defining the objective to narrow, ignoring the responsibility of entities to society (Solomons 1986b, 118). According to the FASB a narrow focus is necessary: *"To identify investors' and creditors' needs as the focal point of financial statement information greatly narrows the range of economic decisions and varied needs for specialized information that general purpose financial statements must try to satisfy, thereby increasing the possibility that the statements can reasonably satisfy the narrower range of needs"* (FASB 1976d, 10).

Others, for instance Beaver and Demski (1974), have proposed that failure to recognize that the users of financial statements are heterogeneous in setting objectives, may make the objectives useless. An increasingly popular view is that the generalization in the conceptual frameworks is a dead end because *"(...) every user wants something different from financial information, (...)"*, and correspondingly, financial reporting *"(...) cannot be based on any one theory or set of technical guidelines"* (Aitken 1990, 222). In other words, according to these commentators it is not sufficient to divide users into broader groups, investors, creditors, etc. Each decision maker has to judge what information is useful to his specific decision. The judgment will be based on such factors as the nature of the decision to be made, the information already in the decision makers' possession or available from other sources, the decision-making process that the decision maker employs and his capacity to process all the information that he obtains (Davies et al. 1997, 51).

Flegm (1984, 1989) and others[10] claims that management should be regarded the primary users of financial statements, as opposed to the external groups advocated by the FASB and other standard setters, while Ijiri, according to Solomons, argued that the producers, or the "accountors", should be emphasized more than the FASB does (Solomons 1986a, 79). However, these views have not gained substantial support.

The other leading standard setters also view investors and creditors as primary users according to the FASB: *"Their frameworks, like that of FASB, are based on the fundamental objectives that financial reporting should provide information that is useful to investors and creditors in making investment and credit decisions"* (FASB 2001, 3).

The IASB identifies a wide group of users of financial reports, but gives attention to the investors. Unlike the FASB, the IASB does not consider creditors primary users (IASB 1989, 10). Also, the Statement of Principles, the ASB Conceptual Framework, identifies a number of users, but concentrates on the shareholders as the major user group (Kirk 1998, 12). The AASB in Australia, the FRSB in New Zealand, and the AcSB in Canada generally followed the FASB and named investors a primary user group. However, these standard setters do not seem to consider investors the single primary user group.

A wide definition of the users of financial reports raises an important question; are all these users, for instance local community and employees, interested in the cash flow oriented information provided by financial reports meeting the decision usefulness objective? The answer is likely to be negative. Investors are believed to act on cash flow oriented information because they evaluate their investments based on the return gained on investments. The local community, on the other hand, may be more concerned about environmental issues and local employment rates. These issues will typically not be answered by reference to cash flow oriented information. Similarly, employees will be concerned with the job environment, compensations offered, etc, and these issues may better be dealt with by information other than cash flow oriented information.

The assumption of homogeneous users limits the usefulness of the conceptual frameworks according to some commentators: *"There must be a decision as to who users are if any complete and relevant total conceptual framework is to be developed"* (Dunn 1988, 24). The selection of investors as primary users does not reflect the different needs of the other users, according to Dunn. This conclusion is not supported by the IASB: *"As investors are providers of risk capital to the enterprise, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy"* (IASB 1989, 10).

3.1.4 Suggestions

SFAC 1 failed to deliver what was promised according to many commentators: *"On the basis of the above analysis, we conclude that the results of the FASB's effort to write objectives and definitions are hardly different from previous attempts of this nature and, as such, are unlikely to help resolve major accounting issues or to set standards of financial reporting as the FASB had expected"* (Dopuch and Sunder 1980, 8). Dopuch and Sunder further criticizes SFAC 1 for being descriptive rather than normative: *"If "should" is removed from each sentence, this objective is reduced to a mere statement of an empirically verified and a widely accepted consequence of financial accounting"* (Dopuch and Sunder 1980, 11). The objectives may be viewed as functional objectives, according to Dopuch and Sunder, and as such, they cannot by themselves serve as normative objectives to guide policymaking.

SFAC 1 was not meant to resolve major accounting issues alone, but was a necessary first step in the development of a framework that should provide the concepts and references necessary to develop consistent accounting policies resolving important accounting issues.[11] Furthermore, there is empirical evidence documenting the decision usefulness of financial reports. For example, Pietroski found evidence that financial reports were useful in separating "winners" from "losers" (Pietroski 2000). These findings suggests that the FASB at least to some extent is meeting their own objective, namely the issuance of accounting standards giving rise to decision useful financial reports.

In this author's opinion consideration of existing practices and practical implications is necessary if a normative approach is to be successful.[12] Such considerations do not by themselves make the approach descriptive. However, if the established objectives are rejected because they are in conflict with existing practices, not because of careful cost-benefit considerations, then the objectives do not represent what they appear to represent, and the approach is in fact descriptive.

Thus, there is a thin line separating the normative and the descriptive approach, a line that may easily be crossed if not the objectives of financial reporting are the primary concern in accounting policy making under all circumstances. Current accounting standard setting may to some extent be crossing this line. Accounting for business combinations and stock compensation represents two areas where the objectives of financial reporting seem to be somewhat ignored.[13] [14]

The objectives will not alone always be sufficient to deduce accounting policies. Under certain circumstances inductive reasoning may represent a more fruitful approach. As Mattessich put it: *"To create an accounting theory for practical use, one must go beyond a purely analytical approach and give it empirical content as well a normative direction"* (Mattessich 1995, 77). For example, if different accounting practices prevail for a certain accounting problem, these practices may be tested against the established objectives. Practices inconsistent with the objectives can be rejected, and the practice meeting the objectives can be recommended. This approach may not give rise to the "best practice", but will exclude practices inconsistent with the objectives.

To sum up, recommendations may result from both induction and deduction. This approach is much like what Littleton proposed in his "Structure of Accounting" (Littleton 1953), and is used by Yu in his "The Structure of Accounting" when he claims that inductive logic often "presupposes" deductive logic: *"Although the 'form' of deductive logic starts with a set of unproved, primitive propositions, the formulation of such a set of propositions – except in the areas of pure mathematics and logic – is often made by*

inductive reasoning and is necessarily conditioned by the theorist's previous knowledge and experience" (Yu 1976, 20).[15]

This author supports the decision usefulness objective of the FASB. In the decision making approach the financial statements should be useful in order to make investment decisions and other decisions based on expectations of future cash flows, while in the stewardship approach the financial statements should be useful in order to make decisions regarding the stewardship. However, an interpretation of the decision usefulness criteria including both the forward-looking uses and backward-looking uses seem to be too ambitious under certain circumstances, and may provide more questions than answers: *"Based on the premise that every financial accounting user wants something different from financial accounting information, it has been logically argued that it is impossible to posit a general theory for financial reporting"* (Aitken 1990, 230). In other words, to enhance the applicability of the framework, a preference for the decision-making demand or the stewardship demand should be made. Users are generally concerned with both demands, and without a more narrow selection of the primary users, it is difficult, if not impossible, to select one of the two as the primary demand.

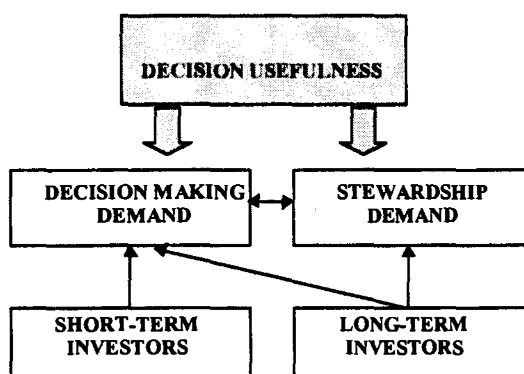
As pointed out by the FASB, investors and potential investors are in need of financial information, in general they have limited sources of financial information, and the informational needs of investors are to a great extent common to many of the other potential user groups: *"The objectives need a focus to avoid being vague or highly abstract. Investors and creditors and their advisors are the most obvious prominent external groups who use the information provided by financial reporting and who generally lack the authority to prescribe the information they want. Their decisions and their uses of information have been studied and described to a much greater extent than those of other external groups, and their decisions significantly affect the allocation of resources in the economy. In addition, information provided to meet investors' and creditors' needs is likely to be generally useful to members of other groups who are interested in essentially the same financial aspects of business enterprises as investors and creditors"* (FASB 1978, 30). It is therefore not difficult to single out investors as the

primary user group of financial statements, regardless of the commentators quoted in chapter 3.1.3 arguing that the primary users should not be defined narrowly. The investment decisions of investors to buy, sell or hold should be the primary consideration of the ones that prepare the financial reports.[16]

Investors can be divided into more narrow groups based on different parameters. It may for the purpose of determining the primary usefulness demand, be wise to separate "short-term" and "long-term" investors. Here, long-term investors are strategic investors that consider the investment in the entity an important part of their business, and that will try to influence the strategic decisions and major operational decisions of the entity. Short-term investors are investors that treat the investment in the entity as a readily realizable investment, and typically do not intend to hold the investment.

Long-term investors will be concerned with both the decision making demand and the stewardship demand, while the stewardship demand will have little or only indirect relevance to the short-term investors.[17] [18] Decision making demand is the common demand, the bridge, between these two categories of investors. The stewardship demand can be met through other means of financial reporting, for example MD&A, letters to stockholders, and documents circulated to the Board of Directors (BOD). Long-term strategic investors will usually have access to these supplementary sources of financial information. Thus, in recognition of the conflict between the decision making demand and the stewardship demand, and that this conflict leads to less useful objectives, an emphasis should be put on decision making demand when the objectives of financial reporting are to be established.[19] The splitting of investors in short-term and long-term users will only give added usefulness to the objectives in these situations.

Figure 3-1 ***Objectives for Financial Reporting***



However, it must be emphasized that the two uses are not independent of each other. Information about the past is relevant for investment decisions, and expected future cash flows may be important to the stewardship relationship. Thus, giving preference to the decision making demand does not imply that financial statements will not be useful in the evaluation of managers, and related stewardship matters.

3.2 Qualitative Characteristics

> *"The "lifeblood" of United States capital markets is financial information that is: (1) comparable from firm to firm; (2) relevant to investment and financing decisions; (3) a reliable and faithful depicition of economic reality; and (4) neutral, favoring neither supplier nor user of capital; neither buyer nor seller of securities"* (FASB 2002b, 1).

Accounting information should meet certain qualitative characteristics to make it useful to the primary users of the financial statements. Staubus (1977) refers to the qualitative characteristics as "criteria for making accounting decisions". The ability of accounting information to meet these characteristics or criteria is given weight when different solutions to accounting problems are evaluated.

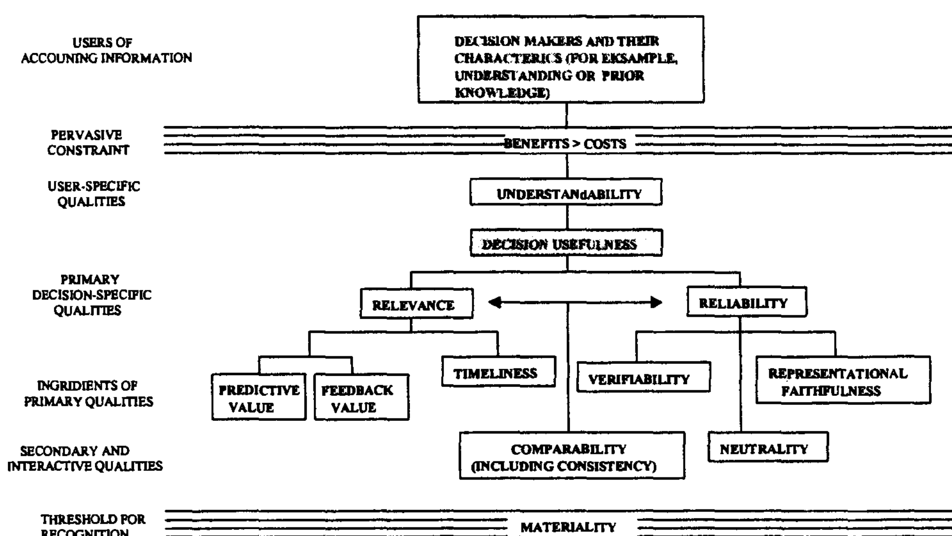
The FASB classifies qualitative characteristics as primary and secondary characteristics (FASB 1980, 14). However, two so-called pervasive constraints override the primary and secondary characteristics.

Information can be useful and yet be too costly to justify providing it. The benefits associated with the information should exceed the costs in providing the information. For instance, the cost component of the qualitative characteristics is used to justify amendments to the expected cash flow approach in SFAC No. 7: *"The accounting problem is to balance the cost of obtaining additional information against the additional reliability that information will bring to the measurement"* (FASB 2000, 51). In other words, the expected cash flow approach is believed to be superior to other cash flow approaches, but the cost constraint may support other approaches. Furthermore, all of the qualities are subject to a materiality threshold. For example, information may be reliable even if it contains immaterial errors.

The qualitative characteristics can be divided into user-specific qualities and information-specific, or decision-specific, qualities. The FASB lists understandability as an important user-specific quality. The user-specific quality depends on who is considered the primary users of financial statements (chapter 3.1). To be useful the information must be new to the user, and the user must be capable of understanding the information.

The primary characteristics that make accounting information useful are reliability and relevance. Reliability requires verifiability, representational faithfulness (validity) and neutrality. Relevant information is information that makes an impact on the decision maker in a particular situation, and may be broken down into three components: Timeliness, predictive value, and feedback value. Information is relevant if it is timely and have predictive or feedback value.

Figure 3-2 ***Qualitative Characteristics***



(FASB 1980, 15).

3.2.1 Reliability

Verifiability is synonymous with objectivity, or the degree of consensus among measurers: *"The ability through consensus among measurers to ensure that information represents what it purports to represent or that the chosen method of measurement has been used without error or bias"* (FASB 1980, xvi). The essence of verification is agreement among a number of independent observers. The different items in financial statements carry different degrees of verifiability: *"As one goes down the asset side of the balance sheet, from more liquid to less liquid items, the degree of consensus among measurers is likely to dimish"* (Solomons 1986a, 91). It should be noted that reliability is not the same as precision. An imprecise measure can be reliable if the circumstances do not call for a high degree of precision: *"Compared with a chronometer, a wrist-watch (even a good one) is imprecise, yet we do not regard it as unreliable as long as it provides the degree of precision needed for daily timekeeping"* (Solomons 1986a, 91).

Prudence, or conservatism, is introduced as a dimension of verifiability by the FASB. There is no room for unwarranted and deliberate conservatism. Similarly, according to the IASB, reliability assumes a degree of caution in the treatment of uncertainty, but does not allow for the creation of hidden reserves or excessive provisions (IASB 1989, 37).

According to the IASB, prudence is closely related to neutrality (to be discussed shortly). Prudence represents secondary qualitative characteristics of accounting information according to the ASB (ASB 1995, 40, Kirk 1998, 14).[20]

Representational faithfulness means that the information represents the measures it appears to represent: *"Correspondence or agreement between a measure or description and the phenomenon it purports to represent (sometimes called validity)"* (FASB 1980, 27). Sterling presents the issue of representational faithfulness as follows: *"The question 'Should we recognize X as an asset?' is quite different from 'Is X an asset?" because the former admits the possibility of recognizing or not recognizing X as an asset without regard to whether it is an asset. If X is an asset (verifiably satisfies the definition of an asset) but is not recognized as such, then the financial statements are verifiably not representational faithful. And the same is true if X is not an asset but is recognized as such"* (Sterling 1985, preface).

A simple example related to the measurement problem may be helpful in understanding the concept. In determining the fair value of a listed entity in an efficient marked, the quoted price would act as a representational faithful measure. However, in determining the fair value of an unlisted entity, the latest trade price, which may be several days, weeks, or months old, may not be a representational faithful measure. The latter measure would indeed give rise to verifiability, and hence the example may serve as an illustration of the potential conflicts between verifiability and representational faithfulness.

Several examples may illustrate the FASB's inability to issue accounting standards providing representational faithfulness. For instance Statement of Financial Accounting Standards No. 87 (SFAS 87) allows for delayed recognition of actuarial gains and losses. Such "allocation" is not consistent with representational faithfulness. The solution was chosen not to force *"(...) to great a change from past practice"* (SFAS 87.107).

Unlike the FASB, the IASB has introduced the concept of substance over form as a necessity to achieve representational faithfulness ("faithful representation") (IASB 1989,

35). According to the IASB, transactions and other events must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. Even though the concept indirectly is referred to in the FASB Conceptual Framework as well, one may, in reference to the more rule-based accounting standards of the FASB, wonder if the lack of explicit reference in the FASB Framework is deliberate.

Neutrality means that the information is free from bias towards a predetermined result (FASB 1980, 99). If information is reliable, it can hardly fail to be neutral. The converse, that is, neutral information may not be reliable, may be true under certain circumstances. Commentators have argued that the need for neutrality in addition to reliability is redundant (Solomons 1986a, 101). In this authors view, however, these commentators fail to recognize that neutrality is one of the components the FASB believe reliability to have, and thus neutrality should not be understood as an additional characteristic.

The FASB is primarily concerned with so-called economic consequences when it refers to neutrality. The FASB refers to the belief that the policy-setting process should primarily be concerned with relevance and reliability rather than the effect a standard or rule might have on a specific user group or entity itself. The existence of economic consequences has of some been advocated as a proof of the inability of the FASB and others to achieve neutrality. By "economic consequences" is meant the impact of "outside forces" on the decision-making behavior of the users of the reports (Zeff 1978). It is argued that these outside forces tend to obscure the objectivity of the financial reports and impair the decision-making. Before, development of accounting policies was considered neutral. The fact that the FASB has commissioned research papers on the economic consequences of selected standards illustrates that these consequences are perceived to be significant. The public interest in accounting standards on business combinations, particular the goodwill issue, stock compensation arrangements, and foreign currency translation, further demonstrates the potential of economic consequences of accounting. Daley and Tranter argued that the conceptual frameworks ignores the role of economic and political pressures by the emphasizes given to the concept of neutrality, and that this choice limits the usefulness of the concepts statements: *"We believe this particular*

characteristic, which the FASB put forth as a desirable characteristic of accounting standards to have, is at the heart of the shortcomings of the CFP. (...) As long as the Concepts Statements ignore the compromises necessary to establish accounting principles in a political environment, SFASs will consistently deviate from the tenets contained in the SFAC" (Daley and Tranter 1990, 15).

3.2.2 Relevance

Relevant information is *"(...) capable of making a difference in a decision by helping users to form predictions about the outcomes of past, present, and future events or to confirm or correct expectations"* (FASB 1980, 21). To be relevant, the information must be capable of making a difference. Relevance must not be confused with the user-specific qualities. For instance, a piece of information may be relevant, that is, capable of making a difference, but it still may not be useful to a particular user group, if the user group already has the piece of information.

In addition to timeliness, relevance must be considered according to predictive and feedback value. The predictive value is obviously closely related to decision-making. Feedback value involves stewardship, or accountability: *"The view of stewardship use of accounting in no way diminishes its importance, nor does it elevate the predictive value of accounting information above its confirmatory value"* (FASB 1980, 12). In addition to being important in decision-making, feedback value is important in assessing how well management has done.

Some commentators have argued that predictive and feedback values under some circumstances are inconsistent with each other. An often-mentioned example in this regard is pension accounting. According to SFAS No. 87 the periodic pension cost should be measured based on the employees' expected future final salary levels, as opposed to current salary. It has been argued that future salaries, being subject to future events such as inflation, seniority, promotion and other relevant factors, such as supply and demand in the employment market, to a great extent will be the responsibility of future management, not current management. The FASB justified the use of future salary levels

on the grounds that prediction of future cash flows is the main objective of financial reporting. From the perspective of current management, representing an accountability view, future salary levels are simply irrelevant, according to these commentators. In summary, according to these commentators, pension accounting represents an example where measurements may be useful for predictive purposes, but less useful, under some circumstances not useful at all, for accountability purposes.

There are certain misunderstandings in the argument leading up to the conclusion. First of all, current management is responsible for the pension agreement entered into with the employees, and if the pension arrangement relies on future salary levels for the determination of the pension benefit, current management should be accountable for the costs in the arrangement. Secondly, the future management does not determine the current pension expense. Future management will be in charge of future salaries, but in the measurement of the current pension expense, only the expectations and salary policies of the current management are reflected.

On the other hand, from the perspective of the future management, the argument cannot be ignored. Future management was not involved in the designing of the pension agreement (assuming management has been replaced afterwards), and under certain circumstances it may therefore be somewhat misleading to evaluate their performance based on a income number reflecting the pension cost.

In other words, in the terminology used in discussion of decision usefulness in chapter 3.1, there may be a conflict between the decision making demand and the stewardship demand.

Feedback value and predictive value cannot always be judged separately. As the FASB puts it: *"(...) without a knowledge of the past, the basis for a prediction will usually be lacking, Without an interest in the future, knowledge of the past is sterile"* (FASB 1980, 51). In other words, feedback value is directly concerned with the past, but without feedback value the predictive value will be less.

3.2.3 Trade-Off Notion

> *"(...), standard setters are expected to consider conflicts between relevance and reliability of accounting information under alternative standards. Standards that over-emphasize credibility in accounting data are likely to lead to financial statements that provide less relevant and less timely information on firm's performance. Alternatively, standards that stress relevance and timeliness without appropriate considerations for credibility will generate accounting information that is viewed skeptically be financial report users"* (Healy and Wahlen 1999, 366).

Relevance and reliability are in many cases to some extent mutually exclusive, and the FASB claims that a trade-off between the two may be necessary: *"Although financial information must be both relevant and reliable to be useful, information may possess both characteristics to varying degrees. It may be possible to trade relevance for reliability or vice versa, though not to the point of dispensing with one of the altogether"* (FASB 1980, 42). The IASB is of the same opinion: *"In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment"* (IASB 1989, 45).

The trade-off between timeliness of producing financial statements and the reliability of the information reported in the statements issued is used as an example of the trade-off notion in the Canadian Conceptual Framework (CICA 1990, 25).[21] FRSB also adopts the trade-off notion. A trade-off between qualitative characteristics is of particular interest for relevance and reliability according to FRSB: *"For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognize the full amount of the claim in the statement of financial position, although it may be relevant to disclose the amount and circumstances of the claim in the*

NHH Norges Handelshøyskole
Biblioteket

notes to the financial report" (NZSA 1993, 6.2). The same example is used by the IASB (1989, 86).

The trade-off notion was not first introduced by the FASB. For instance Staubus applied a trade-off notion in the early seventies: *"Recognition of the basic relevance of up-to-date measures of resources consumed should not obscure the importance of reliability of accounting data. We must sometimes trade off some degree of relevance in order to gain grater reliability of the measure, (...)"* (Staubus 1971, 137). However, according to another important contributor, Chambers, the trade-off notion is meaningless: *"The concepts statements attach importance to the relevance, neutrality and objectivity of the information to be produced by accounting processes (...). However, no such obvious inferences were drawn in the concepts statements. The discriminating potential of the specified features was set aside. Indeed, it was overridden by the "trade-off" notion, as if there were some rate of exchange at which some "necessary" feature could be traded for another "necessary" feature. The idea is absurd. For if, say one-third of relevance were traded for one-quarter of neutrality, the result would be neither relevant nor neutral"* (Chambers 1996, 127).

Those claiming that a trade-off between the two is not possible argue that they are positively correlated. That is, if information is more reliable it is also perceived to be more relevant. However, even if a relationship exists, reliability and relevance are separable. Take for instance long-term construction contracts. The completed contracts method assumes in general no estimates, and replacing this method with the percentage of completion contract assuming uncertain estimates will represent a shift from more to less reliable financial information. Reliability is exchanged for relevance. The correlation concept and denial of the trade-off notion is not supported.

The trade-off notion established between reliability and relevance in SFAC 2 is to a great extent a carry over from SFAC 1, and the balance between decision-making demand and stewardship demand. Decision-making demand tends to favor relevance, while reliability typically supports the stewardship demand.

Under certain circumstances, one of the two has to be preferred over the other. Should the preferred characteristic be relevance or reliability? An impossible question to answer without having answered whether the decision-making demand or the stewardship demand should be the primary objective.

In their content analysis on all the accounting standards issued by the FASB in its first two decades, Hudack and McAllister (1994) found that the FASB emphasizes both relevance and reliability. However, in accounting standards dealing primarily with disclosure issues rather than recognition issues, a stronger emphasis has been given to relevance. Another study showed that users and preparers of financial statements tend to give more weight to relevance than auditors, who tend to emphasize reliability more than relevance (Kennedy et al. 1995).

The FASB seems to be leaning towards relevance as more paramount than reliability. For example, in SFAC 7 the equal importance of relevance and reliability is emphasized, but only as an introduction to the following opinion: *"The use of simplifying assumptions allows accountants to develop present value measurements that are sufficiently reliable and certainly more relevant than undiscounted measurements"* (FASB 2000, 73). In other words, less reliability than traditionally has been required is accepted if gain in relevance is achieved.

The IASB has generally adopted the position of the FASB. Also the IASB seems to prefer relevance to reliability. For instance, the IASB supported their preference for extended use of fair value measurements by reference to the conceptual frameworks "of various standard setters", and their emphasis on users ability to assess future cash flows for the reporting entity. The IASB Board showed by this view a preference for relevance, but admitted that the reliability in fair value measurements has to be considered an important characteristic. However, reliability should, according to the Board, be considered *"(...) a limiting factor on the use of fair values"* (IASB 2000, 14), and the Board seemed by this to downgrade the importance of reliability compared to the role this

characteristic has in the FASB Conceptual Framework. Furthermore, the Board argued that the Framework should be revised to give more guidance about the trade-off between relevance and reliability: *"The chapter of the Framework dealing with measurement is not as helpful at present as it could be. For example, the more can be said about how to assess reliability of fair value measurements in different situations and about acceptable levels of reliability, the more helpful the Framework will become"* (IASB 2000, 15).

As illustrated above, the trade-off notion seems to be of particular interest with respect to measurement bases. Historical cost is generally more reliable than current values, while the latter in most cases is the more relevant measurement base. As such, one may assume that relevance has gained relatively more support the last decades since fair value accounting has become more common. However, this assumption is not as obvious as it at first may seem, and before accepting it one must take into account the formidable development of the market places that has taken place over the same period of time. However, there is a tendency to use fair value accounting beyond effective market places (IAS 40 and IAS 41). This development is controversial.

3.2.4 Secondary Characteristics

According to the FASB, accounting information must meet a secondary qualitative characteristic in addition to the primary characteristics relevance and reliability. The accounting information should be comparative. Comparability is not a quality of information in the same manner as the primary characteristics, but relates to the quality of information in comparative analysis of entities or comparative analysis (cross-sectional comparability) of an entity over time (time-series comparability).[22] Comparability *"(...) is rather a quality of the relationship between the two or more pieces of information"* (FASB 1980, 116). This is why the FASB also refers to it as an "interactive quality". According to the IASB and the AcSB, comparability is a primary ("principal") qualitative characteristic. ASB in the UK considers, as the FASB, comparability as a secondary characteristics.

Comparability assumes consistency: *"(...) conformity from period to period with unchanging policies and procedures"* (FASB 1980, 116). Comparability and consistency will be an indirect result of a functional framework, rather than part of the theoretical structure itself. Comparability, however, is more than consistency. For instance, comparison of revenue figures over a ten-year period without consideration of the purchasing power of the monetary unit may indicate growth in the period even if real revenue has declined in the period. In this example there is consistency between the periods, but the comparability is weak.

Consistency in applying accounting methods over periods of time has always been regarded as a necessary quality of financial information. This does not imply that accounting principles should not be replaced at any time. If the consistency concept is pushed to far, progress in financial reporting may be hampered. For instance, that an entity has applied the completed contracts method in the past should not prevent it from applying the percentage of completion method in the future. Therefore, replacement of "less preferred accounting policies" with "more preferred accounting policies" is not considered in conflict with the consistency concept (FASB 1980, 122).

Comparability involves cross-sectional consistency as well as time-series consistency. Cross-sectional consistency cannot be obtained by one entity alone. One entity can control the time-series consistency, but in order for this entity to be comparable cross-sectional, accounting policies applied by the entity must be consistent with the accounting policies applied by the other entities in the industry.

Another important component of the comparability quality is the uniformity concept. Even if not explicitly stated by the FASB or the other leading standard setters, comparability assumes uniformity in the application of accounting policies. This is for instance explicitly stated in SIC 18. When IAS allow for different policies, there is an underlying assumption that the policy chosen is applied to all similar items. For instance, an entity may not apply LIFO for one group of inventories and FIFO for another group (SIC 1).

3.2.5 Underlying Constraints

The objective of decision usefulness implies a cost-benefit consideration along with a materiality judgment. That is, financial statements should communicate information according to the objective given that the benefits outweigh the costs of providing such information, and the information if omitted or misstated would influence or change a decision. In some of the conceptual frameworks these underlying constraints or assumptions are explicitly discussed (for example in the AcSB Conceptual Framework). This may seem redundant given that decision usefulness would be meaningless without a materiality consideration. Others (AASB) interprets materiality as a qualitative characteristic, while still others (FRSB in New Zealand) defines materiality as an "influence on qualitative characteristics".

The FASB considers the cost-benefit consideration a "pervasive constraint" and the materiality judgment a "threshold for recognition". As a general guideline, the FASB assumes that benefits of information provided should be expected to at least equal the cost involved. Generally, costs of providing financial information fall initially on the preparers, while the benefits are reaped by both the preparers and the users (FASB 1980, 136).[23]

Cost involved include more than the direct costs of providing the information (Elling 2000, 171). The FASB discusses the cost-benefit in both SFAC 1 on objectives and SFAC 2 on qualitative characteristics, and concludes in the objectives statement that *"(...) cost includes not only the resources directly expended to provide the information but may also include adverse effects on an enterprise or its stockholders from disclosing it"* (FASB 1978, 23). The inclusion of indirect costs in the cost-benefit consideration is important. If the cost-benefit consideration did not include indirect costs, an entity would generally be required to provide information that would hamper its competitive advantages. For instance, information about an entity's margins in service contracts may lead to more competition as well as more price sensitive customers. Thus, the direct costs in the equation may only represent part of the total costs of providing the information. On the other hand, competitors, customers, and suppliers may benefit from the information.

If these latter groups were considered among the primary users, an entity would be required to provide the information. However, the FASB has singled out the investors, the creditors, and their advisors as the primary users of the financial statements, and a cost-benefit consideration would therefore not allow for disclosure of the margins in the example here discussed.

FASB has elaborated the cost-benefit consideration in the Conceptual Framework. Even though the link between the cost-benefit consideration and the objective statement, including the ranking of the users, discussed above is not explicitly commented on, the FASB is concerned with it. For instance, according to the FASB, *"(...) comments about a pending lawsuit may jeopardize a successful defense, or comments about future plans may jeopardize a competitive advantage"* (FASB 1978, 23). Furthermore, the FASB puts emphasis on the investors when they recognize that the loss, or the indirect costs, to an entity, and thereby the investors, may be a gain to another party, for instance the customers, the suppliers, or the competitors, and concludes that *"(...), initiative, innovation, and willingness to take risks (...)"* should not be denied by discouraging financial reporting requirements (FASB 1980, 139). The concern of the FASB can only be interpreted to imply that in certain cases the benefits of other users than the investors are of less importance than the costs involved for the investors through their direct economic interest in the entity.[24]

The obvious problem of the cost-benefit consideration is that it is difficult or impossible in most cases to measure the benefits objectively, and as illustrated above, in certain cases it is difficult to measure the costs as well. Therefore, different persons will generally tend to disagree about whether the benefits of the information justify its costs. This problem is a result of the very nature of financial information. The market for information is less complete than the markets for other commodities, and thus it is up to the standard setters to determine what information is worth providing (FASB 1980, 135). This task represents an almost impossible challenge.

The costs and benefits of an accounting standard are direct and indirect, immediate and deferred, and nobody has so far been able to design an objective cost benefit calculation in quantitative terms. Therefore, it is difficult to see what the alternative to the current arrangement in which the responsibility of balancing benefits and costs is left with the standard setters, would be. The only alternative that might come to mind, to cease to be concerned about cost-effectiveness of accounting standards, was explicitly rejected by the FASB: *"To do so would be a dereliction of its duty and a disservice to its constituents"* (FASB 1980, 144).

The cost-benefit and the materiality constraints are considered along with the qualitative characteristics by the FASB. However, the FASB acknowledges that the materiality is something else than the primary qualitative characteristics. It "relates" in some way to relevance and reliability, the two primary qualitative characteristics, according to the FASB.

Certain commentators have claimed that the inclusion of the materiality constraint is redundant since only material information can be relevant. However, this is only partly true, according to the FASB: *"(...) the two concepts can be distinguished. A decision not to disclose certain information may be made, say, because investors have no interest in that kind of information (it is not relevant) or because the amounts involved are too small to make a difference (they are not material)"* (FASB 1980, 125). This distinction is not very clear. If investors (and the other users of financial reports) are not interested in a particular kind of information, then it can hardly be material, or relevant, to these users. In other words, this author tends to agree with those claiming that the materiality constraint is redundant in a conceptual framework where relevance is a primary qualitative characteristic. The IASB discusses materiality as part of the relevance quality, an approach that is more in line with the arguments outlined here.

The distinction between reliability and materiality is less subtle. For instance, the following is an example that the FASB uses to explain the difference between the two concepts: Salary information accurate only to the nearest thousand might not be

acceptable to a job applicant if the estimate is eight thousand, while it most likely will be acceptable if the job pays around hundred thousand (FASB 1980, 127).

One aspect, discussed in chapter 3.1.3, is the informational content financial statements should provide. Another related and important issue is how the information should be presented. Understandability is considered an underlying constraint by the FASB. The IASB, the ASB in the UK, and AcSB consider understandability as a primary, secondary, and "principal" qualitative characteristic, respectively. Understandability is also a qualitative characteristic in the New Zealand Conceptual Framework (NZSA 1993).[25] Should the information be presented in a form that facilitates uneducated readers, or should the presentation in the financial statements assume a certain level of financial and technical competence on behalf of the users? The latter represents the position taken by the FASB: *"(...) those who have a reasonable understanding of business and economic activities and are willing to study the information with reasonable diligence"*"(FASB 1978, 16).[26] The FASB focus on users that are willing to learn to use the information properly, not necessarily professionals, and relevant information should not be excluded merely because it is difficult to understand. On this issue the FASB apparently departs from the position taken in the Trueblood Report, in which the users were assumed to be of "limited ability". Considering that SFAC 1 seems to be "generally a boiled-down version" (Wolk et al. 2001, 209) of the Trueblood Report, this departure may come as a surprise. However, the limited ability objective of the Trueblood Report was according to commentators the most misunderstood of the twelve objectives in the Report: *"Although it may be interpreted to mean that financial statements should serve those with "limited ability", that was not the study group's intention"* (Sorter and Gans 1974, 6). According to these commentators "limited ability" simply meant to be a code for full disclosure and broad, general-purpose statements.

3.2.6 Suggestions

Joyce et al. tested what they believe are three necessary conditions for SFAC 2 to facilitate standard setting (Joyce et al. 1982). Qualitative characteristics should be operational ("convergent validity"), comprehensive in that they represent all factors that

are important for making accounting policy choices ("predictive validity"), and discriminant in that there should be a minimum of overlap in meaning among them ("discriminant validity").[27] They found that only two of the characteristics are operational, namely verifiability and the cost-benefit constraint. SFAC 2 was found to be comprehensive, but the discriminant validity was poor. Furthermore, they found that representational faithfulness had no common meaning at all. The result from their study must be interpreted in light of when the test was conducted. The same study would presumably give SFAC 2 a higher score if conducted today, given that the Statement and the concepts therein should be more familiar now.

In this author's opinion, SFAC 2 represents a valuable contribution to the discipline of accounting. The FASB has managed to organize the qualitative characteristics in a logical and consistent system, and thus creating a useful tool for accounting standard setting.[28] However, the tendency to regard relevance as the paramount qualitative characteristic seems to be inconsistent with the balancing of decision-making and stewardship demand in SFAC 1. A consequence of the proposal of this author to let decision making demand be the primary dimension of the decision usefulness objective would be to resolve this inconsistency: Relevance should be considered the paramount qualitative characteristic.[29]

In this context however, it is important to recognize that relevance is made up of three distinct components, timeliness, predictive value, and feedback value. The two former components are of particular significance when emphasis is put on decision-making demand. Recent research has indicated that timeliness and predictive value may be mutually exclusive characteristics, thus adding another level to the trade-off notion discussed in chapter 3.2.3. In particular, Zhang (2003) found that early revenue recognition policies reflect the economies underlying an entity's revenue generating transactions more timely than other revenue recognition policies, while early revenue recognition policies tend to reduce the predictive power of revenue. The intention here is not to research these findings further, but rather to acknowledge that there may be grounds to further develop the concept of relevance in the conceptual frameworks.

When Staubus argues that traditional historical cost accounting should be replaced by some form of cash flow based accounting, at least to modify the historical cost accounting, he suggests an approach to balance relevance and reliability similar to the approach here suggested: *"We believe that a careful analysis of the needs of users of accounting data will disclose that the property of noncash assets that is most relevant to most decisions of investors and managers is their incremental effect upon the present value of the firm's future cash flows. Other measurement methods can be ranked behind discounting on the criterion of relevance. With these rankings in mind, the accountant can compare his assessment of the reliability with which several measures can be applied in the specific case against their relevance rankings and choose that measure which he believes will provide the most useful information"* (Staubus 1970, 69).

A likely consequence would for instance be that the stock based compensation expense would be based on the underlying option's fair value (SFAS 123) instead of the intrinsic value at the grant date (Accounting Principles Board No. 25, APB 25). Aboody et al. found that investors view stock-based compensation expense as an expense of the entity (Aboody et al. 2001a). Opponents of SFAS 123 argued that disclosure in footnotes (APB 25) should be preferred *"(...) because they claimed it was not possible to measure reliably stock-based compensation expense"* (Aboody et al. 2001b, 9). When the decision making demand is to be met, on behalf of the stewardship demand if necessary, then the reliability argument is relatively less significant than the relevance argument, and based on findings as the one here referred to, recognition of stock-based compensation based on fair values would be difficult to reject.[30]

3.3 Concluding Remarks – Summary of Suggestions

SFAC 1 and SFAC 2 are apart from the rest of the Conceptual Framework important contributions to the field of accounting, and accounting standard setting in particular. These statements benefited greatly from the earlier works of APB, AICPA, and AAA, and the FASB managed to tie the remaining loose ends from these earlier projects in SFAC 1 and SFAC 2.

In conclusion, there is general agreement among the leading standard setters about which qualitative characteristics should be emphasized in financial information. The apparent differences are terminological, and the hierarchy of qualitative characteristics is in substance common.

Based on the analysis of SFAC 1 and SFAC 2, one may get enthusiastic and optimistic about the prospects of a conceptual framework project. The accounting standards dealing with segment reporting and discontinuing operations for example, are direct results of the decision usefulness objective and the demand for information useful in the prediction of future cash flows. The FASB and the followers, the other leading standard setters, did struggle with the next levels of the framework project, definitions, recognition, and measurement.

It is proposed in this chapter that certain of the difficulties the FASB met at the next levels could have been given different, more meaningful solutions if the following insights had been evaluated:

- More strict focus on the common needs of short-term and long-term investors, that is, the decision making demand.
- Adoption of relevance as the paramount qualitative characteristic.

---

[1] This section has benefited from comments and remarks made by Michael Chetkovitch Professor Emiritus of Accounting at Walter A. Haas School of Business, UC Berkeley, George J. Staubus.

[2] Decision makers may be all stakeholders or users (including current and potential providers of debt and equity capital (referred to as creditors and investors in this essay), providers of labor (employees), financial intermediaries (auditors, financial analysts, bond rating agencies etc.), regulators, suppliers, and customers).

[3] The decision-usefulness objective was already in 1954 proposed in a dissertation submitted by Staubus to the University of Chicago faculty (Staubus 1977, 21), and also R. J. Chambers stressed the decision-usefulness objective in his "Blueprint for a Theory of Accounting" as early as 1955 (Staubus 1977, 23). The decision-usefulness objective is also emphasized in Staubus 1958, 1959, and 1961. Note that Staubus referred to the decision usefulness approach as "accounting to investors". Also, AAA recognized the

decision-usefulness criteria in their revision statement of Accounting and Reporting Standards for Corporate Financial Statements as early as 1957, when it was stated that the primary emphasis should be given to *"(...) the use by investors of published financial statements in making investment decisions and in exercising control over management (...)"* (AAA 1965b, 312). AAA did follow up its emphasis on decision usefulness in 1966 in ASOBAT (AAA 1966). This is noteworthy, given that APB No. 4 (1970) was the first AICPA document to recognize the decision-usefulness criteria.

[4] Initially, decision usefulness as the overall objective of financial reporting did not receive full support. In a survey of reactions to the Trueblood Group's objective in 1974, only 37% approved the "usefulness" objective (Solomons 1986b, 67).

[5] Solomons seems to be of the opinion that the reporting uses have suffered from the predictive uses of financial statements in the FASB Framework (Solomons 1986a, 70).

[6] Some commentators, for instance Staubus, one of the first to recognize the importance of accounting objectives and decision-usefulness, showed less interest in this issue (Staubus 1977, 30).

[7] "Corporate governance" is a common subject in empirical accounting research currently. Corporate governance relates closely to what is termed "stewardship demand" and "accountability" in this paper. Corporate governance regards the separatation of ownership and control, and the agency cost problem.

[8] In SATTA stewardship was actually viewed as a special case of decision-making demand: *"The primary objective of accounting is to provide financial information about the economic affairs of an entity to interested parties for use in making decisions. This objective statement is a premise, which most people seem to find acceptable, subject to slight variations. But it may not be suitable unless one interprets 'decisions' broadly. For decisions to encompass the control objective, the term must include making choices about the investigation of variances, choices of employees of honest or dishonest course and treatment of offending employees. If such an interpretation is not acceptable, a second objective – the control objective – must be given equal billing"* (AAA 1977, 13).

[9] Staubus (1972) explained carefully why investors should be regarded the primary users of financial reports.

[10] *"The primary users of financial information are the members of management of the companies whose results are being reported"* (Borst 1981, 12).

[11] *"Establishing objectives should not be confused with setting standards. The function of objectives is to point out the direction, not to prescribe how we should get there. If objectives were to be stated in overly precise terms, they would fail to fulfill their role. Instead, they would require more and more interpretations, finally resulting in gamesmanship where techniques become more important than goals"* (AA 1984, 9).

[12] According to Miller (1985), a conceptual framework cannot both describe and prescribe existing and future practices, respectively.

[13] Accounting for business combinations were up to July 2001 regulated by APB 16 in the US. Accounting for acquisitions as pooling was allowed for under certain circumstances. This set of rules could hardly be

explained by reference to the decision usefulness objective, but was rather a consequence of strong political pressure. SFAS 141 replaced APB 16. According to the current standard all business combinations shall be accounted for as acquisitions. However, this change in policies is accompanied by a change in accounting rules for goodwill. Goodwill was before to be amortized, while the current rules apply a non-amortization approach (see chapter 5.3.4). The non-amortization approach was introduced when the FASB in the process of changing the rules experienced strong objections to the abandoning of the pooling of interests method. However, interestingly enough, there is conducted research supporting the non-amortization approach from a decision usefulness perspective (Moehrle et al. 2001).

[14] Mozes (1998) explains the conflict between the Framework and US GAAP for accounting for stock-based compensation, and in his opinion the inconsistency is unavoidable because the Framework does not provide accounting model or view for such economic events.

[15] The reader should not be fooled by Yu's obvious lack of originality indicated by the choice of book-tittle. The book builds on novel ideas organized and structured in a coherent manner.

[16] In order to make their decisions, investors need cash flow oriented information. How to define this information, as stocks or flows (of cash flow potential), is assessed in chapter 4.

[17] Owners, or investors, make decisions in two major categories, according to Staubus (1977): (1) Investment decisions, to buy or not to buy, to sell or to hold, and (2) voting decisions at shareholder meetings. Staubus concludes after his explorations that the first decisions, the investment decisions, are the decisions financial statements primarily should provide information about, that is, *"(...) evidence of its present cash balance and of future cash flows"* (Staubus 1977, 112).

[18] The assumption that short-term investors do not emphasize stewardship demand does not convey that they necessarily do not consider long-term earnings trends. So-called day-traders tend to rely on other forms of information than financial reports, rumors etc., while the institutional investors tend to be concerned with the long-term earnings trends.

[19] Others, for instance Flegm (1989), disagree. According to Flegm, short-term investors are only interested in quick profits from value arbitrage, and thus may have an informational demand conflicting with the long-term investors and management. The two latter groups will, according to Flegm, demand information that can best be served through *"(...) reliable, transaction-oriented, objective, historical-cost (...)"* based information, and the demands of these two groups should be prioritized in financial accounting (Flegm 1989, 94)..

[20] Solomons (1986a, 99) discusses prudence, or conservatism as a qualitative characteristic.

[21] The trade-off notion between relevance and reliability is considered a separate qualitative characteristic in the Canadian Conceptual Framework: *"Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgement"* (CICA 1990, 24).

[22] The secondary qualitative characteristics are what Wolk et al. (2001) refer to as "output-oriented principles". Output-oriented principles involve certain qualities or characteristics that financial statements

should possess if the input-oriented principles are appropriately executed. Input-oriented principles include recognition, matching, conservatism, disclosure, materiality, and objectivity in their hierarchy.

[23] The FASB refers to *"(...) improved access to capital markets, favorable impact on the enterprise's public relations, and so on"* (FASB 1980, 136) as the potential benefits to the preparers. Thus, one can assume that the FASB identifies preparers with owners, the shareholders. As long as the shareholders are included in the primary user group, it seems redundant to list both preparers and users as potential beneficiaries. Accordingly, the IASB refers only to the users, both with respect to the costs and the benefits (IASB 1989, 44).

[24] Interestingly, an IASB position on the benefit-to-whom issue cannot be derived from the IASB Framework (IASB 1989, 44). Surprisingly, the ASB in the UK has not commented on the cost-benefit consideration at all (ASB 1999).

[25] Understandability is one of two primary qualitative characteristics of the French framework (Walton 1996). The emphasis OEC puts on matching as a secondary qualitative characteristic is, however, more surprising. In other conceptual frameworks, matching of revenues and expenses is a feature at level four, recognition. OEC's focus on matching, as a qualitative characteristic is one of the choices made that is difficult to support. These and other inconsistencies and peculiarities made Walton conclude his evaluation of the French framework as follows: *"While it is certainly an intriguing idea to draw up a conceptual framework for French accounting, on the whole the result is disappointing "* (Walton 1996, 61).

[26] The AcSB Framework is generally in accordance with the FASB Framework, and one may in certain cases be lead to believe that the AcSB Framework is nothing more than a copy of the FASB Framework. For instance, there is little originality when AcSB explains the level of competence of the user groups of financial information by the exact same wording as the FASB (CICA 1990, 19).

[27] Joyce et al. (1982) tested the qualitative characteristics through a set of interviews. They applied the multitrait-multimethod matrix of Campbell and Fiske (1959) to assess whether the qualitative characteristics were operational, testing for comprehensiveness involved assessing the ability of an estimated linear model for each policy maker (the interviewee) to predict that person's accounting policy preferences, and a direct test of parsimony was performed to assess the discriminant validity of the qualitative characteristics.

[28] See for example SFAS 141.B127-B135. Here the application of the qualitative characteristics in standard setting is demonstrated.

[29] The role of relevance is less significant under the stewardship demand: *"In the accountability-based framework, usefulness of accounting information and its relevance to decisions, its faithfulness in representing economic reality, and its other related desirable properties are not of primary importance"* (Ijiri 1983, 78). Under this demand, the quality of objectivity and verifiability is the primary qualitative characteristics.

[30] The stock-based compensation example relates the relevance-reliability issue to initial measurement, or measurement of transactions. The same issue applies to subsequent measurement, for instance the measurement of a financial instrument already on the balance sheet.

4. Recognition

> *"(...) the FASB's Conceptual Framework and a series of recent SFAS (...) challenge two concepts, matching and historical cost, as the cornerstone of income determination"* (Evans 2002, 195).

How to recognize revenue and expense has puzzled academicians, standard setters and professionals for decades, not to say centuries. The growth of the so-called New Economy has stressed the practical implications of revenue recognition in particular[1]:

On December 14, 2000 the SEC announced the settlement of three separate enforcement actions against (1) MicroStrategy Inc., (2) its vice president of finance and its accounting manager and (3) the company's top three officers. In the Release, the SEC alleged that from the time of its initial public offering in June of 1998 through March 2000, MicroStrategy Inc materially overstated its revenues and earnings due to various revenue recognition problems. On March 20, 2000 MicroStrategy Inc announced that it intended to restate its financial results for fiscal years 1999 and 1998; the market share price fell by 60% in a single day and ultimately the market cap declined by about $10 billion.

The MicroStrategy-case is not exceptional, but illustrates the practical implications revenue and expense recognition may have on share prices, the ultimate criterion to measure business success by, according to many investors.

Other examples of practical implications of revenue and expense recognition may include the following:

- Management evaluation, which may have a direct effect on salaries and bonuses and in some cases, may be critical for management in order to maintain their jobs.
- Distributable income, and thus dividend payments.
- Credit standing, and thus the cost of capital.
- Income tax in some jurisdictions.

It is therefore not surprising that income figures are considered to be decision useful information. There are two conceptually different approaches to income determination, the Asset-Liability view (the A-L view) and the Revenue-Expense view (the R-E view), which will produce different income figures under certain circumstances. In the former view, which is adopted by all the leading standard setters, the definitions of the elements in the financial reports play a critical role. In the latter view, which traditionally has been dominating accounting practice, two accrual concepts, the earned revenue concept (revenue recognition) and the matching concept (expense recognition), are of primary importance. Furthermore, the income numbers will vary with different measurement attributes.

The following four criteria must be met before recognition according to the FASB:

1. The item must meet the definition of the relevant element.
2. The item can be measured. That is, there must be relevant measurement attributes associated with the item, and the item can be measured reliably.
3. The information must be relevant, which means that the information should be of importance to the decision maker.
4. The information should be reliable, including verifiability, faithful representation, and neutrality.

The other leading standard setters have essentially adopted the same criteria for recognition[2]. The two last criteria is basically an application of the qualitative characteristics (chapter 3). The four research questions suggested in chapter 1, all refers to the definitions, and it is the first criterion that will be given particular emphasis in this chapter. However, the second criterion, measurement, will also be discussed.

The remainder of this chapter is organized as follows. The interdependence between recognition, measurement, and the definitions is investigated in chapter 4.1. Measurement is explored in chapter 4.2, and the definitions of the elements are discussed in chapter 4.3.

The underlying perspective in the conceptual frameworks, the A-L view, as well as the conflict between the A-L view and the R-E view are explored in chapter 4.4. The accrual concepts, even though not emphasized in the A-L view, will be elaborated in chapter 4.5. To conclude the chapter, achievements in the A-L view are discussed based on different commentators' assessments in chapter 4.6. This last section will represent a relevant background for the analysis of the applicability of the A-L view conducted in chapter 5.

4.1 Dimensions of Recognition: Measurement and Definitions

Recognition represents one of the three lower levels of the FASB Conceptual Framework. Definitions of elements and measurement represent the two other levels. Thus, definitions, recognition and measurement appear to be three separate issues in the FASB Conceptual Framework. However, the separation of recognition and measurement issues will often lead to incomplete and to some extent meaningless arguments. Furthermore, given that the definitions' primary function is to act as one of four recognition criteria, it seems appropriate to integrate the discussion of definitions, recognition and measurement: *"At base recognition is nothing more than the intelligent application of definitions"* (Sterling 1985, 39). The heading in this chapter, "Recognition", implies that definitions and measurement are considered to be dimensions of the general recognition issue. That is, measurements of transactions (initial measurement), and subsequent measurement of the items already on the balance sheet, and the application of the definitions are regarded as recognition issues.

Technically, according to the FASB, recognition is *"(...) the process of formally recording or incorporating an item into the financial statements of an entity"* (Johnson and Storey 1982, 2). The relationship between recognition and measurement is not obvious from this definition. The second recognition criterion in the FASB Framework indicates a close relationship between recognition and measurement. Furthermore, knowing the first recognition criterion in the FASB Framework as listed in the introduction of this chapter, the role of the definitions fall under recognition.[3]

Sterling defines recognition as *"(...) the display of words and numerals in financial statements"* (Sterling 1985, 2). Others have tried to give recognition a more semantic interpretation: *"Recognition attempts to represent or depict in financial statements the effects on an entity of real-world things and events"* (Johnson and Storey 1982). Both these definitions are wide and inclusive, and may be interpreted to include both measurement and the definitions.

Let us put the definitional discussion aside, and attempt to analyze the substance of the concepts. Even if the FASB discusses recognition and measurement in the same concepts statement, it is clear that recognition is assumed to come before measurement. According to some commentators recognition criteria cannot be dealt with unless the measurement attributes have been determined: *"By dealing with recognition ahead of measurement, the FASB put the cart before the horse. The issue of when to recognize an element cannot be discussed until we know the measurement characteristics that are to be recognized. This is the shortcoming of SFAC No. 5"* (Wolk et al. 2001, 228).

In SFAC 7, dealing with present value measurement, measurement and recognition are separated. Only measurement issues are dealt with in the statement. However, the FASB acknowledges that recognition and measurement are related to one another (FASB 2000a, 13). As a matter of fact, interaction between recognition and measurement is "inescapable" according to the FASB (FASB 2000a, 57). Solomons gives the following example to illustrate the close interaction between recognition and measurement: *"(...) for the question whether profits on uncompleted construction contracts or interest on the investment in assets under construction should be recognized is simply another way of asking how construction contracts or assets under construction should be stated in the balance sheet"* (Solomons 1986a, 126). Thus, the close interaction between recognition and measurement makes separation of the two somewhat conceptually artificial and meaningless (Johnson 1994, 4).

Furthermore, under certain circumstances, measurement and the definitions of financial statement elements are linked. As will be discussed in chapter 4.4, in the A-L view

income is determined by the changes in net assets, and recognition is viewed as the process of incorporating in the financial statements items that meet the A-L definitions and the other criteria for recognition. As pointed out by several commentators; *"This is all very well, provided that the issues of measurement and capital maintenance have already been settled. However, this is clearly not the case, with the result that the FASB is either restricting itself in the future development of different accounting models for different purposes, or it might have to develop different definitions of the elements of financial statements as different models are developed"* (Davies et al. 1997, 59). ASB in the UK found it necessary to deny that the A-L view, particularly the interpretation that only items meeting the definitions can be recognized, downgrades the transaction-based accounting model. In the document "Statement of Principles for financial reporting - the way ahead", the ASB argued that the A-L definitions is simply a recognition criterion in the accounting for transactions: *"Some believed that the Board's focus on assets and liabilities would undermine reporting based on the recognition of transactions. The Board's intention is simply to add a measure of discipline to the recording of transactions"* (ASB 1996, 5).

The close relationship between measurement and definition application can further be illustrated by how the IASB proposes to treat contingent liabilities in ED 3 Business Combinations. The position of the IASB in the exposure draft is that even though contingent liabilities do not meet the recognition criteria of IAS 37 Provisions, Contingent Liabilities, and Contingent Assets, and the IASB Framework, a reliable estimate of their value can normally be made in business combinations, and they are therefore to be recognized.

Based on the above, it should be clear that it is meaningful to consider measurement and the definitions of the elements as dimensions of the broader recognition concept. For one thing, considering the de-emphasized role of the accrual concepts in the conceptual frameworks, the recognition concept would be relatively empty if the separation approach was applied. Furthermore, meaningful discussion on measurement and the definitions

would be difficult if not considered in the context of recognition and in the context of each other.

As illustrated by the research questions in question 1, the focus in this dissertation is on the usefulness of the A-L definitions. The leading standard setters have traditionally adopted a transaction based historical cost model. Thus, in this and the following chapters, the usefulness of the A-L definitions will primarily be analyzed in a historical cost model context. First, however, the approaches to measurement in the conceptual frameworks will be discussed.

4.2 Measurement

Measurement issues may be classified into two main categories; namely initial transactions measurement and subsequent measurement. It is generally accepted that initial transactions should be measured at cost.[4] Cost is normally an observable marketplace-determined amount, and initial transaction measurement is therefore typically not associated with controversies. A few exceptions exist. For instance, barter transactions in which goods or services are exchanged for goods or services may not provide the parties involved with an observable market price. In particular, when goods or services are exchanged for similar goods or services, measurement of the initial transaction can raise difficult questions. In the following, measurement refers to measurement subsequent to the initial transaction, unless otherwise stated.

In general terms, one can describe the measurement issue as a question of whether historical cost should prevail as the one basic measurement attribute, or if historical cost accounting should be modified or replaced by some sort of value-based accounting.

In SFAC 5 five alternative measurement attributes are described: (1) Historical cost, (2) current (replacement) cost, (3) current market value, (4) net realizable value[5], and (5) present value of future cash flows.[6] Current cost is often referred to as a value-based system (for instance Nobes 2001, 11). However, current cost is cost-based, not value-based. Thus, the first two attributes are cost-based, and the next two are value-based. It is

somewhat peculiar that present value of future cash flows is included in the list of measurement attributes. Present value of future cash flows is rather a measurement technique applied when the relevant measurement attribute is not observable (FASB 2000a, 1).

"Fair value" is not one of the listed measurement attributes. Considering the extensive use of the term in current accounting literature, this may come as a surprise. The fair value term was in use in US accounting literature before the founding of the FASB. For instance, in APB 16 (1970), the predecessor of SFAS 141 Business Combinations, the fair value term was applied. The FASB did not initially use the term. For instance, there is no reference to "fair value" in SFAS 12 Accounting for Certain Marketable Securities (1975). In more recent accounting standards, for instance SFAS 107 Disclosures about Fair Value of Financial Instruments (1991), SFAS 115 Accounting for Certain Investments in Debt and Equity Securities (1993), SFAS 133 Accounting for Derivative Instruments and Hedging Activities (1998), SFAS 141 Business Combinations (2001), and SFAS 142 Goodwill and Other Intangible Assets (2001), to name a few, "fair value" is the primary measurement term. In the UK, the fair value term first appeared in an accounting standard in the context of capitalized leased assets in SSAP 21 (1984) and in the context of business combinations in SSAP 22 (1984) (Nobes 2001, 11). The IASB first referred to "fair value" in IAS 16 Property, Plant, and Equipment (1982).

Even though slightly different interpretations of the fair value concept exists, "fair value" is customarily defined as the amount at which an asset would be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's-length transaction (Skinner and Milburn 2001, 81). Similarly, the "current market value" term used by the FASB in the Conceptual Framework is defined as *"(...) the amount of cash, or its equivalent, that could be obtained by selling an asset in orderly liquidation"* (FASB 1984, 67). The implication of the wording "orderly liquidation" is somewhat unclear, but it is here assumed that emphasis is to be put in "orderly" and not "liquidation". Thus, "fair value" seems to be similar to "current market value" as defined in the FASB Conceptual Framework, even though the definition in SFAC 5 is limited to asset valuation

(interestingly, the IASB uses the same wording to define "realizable value" (IASB 1989, 100), which is a term used to define a net value, after transaction costs, in the FASB terminology). Thus, both definitions assume going concern and omit transaction costs.

In a discussion paper in 1997, the IASB concluded that "fair value" is analogous to "current value" as used in UK GAAP (IASB 1997, 2.2). However, it has been pointed out that "current value" is a generic term, while "fair value" is just one particular version of current value (Nobes 2001, 12). Fair value is an estimated current market value when the latter is not directly observable.

In the following, the terminology derived from the above discussion will be applied. Generally, value accounting will be referred to as "fair value accounting", but the underlying values will be referred to as "current values". If necessary in the context, the reference will be to "fair value", implying that the current values are not necessarily observable.

Historical cost accounting has prevailed, but the proponents of value-based accounting models have been numerous over time, and the historical cost model has been modified. The modification has generally been developed through the introduction of fair value accounting for certain current assets, and through the introduction of present value techniques of expected cash flows under certain circumstances. That discounting first became part of the FASB Conceptual Frameworks in 2000 (SFAC 7), sixteen years after SFAC 5 about recognition and measurement was issued, is remarkable. Furthermore, the other leading standard setters still have not incorporated the objectives and conceptual basis for using present value techniques in financial accounting measurement in their conceptual frameworks (FASB 2000a, 10).

Present value techniques have been applied, however, in certain specific areas. The FASB and the other leading standard setters require the use of present value calculations in pension accounting, and discounting has been applied to a certain extent in accounting for leasing contracts and financial instruments. The leading standard setters have generally

prohibited present value measurement in accounting for deferred taxes. Present value measurement of deferred tax represents an allowed alternative under certain circumstances in Norwegian GAP.

Roman L. Weil conducted an analysis of the use of discounting in US GAAP in 1990, and he concluded as follows: *"The review and analysis here suggest that accounting treats discounting haphazardly, that inconsistencies have arisen in practice, and that a single conceptual set of criteria consistent with the historical cost accounting model exists to achieve coherence in historical cost accounting for amounts of cash paid or collected in the future. One might wonder why the FASB's conceptual framework has not been more successful in dealing with these issues"* (Weil 1990, 60). Present value measurement is crucial to initial transaction measurement. Transactions are to be measured at cost in a transaction-based accounting model. Cost refers to the time of the transaction, and when payment is made before or after the transaction, the nominal amount implied in the transaction agreement does not represent the best estimate of the transaction price. The time value of money and the risk involved has to be accounted for. When these two components are material and not specified in the exchange agreement, typically in the form of an interest rate, they have to be estimated. The FASB approached the challenge when they initiated their present value project in 1998 (SFAC 7).

4.2.1 The Evolutionary Approach

When the FASB in 1984 released SFAC 5 they concluded that no one measurement attribute is superior to the other measurement attributes in all situations: *"Rather than attempt to select a single attribute and force changes in practice so that all classes of assets and liabilities use that attribute, this Concepts Statement suggests that use of different attributes will continue, and discusses how the Board may select the appropriate attribute in particular cases"* (FASB 1984, 25). The same conclusion was also reached at an earlier stage in the project, in the discussion on objectives: *"The Study Group believes that the objectives of financial statements cannot be best served by the exclusive use of a single valuation basis. The objectives that prescribe statements of earnings and financial position are based on the user's need to predict, compare, and evaluate earning*

power. To satisfy these information requirements, the Study Group concludes that different valuation bases are preferable for different assets and liabilities. That means that financial statements might contain data based on a combination of valuation bases" (FASB 1978, 41).

The FASB could not agree that one particular measurement attribute for all assets and liabilities were in concept the most relevant. Furthermore, they could not agree with reasonable specificity on the circumstances in which a particular attribute was the most relevant. However, eventually there was agreement that *"(...) information based on current prices should be recognized if it is sufficiently relevant and reliable to justify the costs involved and more relevant than alternative information"* (FASB 1984, 90). The FASB approach implies an underlying transaction-based historical cost approach to measurement, with fair values representing a modification of the underlying approach whenever current values can be observed in the marketplace or reliably estimated. As such, one may describe the FASB approach to measurement as a historical cost approach modified by fair values under certain circumstances.

The IASB and the other leading standard setters have like the FASB chosen not to recommend one single measurement attribute.[7] For instance, the different attributes assigned to financial instruments and non-financial assets illustrates this choice: *"One of the challenges is to distinguish financial instruments from non-financial assets and liabilities, and to demonstrate that an accounting system reflecting historical cost and realisation-based principles for non-financial assets is not inconsistent with contract-based recognition and fair valuation of financial instruments"* ("Accounting for financial assets and financial liabilities", discussion paper, IASB 1997, 26). Also, the Norwegian Accounting Act is founded on the historical cost model, but certain financial assets should be measured at fair values.[8]

ASB in the UK showed initially preference for fair value accounting: *"The Board therefore believes that practice should develop by evolving in the direction of greater use of current values to the extent that this is consistent with the constraints of reliability and*

cost" (ASB 1995, 93). However, in their document "Statement of Principles for Financial Reporting-the way ahead", ASB chose to adopt a view more consistent with the views of other leading standard setters: *"The Board believes that, as has been the case for many years, current value measures should be used when other measures such as historical costs are clearly ineffective, particularly in new and emerging areas"* (ASB 1996, 7).

Similarly, FRSB in New Zealand does not make any commitment to one single measurement attribute, and concludes that *"(...) it is unlikely that any single measurement base can cater for every need or would be sufficiently reliable for financial reporting in all circumstances. Hence it is desirable to apply a system that chooses the measurement base most appropriate to the circumstances"* (NZSA 1993, 9.10).

Not surprisingly, the FASB and other standard setters have been criticized for not being sufficient conclusive in their dealing with the alternative measurement attributes: *"They have largely left open questions as to the relative merits of different capital maintenance systems and historical costs, current costs, and current value measurement attributes"* (Milburn 1991, 43).

The inability of the FASB to propose changes to existing practices provoked certain commentators: *"SFAC No. 5, particularly paragraph 2's statements to the effect that change should occur in a gradual and evolutionary manner, effectively stymied reform, at least for the time being"* (Wolk et al. 2001, 229). The FASB's reliance on the evolutionary process was termed a "cop-out" by some (Solomons 1986b, 122)[9]. In Solomon's opinion, the approach of the FASB implied that if a change were called for, it would have to come gradually, through a process of evolution, not as a result of the Conceptual Framework (Solomons 1986b, 116).

The evolutionary approach taken by the FASB was partly a result of the experiences of American Institute of Certified Public Accountants (AICPA) when they proposed that financial reporting should be based on current values in ARS No. 1 and in ARS No. 3 in

the early sixties: *"The response to these two studies, (...), was swift and fairly dramatic. They were issued with a loose insert stating that they were not acceptable to the Board because they were too different from generally accepted accounting principles at the time"* (Hendriksen and van Breda 1992, 101).[10] Consequently, APB rejected them.[11] Similarly, in the UK, the ASB Conceptual Statement *"(...) concludes with the view that practice should evolve over time with the greater use of current values to the extent that this is consistent with the constraints of reliability and cost"* (Kirk 1998, 14). Taking into consideration the experiences ASC had with SSAP 16, the UK approach is not the least surprising.[12]

Measurement was the single subject at a symposium at the School of Business at the University of Kansas in the 1970. The idea of the Symposium was to bring together representatives from each school of thought so that they could present and defend their positions and then, in turn, join in the discussions of the other positions. Ijiri defended historical cost accounting, Bell represented the current replacement cost and business income school of thought, Staubus explained the relevance of cash flows in accounting, and Chambers tried to convince that his "Market-Selling Price-Accounting System" was the best model. Others presenting their ideas at the Symposium included Solomons, Vatter, Bevis, and Bedford. A group of the same prominence and competence in the field of accounting measurement has not often met, not before and not after the 1970 Symposium. It was hoped that the Symposium would result in the resolution of some of the differences between the schools and highlight the reasons for the differences that were not resolved. Another important aspect of the Symposium was to involve practitioners in the debate. It was hoped that the comments of the academicians would be beneficial to the development of practice. However, the only matter there was agreement on was that there was an urgent need to resolve the measurement issue (Sterling 1970). Nevertheless, the 1970 Symposium represented an important contribution to the future thinking on accounting measurement, even though the ambitions of the Symposium to achieve resolution of important differences and to contribute to the development of accounting practice were not, at least not directly, achieved. The FASB approach hardly represents a solution the participants in Kansas in 1970 would approve of.

Regardless of the critics, the FASB continues to support the evolutionary process in SFAC 7: *"The Board does not intend to revisit existing accounting standards and practice solely as a result of issuing this Statement"* (FASB 2000a, 16).

4.2.2 A Normative Frame of Reference to Measurement

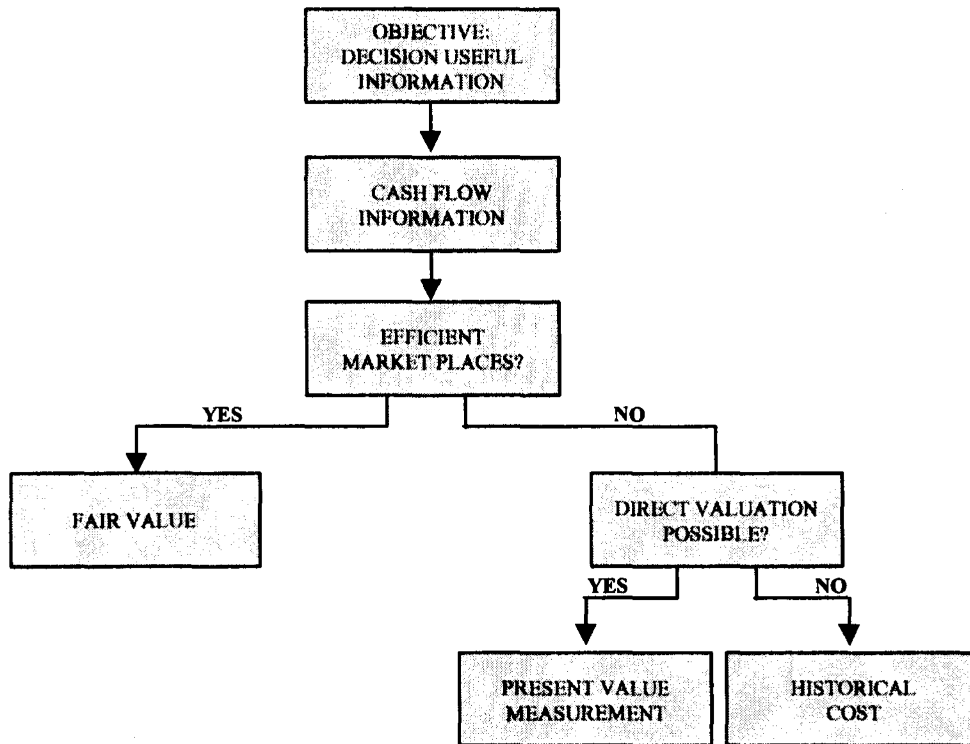
The FASB and the other leading standard setters have not managed to develop a measurement model prescribing a single measurement attribute, and have to some extent left the development of measurement to practice. This approach is inconsistent with the normative and deductive approach the conceptual frameworks build on.

A normative frame of reference to measurement recognizing practical constraints is commented on in this section (based on a model proposed by Frakes and Nunamaker (2002)).

The objective of financial accounting is to provide the users with decision useful information. This objective is best met through the communication of cash flow information. Market prices will reflect the value of expected future cash flows to the extent efficient market places exist for assets and liabilities. If efficient markets do not exist, the value of future cash flows must be estimated directly, or indirect valuation through the use of other attributes must be applied.

Here it is assumed that market prices derived from efficient market places represent the value of expected future cash flows. When such marketplaces do not exist, and the value of the expected future cash flows cannot be estimated directly, through net present value techniques, then a choice among historical cost, replacement cost, and realization value must be made. All these measures have inherent strengths and weaknesses (Sterling 1970). However, the problems associated with the two latter attributes have generally been considered to make them less useful for financial reporting than historical cost. Given the objective of financial reporting and the qualitative characteristics, historical cost may serve well as an indirect valuation of future cash flow potential.

Figure 4-1 ***Measurement in a Normative Perspective***



The model described above is conceptually different from the approach in the conceptual frameworks. The approach in the conceptual frameworks can best be explained as modified historical cost measurement. Net present value of expected future cash flows is singled out as the recommended measurement attribute in the normative approach, and the role of historical cost is limited to practical implementation of the recommended measurement attribute. The primary measurement attribute is effectively historical cost in the conceptual frameworks, modified by fair values when reliably obtainable.

The primary advantage of this normative approach to measurement is that it is consistent with the other elements of the conceptual frameworks, as well as useful in spite of practical limitations.[13]

Sufficiently reliable market prices exist only in rare cases. Certain financial instruments are believed to have reliable market prices, but different market places are in general believed to be inefficient. Direct measurement of future cash flows is typically possible

for monetary items such as trade receivables and payables. Amount and timing are usually certain, and a reliable net present value measurement can therefore be obtained. Direct measurement is less reliable for non-monetary items because both amount and timing are uncertain.

Current practice deviates from the normative approach explained here. For example, net present value techniques are only exceptionally applied for monetary items. This practice may be acceptable if the materiality constraint is considered to give room for flexibility. On the other hand, direct measurement is applied for non-monetary items in cases where the uncertainty inherent in amounts and timing may disqualify direct measurement in the normative model. Pension accounting is an example of this practice. However, the trade-off between relevance and reliability suggested in this paper may leave room for direct measurement to a greater extent than the conceptual frameworks allow for.

In the following, regardless of the normative approach suggested in this section, current accounting will be described as historical cost accounting, consistent with the approach of the leading standard setters.

4.3 Definitions of Elements[14]

The elements of financial statements include the following: Revenues, expenses, gains, losses, assets, liabilities, and equity (FASB 1985, 1).[15] In the A-L view, all items in the financial statements must fit within one of these elements, and the items must meet the definitions of the elements.[16]

Assets are defined as probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.[17]

Future economic benefit of an asset can be embodied in one of the following: Exchange value, production value, and acceptance value, according to SFAC 6 (FASB 1985, 172). Exchange value assumes that something can be received in exchange for the asset,

production value assumes that the asset can be utilized to produce something of value, and acceptance value assumes that the asset can be used to settle a liability.

The inclusion of the term "probable" in the definition is important, and will be discussed specifically in chapter 4.3.1.

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. "Probable" is given the same definition as in assets. "Obligations" is broader than legal obligations: *"It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (Webster's New World Dictionary, p. 981). It includes equitable and constructive obligations as well as legal obligations"* (FASB 1985, 13).[18] The definition of obligations further generalizes the definition of liabilities. The FASB acknowledges that the liability definition is vague, and lists asset impairment and disposal issues, asset retirement obligations, and financial instruments, as three areas in which difficulties in reaching conclusions have been experienced (FASB 2002, 4). Furthermore, the FASB recognizes the following problems inherent in the liability definition (applies to the asset definition as well): Different interpretations of the term probable, different interpretations of the term future sacrifices, confusion between present and future obligations, confusion about obligating events, disagreement about the role of management intent, and lack of guidance for distinguishing between events that give rise to a related asset and liability and events that give rise only to a liability (FASB 2002, 4). An entity is not obligated to others if it can avoid the future transfer or use of assets at its discretion without significant penalty (FASB 1985, 203).

In particular, the inclusion of "constructive obligations" complicates the definition. For instance, the IASB allows for up-front recognition of restructuring costs when a constructive obligation exists, specifying certain criteria that have to be met in order for a constructive obligation to exist (IAS 37.72). A restructuring obligation exists if the entity

has a detailed plan for the restructuring, and the entity has either started to implement the plan or announced its intent to those that will be affected by it.

On the other hand, the FASB states that *"An exit or disposal plan, by itself, does not create a present obligation to others for costs expected to be incurred under the plan; thus, an entity's commitment to an exit or disposal plan, by itself, is not the prerequisite past transaction or event for recognition of a liability"* (SFAS 146.4 (Accounting for Costs Associated with Exit or Disposal)). It is not clear from SFAS 146, however, what transaction or event constitutes a past transaction leading to a constructive obligation, but from the appendix (SFAS 146.Appendix B) one may conclude that the announcement to those affected represents a critical event (SFAS 146.B26). However, whether such an obligation should be recognized depends on for example whether future service requirements exist. Thus, a one-time termination benefit obligation may meet the liability definition at the announcement date, but will not be recognized according to SFAS 146 because the one-time termination benefit is only to be received by the employees if future services are provided in a defined period, for instance six months. In other words, there is no constructive obligation before the employees have performed their part of the agreement. According to SFAS 146, a one-time termination benefit obligation depending on future service should be recognized gradually over the future service period even though the entity may avoid the benefit payment by not terminating the employees at the end of the termination service period.

Based on the above, one can conclude that in the case of a one-time termination benefit arrangement benefiting the employees to the extent they provide services in a defined future period, a constructive obligation exists according to the IASB if an entity has a detailed restructuring plan establishing the conditions for the termination benefits and the arrangement has been communicated to the employees. According to the FASB, however, a constructive obligation is gradually incurred over the termination service period. Others may argue that the entity has not incurred an obligation to be recognized before the end of the termination period. This latter interpretation implies a rejection of

the constructive obligation concept, since the entity normally will be legally obligated to pay the termination benefit at the end of the termination period.

The discussion above illustrates the vagueness of the liability definition allowing for several different interpretations in similar cases. Furthermore, the liability definition does not under all circumstances lead to meaningful discrimination between liabilities and equity.

In SFAC 6, the FASB has linked the definition of liabilities to the "transfer of assets", and since equity shares cannot be assets, an inconsistency exists with respect to certain financial instruments. Thus, according to the definition, as long as an entity can avoid transferring assets by issuing equity shares, no liability exists. FASB became increasingly aware of this problem during its financial instruments project, and during its deliberations that led to the exposure draft, "Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both", in 2000, (led to the issuance of SFAS 150 in 2003) the Board concluded that certain financial instrument components embodying obligations that require (or permit at the issuer's discretion) settlement by issuance of equity shares should be classified as liabilities. The FASB, therefore, issued an exposure draft in which a change of the definition of liabilities in SFAC 6 is proposed ("Proposed Amendment to FASB Concepts Statement No. 6 to revise the Definition of Liabilities").[19] The FASB concluded *"(...) a fundamental basis for determining whether a financial instrument component should be classified as a liability or as equity is the nature of the relationship that the component establishes between the issuer and the holder. For most common types of financial instruments, the original definitions in Concepts Statement 6 appropriately reflected those relationships. The Board believes, however, that the original definitions did not encompass certain financial instrument components in which the type of relationship established was akin to a debtor-creditor relationship"* (ED 213-C.A11). According to the proposed revised definition, if an entity issues a financial instrument which embodies an obligation that requires settlement by issuance of equity shares of a predetermined value, for instance equity shares of 100 worth, the relationship between the entity and the other party is rather a debtor-creditor relationship than an

ownership relationship. In other words, according to the definition, whether the value of the obligation is linked (equal) to the change in fair value of the issuer's shares, is critical for the discrimination of equity and liabilities. The proposed amendment to SFAC 6 has not yet led to changes in the Conceptual Framework.

The IASB has dealt with certain specific and related issues in two accounting standards, namely IAS 32 ("Financial Instruments: Disclosure and Presentation") and IAS 39 ("Financial Instruments: Recognition and Measurement"). For instance, a contractual obligation may be settled by payment of financial assets or by delivery of own equity securities. If the number of equity securities varies with changes in their fair value so that the total fair value of the equity securities paid always equals the amount of the contractual obligation, the contractual obligation is a liability, according to IAS 39.11 and IAS 32.5. Originally, in IAS 32, the IASB did not specify that a contractual obligation to deliver own equity shares under certain circumstances is a liability. However, the IASB became aware of the relationship in the financial instruments recognition and measurement project, and made the necessary amendment of IAS 32 as well.

Unlike the FASB, the IASB has not started a similar process dealing with the relationship between liabilities and equity in the Framework. The IASB does not refer to "assets" in the liability definition in the Framework, but refers to "an outflow of resources". One may assume that delivery of own equity shares qualifies as "an outflow of resources", and the IASB may therefore not have the same inconsistency as the FASB in the Framework. However, a financial liability in IAS 32 is defined in reference to the delivery of "cash or another financial asset", and it therefore seems somewhat unlikely that the lack of initiative to amend the Framework is deliberate.

The FASB uses assets and liabilities in defining the remaining elements of financial statement:

> Equity is defined as a residual, *"the assets of an entity that remains after deducting its liabilities"* (FASB 1985, 17).

> Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.
>
> Expenses are outflows or other using up of assets or incurrence of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.
>
> Gains are increases in equity from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from revenues and investments by owners.
>
> Losses are decreases in equity from peripheral or incidental transactions of an entity and from all other transactions and other events and circumstances affecting the entity except those that result from expenses and distributions to owners.

Equity is thus net assets, while revenue and expense result from changes in net assets. The former reflects an increase in net assets, and the latter reflects a decrease in net assets. It is noteworthy that gains and losses are defined under reference to equity, not as a result of changes in net assets (Most 1982, 422). There is no obvious reason for the difference in basis in the definitions of revenue and expense and gains and losses.

The order in which the elements are defined is not coincidental: *"In short, meaning can be given to assets without first defining income, but the reverse is not true. That is what I mean by conceptual primacy of assets. No one has ever been successful in giving meaning to income without first giving meaning to assets"* (Gellein 1992, 198). In the R-E view, on the other hand, definitions are primarily conventional, not conceptual, and make income measurement largely a matter of individual judgment and personal opinion, according to Storey and Storey (1998, 80).[20] Many critics argue along the lines of Gellein, claiming that the inability to give revenue and expense meaningful definitions

results in circular reasoning on behalf of the R-E view proponents (the R-E conflict between the R-E view and the A-L view is further elaborated in the next section). However, it may be argued that circular reasoning is a fundamental problem of the A-L definitions: *"In other words, the FASB attempts to define the income statement in terms of changes in the balance sheet. This is rather like attempting to define nuclear particles in terms of their effects on X-ray plates. Many argue that this confuses the measurement of revenue with a definition of revenue. There can be no effect of revenue on assets or liabilities until revenue has been recognized; revenue cannot be recognized until it is defined. The attempt to define it in terms of its effects, therefore, involves circular reasoning"* (Hendriksen and van Breda 1992, 356). Sterling supports this view, and rejects the definitions because they are what he refers to as "internal definitions" (Sterling 1982, 105). According to Davies et al. the interrelationship between the definitions of the separate elements makes the definitions less useful: *"The difficulty surrounding the FASB's definitions of the ten elements is that they are so interrelated, that in attempting to piece them together into a meaningful accounting framework, one gets caught up in a tautology of terms which all lead back to the definitions of assets and liabilities"* (Davies et al. 1997, 58).

Let us use accounts receivable as an example illustrating the circularity in the definitions. Accounts receivable is an asset according to the SFAC 6 definition of an asset. Revenue is an increase in accounts receivable. However, how can there be accounts receivable before revenue is recognized? In other words, revenue is defined by its effect, the accounts receivable.

4.3.1 The Effects of Uncertainty

None of the leading standard setters assumes certainty about the future economic benefits and the future sacrifice of economic benefits associated with assets and liabilities. According to the FASB, the *"(...) definitions (...) are not intended to require that the existence and amounts of items be certain for them to qualify as assets, liabilities, revenues, expenses, and so forth, (...)"* (FASB 1985, 46). However, the future (sacrifice of) economic benefits must be "probable" for an asset (liability) to exist. In SFAC 6, the

FASB defines probable as "to what can reasonably be expected or believed" (FASB 1985, 25). The FASB is careful to emphasize that *"(...) degrees of probability are not part of the definitions"* (FASB 1985, 47). Nevertheless, one may assume that the probability term applied implies a chance of occurrence over fifty percent. If an outcome is less likely to happen than not, it can hardly be an "expected" outcome.

The IASB, as the FASB, introduces uncertainty in the A-L definitions. The IASB requires the future (sacrifice of) economic benefits to be "expected". The ASB in the UK, on the other hand, does not introduce uncertainty in the definitions. According to the ASB, assets are *"(...) rights or other access to future economic benefits controlled by an entity as a result of past transactions or events"* (ASB 1999, 4.7). Liabilities are defined as *"(...) obligations of an entity to transfer economic benefits as a result of past transactions or events"* (ASB 1999, 4.24).

According to Gore, the only major difference between the different conceptual frameworks at the recognition level is how uncertainty associated with future (sacrifice of) economic benefits is reflected (Gore 1995, 154). The leading standard setters, with the exception of the FASB, have all dealt with the uncertainty in a separate recognition criterion. For instance, according to the IASB, an item should be recognized if the definition of an element is met, and *"(...) it is probable that any future economic benefit associated with the item will flow to or from the enterprise; (...)"* (IASB 1989, 83). In addition, a third criterion, reliable measurement, is included in the IASB Framework. Even if the wording is different, the same criteria are adopted by the ASB in the UK (ASB 1999, 5). Thus, the recognition criteria of the IASB and the ASB can be summarized as follows: 1) The item must meet the A-L definitions, 2) the future (sacrifice of) economic benefits associated with the item must be probable, and 3) the item can be measured with reliability.

In the case of the IASB, the second recognition criterion seems to be redundant. As explained above, the uncertainty associated with the future (sacrifice of) economic

benefits is included in the A-L definitions, and thus the second recognition criterion seems to repeat the first criterion.

In the case of the ASB, on the other hand, the second criterion is necessary since no reference to uncertainty is made in the A-L definitions. As explained above, the FASB includes uncertainty in the A-L definitions, and as a consequence, the second criterion above is not a separate recognition criterion in the FASB Framework.

In the ASB Framework, the wording referring to uncertainty is somewhat different from the wording in the FASB and the IASB frameworks. Even though not reflected in the A-L definitions, the ASB is careful to point out that the *"(...) future economic benefits need not, (...), be certain"* (ASB 1999, 4.15). According to the ASB, "sufficient evidence" must exist that a new asset or a new liability has been created (ASB 1999,5). One can assume that sufficient evidence refers to the probability of future (sacrifice of) economic benefits, and as such is not intended to have another meaning than probable and expected have in the FASB and the IASB frameworks.

The fact that the terms "probable", "expected", and "sufficient evidence" have no specific meaning in the conceptual frameworks, limits the effectiveness of the A-L definitions.[21] By leaving the terms open, the standard setters allow themselves and others greater flexibility in the interpretation of the recognition guidelines in the conceptual frameworks.

4.3.2 Degrees of Probability in the Provisions Standards

Degrees of probability are not part of the A-L definitions. The degree of probability of a future (sacrifice of) economic benefits required to recognize an item as an asset (liability) is therefore unclear from the conceptual frameworks. One must therefore look to alternative sources to find guidance on this matter.

As will be illustrated in chapter 5, the standard setters have not applied the A-L definitions and the other recognition criteria consistently in the accounting standard

setting process (Hersvik 2003). In one area, however, the standard setters seem to have been particularly concerned with the A-L definitions in their development of recognition guidelines, namely in accounting for provisions. Common to these accounting standards is a principles-based approach in which the objective has been to develop policies not specific to one particular type of provision or to one particular type of industry. Rather, one has attempted to deduce general guidelines from the conceptual frameworks and the A-L definitions in particular. Therefore, these accounting standards may give some indications about how the standard setters themselves interpret the term probable inherent in their definitions and/or other recognition criteria.

In SFAS 5 ("Accounting for Contingencies"), the FASB refers to three degrees of probability: "Probable", "reasonably possible", and "remote". Probable is defined as *"(...) the future event or events are likely to occur (...)"* (SFAS 5.3a). When one unspecified term is used to define another unspecified term, the result has to be of little guidance. According to Skinner (1987, 137) "likely to occur" *"(...) certainly means a probability of over 50% and perhaps much higher"*. Reasonably possible is defined as *"(...) more than remote, but less than likely"* (SFAS 5.3b), and remote is defined as "slight chance of occurrence". In other words, SFAS 5 is not adding a lot to the understanding of the term of probable, but as Skinner points out, probable must imply at least fifty percent chance of occurrence. However, this conclusion can also be drawn from the FASB and the IASB frameworks and the use of expected as a synonym of probable. Furthermore, probable implies a greater chance of occurrence than reasonably possible, which in turn implies a greater chance of occurrence than remote.

In IAS 37 ("Provisions, Contingent Liabilities and Contingent Assets") several degrees of probability are introduced: "Virtually certain", "probable", "possible", "unlikely", and "remote". The IASB defines probable as *"(...) more likely than not to occur, i.e. the probability that the event will occur is greater than the probability that it will not"* (IAS 37.23). The IASB is careful to point out that this interpretation only applies to IAS 37. Thus, the search for a general interpretation of the term probable in the Framework must continue. With respect to the other probability terms used in IAS 37, little specific

guidance can be found. However, one can conclude that virtually certain implies a greater likelihood of occurrence than probable, that possible, remote, and unlikely imply a lower likelihood of occurrence than probable, but it is difficult from the application of the terms in IAS 37 to rank these three latter terms with respect to likelihood of occurrence (Hersvik 2003, 70).

The ASB in the UK also refers to different degrees of probability in the provisions standard (FRS 12 ("Provisions, Contingent Liabilities, and Contingent Assets")). Generally, the terms are the same as the ones used by the IASB in IAS 37, and as the IASB, the ASB quantifies probable as "more likely than not" (FRS 12.23), and the ASB also limits the application of this definition to the provisions standard.[22]

It can be concluded from the analysis that the FASB, the IASB, and the ASB in the UK have not attempted to quantify the effect of uncertainty in their respective A-L definitions and the other recognition criteria. Furthermore, there seems to be a common understanding among them that probable implies a greater chance of occurrence than not (fifty percent) in the case of provisions. The fact that the standard setters emphasizes that their quantification of the term probable in the provisions standards cannot be applied to items scoped out of the standards is rather confusing. The A-L definitions and the other recognition criteria are criticized for being broad and vague. When the interpretation of one of the critical elements of them, the term probable, apparently can be different across different accounting standards, and different liabilities for that matter, the problem of vagueness seems to develop into a problem of deliberate inconsistency.

4.3.3 Examples of Inconsistencies in Accounting Standards

In the following two apparent inconsistencies between the A-L definitions and the accounting standards of the IASB with respect to the application of the term probable will be illustrated.

The distinction between liabilities and equity is not always clear. According to the IASB, components of a financial instrument representing liabilities and equity should be

classified accordingly (IAS 32.18). If there is a contractual obligation to deliver cash or other assets under the financial instrument, then the financial instrument is a liability regardless of how the obligation is to be settled (IAS 32.20). Even though the interpretation is not obvious, the distinction is commonly understood as independent of the likelihood of redemption. For instance, in the case of redeemable preference shares, regardless of whether the likelihood of redemption is 10% or 90%, the preference shares should be classified as a liability. The liability definition assumes a probable or expected cash outflow. In the case of 10% likelihood of redemption, a cash outflow is rather improbable or unexpected. Thus, IAS 32 seems to conflict with the liability definition in the IASB Framework.

According to IAS 38, recognition of internally generated goodwill (IAS 38.36), internally generated research (IAS 38.42), internally generated brands (IAS 38.51), and expenditures on advertising (IAS 38.57) is prohibited. In all these cases, a past event or transaction and future economic benefits are involved. Assuming the third criterion, the controllability criterion, is met (chapter 5.3.4), the only logic for the non-recognition is a low probability with respect to future economic benefits. The implication of the accounting standard is that regardless of the probability associated with the resources generated internally, an asset cannot be recognized. In other words, the accounting standard clearly represents an inconsistency with respect to the A-L definitions. Furthermore, if one accepts the rejection, it is somewhat unclear why these intangibles are recognized as assets if acquired. That is, why are the intangibles considered to be more closely related to probable future economic benefits if acquired from another party?

4.3.4 Concluding Remarks

The conceptual frameworks reflect that uncertainty must be accounted for, typically in reference to a probability criterion, but the standard setters have chosen to widen the A-L definitions and the other recognition criteria to allow for a great flexibility in the interpretation of the criterion. Furthermore, the standard setters have not been able to reduce the vagueness of the conceptual frameworks in the accounting standards. Empirical research shows that the term probable has different meaning across user

groups. For instance, studies among auditors in the US and Canada have found that they ascribe a chance of occurrence of eighty to ninety to "probable", *"(...), thereby implying a meaning of "highly likely" or even "virtually certain"* (Johnson 1994, 9). To accountants in Australia, "probable" means "more likely than not", which implies a chance of occurrence of more than fifty percent (Johnson 1994, 9). In another survey, Davidson and Chrisman found that English-speaking respondents considered "probable" to imply approximately a seventy percent chance of occurrence (1993). Thus, it is fair to conclude that the accounting standard setters have not been able to integrate the effect of uncertainty about future (sacrifice of) economic benefits in an effective manner in the conceptual frameworks and the accounting standards.

4.4 Two Perspectives[23]

The definitions of the elements of financial statements will depend on what perspective the frameworks build on, the A-L view or the R-E view. The FASB, the IASB, and the other leading standard setters all rely on the A-L view in their conceptual frameworks (Gore 1995, 153).[24] Ordres des Experts Comptables (OEC) in France has developed their framework according to an R-E view. However, the French Framework is filled with inconsistencies, and does not appear convincing (Walton 1996). Also, the Norwegian Framework is based on the R-E perspective. However, no attempt to define the elements of the financial statements is made in the Norwegian Framework. As such, the framework developed by the predecessor of the FASB in the US, the Accounting Principles Board (the APB), may better illustrate the alternative to the A-L view. According to the APB, assets are *"(...) economic resources of an enterprise that are recognized and measured in conformity with generally accepted principles"*, and include *"(...) certain deferred charges that are not economic resources"*, and liabilities are *"(...) economic obligations of an enterprise that are recognized and measured in conformity with generally accepted principles"*, and include *"(...) certain deferred credits that are not obligations"* (AICPA 1970, 132). These definitions clearly conflicts with the FASB definitions described in chapter 4.3, and as will be discussed in the following, the tails attached to the two APB-definitions, "deferred charges" and "deferred credits", represent the crux of the conflict between the two perspectives.

It is not always clear what the conflict between the A-L view and the R-E view is. In the following, the most commonly expressed misunderstandings will be explored, before it will be shown that the difference between the A-L view and the R-E view, as exercised by the leading standard setters in their respective conceptual frameworks, boils down to the application of the A-L definitions as an overriding recognition criterion. The R-E view dominated accounting practice well into the seventies. Before the exploration of the conflict, the shift from the R-E view to the A-L view will be discussed.

4.4.1 The Shift

> *"Fifty years ago the principal interest of those concerned with the financial data of business enterprises centered on the periodic display of assets and liabilities (balance sheet). Evidence of this situation may be readily obtained by an examination of what published financial reports existed during the first decade of the twentieth century. Typically the only financial statement presented in these reports was a balance sheet, with any information relating to the results of the operations of the business being presented principally as a means of explaining changes in financial position"* (Hepworth 1953, 51).

In the above quote, Hepworth explains the primacy of the balance sheet at the beginning of the twentieth century. However, the income statement was soon considered to be the primary financial statement.[25] Here "The Shift" refers to the tendency in the sixties and the early seventies to question the usefulness of the income statement unless the balance sheet items could be given "real world meaning" (Storey and Storey 1998), and the following revitalizing of the balance sheet. One may say that the FASB's decision to take on the conceptual framework project in 1973, the first year of operations, was a consequence of the evolving view that the balance sheet ought to be more than a temporary stock of deferred costs. Up to that point, the R-E view had been dominating accounting practice.[26]

Kirk's comment on the UK Framework a couple of decades later illustrates the shift: *"(...) it defines assets and liabilities first and subsequently gains and losses which effectively*

become the residuals under the new system (...). This is revolutionary for accountants (...) who have traditionally put the main emphasis in their preparation of financial statements on ensuring that income is matched against its related expenditure, any residuals being recorded on the balance sheet as accruals/prepayments. (...). The accruals (profit and loss) approach is being replaced by the asset/liability (balance sheet) approach" (Kirk 1998, 14).

There is no doubt that the A-L view currently is the most supported view, and the leading standard setters around the world seem, at least at the outset, to follow this approach in accounting standards setting. To some the R-E view is so meaningless that it hardly deserves to be mentioned: *"It should not be necessary, in this quincentenary year, to re-assert the primacy of the balance sheet in choosing an accounting model and the superiority of an income concept based on changes in net worth over one based on matching costs and revenues"* (Solomons 1995, 43). However, note that Solomons' rejection of the R-E view is a result, at least partly, of his rejection of the historical cost accounting model: *"In particular, it is impossible to reconcile the criteria with a historical cost basis of accounting, for historical cost runs foul of every of them"* (Solomons 1995, 51)[27]. Solomons is a strong supporter of value-based accounting model, and his preference for the A-L view must be understood in this context.

4.4.2 The Conflict

> *"Although the balance sheet has its uses, it should not be used as a determinant of income. The FASB's infatuation with the balance sheet as such a determinant is overdone. The matching of costs and revenues to determine income was always the overwhelming thrust of the Accounting Principles Board, and, although the FASB Concept Statements give that notion recognition, it is mostly by sufferance"* (Defliese 1991, 89).

The A-L view has been, and to some extent still is, misunderstood: *"There are differences between the asset/liability view and the revenue/expense view, but,*

unfortunately, there is a tendency to attempt to find differences that do not exist" (Sprouse 1978, 67).

Certain commentators seem to associate the A-L view and the R-E view with the decision making demand and stewardship demand, respectively, and at the same time interpret an income statement focus in the objectives of the conceptual frameworks (Davies et al. 1997, 49). According to these authors, there seems therefore to be inconsistency between the objectives of the FASB Conceptual Framework supporting an R-E view through the objectives, and recognition focusing on assets and liabilities definitions. However, the decision usefulness of earnings information is not a controversy between the two views, and the introduction of the A-L definitions cannot be interpreted as an attempt to downgrade the importance of income measurement.

Others, without involving the decision making demand and the stewardship demand, has said that the purpose of the A-L view is to downgrade the importance of net income and the income statement by making the balance sheet more important than the income statement: *"SFAC No. 6 represented a major switch from matching to the asset-liability approach and from the Income Statement to the Balance Sheet as the primary financial statement. The Balance Sheet becomes more important because its focus is on the measurement of the net assets of the firm"* (Evans 2002, 203).[28] [29] For instance, in a survey carried out in 1997 in the UK *"(...) 41% were unhappy about the proposed downgrading of the Profit and Loss Account in favour of the Balance Sheet as the primary statement"* (Kirk 1998, 16).

Still others have claimed that the intent of the A-L view is to supplant accounting based on completed transactions and matching of costs and revenues with a accounting based on the valuation of assets and liabilities at current values or costs, labeling it a "valuation approach" (Storey and Storey 1998, 83).[30]

However, both these views, the association of the A-L view with a de-emphasizing of income measurement and the association of the A-L view with value accounting, represent misconceptions.

Certain commentators have argued that in the A-L view the definitions of elements of financial statements are considered more important than recognition and measurement in financial statements, and the definitions of assets and liabilities control revenues and expenses. On the other hand, according to the R-E view, assets and liabilities are not controlling, but rather depending on revenues and expenses. In other words, according to some commentators: *"The difference between them is about the primacy of the income statement or the balance sheet"* (Solomons 1986a, 130).[31]

The attempt to explain the two views by reference to the primacy of assets and liabilities and revenues and expenses, respectively, is somewhat misleading. Moreover, it is clearly a misunderstanding that the importance of net income is the source of the conflict. The leading standard setters do not ignore the emphasis of the primary users of financial reports on earnings and performance measures (Healey and Wahlen 1999), and the conflict is rather how to achieve the best performance measures: *"Proponents of both views generally consider earnings to be more important in terms of primary interest to users. The question is which view results in the more meaningful measure of earnings"* (Sprouse 1978, 69).

Also, the conflict between the A-L and the R-E view is not necessarily a disagreement primarily concerning measurement basis. It is not true that particular measurement bases goes hand in hand with one of the two views: *"Clearly, however, the two views are equally adaptable to using measures of either historical cost or current value"* (Sprouse 1978, 68).[32] Thus, it is the intention here to discuss the A-L view as a separate issue from value accounting, and it may be appropriate to emphasize that accounting is not viewed solely as a process of valuation. Primarily, accounting is currently historical in approach, with valuation entering into it at times "as a safeguard", but with emphasis on cost.[33] This latter approach has of some been held synonymous to the R-E view, while the valuation

approach has been held synonymous with the A-L view. But again, the perspectives and measurement attributes are considered two separate dimensions.[34 35 36]

In chapter 4.1, it was argued that measurement and the definitions are interrelated. This relationship can be explained by the fact that both dimensions have an important role in recognition. The discussion of the perspectives and the role of the definitions as a separate issue from measurement are not in conflict with this relationship. The role of the definitions can be determined regardless of the application of measurement attributes. For instance, whether current value or historical cost is the measurement attribute to be applied does not alone solve the question of how to account for research and development costs. It has been argued that deferred tax assets should not be recognized in an A-L view because they do not meet the definition of assets. This conclusion can be reached without addressing the measurement issue.

The refusal of the association of the A-L view and fair value accounting and the R-E view and historical cost accounting is critical. Historical cost accounting would not be an issue in an ideal world with full and perfect information about all current values. That is, if the current value of all assets and liabilities were known at all times, the arguments in favor of historical cost accounting would not be valid. There would be no reliability issue, and relevance would generally favor current values over historic cost information. Income would have to be measured by the changes in current values. There is in other words no conflict between the two perspectives in the perfect information scenario. However, this scenario is unrealistic, and thus less interesting.

From the above, one can conclude that the conflict between the A-L view and the R-E view is not about primacy of the balance sheet or the income statement and the importance of income determination, and it is not about measurement. The most promising approach to describe the essentials of the two incompatible views is rather to focus on the attributes of income. In the A-L view income should be defined in terms of changes in assets and liabilities that represent an entity's economic resources and its obligations to transfer economic resources to other entities in the future, while income in

the R-E view is defined in terms of needs of earnings measurement regardless of whether the related balance sheet items represent economic resources and obligations to transfer economic resources (FASB 1976c, 103).

Figure 4-2 ***The Asset-Liability View versus the Revenue-Expense View***

	HC	CV
A-L	**Modified Matching**	**X**
R-E	**Matching**	

Under the historical cost approach, or a modified historical cost approach, the A-L definitions alone are not sufficient to measure income. Given that there is imperfect information about current values and the demand for reliable information, the historical cost measurement must be accompanied by some rules for the timing of revenues and expenses. This is where the matching principle plays a role. In the R-E view all costs should be matched with the corresponding revenues, and expensed accordingly. In the A-L view matching should be achieved, but not to the extent that assets and liabilities not meeting certain definitions are recognized.

In spite of the rejection of the measurement conflict above, the term "A-L view" was originally meant for the fair value accounting scenario, and may not be an adequate term to describe what the FASB, the IASB, and the other leading standard setters refer to when they describe their frameworks.[37] For instance, matching is modified by the asset and liability definitions: *"(...), the application of the matching concept under this Framework does not allow for recognition of items in the balance sheet which do not meet the definition of assets or liabilities"* (IASB 1989, 95),[38] or as FRSB in New Zealand puts it, matching *"(...) may result in recognition and/or classification decisions that are inconsistent with the definitions adopted in this Statement. If the application of the matching principle would result in the recognition of items which do not meet the definition of assets or liabilities, it is inappropriate and not permitted"* (NZSA 1993, 7.25). "Modified R-E view" is probably a better term, but may lead to some confusion.

"Modified R-E view" refers to the A-L definitions as modifiers, while the term "modified historical cost approach" commented on above (chapter 4.2), refers to the introduction of current value measurements in the historical cost approach. To avoid further confusion, the terminology of the leading standard setters referring to a modified R-E view as the "A-L view" is here adopted.

Thus, in essence, the conflict between the A-L view and the R-E view boils down to the definitions of the items in the financial statements, and the role of the definitions for accounting recognition: *"The crux of the matter involves limits on what can be included in revenues and expenses and, therefore, in earnings"* (Sprouse 1978, 68). In the A-L view assets and liabilities are economic resources and obligations. Economic resources and obligations will typically be included in the balance sheet in an R-E view as assets and liabilities as well. However, in addition the balance sheet will include certain accruals (accrued costs and revenues) and deferrals (deferred costs and revenues) that are not economic resources or obligations (FASB 1976c, 106). It is not always clear what these accruals and deferrals are, except that they are not assets and liabilities according to the A-L view proponents: *"The concept of 'deferred costs' does not exist under IASC's literature. Comments received on E50 showed that perception differs worldwide of what 'deferred costs' are and what their accounting treatment should be. The Board does not intend to define what 'deferred costs' are or to introduce such a concept in IASC literature. The Board believes that only those items that meet the definition of, and recognition criteria for, an asset in the IASC's Framework or an International Accounting Standard, should be recognised as an asset"* (from E60 on intangible assets, the exposure draft preceding IAS 38).[39]

Thus, the title of this section, "The Conflict", refers to the different approaches to achieve meaningful income measurement. In the R-E view, meaningful income measurement is primarily achieved through the application of certain accounting concepts, the earned revenue concept and the matching concept in particular, while meaningful income measurement in the A-L view introduces an extra recognition criterion, the A-L

definitions. The A-L definitions may therefore, as explained above, be considered recognition modifiers.

It has been argued that the role of the definitions is overstated, and that the conflict between the A-L view and the R-E view has little practical implications: *"An explicit discussion of the main sources of disagreement would have been more fruitful than a "new" set of definitions. Circular as they are, the conflict on definitions seems to us to be only a proxy debate whose principal, to which we return later, is the debate about the accounting rules themselves"* (Dopuch and Sunder 1980, 5). [40] [41] Kripke is of the same opinion: *"It is apparent that the issue had great importance to accounting theorists. Yet it can be questioned whether for most readers of financial statements this discussion had any significant content"* (Kripke 1989, 21).

The examples in the following chapters contradict these arguments.[42] [43] However, it may to some extent be true if the A-L view is interpreted to be the practice of the FASB and the IASB. The FASB and the ISAB and other leading standard setters have chosen to issue accounting standards in conflict with the A-L definitions when loyalty would have caused irrelevant fluctuations in the income statement, and thus the practical implications may seem minor, or even non-existing to some commentators.

The conflict between the perspectives is often illustrated by the insurance-example (FASB 1976c, 59, Johnson 1994, 1) Consider the accounting by a company that chose to cancel its insurance coverage for employee accidents, and thus electing to be "self-insured" by absorbing those costs itself. Supporters of the R-E view have suggested that the company should charge a yearly expense equal to the yearly average of any expected losses.[44] The proponents of the A-L view dispute this treatment, believing that a liability should not be recognized until an accident actually happens, claiming that the mere fact that future loss is probable does not justify recognition of a liability. The intention of management to incur losses in the future does not create a liability. Events do create liabilities, and only an accident leading to a financial loss gives rise to a provision (Lennard 1994, 95).

The insurance-example gave as part of SFAS No 5 Accounting for Contingencies (1975), along with the issues discussed in SFAS No 2 Accounting for Research and Development Costs (1974) and SFAS No 7 Accounting and Reporting by Developmental Stage Enterprises (1975), rise to certain fundamental questions the FASB chose to deal with at an early stage of its existence: Do reserves for self-insurance and the like constitute liabilities? And do expenditures for research and development, start-up, and the like represent assets? The FASB answer to both of these questions is "no".

A recent development within the IASB may illustrate the crux of the conflict. In the proposed improvements to IAS 28, equity accounting is not abolished. However, a proposal to reject equity method accounting and proportionate consolidation is seriously considered by the IASB. Recognition is derived from the earned revenue concept in both the equity method and the proportionate consolidation method, and the difference between them is basically just a presentational issue. The arguments rejecting the proportionate consolidation method are therefore equally relevant with respect to the equity method, and vice versa. The methods both lead to balance sheet items in conflict with the A-L view since the investor necessarily does not control the assets and liabilities recognized (chapter 5.3.5, chapter 7.1).

If investments in associates and joint ventures were valued at some sort of current value, equity method accounting and proportionate consolidation would be irrelevant. The IASB proposal replaces equity method accounting and proportionate consolidation with current value measurement when a reliable estimate can be made. In other cases, the A-L view approach suggested implies historical cost accounting. The IASB proposal does really nothing more than expanding the perfect information scenario, the scenario in which there is no conflict between the A-L view and the R-E view. It is outside the perfect information scenario the conflict is illustrated. In the A-L view, and in the proposal considered by the IASB currently, investments in associates and joint ventures, which cannot be reliably measured at current value, should be valued at cost. In the R-E view,

with the primary emphasis on earnings measures, equity method accounting and proportionate consolidation should be applied when fair value measurement is unreliable.

The conceptual frameworks are normative and deductive in form. Thus, the A-L definitions should ideally be deducted from the decision usefulness objective. However, as the above example illustrates, and as will be further illustrated in the following chapters, the application of the A-L definitions will in certain cases reject the more useful information.

It is important to recognize that the modifiers, the A-L definitions, do not always lead to modified recognition. For instance, when provisions for maintenance etc. are not allowed for in the A-L view, these costs are typically treated as replacement of an asset component, and hence, reflected in the amortization schedule (maintenance cost accounting is further discussed in chapter 5.3.2). In other words, the A-L definitions only modify the classification, and not the timing of the recognition. However, the A-L definitions may lead to modified recognition when accounting for certain costs associated with intangible resources. For example, application of the matching concept may lead to capitalization of expenditures to research and development not meeting the A-L definitions, and thus different expense timing in the two views.

4.5 Income Recognition

In the R-E perspective, the objective of decision useful financial information is considered best met through meaningful revenue and expense recognition guidelines, not subject to asset and liability tests. Revenue recognition is guided by the earned revenue concept. Expense recognition is guided by the matching principle. According to this principle, costs should be expensed in the same accounting period as the corresponding revenue. In other words, the revenue recognition guidelines may be viewed as the "controlling" element of recognition in that expense recognition, as well as asset and liability recognition, depend on these guidelines.

The concept of earned revenue and the matching principle are both recognized in the conceptual frameworks. For instance, the FASB introduces the two concepts under the heading "Guidance in applying criteria to components of earnings" (FASB 1984, 78-87). *"Revenues are not recognized until earned"* represents one of two "factors" to consider in revenue recognition in the application of the "fundamental recognition criteria" (FASB 1984, 83). The other factor is the realized or realizable criterion.

The concept of matching is de-emphasized compared to the earned revenue concept in the FASB Framework. As a guideline in application of the fundamental recognition criteria, the FASB introduces the "consumption of economic benefits" concept: *"Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits"* (FASB 1984, 85). The matching concept is explained as one of three approaches to the consumption of economic benefits concept (systematic and rational allocation and immediate expensing represent the two other approaches).

In addition to the fact that the earned revenue and the matching concept only represent guidance in the application of the fundamental recognition criteria, it is interesting to note that the FASB seemingly introduces these concepts in a descriptive manner (*"Revenues are (...)", "Expenses and losses are (...)"*), as opposed to application of the concepts in a normative model in which the earned revenue and the matching concept are deducted from the decision usefulness objective.

The earned revenue concept is seemingly not important in the IASB Framework. The IASB recognizes that the earned revenue concept is *"(...) adopted in practice (...)"* (IASB 1989, 93), and explains that the concept is *"(...) directed at restricting the recognition of income to those items that can be measured reliably and have a sufficient degree of certainty"* (IASB 1989, 93). Thus, the IASB seems to interpret the earned revenue concepts as a practical guideline in accounting practice, not as a separate revenue

recognition concept, but rather as a tool useful in determining whether the applicable measurement attribute leads to reliable accounting information, as prescribed by the measurement rules.

From the earned revenue concept in the IASB Framework, one can conclude that unearned revenue cannot be recognized as income. Furthermore, recognition of earned revenue may in certain circumstances lead to recognition of a liability in conflict with the A-L definitions, and recognition of earned revenue will in these cases not be allowed (IASB 1989, 83). An inflow of cash must always be accompanied by a credit entry. If the inflow is associated with earned revenue, then the appropriate credit entry is in the income statement. If associated with unearned revenue, then the appropriate credit entry must be in the balance sheet, as a liability. As such, there seems to be consistency between the A-L definitions and the earned revenue concept in the IASB Framework, even though their restrictive function are based on different concepts. However, under certain circumstances, the restriction imposed by the A-L definition conflicts with the restriction imposed by the earned revenue concept. An example of such a conflict will be examined in chapter 4.5.1.1.

In the R-E view, the earned revenue concept is the principal revenue recognition concept, primarily viewed as a concept guiding the timing of recognition. As such, the IASB interpretation of the earned revenue concept does not seem to be in accordance with the understanding in the R-E view.

The lack of emphasis on the concept of earned revenue is particularly confusing when the guidance to recognition elsewhere in the IASB Framework is scarce. One possible explanation may be that the Framework is founded on a value-based approach in which revenue is determined solely by changes in asset and liability values. However, as discussed in chapter 4.2, the IASB does not adopt a value-based measurement attribute in the Framework, but rather concludes that historical cost has the most merits in practice and thereby implies a preference for historical cost accounting.

The matching concept, however, seems to be acknowledged by the IASB as an important recognition concept, and the systematic and rational allocation approach and immediate recognition approach are referred to as applications of the matching concept in the IASB Framework (IASB 1989, 95, 96). The IASB is, however, careful to emphasize that the IASB Framework does not allow for matching to the extent that it leads to *"(...) recognition of items in the balance sheet which do not meet the definition of assets or liabilities"* (IASB 1989, 95). This modification is repeated in IAS 1.26.

A similar modification of earned revenue concept is not explicitly made in the Framework or in IAS 1. Nevertheless, the structure of the Conceptual Framework implies that the A-L definitions also modify revenue recognition. However, the lack of application of the A-L definitions in IAS 18 ("Revenue") together with the lack of explicit modification of the earned revenue concept in the Framework is noteworthy.

Even though the earned revenue concept and the matching principle apparently play a smaller role in the conceptual frameworks compared to in the R-E view, their application in accounting standard setting, also among the leading standard setters, is important. The timing of revenue and expense recognition cannot be solved by the A-L definitions, and the concepts of earned revenue and matching will therefore be explored in the following.

4.5.1 Revenue Recognition

There was a time when net income was not considered a predictive valuation base in the high-tech industries, and focus has been turned to revenue:[45] *"(...) revenue is proxy for marketplace acceptance and market share"* (Herring Investor, 10 March 1999). In the March 20, 2000 issue of Fortune one of the headings read *"PRESTO CHANGO! SALES are HUGE! The do-coms have been quick to learn accounting slight of hand. Their best trick: pulling revenues out of thin air"*. The close immediate relation between reported revenue and market cap has, according to the article, provided Internet executives with a powerful incentive to inflate revenue figures through "accounting gimmicks". This change in focus has for example motivated companies to recognize revenues prematurely,

to"gross up" revenues, and to recognize revenues from barter transactions in a questionable manner.

The relationship between recognized revenue and share prices has been documented in several empirical studies. Among others, Trueman et al. (2000) concluded that even if stock prices do not seem to be associated with reported net income in the internet industry, there is a positive and significant correlation between reported revenue and security prices.

The leading accounting standard setters all recognize the lack of coherent and consistent revenue recognition guidelines: " *There is a need for a coherent framework that can be used consistently to address revenue issues in different contexts.(...) The ASB recognises that revenue recognition issues are not unique to the UK and the Republic of Ireland.(...) It hopes to develop, in conjunction with the IASB and other standard-setters, a framework that can be used as the basis for a standard dealing with general revenue principles.* " (ASB 2001). In other words, the ASB admits that the Framework offers little guidance in the development of revenue recognition policies, and the normative and deductive approach of the Framework has failed.

The current revenue recognition project of the FASB commented on in the next section illustrates that lack of coherent and consistent revenue recognition guidelines are not a particular UK problem. The FASB and the IASB are currently considering carrying out the FASB revenue recognition project as a joint project.

4.5.1.1 Earning and Realizability

According to US GAAP, the two basic criteria for revenue recognition are earning[46] and realizability.[47] Strictly speaking, revenues should be recognized continuously over the entire earnings process. However, practical problems have led accountants to search for other valid interpretations of the earning criterion .

It is meaningful to accrue and defer positive cash flows according to the earnings process given the decision usefulness objective and the demand for allocation of cash flows between accounting periods. The earned revenue concept represents a useful tool in describing how the entity has performed in the past, but more importantly, it indicates the cash flow potential of the entity. For instance, an entity signs a long-term construction contract that eventually will earn the entity a certain revenue amount. By period end the recognized revenue indicates how much of the contract revenue has been earned, and thus also how much revenue is to be earned in future periods (on this and new contracts). The greater the amount that has already been earned the greater the future cash flow potential.

Revenue realization was originally used to refer to the recording of revenue (Hendriksen and van Breda 1992, 361). Realization generally meant the reporting of revenue when it was validated by a sale. To some, however, "earning" and "realization" were synonyms.

Revenue is an "inflow of assets" according to Sterling, and related to the disposal of products or rendering of services: *"Definition 1. Revenue is the receipt of cash or near-cash from sales. (...) Definition 2. Realization occurs when cash or near-cash is received from sales. (...) Definition 3. Earned equals realized"* (Sterling 1967, 527). Sterling borrows the last definition from Finney: *"As used in accounting, however, 'earned' and 'realized' are generally regarded as synonymous"* (Finney 1944, 363). From his initial set of definitions, Sterling claims that a fourth definition can be deducted: *"Definition 4. Revenue occurs when cash or near-cash is received from sales"* (Sterling 1967, 528). His reasoning is that one cannot have receipts from sale without the occurrence of a sale, and that revenue is the more general term, and Sterling argues that substitution of "revenue" for "realization" in definition 2 does not distort the meaning. "Realized revenue" is according to Sterling a redundant term. Revenue is defined as receipts from sales, and, therefore, revenue occurs when the sale is made.[48]

The FASB uses the term realization to describe *"(...) the process of converting noncash resources and rights into money"* (FASB 1985, 143). Realizability means the ability to convert claims into cash. Thus, while an actual sale had to take place to meet the former

realization criterion, the current realizability criterion supports revenue recognition before actual sale under certain circumstances.

Earnings may exist without realizability, but earned revenue not realizable should not be recognized. It may be argued that revenue should be recognized when earned regardless of realizability, and that unrealizable claims should be recognized as expense, according to IAS 18. However, a careful analysis of the recognition criteria in IAS 18 does not allow for this interpretation. According to IAS 18.14 revenue should be recognized in the course of selling goods when all of the following criteria are met:

- Significant risks and rewards of ownership are transferred.
- The selling enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods.
- The amount of revenue can be measured reliably.
- The costs incurred or to be incurred in respect of the transaction can be measured reliably.
- It is probable that the economic benefits associated with the transaction will flow to the enterprise.

Relizability is included in the criteria above (the last criterion), and there seems to be no real difference between the US GAAP criterion of relizability and IAS 18.

Under US GAAP and IAS a basic recognition criterion is that the resulting balance sheet item meets the definition of an asset. This is clear from the definition of revenue relating revenue directly to *"(...) the enhancements of assets of an entity or settlements of its liabilities"* (FASB 1985, 78). Unrealizable receivables would not meet the asset definition, and indirectly, based on the asset definition, realizability seems to be a necessary recognition criterion under IAS as well as US GAAP.

In May 2002, the FASB added to its technical agenda a project to develop a comprehensive Statement of Financial Accounting Standards on revenue recognition

(FASB 2002). The decision was primarily reached because US GAAP has no comprehensive accounting standard on revenue recognition, but the decision also reflects the fact that inconsistencies exists between the numerous authoritative pronouncements within US GAAP dealing with revenue recognition issues (US GAAP includes close to hundred and fifty pronouncements on revenue recognition). In the preliminary research, as well as in the development of the standard, it became clear to the Board there are inconsistencies with the Conceptual Framework, and the Board decided that the conceptual inconsistencies in the Framework should be addressed in the revenue recognition project (FASB Project Updates, October 2, 2002).

According to the Board, the realization and earnings approach in SFAC 5, even though presented as additional guidance to the fundamental recognition criteria, seem to override the revenue definition in SFAC 6 in terms of changes of assets and liabilities. In particular, the earnings approach creates inconsistencies between the additional guidance and the fundamental criterion of the A-L definitions because it focuses on "substantial accomplishment" rather than whether a liability is created (FASB 2002, 3). For example, in a multiple element revenue arrangement in which the customer has paid in advance, the earnings criterion may lead to deferral of revenue recognition even though the entity has fulfilled the obligation under one of the elements (revenue recognition must be deferred to all the elements have been substantially accomplished under the earnings criterion). In this case, the deferred revenue on the balance sheet may conflict with the liability definition that assumes that a liability only exists if a present obligation to transfer assets or provide services in the future is present.

In the example above, one would expect that the fundamental criterion would override the additional guidance on the earnings criterion. This is often not the case in practice. More problematic though, from SFAC 5 it may be inferred that the earnings criterion overrides the A-L definitions. The FASB acknowledges this conceptual inconsistency, and aim at solving it in the revenue recognition project (FASB 2002). Even though the FASB approaches the task expecting to maintain the A-L definitions as one of the fundamental revenue recognition criteria, it accepts that one possible route may be to

disregard the A-L definitions as a fundamental revenue recognition criterion (FASB 2002, 8).

4.5.2 Expense Recognition

> *"In order to be of value to a business concern, it is assumed that an asset must be capable of contributing to the production of revenue, and this appears to be a reasonable assumption. Thus, an asset which cannot contribute to the inflow of revenue has a zero, or perhaps a negative, value. Matching of revenue and expense is concerned with reducing the "value" of assets in accord with the flow of revenue to which the asset contributes. This is the essence of the matching convention"* (Hylton 1965, 824).

The objective of financial reporting can be explained as the providing of *"(...) information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts (...)"* (FASB 1978, 37). As discussed in chapter 3.1.1, the straight forward recognition of cash flows are not the most informative way of meeting this objective: *"Current earning, which reflect management reporting judgment, have been widely found to be value-relevant and are typically better predictors of future cash flow performance than current cash flows"* (Healy and Wahlen 1999, 367). Earnings measurement involve the recognition of revenues and expenses in different accounting periods from the corresponding cash flows, and the matching principle has traditionally been considered a useful tool in the development of a useful income measure.

4.5.2.1 The Matching Concept

It has been suggested that matching is nothing more than a *"(...) rule for assigning revenues and expenses to a particular accounting period"* (Hylton 1965, 826). However, the underlying idea of matching is somewhat more sophisticated than that, and is based on a perceived causality between costs and revenues. Revenues are a result of the costs incurred. If costs give rise to revenues, then costs should be expensed in the same

accounting period as the corresponding revenues are recognized. This relationship is called the matching concept or principle.

The causality notion is much debated. The controversy is not whether the matching principle implies a cause-effect relationship: *"Matching is the process of reporting expenses on the basis of a cause-and-effect relationship with reported revenues"* (Hendriksen and Van Breda 1992, 376). Rather, the controversy regards the direction of the cause-effect relationship and whether the implied causality notion in the matching concept disqualifies matching as an appropriate recognition guideline when the link between costs and revenues is weak.

It is generally accepted that costs causes revenues, but certain commentators have assumed an opposite causal relationship: *"Which of the elements, revenue or cost, should be measured first? Does revenue govern the cost, or does cost govern the revenue?"* (Hylton 1965, 825) [49]. Storey was as Hylton somewhat ambivalent in his dealing with the direction of the cause-effect relationship: *"Either revenue or expense must be chosen as the controlling factor and assigned to periods first. The other is then allocated to accounting periods on the basis of its relationship to the controlling factor. Although either element presumably could be chosen, accountants overwhelmingly agree that revenue is to be allocated first and then costs are to be matched against revenue"* (1960, 155). In other words, according to these authors, revenues may cause expenditures of an entity. This causality can not be. That is, it is not unlikely that there is a correlation between revenues and costs (the dependent variable). If taken seriously, however, one would have to accept that the motivation of an entity that chooses to incur costs is that it has had revenues, and need to spend earnings for the sake of spending, not for the purpose of investment. Assuming rationality on behalf of the entities, this relationship cannot exist.[50]

Both the FASB and the IASB assume that when the link becomes too tenuous matching is no longer an appropriate concept, and must be replaced by some kind of allocation concept. However, the FASB seem to regard allocation as a separate concept from

matching while allocation may be interpreted as an application of the matching concept in the IASB Framework: *"When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures"* (IASB 1989, 96).

If allocation is considered to be a separate concept from matching because the latter implies a causality notion, it may be difficult to distinguish allocation from smoothing. This issue is further addressed in chapter 4.5.2.2.

4.5.2.2 Matching Versus Smoothing

> *"Smoothing (...) is a function of analysis, not financial reporting"* (Knutson and Napolitano 1998, 172).

Several empirical studies document that smoothing occurs, and numerous reasons for the smoothing action have been proposed. For instance, Ronen and Sadan (1981) suggested that managers believe that investors are willing to pay more for entities with smoother income streams. Lambert (1984) and Dye (1988) demonstrated that risk-averse managers precluded from borrowing and lending has an incentive to smooth income. Trueman and Titman (1988) showed theoretically that managers regardless of risk-aversion and restricted access to capital markets have an incentive to lower the variability in income in order to lower claimants' assessment of the probability of bankruptcy, and that such behavior may have a positive effect on stock prices. In other words, there seem to be evidence that smooth income streams are favorable to management, and that it actually occurs. The questions addressed here are what separates smoothing from matching and whether smoothing should be permitted.

The failing attempts of the APB and the Committee of Accounting Procedure (CAP)[51] to develop *"(...) a core of fundamental concepts that were neither subject to nor dependent on the moment's particular, transitory consensus (...)"* (Storey and Storey 1998, 66),

was, according to the FASB, unavoidable given these standard setters' commitment to matching without regard to the resulting balance sheet items.

The following statement by Delmer Hylton, an often quoted accounting commentator at the time, expressed a similar view: *"Concurrent with the ascendancy of the income statement in recent years, we have also witnessed increasing emphasis on the accounting convention known as "matching revenue with expense." In fact, it seems that most innovations in accounting in recent years have been justified essentially as better performing this matching process. In the minds of many accountants, this single convention outweighs all others; in other words, if a given procedure can be asserted to conform to the matching concept, nothing else need to be said: the matter is settled and the procedure is justified"* (Hylton 1965, 824).[52]

It was argued that the R-E view *"(...) is at odds with the actual process of valuation in a free competitive market"* (Storey and Storey 1998, 62), and that the *"(...) matching guidelines can become potentially dangerous when it attempts to match today's real costs with hopes of tomorrow's revenues"* (Bevis 1965, 100).

"Smoothing", or "non-distortion", is of some commentators believed to be acceptable in the R-E view (Bevis 1965). However, it is the opinion of this author that smoothing simply is misunderstood matching, and that the problem of the R-E view was not the inability to give rise to objective recognition criteria, but rather the justifying of smoothing as a form of matching.

Staubus seems to recognize that smoothing is unacceptable matching when he claims that *"(...) smoothing of earnings under the guise of matching costs with revenues, (...), cannot be defended (...)"* (Staubus 1999, 337).[53] It should be noted that smoothing gives rise to balance sheet items clearly in conflict with the asset and liability definitions in the A-L view. The following statement in Accounting Research Bulletin No. 24 (ARB 24) illustrates that smoothing beyond matching was applied: *"(...) when the term of existence of such intangibles has become limited (...) the cost should be amortized by systematic*

charges in the income statement over the estimated remaining period of usefulness or, if such charges would result in distortion of the income statement, a partial write-down may be made by a charge to earned surplus, and the balance of the cost may be amortized over the remaining period of usefulness".[54]

It is suggested that matching and smoothing to some extent have been, and still are, confused, and the line between matching and smoothing is under certain circumstances thin. For instance, when Gordon suggested that *"(...) the criterion that should be used in choosing among principles is the minimization of stockholder bias in extrapolating past income to estimate future income"* (Gordon 1964, 260), it was not clear whether he was applying matching, or if he was supporting smoothing. The objective of matching is to give the investors and other users meaningful information in their valuation efforts, and thus the income statement should be a reasonable estimate of the future earnings. However, Gordon's proposal builds on propositions suggesting that management should choose accounting principles leading to the most favorable evaluation of their performance, and a theorem suggesting that the stockholders evaluating the managers will tend to be more positive the greater the consistency in income is over several periods, and the more stable the growth in income is. Hence, the support for income smoothing offered by Gordon seems to include more than proper matching.

The distinction between smoothing and matching becomes clearer by the list of "Accounting Techniques Aimed at the Smoothing of Periodic Income" authored by Hepworth (1953). Hepworth was the first to suggest that entities intentionally smooth income (Eckel 1981, 28).[55] For instance, gross revenue manipulation through inter-period shifting of revenue was (is) a common way of income smoothing, according to Hepworth: *"Given actual knowledge of or expectations about the operating results of two accounting periods, speeding or delaying the shipment of and billing for product and hence the recognition of revenue, may accomplish some degree of leveling of the income of the two periods"* (1953, 54).[56] Hepworth acknowledges that smoothing and manipulation is not the same. When discussing the use of production as a criterion for revenue recognition, he admits that smoothing may be the result, but not manipulation:

"However, it is hardly appropriate to consider this as a method of artificially smoothing income, but rather as the use of realistic and logical method of gross revenue booking" (Hepworth 1953, 54).

It is meaningful to distinguish between "intentional smoothing" and "natural smoothing". Intentional smoothing is the smoothing of income that results from management's efforts to reduce the variability in earnings and to stabilize earnings growth. Natural smoothing follows from proper matching: *"A naturally smooth income stream simply implies that the income generating process inherently produces a smooth income stream"* (Eckel 1981, 28). Intentional smoothing can be divided into to groups, "artificial smoothing" and "real smoothing". Both forms of smoothing result from management actions. However, the distinction between artificial and real smoothing is that the former does not affect cash flows, while the latter does.[57] Thus, artificial smoothing may be defined as accounting manipulations undertaken by management to smooth income (Eckel 1981, 29). Artificial smoothing is in certain cases allowed under GAAP. For instance, application of the amortization approach and the corridor approach when accounting for changes in underlying economic and actuarial assumptions in pension accounting represents allowed artificial smoothing.

A service contract with or without milestones may illustrate the difference between artificial and real smoothing. Assume the service provider can choose to design the contract with or without milestones. In the milestone design, the service receiver can choose to cancel the contract at any of the defined milestones, and the payment schedule under the contract reflects the cancellation clause. That is, assume there are two milestones in addition to the beginning and the end of the service period. One third of the consideration under the contract is to be paid at the first milestone, one third at the second milestone, and one third at the end of the service period. If the service receiver chooses to terminate the contract at the first milestone, no more payments are to be made (the provider ends up receiving one third of the total payment under the contract). In the no-milestone design, none of the parties can cancel the contract and full payment is made up front. The latter contract design will typically require up-front revenue recognition of the

full consideration, while the former contract design typically will require partial revenue recognition at each of the milestones (two thirds may be recognized at the second milestone since the service receiver cannot effectively cancel the contract after this milestone (if the service receiver cancels between the second milestone and the end of the service period, it has no effect on the consideration to be paid)). The no-milestone design is economical beneficiary to the service provider. If the service provider still chooses the milestone design, it can be assumed that the entity is engaged in real smoothing.

The revenue recognition timing in the example above would not change even if the payment schedule is changed. For instance, assume that the full consideration is to be paid at the end of the service period in both contract designs. Still the revenue recognition timing explained above applies in both designs. If the service provider chooses the milestone design the entity is still engaged in real smoothing as opposed to artificial smoothing, even if the choice of design does not have a direct effect on the cash flow profile. The choice between the two designs has economic consequences and leads to different revenue recognition timing, and therefore represents more than artificial smoothing.

Figure 4-3 ***Smoothing***

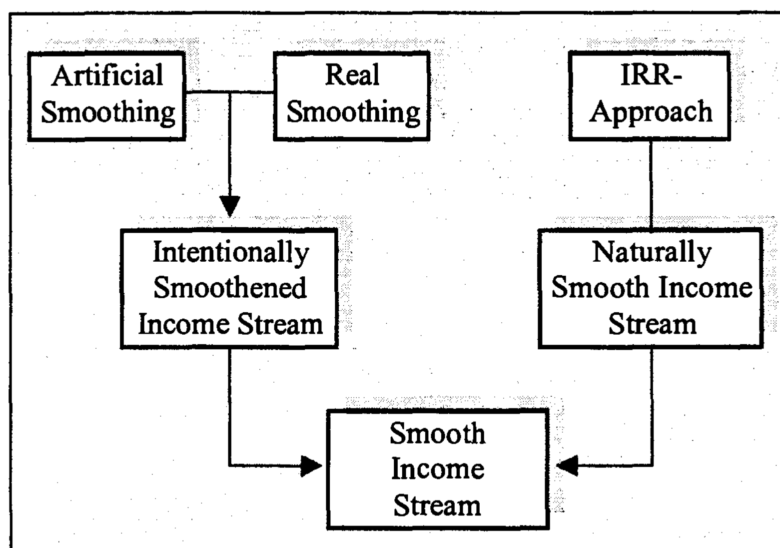


Figure 4-3 is based on the relationships employed by Eckel (1981).

Artificial smoothing should be advised against. This view is in accordance with the FASB view: *"(...) the present accounting process has tended to produce an artificially stable growth in reported earnings. A stable growth of earnings creates an expectation that the marketplace evaluates highly. If this stable growth is artificial and not real, the result may be exaggerated stock-marked prices. The truth of the matter is that changes in economic values probably come unevenly. If the ups and downs were reported, the risks in business would be evaluated more realistically. Variations in earnings are crucial information to the financial-statement user in judging risks and should not be concealed by "trending" profits or by "spreading" methods of accounting (...) Accountants must get back into the economic area where the business battles are fought. They must discard the notion that fluctuations in earnings are necessarily distortive"* (FASB 1976c, 103). Actual volatility should be reflected in reported earnings. By engaging in artificial smoothing the accountants manipulate financial information and disguise risk in the form of actual volatility: *"If it is true that volatility affects market prices of securities and the related costs of capital, it is especially important that, where it actually exists, volatility be revealed rather than concealed by accounting practices. Otherwise, financial statements do not faithfully represent the results of risks to which the enterprise is actually exposed"* (Sprouse 1987, 88).

On the other hand, naturally smooth income streams reflect the business operations, and introduction of different recognition criteria, for instance A-L definitions, disguising natural smooth income streams will not contribute to the faithfulness of the financial reports. Rather, such manipulated variability in earnings may tend to confuse the users of the financial reports. For example, as will be explained in chapter 5.3.3, if the A-L definitions are applied in income tax accounting, deferral of tax consequences cannot be done. In chapter 6, it is shown that the users of the financial reports find income tax deferral useful.

4.5.2.3 The Case of Amortization

In the following, let us try to explore the relationship between the three concepts explored in the two former sections, matching, allocation, and smoothing, in the context of amortization of fixed assets.

When an entity invests in a fixed asset, for example a plant, the cost of the plant is capitalized and amortized over future periods. The rationale for the capitalization and amortization approach is that the plant is expected to catalyze revenues in the future. The plant is a necessity in the operations of the entity, and the goods produced in the plant are the direct cause of the revenues of the entity. The link between the direct costs of goods sold and the revenues is strong and deferral of the direct costs of producing the goods is therefore not considered a controversial issue. The expensing of the direct costs of goods when the goods are sold and the associated revenue is recognized is thus a straightforward application of the matching concept.

The cost of the plant is clearly costs contributing to the revenues. However, the cause-effect relationship is indirect. When the association between revenue and costs can only be broadly or indirectly be determined, some sort of indirect matching or allocation must be applied. The concept of allocation of indirect costs over future accounting periods is typically guided by some sort of reasonableness criterion: *"The problem of properly matching revenues and costs is primarily one of finding satisfactory bases of association – clues to relationships which unite revenue deductions and revenue (...). It should be emphasized, however, that the essential test is reasonableness (...)."* (Paton and Littleton 1940, 71). Under US GAAP, allocation should be "systematic and rational" (ARB 43). The requirement of systematic and rational allocation in current accounting literature is an interpretation of the reasonableness test of Paton and Littleton.

It is advocated by some commentators and standard setters that the allocation concept must be separated from the matching concept. For example, the FASB clearly separates allocation in the form of amortization from matching when amortization is explained as *"(...) a cost of using up assets, not a technique for matching expenses with revenues"*

(SFAS 93.23). However, if the reasonableness criterion and the systematic criterion refer to the associated benefits the separation of the two is less meaningful. For instance, the FASB assumes that the allocation procedure for indirect costs yielding benefits to the entity over several periods has the same purpose as matching (FASB 1985, 149). Whether this assumption only refers to the allocation period or also refers to the profile of the associated benefits is not clear from the FASB Conceptual Framework.

Similarly, in the IASB Framework the emphasis seems to be put on the allocation period and not on the allocation profile when the link between allocation and matching is discussed: *"The allocation procedures are intended to recognise expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire"* (IASB 1989, 96). The IASB seems, however, in the accounting standard dealing with property, plant, and equipment to assume a matching allocation profile in the allocation procedure recommended: *"The depreciation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise"* (IAS 16.41). The IASB refers to "consumption of benefits" when allocation methods are discussed, while matching is discussed in the context of revenue streams. Apparently, the consumption of benefits may not align perfectly with the inflow of the associated revenue streams. Thus, allocation methods in the IASB Framework relies on a somewhat different foundation than the matching concept. That is, costs are matched with consumption, not revenue.

However, it is reasonable to assume that there is a link between the consumption of benefits profile and the revenue stream. For instance, let us use production facility as an example. In periods of high production, the production facility is "consumed" at a higher rate than in periods of low production. Similarly, in periods of high production there are typically higher revenue inflows than in periods of low production. In this example it is assumed that production is caused by demand. However, if an entity produces for stock in low demand periods in order to be prepared for high demand in later periods, then consumption matching and revenue matching may lead to different allocation profiles.

However, if cost of goods sold in this case includes depreciation costs (as is the case in IAS 2), the allocation profiles will be the same.

From the above one may conclude that whether the applied concept is matching or allocation, an underlying assumption is that there is a causal relationship between the expenses and the revenues recognized in the same accounting period: *"(...) allocation is applied if causal relations are (...) identified"* (FASB 1985, 149). The distinguishing feature of the concepts is the link between the cause (the cost) and the effect (the revenue). If the link is direct, matching is applied. Thus, one may describe allocation as an application of matching when the link between cost and the revenue is not strong enough for matching.

When allocation is viewed as an approach to matching, the allocation procedure must be designed to match associated benefits both in time and in profile: *"(...) to perform any reasonable sort of matching, an estimate of revenue must be made, in terms of time, if not in amount"* (Hylton 1965, 824). That is, an allocation procedure for fixed assets allowing costs to be allocated over the useful economic life of the asset without regard to the expected profile of the associated benefits over this period can hardly qualify as a matching approach. Hylton is of the same opinion, and argues that amortization of fixed assets represents allocation of cost over accounting periods, and not matching: *"The depreciable asset is assumed to have a productive life and its cost is apportioned over this period during which it is expected to contribute to revenues. (...) If at some point during the useful life of an asset, revenue falls to the zero point; this has no effect on the assignment of expense if it is reasonably expected that the asset will contribute to income in subsequent periods. For example, if the plant is closed because of a strike, expense is still assigned even though no revenue is being realized. Time and its deteriorating effects are not halted by the lack of revenue"* (Hylton 1965, 824).

Take for instance expenditures to research and development activities of 100. Let us assume that there is no uncertainty as to the following timing and the amounts of the future revenues resulting from these expenditures: 10 in period 1, 15 in period 2, 20 in

period 3, 155 in period 4, and no revenues in the later periods. If matching only refers to timing, then the only requirement would be to expense in all four periods. Linear allocation of the expenditures over the four periods, that is recognition of 25 in expenses each period, would represent an allowed expense profile. The entity would report losses in all of the three first accounting periods, and then a gain in the fourth accounting period making up for the prior period losses. The return on book values (RBV) would be –15%, -13%, -10%, and +520% in period 1, 2, 3, and 4, respectively. The only valid interpretation of this solution would be that more resources have to be invested in order to get the initial sales compared to the sales in the fourth period. This may be true in certain special cases, but the opposite is the rule. In other words, it takes 1 in expenditure to achieve 2 in revenue in period 1, as well as in period 2, period 3, and period 4.

From this, it should be apparent that matching must involve both timing and amounts (profile). If the allocation procedure only requires matching in the sense of timing it is more meaningful to view the allocation as a form of smoothing. For example, spreading of costs of fixed assets over the useful life of the assets taking the timing and the amount of the associated benefits into account may be considered matching. The costs are linked with the corresponding revenues. However, the allocation of the effect of changes in the useful life of a fixed asset over future periods cannot be explained as matching. There is really no other plausible justification than the urge for minimum distortion in the income statement (smoothing). Although this conclusion is drawn in the context of amortization of fixed assets, it applies to the effect of changes in accounting estimates in general.

Application of the matching concept in allocation of indirect costs is by some commentators considered meaningless: *"It is futile and unnecessary to try to apportion these costs in relation to assumed amounts of periodic revenue"* (Hylton 1965, 828). Amortization of fixed assets represents the most common example used to support the viewpoint of Hylton and other supporters of the allocation approach as a separate approach from the matching concept.

If allocation is not matching, little separates the allocation approach from smoothing. For instance, Paterson suggests that *"(...) matching becomes smoothing when the supposed link between costs and benefits becomes too tenuous"* (Paterson 1990, 81). The AcSB in Canada views the amortization of fixed assets as an example of smoothing, because the link between costs and benefits "becomes too tenuous", to use the wording of Paterson (CICA 1990), and Staubus suggests that *"(...) capitalizing and amortizing research and development costs, using self-insurance reserves, deferring losses on early extinguishment of debts, and full costing for oil and gas exploration costs (...)"* all represent smoothing (1999, 337).

To sum up, the approaches applied in recognition of indirect costs being associated with future periods' revenues by the leading standard setters are often referred to as "allocation procedures". Some view these procedures as independent from the matching concept while others view them as applications of the matching concept. The choice of terminology is not important. However, allocation procedures requiring costs to be allocated according to both the timing of the associated revenues and the profile of the associated revenues represent applications of the matching concept and may therefore be termed matching procedures. On the other hand, allocation procedures only tied to the timing of the associated revenues and allocation procedures with no ties to the profile of the associated revenues fall under the smoothing category discussed in chapter 4.5.2.2.

4.6 The Critics of the A-L Perspective

The numerous examples of accounting standards issued by the FASB and the IASB conflicting with their respective conceptual frameworks, illustrate the problem of the A-L view. Kripke (1989) argues that these examples are consequences of the frameworks rigidity and emphasis on theory and logic, while others argue that the examples rather is evidence of the FASB's ability to use pragmatism where it belongs, *"(...) in the many judgments about trade-offs, such as between relevance and reliability and between costs and benefits, that standards setters make resolving specific reporting problems"* (Kirk 1989, 95).

Critics of the FASB Conceptual Framework have argued that SFAC 5 is descriptive rather than normative, and adds little to current practice: *"SFAC 5 is more pragmatic than conceptual; it is more an inventory of existing practices than a consensus on future direction"* (Kay and Searfoss 1989, 2-11). Perera and Rahman include all conceptual frameworks when they conclude their analysis of the conceptual frameworks of Australia and New Zealand: *"Conceptual Frameworks are supposed to prescribe how things ought to be and not to describe the way they are (FASB 1976, 2). However, it is noticeable that they all tend suddenly to become descriptive of current practice when discussing the issue of measurement in financial reporting"* (Perera and Rahman 1995, 11). As explained in chapter 4.2, SFAC 5 does little more than describing the current treatment of measurement issues. Krasnoff is of the same opinion, but includes recognition issues other than measurement issues when he characterizes SFAC 5 as a descriptive document: *"The new pronouncement establishes which financial statements should be presented and how to present them; however, it merely catalogues present practices instead of dealing with recognition and measurement questions"* (Krasnoff 1985, 67). The Krasnoff critic is not disputed by the FASB: *"Most aspects of current practice are consistent with the recognition criteria and guidance in this Statement, but the criteria and guidance do not foreclose the possibility of future changes in practice"* (FASB 1984, 31), and the introduction in SFAC 5 reveals that the FASB got less ambitious during the process: *"The recognition criteria and guidance in this Statement are generally consistent with current practice and do not imply radical change. Nor do they foreclose the possibility of future change in practice. The Board intends future change to occur in the gradual, evolutionary way that has characterized past change"* (FASB 1984, x). Whether current practices are consistent with the recognition guidance in SFAC 5 will be explored in chapter 5. The FASB's James Leisenring (now a member of the IASB) admitted at an international accounting conference in Brussels in 1991 that the treatment of recognition and measurement in the FASB Conceptual Statement is not satisfactory: *"Concepts of recognition and measurement still remain to be completed because the Board was not able to agree on controversial recognition and measurement matters, even at a conceptual level. As the result of compromises necessary to issue the Concepts Statement on recognition and measurement in financial statements of business enterprises (No. 5), it*

merely describes present recognition and measurement practices and some of the reasons that have been used to support or explain them. Some critics have said that it provides little conceptual guidance for analyzing and making choices about the controversial issues of recognition and measurement" (quote referred in NOU 1995:30, 25).

According to the critics, SFAC 5 fails its primary function, namely to implement the relationships established in SFAC 1, SFAC 2, and SFAC 3 (FASB 1980b) (replaced by SFAC 6): *"In the 1970s and 1980s, the FASB invested a great deal of energy and resources into fashioning a conceptual framework. Although the project got off to a promising start, it eventually foundered when difficult decisions on recognition and measurement were addressed. In the end, the FASB's conceptual framework failed to fulfill expectations that it might constitute a powerful intellectual force for improving financial reporting (...)"* (Zeff 1995, 60).

The failure of the FASB to complete the conceptual framework project with useful guidelines for measurement and recognition, can, according to many commentators, be attributed to the definitions of the elements of financial statements: *"(...), the FASB's failure to deal effectively with the recognition and measurement issues can be largely attributed to the fact that they were limited by the definitions of the elements of financial statements given in SFAC No. 3"* (Davies et al. 1997, 79). Others seem to imply that the definitions do not give the balance sheet items real world meaning, as they were intended to. For instance, Samuelson concluded that the A-L definitions *"(...) confuses definition with measurement, stocks with flows, and it lacks empirical content"* (1996, 147). As pointed out before, the failure of the FASB and the other leading standard setters in their attempt to deduce recognition policies from the objectives, qualitative characteristics, and the A-L definitions is critical to the usefulness of the conceptual frameworks: *"A noteworthy feature of the FASB's definitions is their dependence on unspecified "accounting rules and conventions", (...). This qualification appears to be inconsistent with the claim that conceptual frameworks can lead to the selection of appropriate principles and rules of measurement and recognition "* (Dopuch and Sunder 1980, 4).

Some commentators have questioned the consistency of the A-L definitions in SFAC 6 and the recognition guidelines in SFAC 5. The focus in SFAC 5 is on whether the earnings process is complete (R-E view), while the focus in SFAC 6 is whether an asset has been received (chapter 4.5.1.1). Not surprisingly, different focus creates internal inconsistencies in the Framework (Schipper 2002; Schipper 2003, 63).

Furthermore, commentators question whether the A-L view is consistent with the objective of decision usefulness: *"(...), if the primary focus of financial reporting is the measurement of earnings, then surely the starting point should be definitions of earnings and its components, with assets and liabilities being the residuals – rather than the other way around?"* (Davies et al. 1997, 58).

Lastly, but not least, the A-L definitions have proven to be inappropriate to deal with issues of particular relevance to financial position presentation. So-called off-balance sheet financing has come under public scrutiny, and the accounting standard setters and the regulators have been criticized for not issuing accounting standards preventing misstatements of the financial position. The failure to include financial obligations giving rise to bankruptcy and similar consequences in an A-L approach to recognition indicates limited usefulness of the approach. Even before the unfolding of the accounting scandals we have witnessed the last couple of years, the IASB admitted that the definitions do not serve effectively as recognition criteria, and the definitions of elements should, according to the Board, be revised to improve *"(...) the concepts for the recognition of contractual rights and liabilities"* (IASB 2000, 27).

The purpose of SFAC 5 was to collect all loose ends from SFAC 1, SFAC 2, and SFAC 3, and based on these concepts statements issue guidelines for recognition. Nevertheless, SFAC 5 is little more than a description of existing practices, and fails to complete the conceptual framework: *"The weakness of the FASB's conceptual framework project may be attributed to a number of factors; however, the most significant reason will probably be shown to be the Board's failure to deal with the fundamental issues of recognition and measurement"* (Davies et al. 1997, 63). To sum up, the conclusion of Nussbaumer seems

appropriate: *"The issuance of SFAC 5 marked the greatest disappointment of the FASB's project for the conceptual framework. It did nothing more than describe present practice; it was not prescriptive at all"* (1992, 240).

Nevertheless, the difficulties experienced in implementing the A-L view do not alone justify the rejection of the perspective on behalf of the alternative, the R-E view. Still, all the leading standard setters continue to rely on the A-L view, and according to some commentators the R-E view is not a relevant alternative: *"The "asset and liability view" has proved to be superior in both concept and practice to the revenue-expense matching view that had previously dominated financial accounting"* (Skinner and Milburn 2001, 581). The conceptual "superiority" of the A-L view has been challenged in this chapter, and will be further investigated in chapter 6. The practical "superiority" will be investigated in the next chapter, chapter 5.

4.7 Concluding Remarks

Definitions, recognition, and measurement are interrelated, and may all be considered part of the general recognition issue. In the A-L view, recognition of an item assumes that certain definitions are met and that a reliable measure can be made. The conceptual frameworks do not prescribe a certain measurement base, but simply acknowledge that historical cost is the most commonly adopted measurement base. However, it is generally assumed in the frameworks that current values are more relevant than historical cost, and if reliable estimates of current values exist, historical cost accounting should be replaced by fair value accounting. Thus, over the years, fair value accounting has gradually modified historical cost accounting. It is important in this context to emphasize that the conflict between the A-L view and the R-E view must not be mistaken for a conflict with respect to measurement bases. Assuming agreement on the primacy of earnings measures and decision usefulness across the perspectives and on appropriate reliability thresholds, proponents of both views would favor fair value accounting over historical cost accounting under circumstances in which a reliable estimate of current values exist. The conflict generally is only meaningful when such reliable estimates of current values do not exist. For instance, as mentioned in chapter 4.4.2 (and elaborated on in chapter 5.3.5),

investments in associates and joint ventures when fair value accounting would lead to unreliable measures, should be accounted for at cost in the A-L view, while equity method accounting and proportionate consolidation would apply in the R-E view. The R-E view treatment is derived from the earned revenue concept and the matching concept. The treatment is rejected in the A-L view, not necessarily because it is a less decision useful approach, but because it leads to balance sheet items not meeting the A-L definitions.

---

[1] The term "New Economy" as used here describes an economy dependent upon high-technology related human capital, as represented by ".coms", "e-tailers", "pure-play net firms", other internet-related entities and other high-tech entities not depending on the internet for their operations. Thus entities within the telecom and software industries for example, do also represent a part of this economy. The entities in the New Economy will here in common be referred to as "high-tech entities".

[2] The recognition criteria of the other leading standard setters are summarized and commented on in Johnson 1994 (Appendix A).

[3] The definitions of recognition in the leading standard setters' conceptual frameworks are summarized and commented on in Johnson 1994 (Appendix A).

[4] An alternative view, ignoring the emphasis traditionally put on transactions, recognizes that the transaction price may not reflect the current value under all circumstances, and does therefore not as a general rule allow for cost to be the measurement attribute. For instance, an entity may in some rare cases "make a good deal". In the case of business combinations, the alternative view does not allow for negative goodwill on the balance sheet.

[5] Net realizable value was termed "exit value" by Sterling (1979). In Sterling's opinion, exit value as the one and only measurement attribute, would meet the two necessary criteria of measurement attributes, namely "empirical testability" and "relevance" (Sterling 1979, 215).

[6] In ARS No. 1 (1961) and ARS No. 3 (1962) AICPA tried to persuade that current or net realizable values where the only sound measurement bases for accounting (Davies et al. 1997, 43). This was reflected, for example, in the statement that *"(...) inventories which are readily saleable at known prices with negligible costs of disposal, or with known or readily predictable costs of disposal, should be measured at net realizable value"* (ARS No. 1, 27).

[7] A conceptual problem inherent in the multiple-measurement attribute approach is that the inability to single out one measurement attribute makes the financial statements inadditive. For example, one of the most often sited problems of ARS No. 3 was that the "principles" were not additive (Wolk et al. 2001, 134). That is, different attributes unable straightforward addition of the items in the financial statements.

The FASB and the other leading standard setters do not seem to be concerned about this potential inconsistency. Staubus explained the problem of inadditivity as follows: *"(...) that the amount of one asset measured at present value, another at replacement cost, a third at net realizable value and a fourth at historical cost produced a sum comparable to the addition of US dollars, pounds, sterling, Australian dollars, and Swiss Francs"* (2002, 18). Ijiri argue that the problem of inadditivity is inherent in current cost accounting, while historical cost accounting is additive (Ijiri 1970, 7). However, it seems that Ijiri discusses another dimension of the problem of additivity when he explains that the aggregate current value of the assets may be considerably different from the entity as a whole. It is not difficult to agree when Solomons explains that historical cost also is inadditive in this dimension, and is additive only in the sense that the numbers can be added together (Solomons 1970, 109). The problem of inadditivity may be illustrated by the fair value measurement of certain financial instruments and the measurement of other current assets, for instance inventory, at the lower of cost and marked. The effect of the multi-measurement approach is that total assets represent partly fair values and partly cost values, and that the earnings number includes certain unrealized gains and excludes others. In the context of financial reporting, the impact of the inadditivity problem is to some extent compensated through disclosures. The bottom line alone, net income in the income statement, and total assets or equity in the balance sheet, may not be sufficient informative, but the user of the financial reports can learn about the measurements used in the disclosures. There is no problem as long as the fair value measurement is reflected in both the income statement and the balance sheet. An unrealized gain recognized in the income statement will be accompanied by a similar increase in assets (or decrease in liabilities), and the effect on different commonly used relative earnings measures, for instance interest on total assets, interest on equity, revenue on total assets, etc., will be the same as with any increase in the numerator. As long as the numerator and the denominator are different in magnitude, the recognition of unrealized gains will off course have an effect on the relative earnings number, but only as a result of the law of relativity. A practice of excluding certain holding gains from the income statement, and including these in comprehensive income, has been advocated by some of the leading standard setters. Typically, gains on financial instruments not intended for trading, are included in equity through comprehensive income. The effect is that different relative earnings measure loose meaning. However, this is not a particular problem of inadditivity, but rather a problem of non-articulating financial statements.

[8] In the Norwegian Accounting Act, however, no modification of the transaction-based accounting model is made with respect to the timing of recognition. Contract-based recognition, as discussed by the IASB in the 1997 discussion paper, modifies the timing of the recognition as well as the measurement.

[9] Solomons (1986b) was also disappointed with the failure to deal with exectuory contracts in terms of either their possible inclusion within the body of the financial statement, or their disclosure in footnotes.

[10] *"(...), the criticism which was leveled at these studies appeared to be based more on the fear of the unknown, rather than on any intellectual shortcomings"* (Davies et al. 1997, 44).

[11] ARS No. 1 and ARS No. 3 were followed by ARS No. 7, Inventory of Generally Accepted Accounting Principles for Business Enterprises: *"ARS 7 rejected the imposition of a single uniform system of*

accounting, instead emphasizing diversity in accounting as a basic concept" (Hendriksen and van Breda 1992, 102).

[12] Accounting Standards Committee (ASC) was the predecessor to ASB in the UK.

[13] The additivity problem commented on above, may be rejected in the normative approach here presented. The relevant measurement attribute is net present value of expected future cash flows or a surrogate, and there are no additivity problem, only different estimation techniques: *"My view was, and is, that none of those accounting measurement methods is perfect. All reflect a market's estimate of an asset's value, at some time, somewhere, so are additive. Differences in estimation techniques do not destroy additivity"* (Staubus 2002, 18).

[14] This section is based on the definitions in the FASB Conceptual Framework. In Johnson (1994), the definitions in the other leading standard setters' conceptual frameworks are summarized and commented on (Appendix A).

[15] All leading standard setters, except AASB and FRSB in Australia and New Zealand, respectively, have defined these seven elements of financial statements. AASB and FRSB do not distinguish between revenue and gain and expense and loss.

[16] The term "item" is here reserved for particular economic phenomena giving rise to separate specification in financial statements, for example, cash, sales revenue, and accounts payable.

[17] Staubus (1977) offers a slightly different definition of assets: *"An asset of any entity is any economic resource that is capable of providing services to the entity and that is presently measurable in monetary terms"* (Staubus 1977, 126).

[18] The IASB defines "constructive obligations" as *"(...) an obligation that derives from an enterprise's actions where: (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the enterprise has indicated to other parties that it will accept certain responsibilities; and (b) as a result, the enterprise has created a valid expectation on the part of those parties that it will discharge those responsibilities"* (IAS 37.3).

[19] The AAA Financial Accounting Standards Committee analyzes the exposure draft preceding SFAS 150 in depth in an article in Accounting Horizon (AAA 2001). The complexity involved in giving liabilities a stringent definition is illustrated by the objections of the AAA.

[20] *"(...) the assertion about accounting principles as "conventions" is intended to convey the idea that they are generalizations, inferences drawn from a large body of data, and that they are not intended to be literal descriptions of reality"* (Moonitz 1963, p 44), as opposed to the "real" assets and liabilities in the A-L view.

[21] As the only leading standard setter, FRSB in New Zealand has chosen to operationalize the term "probable" in the conceptual framework. According to the FRSB Conceptual Framework, "probable" means "more likely rather than less likely" (NZSA 1993).

[22] Hersvik (2003) has analyzed the application of the different probability terms in accounting standards in greater detail.

[23] A third view not discussed in length in the accounting literature, is the so-called Non-Articulation view (N-A view) (FASB 1976c). This view generally implies that articulation of financial statements is not a necessity, and inhibits good measurement. In an N-A view an A-L view in the balance sheet could be combined with an R-E view in the income statement. Articulation is generally considered to be fundamental to financial statements, and the N-A view has not achieved support, and is not further explored here. However, note that for instance Paterson has shown some preference for the N-A view: *"One possibility which might be explored is whether the two approaches could be made to run in parallel, so that the matching approach could be used for the profit and loss account while the balance sheet approach would be used for the balance sheet. An inevitable, but not necessarily unattractive, result of this would be that the articulation between the two statements would be broken, and there would need to be some new means of linking or reconciling the two"* (Paterson 1990, 81). Interestingly, the current tendency among the leading standard setters to use fair value measurement for balance sheet purposes with the valuation effect charged to equity, for instance in the case of certain financial instruments and in the case of certain currency effects, seems to be an application of the N-A view.

[24] *"Since they adopted their conceptual frameworks, all member organizations of the G4+1 increasingly have focused their standard-setting activities on the balance sheet, guided by their respective framework's definitions of assets and liabilities"* (Monson 2000, 277).

[25] Schmalenbach describes the focus at the beginning of the century in his book "Dynamic Accounting": *"When the writer first began to publish his opinions on the subject, in the year 1908, the great majority of lawyers and accountants still believed that the primary function of the annual accounts was the ascertainment of capital, and that the year's profit or loss was the difference between the opening and the closing capital"* (Schmalenbach 1959, 3). Schmalenbach argued that this focus lacked an important aspect, namely the aspect of performance, or the "results of business operations": *"My object was to oppose this concept by substituting one based on a better foundation"* (Schmalenbach 1959, 3).

[26] In Edward G. Nelson's article in the Accounting Review in April 1942, "The Relation Between the Balance Sheet and the Profit-and-Loss Statement", the balance sheet is explained in the words of Dewing as *"(...) a statement representing an arithmetical summation of a series of ledger accounts balanced as of a particular moment in time"* (Moonitz and Littleton 1965, 158), and the primacy of the income statement is not to be disputed. More interestingly though, is the fact that Nelson in his conclusive remarks in the same article seems to view the function of the balance sheet more favorably: *"The balance sheet and the profit and loss statement are complementary: each completes the picture by presenting a different aspect of enterprise receipts and disbursements"* (Moonitz and Littleton 1965, 170).

[27] "Criteria" in the quote refers to Solomons seven criteria for choosing an accounting model (Solomons 1995).

[28] Professor Robert Mautz explained his understanding of the conflict as discussed in FASB 1976b at the Conference on the Conceptual Framework of Accounting held at the Wharton School in May 1977: *"(...) the DM itself in its own words pointed out that we're presented with two distinct conceptual views of*

earnings, and the reader is asked to choose between them. He's asked to choose between emphasis on assets and liabilities and revenue and expense. In so doing, he is selecting the most fundamental elements, whose precise definitions control the definitions of other elements. And this choice is presented as if they were mutually exclusive, and that's where I run into difficulty. It's a decision that's impossible for me to make. I accept that the definition of assets is absolutely fundamental to any theoretical exposition of accounting. At the same time, I think that the presentation of revenues and expenses on a matching basis is the most useful service that accounting can render. And I have to merge these two somehow. I am not really given that possibility within the discussion memorandum. It leaves me kind of homeless. I can't give allegiance to either one of these" (Kripke 1989, 23).

[29] If the discussion was about which statement, the balance sheet or the income statement, was the most important one, it would resemble the discussion once told by the economist Abba Lerner about the moon and the sun: When asked which was more important, which we could best do without, a man answered: *"Well, we could do best without the sun rather than the moon, I think, because the moon gives light when we need it"* (Bell 1997, 26).

[30] See for instance Ernst & Ernst's contribution on the Discussion Memorandum leading up to the FASB Conceptual Framework: *"The Discussion Memorandum constitutes a continuing contest between traditional accounting and current value accounting with traditional accounting programmed as the loser"* (Ernst & Ernst 1977, 44). Staubus comments on this issue in his memoir, but with emphasis on the resistance to the decision usefulness objective, and the implications for smoothing: *"As I saw it, opponents believed, quite rightly, that achievement of the decision-usefulness objective would require the reporting of current values when they could be measured with acceptable reliability and cost. That would mean the loss of a great tool for managing earnings – the ability to convert noncurrent values to realized gains or losses as needed"* (2002, 21).

[31] Solomons further explains the difference in approaches by a water-tank example (Solomons 1986a, 130). This analogy only illustrates the difference in approaches taken to measure income, but does not indicate whether the balance sheet or the income statement as the primary statement.

[32] The FASB has been criticized for not taking an unambiguous stand on the question of measurement attributes, and Kripke (1989) argued strongly that the historical cost basis lacked relevance, and should be abandoned.

[33] George A. May proposed at the annual meeting of AICPA in 1935 that valuation should be used as a safeguard in historical cost accounting (Storey 1963, 45).

[34] To some commentators it is meaningless to discuss the A-L view and value accounting separately, since, in their view, the only issue of conflict is measurement basis (see for instance Ernst & Ernst 1977).

[35] To some the A-L view taken by the FASB and the IASB is not consistent with the historical cost approach: *"(...); to my mind it is futile to emphasis the balance sheet in a system where the assets are measured at historical cost"* (Paterson 1988, 27).

[36] In Sprouse's opinion the misunderstanding that the A-L view is synonymous with fair value accounting is irrational and unexplainable, and must stem from lack of basic knowledge of accounting: *"Some "current value paranoia" was also evident in the reluctance or downright refusal of some to react to proposed definitions of assets and liabilities without their measurement first being settled. Those various reactions suggested that either the accounting education of many had been woefully lacking in developing an enduring fundamental framework for analyzing accounting issues or that their education had been forgotten or become rusty from disuse"* (Sprouse 1988, 126).

[37] The terminology used to separate the different views was criticized by Sprouse: *"If one understands the differences among the three views, the terms are reasonable descriptive, but (...) events reveal that many were misled about the essential differences among the views and that the shorthand designations may have been an unfortunate choice"* (1978, 67).

[38] The overriding role of the definitions in recognition is explained in IAS 1, in addition to in the Framework (IAS 1.26). This may have important implications, and is discussed in chapter 2.2.

[39] Paterson (1990) proposed an N-A view, and suggested that the deferrals and accruals not meeting the A-L definitions should be regarded as a separate component of equity (Paterson 1990, 81).

[40] Some may argue that the discussion of primacy of the balance sheet or the income statement has nothing more than syntactic interest, and adds little to the fundamental question.

[41] From the quote one should note that Dopuch and Sunder seem to imply that the timing of recognition should be the focus of the discussion.

[42] Sprouse (1978) argues that the conflict between the A-L view and the R-E view has practical implications. Also, Kirk, in his commentary on Kripke's paper, emphasizes the importance of the conflict: *"Kripke considers the asset-liability and the revenue-expense dichotomy (....) as a trivial issue. It wasn't and still isn't"* (Kirk 1989, 90).

[43] See Solomons 1986a (127-132) for a further discussion of the practical implications of the conflict between the A-L view and the R-E view.

[44] It should be noted that the provision treatment is controversial even among R-E proponents. It may be argued that this treatment does not represent proper matching, and rather is a result of a "smoothing" or nondistortion notion. Assuming that the probability of a loss is independent of whether a loss has occurred in earlier periods, it may be argued that the loss should be accounted for in full when it occurs in an R-E view. Another explanation for recognition of a provision is the prudence concept (Lennard 1994, 95). The role of smoothing is further discussed in chapter 4.5.2.2.

[45] Traditionally net income, or earnings, has been the most relevant accounting measure to value enterprises by: *"The relationship between accounting earnings and security prices is probably the most important relationship in security analysis, and its prominence is reflected in the attention given to price-earnings ratios"* (Beaver 1998, 38).

[46] Strictly speaking, revenues should be recognized continuously over the entire product cycle. The percentage-of-completion method illustrates recognition when earned. Practical problems have led

accountants to search for other valid interpretations of the earning criterion (Hendriksen and van Breda 1992, 360).

[47] The realization concept is discussed in length in AAA 1965b. See also Backer and Bell 1966, 84.

[48] Need to be further elaborated - Sterling's starting point is Finney's reasoning (Finney 1944).

[49] Hylton (1965) named his paper "On Matching Revenue With Expense" and thereby indicated that he was matching revenue with expenses, not the other way around.

[50] It is nevertheless important to emphasize that revenue under certain circumstances comes before costs. For instance, a sales agreement may be signed before the seller has acquired the sales item. However, short selling is typically involving high risks, and does not represent the most common trading form.

[51] Committee on Accounting Procedure (1938-1959), a committee of the American Institute of Accountants (AIA, American Institute of Certified Public Accountants (AICPA) since 1957).

[52] Today, some may argue that if "the matching concept" was substituted by "the asset and liability definitions" in Hylton's statement, reading *"(...) if a given procedure can be asserted to conform to the asset and liability definitions, nothing else need to be said: the matter is settled and the procedure is justified (...)"*, the statement would explain the current view of the leading accounting standard setters.

[53] Hepworth gave smoothing a less favorable flavor when he tried to explain what motivates smoothing, and thereby clearly indicating that smoothing could not be explained as a form of matching. An important motivation was explained by tax advantages (when there was a direct link between the financial statements and the tax bases). More importantly though, according to Hepworth, were the more psychological effects of nondistortive income statements: *"Certainly the owners and creditors of an enterprise will feel more confident toward a corporate management which is able to report stable earnings than if considerable fluctuation of reported earnings exists. The stable dividend policy which level earnings facilitate does nothing to lessen satisfactory stockholder relations"* (Hepworth 1953, 53).

[54] ARB 24 was released in 1944, and replaced by ARB 43 in 1953. While this exact sentence is not found in ARB 43, its sense is included in paragraph 6. ARB 43 was replaced by APB 17, in which the issue is dealt with in paragraph 12.

[55] Gordon (1964) elaborated the suggestion by Hepworth that entities intentionally engaged in income smoothing. Gordon was followed by several empirical studies the next decade supporting the suggestions of Hepworth and Gordon (Eckel 1981, 28).

[56] Hepworth lists several methods of manipulative smoothing: Intangible asset accounting (great latitude in choices, ranging from immediate expensing to amortization over rather long periods), inventory accounting (the use of LIFO causing "current costs being matched with current revenues"), property accounting (latitude in determination of acquisition cost, revaluation (not allowed according to current US GAAP), and alternative methods of depreciation), reserve accounting (misuse of the prudence concept (less latitude in current US GAAP)), and treatment of non-recurring charges or credits (choice between inclusion in income or direct charge against retained earnings (no choice in current US GAAP)) (Hepworth 1953, 54-60).

---

[57] There is extensive literature concerning earnings management, defined as the use of *"(...) judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on the reported accounting numbers"* (Healy and Wahlen 1999, 368).

5. The Application and Effectiveness of the A-L Definitions

The R-E view was perceived inadequate in establishing objective recognition criteria. Proponents of the A-L view argued that recognition criteria could effectively be established only in the A-L view. As a consequence one would expect that accounting standards issued after the release of the conceptual frameworks apply the definitions actively in the recognition recommendations, and that references to the conceptual frameworks are numerous.[1] Anthony (1987) relied on this assumption in his analysis of the usefulness of the FASB Conceptual Framework. He looked at the period between April 1979 and December 1985. The FASB issued 63 statements and 44 interpretations in this period, and made only 28 references to the conceptual framework. Anthony's conclusion was that the conceptual framework had not provided the guidance that would lead to consistent standards, and a new framework should replace the FASB Conceptual Framework.

While Anthony's remarks are interesting, it must be considered that the majority of the standards and interpretations in his study were issued prior to the completion of the FASB Conceptual Framework. On the other hand, all of the present accounting standards and interpretations of the IASB have been issued, revised or reformatted after the issuance of the IASB Conceptual Framework in 1989. A study of the IASB standards and interpretations similar to the one conducted by Anthony in the US may therefore be carried out without the weakness of the Anthony study.[2]

The major revisions and issuances conducted by the IASB in 1998 (IAS 22, IAS 36, IAS 37, IAS 38) and later revisions were in part a result of an explicit commitment made by the Board to the Framework. One of the priorities was to eliminate conflicts between existing standards and the A-L definitions. The commitment was made in spite of the criticism questioning the usefulness of the original framework, the FASB Framework, in the early- and mid-nineties, leading many commentators to conclude that the FASB Framework did not represent a useful tool when dealing with recognition issues: *"In the 1970s and 1980s, the FASB invested a great deal of energy and resources into fashioning*

a conceptual framework. Although the project got off to a promising start, it eventually foundered when difficult decisions on recognition and measurement were addressed. In the end, FASB's conceptual framework failed to fulfill expectations that it might constitute a powerful intellectual force for improving financial reporting (...)" (Zeff 1995, 60). The IASB commitment represents an interesting background for an analysis of the application of the A-L definitions in the current accounting standards and interpretations of the IASB.

The international harmonization process evidenced by the European Union (EU) Regulation requiring all EU entities listed in a regulated market to prepare consolidated accounts in accordance with IAS by 2005, and the effect this harmonization process will have on financial reporting in the US, further support an analysis of the accounting standards and interpretations of the IASB. [3] [4]

Several others have commented on the usefulness of the conceptual frameworks over the years. Some of the commentators have assessed the usefulness of one or more elements of the conceptual frameworks, for example, the usefulness of the objectives and/or the qualitative characteristics (for example Joyce et al. 1982; Daley and Tranter 1990; Hudack and McAllister 1994), while others have commented on the usefulness of the conceptual frameworks in general (for example DePree 1989). The A-L definitions have only in a few cases been the focus of the commentators (for example Paterson 2000). The usefulness has typically been evaluated based on the analysis of one or two accounting standards (for example Foran and Foran 1987). Anthony (1987) designed and conducted a more comprehensive test of the usefulness of the FASB Conceptual Framework. However, Anthony did not test for the usefulness of the A-L definitions in particular. In this chapter, the test-design of Anthony will be employed in order to assess the usefulness of the IASB Conceptual Framework, with particular emphasis on the A-L definitions.

The Anthony (1987) approach alone does not provide a sufficient background to draw conclusive remarks about the usefulness of the A-L definitions. Supplementary research efforts are necessary to investigate the indications provided by the analysis of the IASB

recommendations. Several approaches may be adequate. One approach is to investigate certain areas of accounting recognition in particular. By analyzing the effectiveness and application of the A-L definitions in areas that traditionally have been controversial and therefore have drawn significant attention to them, one will be able to improve the explanatory power of the analysis. The analysis of the IASB recommendations will therefore be followed up by an in-depth analysis of four important areas of accounting recognition, namely pension accounting, maintenance cost accounting, income tax accounting, and goodwill accounting.

The remainder of this chapter is organized as follows. In the next section, the methodology of the analyses is explained. An analysis of the explicit use of the IASB Framework and the asset and liability definitions therein in the IASB accounting standards and interpretations is conducted in chapter 5.2. In chapter 5.3, the effectiveness of the A-L definitions in accounting for pensions, maintenance cost, income tax, and goodwill, and the application of the definitions by the standard setters, is researched. In the final section, chapter 5.4, concluding remarks are offered.

5.1 Methodology

Research opportunities provided by the accounting standard setting process are numerous. Evaluation of shortcomings in the conceptual frameworks represents one obvious avenue (Wyatt 1990, 87). This research opportunity may be approached in several ways. An analysis of departures from the conceptual frameworks in the accounting standards represents a feasible approach. The Anthony (1987) approach applied to the accounting standards and interpretations of the IASB cannot give rise to conclusive evidence, but the outcome of an analysis of references to the Framework will represent a meaningful indicator of the use of the Framework.

One would expect that the use of a framework would be reflected directly in the accounting standards and interpretations. An absence of references to the Framework will indicate that the Framework is less useful, and it will be fair to say that there is little evidence to document the usefulness.[5] Wilson et al. (2001) supports the analysis of

references approach when they consider the usefulness of the FASB Conceptual Framework: *"Perhaps the acid test may be found in analysing the extent to which the FASB has used the framework in the development of accounting standards"* (Wilson et al. 2001, 102). They recognize that the Framework may have *"(...) guided the thinking of the FASB members without it being expressly stated"* (Wilson et al. 2001, 102), but are not convinced by the argument: *"(...), if this were the case, why is it that the FASB has, for example, issued a statement on reporting comprehensive income (SFAS 130) which seemingly lacks any conceptual integrity and is in conflict with the framework? The same might be said of the standard on deferred tax (SFAS 109) which similarly lacks any discernible conceptual underpinning"* (Wilson et al. 2001, 102).

Furthermore, a careful evaluation of the contribution of the Framework in the accounting standards and interpretations in combination with the Anthony (1987) approach will enhance the usefulness of the analysis. If the Framework has made material contributions to the development of an accounting standard or an interpretation, then there is evidence of usefulness regardless of the number of occurrences of explicit application of the Framework. On the other hand, if the references made to the Framework are formalistic and make no material contributions in the standard setting process, then there are indications of limited usefulness despite explicit references.

The analysis of references will be based on a computerized test for direct references to the IASB Conceptual Framework and the A-L definitions in the accounting standards, including the basis for conclusions appendixes, and the interpretations. The qualitative evaluation will rely on the findings in the computerized test, but will also cover certain indirect references.

One of the objectives of the conceptual frameworks is to guide the body responsible for setting accounting standards, and the standard setting body itself is believed to be the primary beneficiary of the frameworks: *"The Board itself is likely to be the major user and thus the most direct beneficiary of the guidance provided by the new series"* (introductory paragraph of the FASB Concepts Statements). The issue to be analyzed in

this analysis is not whether the standard setting bodies have been "the most direct beneficiary", but whether there is evidence in the experiences of the leading standard setting bodies documenting the usefulness the A-L definitions to these primary beneficiaries in their efforts to establish objective recognition policies in financial reporting standards.

The intention is to analyze the usefulness of the A-L definitions as recognition modifiers. A direct way to test the standard setter application of the A-L definitions would be to assess the actual standard setting process. Unfortunately, there is no operational way to make this assessment. Instead, an alternative test must be settled for. For the A-L definitions to be useful, they have to be effective modifiers in the recognition process as well as the standard setter has to apply them in the standard setting process.

Thus, the usefulness of the A-L definitions in accounting standard setting involves two dimensions: (1) The A-L definitions have to be effective, and (2) the accounting standard setters have to apply the effective definitions. These two dimensions will both be investigated in the analysis. The matrix in Figure 5-1 illustrates the methodology.

Figure 5-1 ***The Analysis Matrix***

	Applied by the Standard Setter	Rejected by the Standard Setter
Effective	**USEFUL**	**NOT USEFUL**
Not Effective	**NOT USEFUL**	**NOT USEFUL**

If the A-L definitions are effective and applied by the standard setter in the standard setting process, then the definitions are useful (upper left corner). If the A-L definitions are effective but rejected by the standard setter, then the definitions are not useful (upper right corner). If the A-L definitions are not effective they cannot be useful, regardless of

whether the standard setter applies them (the two lower corners). The A-L definitions, and hence the A-L view, may only be rejected to the extent the A-L definitions prove ineffective (regardless of whether the standard setter apply them or not). However, effective definitions not applied by the standard setter will raise a follow up question, namely why the rejection?

It is important to recognize that effectiveness does not necessarily imply different timing of recognition under the two approaches (see chapter 4.4.2). A modifier may only affect the classification and still be considered effective. It is assumed that the A-L definitions have been useful, and thus effective, to the extent that the IASB recommends solutions in conflict with the R-E view (and in accordance with the A-L view).

The methodology explained above does not provide for conclusive evidences. A lack of application, indicated by no references to the A-L definitions, may be explained in three ways: (1) The A-L definitions are in use, but the application was not detected in the analysis, (2) the A-L definitions are not effective, or (3) the A-L definitions are effective but ignored by the standard setter.

The methodology does not ensure that the first explanation does not apply, and this explanation can therefore not be ruled out. However, no explicit application is undetected, and a reasonable assumption is that the IASB would refer to the A-L definitions if the choice between two alternative solutions has been solved by the application of the definitions. The second explanation assumes that the A-L view and the R-E view do not lead to different accounting solutions, and hence there is no reason for the standard setter to refer to the A-L definitions. The third explanation recognizes the discriminating power of the modifier, but blames the standard setter for not taking advantage of the effectiveness of the A-L definitions, and assumes that the standard setter therefore avoids making references to the A-L definitions.

The analysis of the accounting standards and interpretations of the IASB will be followed up by a closer look at four controversial areas of financial reporting: Accounting for

pensions, maintenance costs, income tax, and goodwill. The purpose of this in-depth analysis is to add explanatory power to the analysis of international accounting standards and interpretations. In particular, whether the A-L definitions are effective, and if so, whether they are rejected by the standard setters in the policy making process, will be investigated. Furthermore, the follow-up analysis will indirectly confirm or reject the first of the three possible explanations of lacking application of the A-L definitions listed above, namely the imperfect methodology explanation.

5.2 Explicit Application of the IASB Conceptual Framework

The official IAS-literature is made up of accounting standards and interpretations. Accounting standards issued by the IASB will in the future be termed International Financial Reporting Standards (IFRS). The Standing Interpretations Committee (SIC) has traditionally been responsible for the issuance of interpretations. The SIC was in 2002 replaced by a new body, the International Financial Reporting Interpretations Committee (IFRIC). The replacement involves more than a name change. The new body should *"(...) provide timely assistance to entities applying IFRSs"*, and *"(...) consider a much wider range of issues than it has dealt with in the past"* (IASB Insight, January 2002). At the cut-off time of the study, March 2002, there were thirty-four accounting standards, and thirty-one effective interpretations.[6]

In the following all explicit references to the IASB Framework and the A-L definitions in the accounting standards and interpretations of the IASB will be listed and analyzed.[7] References to the IASB Framework as such are included in the analysis in order to obtain a more complete understanding of the application of the Framework, but the emphasis is on the A-L definitions. There is no explicit evidence of the usefulness of the Framework, and of the A-L definitions in particular, in the accounting standards and interpretations not commented on.

The methodology of the analysis does not ensure that indirect references to the IASB Framework are reflected. Direct or explicit references, here referred to as "explicit application", are evidenced by the use of the terms "framework" (as in "conceptual

framework") and "definition" (as in A-L definitions). Components of the definitions, for example the control criterion and the past transaction criterion, are in some of the accounting standards and interpretations loosely referred to, but not in the context of the other components of the definitions or in reference to the Framework. Such loose and at best implicit references are generally not considered to be indications of the usefulness of the Framework in this analysis. Indirect or implicit references may thus exist even if not commented on. However, certain indirect references are found to be of significance, and are commented on (IAS 12, IAS 14, IAS 18, IAS 37, and IAS 38). The line between direct or explicit and indirect or implicit references drawn here represents a discrimination that is useful for the purpose of the analysis. It may be argued that it would be more meaningful to discriminate between the applications of the Framework and the A-L definitions that can be detected in the conducted analysis (the "explicit" and "implicit" applications) and the applications that cannot be detected from the analysis. That is, the IASB and the SIC may have applied the Framework and the A-L definitions even if the applications cannot be screened in the conducted analysis. However, it should be self-explanatory why applications that cannot be documented in the standards and interpretations have to fall outside the scope of the analysis. Furthermore, as commented on in the introduction to this chapter, not everybody agrees that undetectable applications are likely to exist (Wilson et al. 2001, 102).

5.2.1 IAS

In IAS 1, guidelines for presentation of financial statements are established. It is stated that all guidelines in the IAS must be followed. In the absence of specific accounting standards and interpretations, the entity should look to the requirements of a specific IAS dealing with similar or related issues, but also the Framework. IAS 1 allows for the application of pronouncements of other standard setting bodies if not in conflict with the Framework (FASB 1999, 72). In other words, the IASB recommends that the producers of accounts and financial statements rely on the definitions and recognition criteria of the Framework, thus elevating the producers as one of the primary potential user groups of the Framework.

As explained, the modified matching concept of the IASB Framework is emphasized in IAS 1 (IAS 1.26). The inclusion of the modified matching concept elevates the significance of the A-L definitions.

The IASB Conceptual Framework and the A-L definitions are referred to in IAS 8 Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies (IAS 8.9). However, the reference is general in nature, and is not of significance in this context. The reference plays no role in the development of accounting policies in IAS 8, and cannot be interpreted as an indication of usefulness on behalf of the Framework.

In IAS 11 Construction Contracts, however, a commitment to the recognition criteria in the Framework is stated, even if the application of the definitions is not mentioned specifically: *"This Standard uses the recognition criteria established in the Framework for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the income statement. It also provides practical guidance on the application of these criteria"* (IAS 11.Objective). Even if there is no further mention of the Framework, the commitment expressed in the introduction is strong, and one would feel confident that IAS 11 is in accordance with the Framework, and the A-L definitions. Another, not as obvious reflection, is that the explicit commitment made in IAS 11 may reveal something about the other accounting standards. For instance, in IAS 12 Income Taxes, no direct reference to the Framework is made (see chapter 5.3.3).

Interestingly though, the stage of completion method advocated in IAS 11, represented accounting practice long before the introduction of the conceptual frameworks and the A-L definitions. Pre-Framework practice should be considered when assessing the importance of the IASB commitment in IAS 11. The IASB interpreted current practice at the time, namely application of the stage of completion method, as not conflicting with the A-L view. Hence, it would be deceiving to conclude that the A-L definitions had played an important role in policy making in IAS 11.

No direct references are made to the Framework or the A-L definitions in IAS 12 Income Taxes. However, the so-called deferral method is explicitly prohibited, and the "balance sheet liability method" is required when accounting for income taxes (IAS 12.1). Generally, the deferral method is believed to be consistent with the R-E view, while the liability method is considered to be in accordance with the A-L view, and the FASB chose to replace the deferral method with a liability method when they replaced APB 11 with SFAS 96, and later SFAS 109, arguing that only the latter method was in accordance with the A-L view. However, others find the differences between the two methods merely technical, and consider deferred tax accounting nothing more than a matching issue: *"The only real world obligation, as far as tax is concerned, is that which is shown on tax assessments, based on profits measured under the tax rules. In contrast, deferred tax is merely an accountant's abstraction, designed to reconcile taxable profit with accounting profit"* (Paterson 2000, 108).

In IAS 14 Segment Reporting the qualitative characteristics of the Framework are used as arguments in support of the solutions recommended (IAS 14.15). The revenue definition in the Framework is repeated in the section of definitions in the standard (IAS 14.8), but the A-L definitions play no apparent role in the policy making process.

In IAS 16 Property, Plant and Equipment, the strongest and clearest commitment to the Frameworks definitions is made: *"This Standard requires an item of property, plant and equipment to be recognised as an asset when it satisfies the definition and recognition criteria for an asset in the Framework for the Preparation and Presentation of Financial Statements"* (IAS 16.Objective). Capitalization of expenditures to property, plant, and equipment and other tangible assets has not been a controversial issue. The debate has rather concerned capitalization of expenditures to intangible assets. It is therefore difficult to regard the commitment made by the IASB in this standard as an indication of usefulness of the A-L definitions. Again, one may ask why a similar statement is not made in all standards and interpretations dealing with recognition. A reasonable answer, but nevertheless hardly true under all circumstances, is that such a statement requires that the definitions and the recognition criteria in the Framework actually apply, and that

except in the rare cases when such a statement is made, the accounting standard and interpretations are not in accordance with the Framework.[8]

IAS 18 Revenue is introduced by a reference to the Framework, and the definition of income, including both revenue and gain. Then it goes on to state the objective, which is to determine *"(...) when to recognise revenue"*. A direct commitment to the A-L definitions is made, when it is stated that revenue is to be recognized when it is probable that future economic benefits will flow to the enterprise. However, except for these general references, and an inclusion of the revenue definition from the Framework in the section of definitions (IAS 18.7), IAS 18 exhibits few, if any, A-L view characteristics. As explained, one of the important differences between the A-L view and the R-E view is that the former assumes revenue and expenses as consequences of changes in assets and liabilities. There is no evidence in IAS 18 of this relationship. There is no reference to the definitions as an overriding recognition criterion, and indeed revenue recognition is approached in a traditional R-E manner.

In the basis for conclusions in IAS 19 Employee Benefits several references are made to the A-L definitions (IAS 19.A3). The definition of a liability in the Framework is referred to, and a pension liability should be recognized when an employee in a defined benefit plan has rendered service in exchange for benefits promised under the plan (IAS 19.A3.13). This conclusion applies even if the benefit is not vested according to the IASB (IAS 19.A3.14).

It is acknowledged that deferral of actuarial gains and losses are in conflict with the Framework, since it leads to items in the balance sheet that do not meet the definitions of assets and liabilities. However, the IASB did not find the immediate recognition approach "feasible", and chose to recommend deferred recognition (IAS 19.A3.41).

The corridor approach is supported by reference to paragraph 34 of the IASB Framework, in which the IASB notes that it may be relevant to recognize items despite inherent difficulties in identifying transactions or other events or in measurement.

interim financial reporting dates" (IAS 34.31). It is true that the definitions have a crucial role in the Framework, and as such, this statement at least serves the purpose of reminding the reader of this role. In addition, the statement may signal a commitment on behalf of the standard setter to comply with the recognition criteria in the Framework. And, when read together with paragraph 33, there is no doubt that the IASB in IAS 34 is firmly committed to meet the recognition criteria in the Framework, including the definitions of the elements. This is of particular interest given that more frequent accounting periods potentially gives rise to additional accruals and deferrals.

Take for instance seasonal businesses. Recognition of indirect costs on a time basis could easily lead to losses being reported in an interim period even if there is net income on a yearly basis. Under such circumstances the abandonment of accruals and deferrals not meeting the A-L definitions would emphasis the limited usefulness of the interim reports, because such reports have little meaning in isolation.

In IAS 34, the IASB seems to feel obligated by their commitment to the Framework, and it is emphasized that *"(...) a cost that does not meet the definition of an asset at the end of an interim period is not deferred on the balance sheet either to await future information as to whether it has met the definition of an asset or to smooth earnings over interim periods within a financial year, (...)"* (IAS 34.30b). In this way the IASB limits the usefulness of the interim reports, but stays loyal to the Framework.

No references are made to the Framework or the definitions in IAS 36. However, in the basis for conclusions appendix a general reference to the Framework is made to support the decision in the standard to require reversals of impairment losses. It is merely noted that reversal of impairment losses *"(...) is consistent with the IASC Framework and the view that future economic benefits that were not previously expected to flow from an asset have been re-assessed as probable"* (IAS 36.A2.111). No further explanation is provided. It is reasonable to assume that the reference regards the recognition criterion in paragraph 83a in the Framework. The application of this recognition criterion is not undisputable, and cannot be regarded as evidence of the usefulness of the Framework

There are no direct references to the Framework in IAS 37, but the liability definition of the Framework is applied to explain when a provision should be recognized (IAS 37.14). The liability definition in the Framework is repeated in the section of definitions in the standard (IAS 37.10). The past event criterion in the liability definition has explicitly been applied in this standard (IAS 37.17-22). In the section dealing with application of the recognition rules, the impact of the liability definition is significant. Furthermore, the application of the A-L definitions in IAS 37 is to some extent reflected in other standards (IAS 16 and IAS 22 in particular). IAS 37 is therefore an accounting standard in which the A-L definitions seem to have been contributing to the development of accounting policies, even though no explicit references are made to the Framework or the definitions.

Explicit application of the Framework and the definitions cannot be found in IAS 38. However, the asset definition of the Framework is repeated in the introduction of the standard and in the section of definitions in the standard (IAS 38.7). Furthermore, references to the Framework and the definitions are made in the basis for conclusions in an appendix. According to IAS 38 expenditure on internally generated intangible assets should be recognized in the balance sheet whenever certain criteria are met (IAS 38.A22). Not everybody supports this recommendation claiming that internally generated intangible assets fail to meet the asset definition in the Framework (IAS 38.A21).

There is no "separability" criterion in IAS 38. The decision to exclude this criterion is partly supported by the fact that there is no mention of "separability" in the Framework (IAS 28.A28). In this instance, the usefulness of the Framework is at best indirect.

IAS 38 does not allow for revaluation of intangible assets at fair value. Some commentators have argued that IAS 38 contradicts paragraph 83 in the IASB Framework (IAS 38.A30). The IASB rejects this argument. This example does not illustrate usefulness of the Framework. If anything, it illustrates that the Framework leaves room for different interpretations when applied.

In IAS 39 the IASB refers to the Framework when fair value measurement of certain financial instruments is recommended (IAS 39.102). The Framework simply states that estimates do not undermine the reliability of financial statements, and that the use of reliable estimates is essential in the reasoning leading to fair value measurement (IAS 89, 86).

No direct application of the Framework and the definitions can be found in IAS 40. However, in the appendix explaining the basis for conclusions, certain commentators arguing that fair value measurement of investment property is in conflict with paragraphs 92 and 93 in the Framework are referred to (IAS 40.B63). The IASB does not agree with their interpretation of the Framework.

In IAS 41 certain references to the Framework is made in the basis for conclusions. However, none of these regards the A-L definitions. Commentators arguing that fair value measurement is in conflict with the Framework are referred to in IAS 41.B17. Since the IASB does not recommend one single measurement attribute in the Framework, the rejection of this objection to fair value measurement is valid (IAS 41.B18). A proposal to require changes in fair value of biological assets to be included directly in equity is rejected by the IASB. The ground for the rejection is that no distinction between recognition in the balance sheet and in the income statement is made in the Framework. Recognition of conditional government grants in the income statement is refused under reference to the recognition criterion in the IASB Framework requiring reliable measurement (IAS 41.B69, B72).

5.2.2 SIC

SIC has been criticized for not providing timely guidance. Furthermore, SIC has to a certain extent limited its operations to dealing with interpretations of the existing accounting standards, avoiding important and challenging conceptual and technical problems not dealt with elsewhere. It may therefore come as no surprise that the explicit application of the A-L definitions in the interpretations is limited. Several references to

the Framework are made, but the usefulness of these references seems generally to be immaterial, not playing a significant role in policy making.

The A-L definitions have only been directly applied in five of the interpretations (SIC 6, SIC 13, SIC 14, SIC 21, and SIC 27). In the other interpretations in which the Framework is referred to, the references are made to other elements of the Framework than the definitions. In two occasions, the references to the Framework are made to the decision usefulness objective (SIC 29 and SIC 30). In four occasions, the references are made to the qualitative characteristics (SIC 1, SIC 2, SIC 18, and SIC 31). In three occasions, the references are made to the substance over form assumption (SIC 12, SIC 15, and SIC 19). In SIC 17, SIC 28, and SIC 32, the references are made to the recognition guidelines of the Framework. However, the A-L definitions play no part in the interpretations.

To further elaborate on the role of the Framework, and the A-L definitions in particular, in the interpretations, the relevant interpretations are discussed in chronological order in the following.

In SIC 1 the issue is whether an entity may apply different cost formulas for different types of inventories (LIFO, FIFO, or weighted average cost). In other words, a question of the role of uniformity in policy application is raised. As a basis for the conclusion, that an enterprise should use the same cost formula for all inventories having similar nature and use to the enterprise, a reference is made to the IASB Conceptual Framework: *"To ensure comparability, paragraph 39 of the Framework explains that the measurement of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time in separate and consolidated financial statements"* (SIC 1.4). Here, the Framework clearly has a significant and substantial role in policy making. Be aware though, this is hardly a question of recognition, rather a question to be solved at a higher level, namely the qualitative characteristics level.

In SIC 2 the issue is similar: Should an enterprise that has chosen a policy of capitalizing borrowing costs apply this policy to all qualifying assets or may the enterprise choose to

capitalize borrowing cost for certain qualifying assets and not for others (IAS 23.07 and IAS 23.11)? By making the same reference as in SIC 1, SIC concludes that the same policy should be applied to all qualifying assets. Again, here the Framework plays a substantial role in policy making.

In SIC 6 the issue is whether costs incurred in modifying existing software systems to enable them to continue to operate as intended after the turn of the millennium may be capitalized, and if not, when such costs should be expensed. As the only general reference made in the SICs, the IASB Conceptual Framework is referred to. More importantly though, SIC uses the recognition criteria in their argumentation leading up to a conclusion that supports capitalization: *"In accordance with paragraphs 89 and 90 of the Framework (and applying the rationale of IAS 16.23 to 27 (revised 1998) by analogy), subsequent costs for modifying existing software systems should be recognised as an expense when they are incurred unless (a) it is probable that those costs will enable the software to generate specifically attributable future economic benefits in excess of its originally assessed standard of performance and (b) those costs can be measured and attributed to the asset reliably"* (SIC 6.6). Furthermore, the recognition criteria in paragraph 91 in the Framework is used to support a conclusion denying upfront expense recognition of costs associated with modification of existing software: *"The fact that the expenditure may be necessary for the enterprise to continue in business does not create a legal or constructive obligation towards an external party. A liability is, therefore, recognised only as the work related to the modification of existing software is performed by third parties"* (SIC 6.7).

In SIC 12 the issue is when a Special Purpose Entity (SPE) should be consolidated. SIC conclude that SPEs should be consolidated when the substance of the relationship between an enterprise and the SPE indicates that the SPE is controlled by that enterprise. This conclusion is supported by reference to the Framework: *"Paragraph 35 of the Framework and IAS 1.20(b)(ii) (revised 1997) require that transactions and other events are accounted for in accordance with their substance and economic reality, and not*

merely their legal form" (SIC 12.12). Again, here the Framework represents a substantial source of reference. However, the issue is not a recognition issue.

The issue in SIC 13 is if a venturer should recognize a gain or loss in the income statement when making a non-monetary contribution to a "jointly controlled entity" (JCE).[9] SIC concludes that a gain or loss should be recognized in the income statement, except when risks and rewards have not been transferred to the JCE, the gain or loss cannot be measured reliably, or the contribution is in fact an exchange of similar assets with the other venturers.[10] This conclusion is reached by referring to the recognition criteria in paragraph 92 in the Framework: *"Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably"* (SIC 13.10). No gain or loss is to be recognized if the contribution is considered to be an exchange of similar assets. One possible method of accounting under such circumstances would be to defer the gain or loss. This solution is not allowed because deferred items do not meet the recognition criteria in the Framework, according to SIC: *"It is not appropriate to present unrealised gains or losses on non-monetary assets contributed to JCEs as deferred items since such items do not meet the recognition criteria for assets or liabilities as defined in the Framework (paragraphs 53-64 and paragraphs 89-91)"* (SIC 13.13).

In SIC 14, the issue is three-fold: How should impairments or losses of items of property, plant and equipment be accounted for? How should related compensation from third parties, for example reimbursements from insurance companies, be accounted for? And, how should subsequent restoration, purchase or construction of assets be accounted for? According to SIC, all these three events should be accounted for as separate events, and the impairment should thus be accounted for under IAS 36, related compensation should be included in the income statement, and the subsequent restoration, purchase or construction should be accounted for under IAS 16. In determining how to account for the compensation, SIC turns to the definition of income in paragraph 92 in the Framework: *"The same rationale applies to compensation receivable from third parties by an enterprise for the restoration or replacement of items of property, plant and*

equipment that were impaired, lost or given up in the past" (SIC 14.8). This analogy is not controversial. It is rather the view that each of the three components should be recognized as separate transactions that may be questionable. However, to solve that issue SIC has chosen not to look for the answer in the Framework.

In SIC 15 a conclusion is reached as to how incentives in operating leases are to be accounted for by both the lessor and the lessee: All incentives for the agreement should be recognized as an integral part of the net consideration agreed for the use of the leased asset, irrespective of the incentive's nature or form or the timing of payments. This solution is based on an assumption that all payments *"(...) made by the lessor to or on behalf of a lessee, or allowances in rental cost made by a lessor, as incentives for the agreement of a new or renewed lease are an inseparable part of the net amount receivable or payable under the operating lease"* (SIC 15.9), and according to the Framework substance over form rules: *"Paragraph 35 of the Framework explains that if information is to represent faithfully the transactions and events that it purports to represent, it is necessary that transactions and events are accounted for and presented in accordance with their substance and economic reality and not merely their legal form"* (IAS 15.7). In addition, to end on the conclusion SIC refers to paragraph 22 in the Framework in which the support for accrual basis of accounting is stated (SIC 15.8).

In SIC 17 the issue is accounting for costs of equity transactions, and in conclusion SIC states that such costs should be accounted for as a deduction from equity. There is no direct support for this solution in the Framework, but the solution is at least not in conflict with the Framework: *"Paragraph 65 of the Framework explains that funds contributed by shareholders may be shown as a separate component of equity. IAS 8.07 together with Paragraphs 94/98 of the Framework indicates that all items of income and expense should be included in the determination of net profit or loss unless an IAS requires or permits otherwise"* (SIC 17.10).

Certain IAS' provide explicit choice between alternative accounting policies, but are silent on the manner of exercising that choice. In SIC 18 it is concluded that when

alternative accounting polices are allowed, an enterprise should choose and apply consistently one of those policies, unless otherwise is stated in the accounting standard. Given paragraph 39 in the Framework, landing on this conclusion is not surprising: *"To ensure comparability, paragraph 39 of the Framework explains that the measurement of like transactions and other events must be carried out in a consistent way throughout an enterprise and over time in separate and consolidated financial statements"* (SIC 18.5).

The issues in SIC 19 are how an enterprise determines a currency for measuring items in its financial statements (the "measurement currency"), whether an enterprise may use a currency other than the measurement currency for presenting its financial statements (the "presentation currency"), and if so, how the financial statements should be translated from the measurement currency to the presentation currency. Among other sources, the Framework (paragraphs 17, 35, 39 and 46) is used to underline the substance over form assumption that should be applied to reflect *"(...) the economic substance of the underlying events and circumstances"*, and it is concluded that the choice of measurement currency should reflect the economic substance of the business of the entity.

The issue in SIC 21 is how to interpret "recovery" of the carrying amount of non-depreciable assets in the context of revaluation of assets. The asset definition in the Framework is indirectly referred to in order to reach the conclusion that the deferred tax liability that arises from the revaluation of a non-depreciably asset should be measured based on the tax consequences of a sale of that asset (SIC 21.6). However, it appears that the reference is rather formal, and makes no incremental support for the conclusion reached: *"The Framework indicates that an enterprise recognises an asset if it is probable that the future economic benefits associated with the asset will flow to the enterprise. Generally, those future economic benefits will be derived (and therefore the carrying amount of an asset will be recovered) through sale, through use, or through use and subsequent sale. Recognition of depreciation implies that the carrying amount of a depreciable asset is expected to be recovered through use to the extent of its depreciable amount, and through sale at its residual value. Consistent with this, the carrying amount*

of a non-depreciable asset, such as land having an unlimited life, will be recovered only through sale. That is, because the asset is not depreciated, no part of its carrying amount is expected to be recovered (that is, consumed) through use. Deferred taxes associated with the non-depreciable asset reflect the tax consequences of selling the asset" (SIC 21.6).

The issue in SIC 27 is under which conditions sale-leaseback, lease-leaseback, and similar transactions should be accounted for. Particularly, whether such series of transactions should be accounted for as one or more transactions, and whether the arrangements meet the definition of a lease under IAS 17. The substance over form assumption in the Framework is referred to deal with the first question, and the conclusion is that when a series of legal transactions can be understood by assessing the transactions as one economic transaction, then these legal transactions should be accounted for as one transaction. To solve the second question, a general reference to the definitions in the Framework is made. More detailed criteria for determining whether the definition in IAS 17 is met, is listed, but with no direct reference to the definitions in the Framework. In SIC 27.14, the control-requirement in the definitions is applied to disregard certain arrangements in which the entity does not control the asset in question, from recognition. Finally, a reference is made to the nature of gains and revenue according to the Framework, when a critical event approach is proposed for fees gained in lease arrangements.

The Framework, and particularly the A-L definitions, has apparently been applied in the basis for the conclusions in SIC 27. The substance over form assumption in the Framework is definitely important in the reasoning leading up to the conclusions. The definitions are referred to, but it is difficult to assess whether the definitions actually have been helpful in reaching the conclusions. In general, leasing may be an area in which assets and liabilities are conflicting in the A-L view.[11]

Problems associated with business combinations are the issues in SIC 28. The issues are three-fold: What is the measurement date, the "date of exchange", when is it appropriate

to use alternative valuation methods to the published price of quoted equity instruments, and what information should be disclosed if an alternative valuation method is applied. Splitting acquisitions achieved in one exchange transaction, and acquisitions achieved in successive share purchases solves the solution to the first question. In the former the acquisition date is considered to be the date of exchange, while the date of exchange in successive purchases is each date the individual successive purchases are recognized in the books of the acquirer (this interpretation is in line with the proposed IFRS on business combinations, ED 3 (issued in 2002). Other valuation methods than the published share price are only to be used in rare cases when the published share price is considered unreliable because of undue price fluctuations or narrowness of the market. When other valuation methods than the published share price is applied, the fact, the reason, the method, and the aggregated difference in fair value between the methods, should be disclosed.

The IASB Framework is only referred to in one instance in SIC 28 to reach the conclusions above. In choosing the date of the acquisition as the measurement date in one-exchange acquisitions, a reference to the general statement in paragraph 100 in the Framework saying that historical cost is the fair value at the date of acquisition. However, this reference does not necessarily lead to the conclusion reached for successive share purchase acquisitions. It could be argued from an entity view that the date of acquisition in a successive share purchase acquisition is the date the acquirer gains control over the acquiree. That is not to say that the conclusion is in direct conflict with the Framework, but a discussion of the alternative solution would have been adequate. To reach the conclusion that alternative valuation methods may be applied, one can assume that the qualitative characteristics of the Framework have been considered. However, there is no reference to such considerations.

SIC 29 is an interpretation of disclosure issues related to service concession arrangements. A service concession arrangement is an arrangement in which the concession operator enters into an agreement with the concession provider giving the public access to major economic and social facilities. Examples are water treatment and

supply facilities, motorways, tunnels, bridges, airports, and telecommunication networks. The issue is what information to disclose in such arrangements. SIC requires extensive disclosure about service concession arrangements, including description of the arrangement, the terms in the arrangement, the nature and the extent of rights and obligations in the arrangement, and changes in the arrangement. To reach the conclusion SIC refers to the decision usefulness objective of the Framework, and the need for information that may affect future cash flows.

In SIC 30 the issue is how to translate financial statements from the measurement currency to the presentation currency, and what information to disclose about the translation. According to SIC 30, the translation should be conducted according to a current rate method. In this method all balance sheet items are translated at the closing currency rate, while items in the income statement should be translated at the rate at the transaction date, or proxies to the actual exchange rates, and the resulting exchanges differences should be charged to equity. The disclosure requirement in SIC 30 is extensive. The disclosure requirement is backed up by a reference to the decision-making demand objective in the Framework.

The issue in SIC 31 is under what circumstances an entity can provide a reliable fair value measure of revenue in a barter transaction involving advertising services. SIC concludes that a reliable fair value measure cannot be obtained from the advertising services received. However, the advertising services provided in a barter transaction may under certain circumstances give rise to a reliable fair value measurement. To recognize revenue in barter transactions involving advertising services the entity must have experience from similar non-barting transactions that occur frequently with other parties than the barter counterpart. A reference to the reliability characteristic of the Framework is made in order to argue that a reliable fair value measurement cannot be based on the services received. It is difficult to see how the reference to the Framework makes any difference in this case. The Framework does not deal with identical or analogous issues, and the reference cannot be considered more than a general reference to the qualitative characteristics.

In SIC 32 the issue is how to account for internal expenditure on the development and operation of an entity's own web site for internal and external access. Such expenditures may only be capitalized if the requirements of IAS 38 are met. More often than not this will not be possible. In particular, an entity will only in rare cases be able to demonstrate that the web site will generate probable future economic benefits under IAS 38.45. It is not to reach this conclusion that the IASB applies the Framework. The Framework is only referred to when it is concluded that expenditure incurred on an internet service provider hosting the entity's web site should be expensed when the service is received. Here the Framework has played no major role in policy making, and it is difficult to interpret the reference to the Framework as anything more than a non-substantial cosmetic reference.

5.2.3 Summary

The findings in this analysis indicate that the A-L definitions to some extent are ignored in the development of recognition recommendations in the accounting standards.

The IASB Conceptual Framework is explicitly referred to in 41% of the accounting standards (when references in "basis for conclusions" appendixes are accounted for), and in a significant number of these cases the references are of general character. In 57% of the accounting standards where the Framework is explicitly referred to, references are made to the definitions. A direct reference to the Framework is made in 55% of the SIC interpretations. Surprisingly though, in only 12% of the interpretations where the Framework is referred to, references are made to the definitions. Furthermore, when the definitions are referred to, their role is generally not substantial in the policy making process. A more detailed summary of the direct references is given in Appendix A.

There is more evidence of the impact of the Framework in the interpretations than in the accounting standards. Furthermore, it seems like the Framework to some extent has represented an important tool in the solving of issues treated by SIC, and in certain cases the Framework has played an important role in policy making. This conclusion however, applies primarily to issues concerning presentation and reporting. There is little evidence

of the same impact on recognition issues, and the limited explicit applications of the A-L definitions seem to be formal, rather than substantial.

The basis for the conclusions drawn in the accounting standards is generally not explained. Certain exceptions from this rule are made, and the explicit references to the A-L definitions are somewhat more common in these appendixes. However, an interesting observation is that the references typically are made to explain recommendations that contradict the A-L definitions in these appendixes.

5.2.4 Concluding Remarks

The assumption that an effective modifier will exclude certain solutions not excluded if the modifier did not apply has been fundamental to the conducted analysis. The analysis has not provided sufficient evidence to conclude that the A-L definitions represent effective modifiers in recognition. It is not clear whether this finding is a result of an imperfect methodology, ineffectiveness of the modifiers, or rejection of the A-L definitions by the IASB.

Several of the current accounting standards of the IASB are revised after the issuance of the Framework in 1989. A possible extension of this analysis would be to research to what extent these revisions were made in order to make the standards in accordance with the Framework. However, such an extension of the analysis would only to a limited extent be relevant to the issue analyzed here, namely whether the Framework, and the A-L definitions in particular, have been useful in standard setting. Furthermore, the analysis conducted may indicate that an extension would lead to a negative conclusion to the research question (see for instance the evaluation of IAS 11, IAS 19, IAS 22, and IAS 38).

The analysis conducted is current as of March 2002. The IASB issued twelve new exposure drafts in May 2002 as part of the so-called Improvements Project. These exposure drafts represent the first official issuances of the IASB (after replacing the IASC), and it is therefore appropriate to make the cut-off made in the analysis. It is left to

others to extend the analysis to the new accounting standards of the IASB in the future. However, it is noteworthy that the IASB in the background section of the exposure drafts does not mention the Framework when the objective of the Improvements Project is explained: *"The Board's objectives in the improvement project are to reduce or eliminate alternatives, redundancies and conflicts within existing Standards and to make other improvements to them. The Board also deals with some convergence issues and to merge any related SIC consensus into the Standard whenever the revision of a Standard presented a suitable opportunity"* (IASB 2002, 1).

5.3 Effectiveness and Rejection of the A-L Definitions

There are reasons to believe that potential flaws in the research methodology cannot explain the finding in chapter 5.2 alone. The accounting standards dealing with pension, income tax, and goodwill accounting (IAS 12, IAS 19 and IAS 22), support this assumption. Given the controversies in these areas, one would expect that the IASB had applied the Framework more directly in their recommendations.

In the following, the effectiveness of the A-L definitions in pension accounting[12], maintenance cost accounting, income tax accounting[13], and goodwill accounting[14] will be investigated. If the definitions are found to be effective, the next step will be to investigate whether the finding in chapter 5.2 is a result of an imperfect methodology or rejection of the A-L definitions by the standard setters.

Accounting for pension, income tax, and goodwill is not chosen by accident for this analysis. The introduction of the current accounting standards in these areas gave rise to heated discussions among academicians as well as professionals. As shown in chapter 5.2, the IASB has nevertheless apparently chosen not to explicitly rely on the Framework, and has to some extent explicitly chosen to deviate from the A-L definitions (see for example the analysis of IAS 19 and IAS 22 in chapter 5.2.1). The FASB has put enormous resources into all of these three areas in their development of the respective accounting standards, and the current accounting standards all represented dramatic shifts

in accounting practice. Last, in July 2001, the long lasting guidelines for goodwill accounting were replaced by guidelines relying on a fundamentally different approach.

Accounting for maintenance is included in the analysis primarily to illustrate that the A-L definitions may be effective even though recognition is not modified. Furthermore, as explained in chapter 5.2, accounting for maintenance costs represent one the few areas in which the A-L definitions have proven to be useful to the IASB (effective definitions applied by the standard setter). Under US GAAP, no general guidance for accounting for such costs has been developed.

In investigating the four areas, alternative approaches will not be limited to the ones currently recommended by the leading standard setters. However, the generally accepted practices will naturally be of primary interest since the application of the A-L definitions by the standard setters is one of two dimensions to be researched. The other leading standard setters have generally chosen to follow the FASB approach in all of the areas addressed. The relevant US GAAP literature is comprehensive, in particular with respect to the three first areas to be investigated. The analysis will therefore primarily take the US GAAP literature into consideration.

The conflict between the A-L view and the R-E view is important in all of these four areas. Other areas, for instance accounting for leases, may be applied to illustrate the usefulness of the A-L view as well. Lease accounting may therefore be an appropriate area for extension of this analysis in the future.

5.3.1 Pension Accounting

The first pronouncement dealing with accounting for pensions in the US was issued in 1948 (Accounting Research Bulletin No. 36 (ARB 36)). Several similar documents followed, and APB 8 was issued 1966. APB 8 is a comprehensive document, and in this document the fundamentals of the current generally accepted accounting principles (GAAP), SFAS 87, Employers' Accounting for Pensions, were laid down. When SFAS 87 was released in 1985 it represented the product of six years of intense efforts, and it

came as no surprise that the other leading standard setters chose to pattern their pension accounting standards after SFAS 87.[15]

5.3.1.1 The Method

In SFAS 87 two major classes of pension arrangements are defined: Defined contribution plans and defined benefit plans: *"A defined benefit pension plan is one that defines an amount of pension benefits to be provided, usually as a function of one or more factors such as age, years of service, or compensation. (...) A defined contribution plan is a plan that provides pension benefits in return for services rendered, provides an individual account for each participant, and has terms that specify how contributions to the individual's account are to be determined rather than the amount of pension benefits the individual is to receive"* (SFAS 87.11,66).[16]

Under a defined contribution plan, the amount contributed by the employer is determined by a set formula such as a percentage of the employee's salary. The amount accumulated for each employee over the years, together with the return on the accumulated amount, provides a fund from which an annuity can be bought at retirement. The employee has no assurance as to the amount of pension benefits to be received. In contrast, under a defined benefit plan the employer provides a formula for calculating the pension benefits to be paid after retirement. The formula is usually related to years of service and to wage levels while employed. Such plans may be funded or unfunded.

The contribution will normally represent the pension expense in defined contribution plans, while determination of the periodic pension expense is somewhat more complicated in defined benefit plans, both technically and conceptually.

Under most defined benefit plans, the employer's legal obligation to make benefit payments is generally limited to the amounts funded for that purpose. However, an entity that adopts this type of plan typically undertakes substantive obligations to provide retirement benefits in excess of its legal obligations since it usually intends to continue the plan in the foreseeable future. The cost of meeting these substantive obligations,

whether funded or not, should be accrued for accounting purposes, according to SFAS 87 and the equivalent accounting standards of the other leading accounting standard setters.

The estimated present value of benefits expected to be paid should be accrued. This determination requires assumptions as to interest rates, mortality, turnover, future compensation levels, retirement age and other factors, depending on the plan.

The periodic pension expense combines several components reflecting different aspects of the employer's financing, as well as the present value of the service cost. This latter component, the service cost, is determined independent of the financial arrangement of the employer, and is thus conceptually identical in plans organized as pay-as-you-go schemes and funded plans. The periodic pension expense will in addition to the net present value of the current and past service cost reflect the interest cost, the return on plan assets, and the effect of changes in the underlying economic and actuarial assumptions ("gains and losses").

The distinction between the projected benefit obligation (PBO) and the accumulated benefit obligation (ABO) is important. The former is calculated using the expected salary level at retirement, since the benefits normally are determined based on the level of salary at retirement, while the ABO represents the benefits given that the current salary level was to be used to determine the benefits. In other words, the two differ in that the ABO does not reflect expected salary increases.

To calculate the defined benefit obligation the Projected Unit Credit Method should be applied according to SFAS 87. Each period of service is considered to give rise to an additional unit of benefit entitlement, and each unit is measured separately to build up the final obligation.[17]

Actuarial gains and losses consist of changes in the amount of either the benefit obligation or plan assets resulting from actual plan experience or from actuarial assumptions that are different from those assumed in prior calculations of the obligation.

A "corridor" approach is commonly allowed for recognition of actuarial gains and losses. The corridor approach results in a minimum level of amortization.[18]

Current service cost is the increase in the present value of the defined benefit obligation resulting form employee service in the current period. Prior service cost is the increase in the present value of the defined benefit obligation for employee service in prior periods, resulting in the current period from the introduction of, or changes to, pension benefits. Prior service cost should be amortized according to SFAS 87.[19]

5.3.1.2 The Application of the A-L Definitions

Supporters of the A-L view often refer to pension accounting when they are illustrating the A-L view. Petree uses SFAS 87 as an example when he describes the shift from the R-E view to the A-L view in his article "Shifting to the Balance Sheet – FASB's Conceptual Framework" (Petree 1993). Also Miller refers to SFAS 87: *"With this choice, FASB set the stage for the end of matching as justification for many longstanding practices, (...) It's effects are already apparent in the Board's standards that demonstrate initial concern with measuring assets and liabilities, and the assigning changes in those measures to the income statement"* (Miller 1990, 27). Similarly, Barth et al. seem to regard SFAS 87 a product of the A-L view: *"Previous accounting standards were based on a revenue-expense approach, which emphasized the recognition and measurement of annual pension expense. In SFAS 87, more rigid uniformity is evident in both expense measurement and the balance sheet recognition of unfunded pension benefits"* (Barth et al. 1993, 18).[20] Flegm, even though not an A-L view supporter, also consider SFAS 87 to be based on the A-L view (1989, 92-93).

However, quite a few commentators disagree with the authors above in that SFAS 87 is based on an A-L view. For instance, in the UK there seems to be a general opinion that the former SSAP 24 and the discussion paper preceding the current accounting standard, "Discussion Paper on Pension Costs in the Employer's Financial Statements", represent the R-E view: *"(...), in the recent discussion papers dealing with tax and pension costs, the majority of the Board shows a preference for a matching approach to a balance sheet*

approach" (Paterson 1995, 81).[21] Nobes and Parker offer the same interpretation to the SFAS 87 in the US: *"However, it is not clear whether the conceptual framework in its present state does help to force the FASB to particular conclusions in any topic area. For example, SFAC 2's preference to taking a balance sheet, rather than an income statement, view may have influenced the move to the liability method for deferred tax (in SFAS 109), but it seems not to have determined the treatment for pensions (SFAS 87)"* (Nobes and Parker 1995, 155).[22] Daley and Tranter simply say that there is *"(...) apparent inconsistency with the Conceptual Framework, (...)"* in SFAS 87 (Daley and Tranter 1990, 23).

The UK pension accounting approach is similar to the US pension accounting approach, and it is difficult to accept that these accounting standards can illustrate both the A-L view and the R-E view. Both accounting standards are developed parallel to or shortly after the issuance of the respective conceptual frameworks, and the impact of a conflict between these accounting standards and the frameworks cannot be ignored. Paterson emphasizes this issue when he comments on the ASB discussion: *"(...); the pension costs paper discretely avoids mentioning the Statement of Principles at all!"* (Paterson 1995, 81). It is also worth noting that the ASB Statement of Principles does not mention the discussion paper and the relevant conceptual issues, even if other papers and accounting standards were discussed in the Statement.

A valid question is whether recognition of PBO meets the definition criterion.[23] That is, is the PBO a liability? The FASB has defined liabilities as *"(...) probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events"* (FASB 1985, 13). The pension liability belongs partly to future periods, according to some commentators, and therefore does not meet the definition of a liability. However, the pension obligation does represent an obligation to transfer economic resources to others. The entity has through the plan committed itself to pay a defined amount at a future point in time. The fact that the amount is uncertain because of unconfirmed assumptions, does not free the entity from the obligation. Furthermore, the

liability is a result of a past transaction or event since it is consideration for service already delivered by the employee (prior and current service).

The use of expected future salary levels in estimating the pension liability is conflicting according to some critics: *"In response to Exposure Draft and earlier documents issued as part of this project, some respondents argued that, based on the definition of a liability, pension benefits dependent on future increases in compensation cannot be a present obligation and, therefore, the liability measurement should be based only on actual compensation experience to date"* (SFAS 87.138). According to the FASB though, this is a measurement issue, not a definitional issue, and expected future salary levels give rise to the best estimates of the obligation.

Prior service cost is to be amortized over future periods according to SFAS 87. Other leading standard setters allow for immediate recognition of prior service cost under certain circumstances. For instance, vested prior service cost is to be recognized immediately according to Financial Reporting Standard No. 17 in the UK (FRS 17.60) According to some commentators immediate recognition of prior service cost clearly gives rise to liabilities not meeting the definition: *"A number of respondents argued that increased pension benefits granted in a plan amendment are exchanged for employees' future services, even when the amount of the benefit is computed based on prior service. In this view, the employer's liability for such benefits arises only as the future services are rendered"* (SFAS 87.145). The issue relates to the fact that liabilities, as well as assets, must be a result of "past transactions or events": *"Past events are explicitly embodied in the definitions of assets and liabilities (the result of past transactions and events), thereby making the occurrence of past events essential to the existence of assets and liabilities (as well as other elements). That linkage places a critical restraint on future events because they cannot be considered – even if they are virtually certain to occur – unless there is a past event. Thus, there is a tension between past events and future events that is evident in the future events question"* (Johnson 1994, 2).

Prior service costs result from amendments of pension plans. The amendment of the pension plan qualifies as a "past transaction or event". Thus, the questions are whether the change in pension plan creates an obligation that is a liability, and if so, whether this liability should be recognized according to the recognition criteria.

The first question must be solved on a case-by-case basis. If the new benefits are vested at the time of amendment, then there has been an event giving rise to an obligation meeting the liability definition in the A-L view.[24]

However, even if the definition of a liability is met, the second question is still unresolved. Remember, the definition is a necessary but not sufficient criterion for recognition. To solve the second question, "the additional guidance" in SFAC 6 must be applied, the matching concept in particular. The question is whether the amendment of the pension plan leads to costs that should be matched with prior revenues or future revenues. Or, put another way; are the increased benefits under the plan consideration for past service or future service?

The FASB argues that the plan amendment is consideration for future service: *"The Board believes that a future economic benefit exists, that the cost of acquiring that benefit can be determined, and that amortization of that cost over future periods is consistent with accounting practice in other areas"* (SFAS 87.159). Others, for instance the NASB, argue that prior service cost should be recognized immediately (NRS 6 (the NASB still allows for amortization over future periods under reference to international accounting practice)). Some critics are skeptical to the FASB explanation: *"The preceding arguments that suggest nonrecognition of the obligation or the allocation of the prior service cost over arbitrary periods appear to have as their real objective the smoothing of net income. The results may be politically acceptable, but they lead to semantically unintelligible results"* (Hendriksen and van Breda 1992, 749).

Another similar issue is whether there is room for the amortization and corridor approach for gains and losses resulting from changes in estimates in the A-L view.[25] The answer is

no. Assume for instance that the discount rate is changed from 5% to 6% giving rise to a lower pension liability. Assuming that the entity applies amortization of gains and losses as a policy, only a portion of the gain is recognized. If within the corridor, nothing is recognized. In this example the entity will carry a liability on its balance sheet exceeding its "present obligation to transfer resources". On the other hand, if the discount rate is changed from 6% to 5%, it follows from the amortization and corridor approach that only a part of the pension obligation, or no part of the pension obligation if the 10% corridor threshold is not triggered, is recognized. The role of the A-L definitions is to ensure that no items not meeting the A-L definitions are recognized. However, the criterion does not ensure that all assets and liabilities are recognized. The other leading standard setters have adopted similar approaches, but the ASB in the UK has in FRS 17 rejected the amortization and corridor approach to ensure consistency between the UK Conceptual Framework (the Statement of Principles) and the pension accounting policies (FRS 17.57).[26]

The apparent inconsistency resulting from the amortization and corridor approach explained above may very well be explained as a measurement issue, not a definitional inconsistency. However, it clearly cannot be derived from any economically meaningful measurement bases, and will here be referred to as a definitional inconsistency.

As illustrated above, with one significant exception[27], one may argue that current pension accounting standards are in accordance with the A-L view.[28] However, it should be quite clear from the stated objective in SFAS 87 that the focus is on expense recognition and entity performance: *"The Board's objective for this Statement, in broad terms, are as follows: a) To provide a measure of net periodic pension cost that is more representationally faithful than those used in past practice because it better approximates the recognition of the cost of an employee's pension over that employee's service period. b) To provide a measure of net periodic pension cost that is more understandable and comparable and is, therefore, more useful than those in past practice. c) To provide disclosure that will allow users to understand better the extent and effect of an*

employer's undertaking to provide employee pensions and related financial agreements. d) To improve reporting of financial position " (SFAS 87.6).

Before the revision in 1998, the title of IAS 19 revealed what the focus of the standard was. The title, "Retirement Benefit Costs", did lead the reader towards the income statement. Furthermore, the stated objective left little doubt: *"The objective of this Standard is to prescribe when the cost of providing retirement benefits should be recognised as an expense and the amount that should be recognised"* (IAS 19 (Revised 1993).Objective). The IASB chose to shift the emphasis of IAS 19, and in IAS 19 (Revised 1998) the title, "Employee Benefits", and the objective is shifted towards the balance sheet: *"The objective of this Standard is to prescribe the accounting and disclosure for employee benefits. The Standard requires an enterprise to recognise: (a) a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and (b) an expense when the enterprise consumes the economic benefit arising from service provided by an employee in exchange for employee benefits"* (IAS 19 (Revised 1998). Objective).[29]

Good arguments support the FASB-conclusion that the pension liability meets the liability definition. However, these arguments demonstrate what some commentators claim is a major problem with the definitions; they are unnecessarily vague. Given that the definitions were introduced as the recognition criterion that would reduce the subjectivity and manipulation in the books, the argument is important. The following criticism applies to the liability as well as the asset definition since liabilities technically are defined as negative assets: *"The FASB's definition is so complex, so abstract, so open-ended, so all-inclusive, and so vague that we cannot use it to solve problems (...) The definition does not discriminate and help us to decide whether something or anything is an asset. That definition describes an empty box. A large empty box. A large empty box with sideboards. Almost everything or anything can be fit into it"* (Scheutze 1993, 66). The definition is according to Samuelson so general in nature that even obligations that do not represent an obligation to transfer resources to others meet the definition: *"By shifting the focus of policy making to the definition and measurement of assets and*

liabilities, proponents of the asset/liability view were of the opinion that 'deferred charges that are not assets' and 'deferred credits that are not liabilities' would be eliminated from corporate balance sheets. Except from a few instances, (...), this has not happened" (Samuelson 1996, 149).[30]

5.3.1.3 Conclusion

In conclusion, the A-L definitions are ineffective recognition criteria in the case of pension accounting. The accounting under the A-L view is in generally in accordance with the accounting under the R-E view in the case of pension. Furthermore, the standard setters reject the A-L definitions when allowing for delayed recognition of actuarial gains and losses (delayed recognition should be rejected in the R-E view as well). In the analysis matrix presented in this chapter in the introduction, figure 5-1, pension accounting falls into the lower right corner (in the specific case of actuarial gains and losses, pension accounting falls into the higher right corner).

5.3.2 Maintenance Cost Accounting

To fully exploit the economic potential of property, plant, and equipment, certain expenditures subsequent to the initial acquisition and recognition are commonplace. In particular, certain maintenance costs will typically be incurred over the economic lifetime of the property, plant, and equipment. Generally, the frequency and amount of maintenance expenditures are not known beforehand, and the expenditures are expensed as incurred. Under certain circumstances, however, the frequency and amount of the maintenance expenditures to be incurred can be reliably estimated at the time of the acquisition of the asset, and one may thus refer to "planned major maintenance activities".

Under US GAAP no accounting standard deals with maintenance costs in particular, and diversity in accounting practice has been observed. Certain related costs are dealt with in separate accounting standards, for instance indirect and overhead costs in real estate projects (SFAS 67), direct lease costs (SFAS 91), and computer software development costs (SOP 98-1), and the guidelines in these statements are in many cases generalized

and applied analogous in other cases leading to diverse accounting practice. The AICPA issued in 2001 an exposure draft on "Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment". The objective of the statement is to provide for more uniform accounting practice for certain costs, including maintenance costs, related to property, plant, and equipment. The exposure draft has still not materialized into a final SOP (Statement of Position), partly because the FASB and the AICPA currently consider whether the subject should be dealt with in a separate accounting standard.

5.3.2.1 The Methods

Accounting for costs incurred in planned maintenance activities may be done according to one of four methods that all have gained acceptance in practice:

1. Expense as incurred.
2. Accrue in advance.
3. Defer and amortize.
4. Decompose acquisition cost and amortize maintenance component separately ("built-in overhaul method").

The AICPA has proposed that only the first method should be allowed under US GAAP. The method is rationalized by assuming that maintenance costs are relatively consistent from period to period, that the costs do not constitute separately identifiable assets themselves, and that they serve only to restore the asset to the original condition.

Under the second method, an estimate of the costs that are expected to be incurred in planned future maintenance activities is made. The estimate is then accrued in a systematic manner over the period until the next planned maintenance activity occurs. Any difference between the accrual and the actual costs incurred in the maintenance activity is recognized in the period of the maintenance activity.

In the third method, actual maintenance expenditures are capitalized and amortized in a systematic manner over the period between the planned maintenance activities.

In the fourth method, the acquisition cost is decomposed, and a maintenance component is amortized separately. That is, the expected useful economic life implied by the amortization period of the underlying asset assumes certain major maintenance activities. The expenditures to be incurred in the first planned maintenance activity are estimated, and a maintenance component of the asset is singled out for amortization purposes. For instance, to realize the expected useful economic life of ten years of a ship acquired for 100 a major maintenance activity will have to be conducted in year 5. The year 5 maintenance expenditure is estimated to 10. The ship is therefore for amortization purposes decomposed in the underlying asset, the ship, and a maintenance component. The former is amortized over ten years while the latter is amortized over five years. The actual expenditures incurred in the maintenance activity are capitalized and amortized over the next five years. The built-in overhaul method is in accordance with IAS 37.

To summarize, let us illustrate the income statement effect of the different methods using the example introduced above assuming that actual maintenance expenditures incurred equals the expected maintenance expenditures. Tax and discounting effects are ignored.

Figure 5-2 ***The Maintenance Cost Example***

Period 1-4	**Expense as Incurred Method**	**Accrual Method**	**Deferral Method**	**Built-in Overhaul Method**
Amortization of ship	10	10	10	9
Maintenance amortization				2
Maintenance accrual		2		
Net income	**(10)**	**(12)**	**(10)**	**(11)**

Period 5	**Expense as Incurred Method**	**Accrual Method**	**Deferral Method**	**Built-in Overhaul Method**
Amortization of ship	10	10	10	9
Maintenance amortization				2
Maintenance accrual		2		
Maintenance expenditures	10			
Net income	**(20)**	**(12)**	**(10)**	**(11)**

Period 6-10	Expense as Incurred Method	Accrual Method	Deferral Method	Built-in Overhaul Method
Amortization of ship	10	10	10	9
Maintenance amortization			2	2
Net income	**(10)**	**(10)**	**(12)**	**(11)**

Accumulated	Expense as Incurred Method	Accrual Method	Deferral Method	Built-in Overhaul Method
Amortization of ship	100	100	100	90
Maintenance amortization			10	20
Maintenance accrual		10		
Maintenance expenditures	10			
Net income	**(110)**	**(110)**	**(110)**	**(110)**

It should come as no surprise that the accumulated net income effect over the ten years is the same regardless of method. However, note that only the built-in overhaul method allocates the maintenance expenditures over the ten years. The maintenance expenditures are charged to the income statement in one single period, period 5, in the expense as incurred method, while the expenditures are allocated over the first and last five periods in the accrual and deferral method, respectively.

5.3.2.2 The Application of the A-L Definitions

As explained in chapter 4, the A-L definitions were introduced in order to give the balance sheet "real-world meaning" (Storey and Storey 1998), and accruals and deferrals that are not economic resources or obligations are to be excluded from the balance sheet (FASB 1976c, 106). Maintenance accruals and deferrals are often referred to when proponents of the A-L view are asked to illustrate accounting practices the A-L view was introduced to eliminate.

The deferral and the accrual methods illustrated in chapter 5.3.2.1 lead to balance sheet items inconsistent with the A-L definitions. That is, the entity has no present obligation to conduct maintenance, and may choose not to conduct maintenance (even though a decision to not conduct maintenance is economically irrational), and the accrual does therefore not represent a liability: *"Specifically, prior to the performance of the planned major maintenance activity, an entity does not have a present unavoidable duty or*

responsibility to sacrifice assets in the future. Moreover, AcSEC does not believe that there has been an obligating event prior to the maintenance activities being performed" (AICPA 2001.A37). Similarly, capitalization and amortization of the maintenance expenditures incurred in period 5 is inconsistent with the asset definition, even though the conflict may not be as obvious in this case as with the accruals. One may argue that the maintenance activity indirectly leads to probable future economic benefits. That is, the future economic benefit potential of the underlying asset is higher with maintenance than without maintenance. This reasoning does not, however, support capitalization of the maintenance expenditures as such. The maintenance itself cannot constitute an asset.

Both the accrual and the deferral methods have traditionally been considered acceptable in practice, even after the A-L view was introduced in the conceptual frameworks. However, as explained in chapter 5.2, IAS 37 represents an accounting standard in which the IASB has chosen to explicitly apply the A-L definitions, and neither the accrual nor the deferral method is allowed under IFRS. The proposed SOP referred to above suggests rejection of both methods as well.

To alternative methods remain, namely the expense as incurred method and the built-in overhaul method. Intuitively, recognizing the close relationship between the accrual and the deferral methods and the built-in overhaul method, one may assume that the latter method also conflict with the A-L definitions. In the built-in overhaul method no accruals are made. However, maintenance expenditures are deferred (capitalized and amortized). The deferral method was rejected above by reference to the lack of probable future economic benefits separate from the underlying asset. In the built-in overhaul method this concern is less relevant. The IASB has found that the built-in overhaul method is consistent with the A-L view, and recommends the method under certain circumstances (SIC 23.5). Generally, however, the IASB recommends the expense as incurred method. AICPA rejects the built-in overhaul method, but not in reference to the A-L definitions (one may therefore assume that the AICPA does not consider the method inconsistent with the A-L definitions) (AICPA 2002.A38). According to the proposed SOP all maintenance costs should be expensed as incurred.

To sum up, only the expense as incurred method and the built-in overhaul method are consistent with the A-L view. The two other methods, the accrual method and the deferral method, both give rise to balance sheet items in conflict with the A-L definitions. The commonality among all of the methods, perhaps with the exception of the expense as incurred method, is the underlying objective of matching costs with revenues (neither the IASB or the AICPA refer to the matching concept when discussing the different methods). As such, one may assume that all four methods are acceptable in the R-E view, with a preference for the one leading to the "best" matching. It would be beyond the scope of the paper to address the "best" matching issue, and, furthermore, the example used in this section does not provide one with sufficient information to consider the issue specifically.

However, a preference for the accrual method over the deferral method based on a matching concept applies. The need for maintenance activity results from the employment of the asset, and maintenance costs are therefore associated with revenue earned and recognized before the maintenance expenditure is incurred. As such, maintenance costs accrue before the maintenance expenditure is incurred. From this perspective, therefore, the accrual method has merits. On the other hand, in the deferral method, expense recognition is not only deferred compared to the accrual of the costs, it is deferred beyond the time of the incurring of the maintenance cost. The deferral method is therefore rejected in the R-E perspective as well.

5.3.2.3 Conclusion

In conclusion, the A-L definitions are effective recognition criteria in the case of maintenance cost accounting. The effectiveness may or may not involve different expense recognition, but the A-L definitions effectively exclude certain methods relevant in the R-E view. Furthermore, the analysis in this section shows that the standard setters seem to apply the A-L definitions in their dealing with maintenance costs in standard setting. Thus, in the analysis matrix presented for the analysis in this chapter in the introduction, figure 5-1, maintenance cost accounting falls into the upper left corner.

5.3.3 Income Tax Accounting

SFAS 109 regulates accounting for income taxes in the US. AS with SFAS 87, SFAS 109 has been used to illustrate both the A-L view and the R-E view. However, in contrast to the SFAS 87 experience, the FASB has explicitly tried to make the accounting rules for income taxes fit into an A-L view in SFAS 109: *"The replacement of the long standing principles underlying the computation of deferred tax assets and liabilities, as promulgated by APB 11, in favor of a balance sheet approach was foretold by the issuance of Statement of Financial Accounting Concepts (SFAC) 6, Elements of Financial Statements, which incorporated definitions of assets and liabilities which seemingly excluded deferred tax assets and liabilities computed in accordance with that standard. APB 11 was superseded by the ill-fated SFAS 96 in late 1987. SFAS 96 had an original effective date of years beginning after December 31, 1988, and was deferred three times for a total of four years; the SFAS was not widely implemented. The major causes of the almost universal dissatisfaction with SFAS 96 were its complex scheduling requirements and the ban on reporting in the balance sheet of most deferred tax benefits. SFAS 109, which replaced SFAS 96 in 1992, and which became effective for years beginning after December 15, 1992, continued the balance sheet orientation of its immediate predecessor"* (Delaney et al. 1996, 491). The lack of consistency between SFAC 6 and APB 11 was one of the primary reasons for reconsideration of APB 11, which culminated in the issuance of SFAS 96, and then SFAS 109.

Along with a further analysis of this issue, let us review the general guidelines in SFAS 109, and compare it to similar accounting standards of the other leading standard setters.

5.3.3.1 The Methods

Prior to APB 11, the debate centered around the level of allocation: No allocation, reporting taxes currently payable as income tax expense, partial allocation, providing deferred taxes only for those timing differences whose net reversal could be reasonably predicted, or comprehensive allocation, providing for deferred taxes for all temporary differences (see for instance Huss 1985; Lindsay 1985; Martin et al. 1989; Read and

Bartsch 1991).[31] In APB 11, comprehensive allocation was endorsed, and this position was also adopted by the FASB in SFAS 96 and SFAS 109.

Comprehensive tax allocation is founded on the idea that most revenues earned are included in taxable income sooner or later, and most costs incurred are allowed as deductions sooner or later (SFAS 109.205).

Two general methods of expense measurement have been debated over the years: The deferral method and the liability method. The former was the only allowed method in APB 11, while the latter is the one applied in SFAS 109, as well as in SFAS 96. All the other leading standard setters have adopted the liability method, as well as the NASB in Norway (AA 2000).

Generally, the deferral method is believed to be consistent with the R-E view, while the liability method is considered to be in accordance with the A-L view: *"Although the deferred method was soundly based on the matching principle, as defined by the APB, it was complex to apply and sometimes resulted in apparent distortion in the balance sheet. As attention in recent yeas has shifted again to the meaningful reporting of financial position, these issues have received renewed scrutiny. Following the promulgation of SFAC 6, it became inevitable that substantial changes in accounting for income taxes would be made. As defined in SFAC 6, the deferred charges and credits created by the proper application of APB 11 are generally not true assets or liabilities and do not belong on the balance sheet"* (Delaney et al. 1996, 495). The FASB refers to the liability method as an "asset and liability approach" that is consistent with the definitions in SFAC 6 (SFAS 109.62). On the other hand, the FASB refers to the deferral method as a matching method leading to deferred credits and charges not being receivables and payables (SFAS 109.207).

Under the deferral method the income tax expense for the period is based on the accounting income while the current liability is based on taxable income. The difference between the current liability and the tax expense is treated as a deferred charge or credit

which is amortized as the timing differences reverse: *"Suppose a particular item of revenue or expense enters into taxable income in a different period from that in which it enters into reported accounting income. Then the associated tax charge or tax reduction is moved from reported tax expense of the period of taxation to the reported tax expense of the period in which the revenue or expense item is recognized for accounting purposes. This allocation of tax charges or tax reductions results in deferred debits or credits in the balance sheet. These are regarded primarily as adjustments required to achieve better matching of tax expense with pretax reported accounting income. No particular effort is made to explain the nature of these deferred assets and liabilities"* (Skinner 1987, 248).

The primary goal of the liability method is to present the estimated actual taxes to be payable in the future periods as the income tax liability on the balance sheet, and it is necessary to consider the effect of future changes in the tax rates and rules when computing the current period's tax provision: *"This method does attempt to explain the balance sheet amounts that result from interperiod allocation. A recorded liability is held to represent the future tax burden that is attributable to timing differences, while a recorded asset is held to represent future tax advantages attributable to timing differences. Since those advantages or that burden will be realized in the future, their amounts depend upon the tax rates that will exist in the future. Accordingly, it is held that the balances should be calculated originally and subsequently recalculated based on best estimates of tax rates that will exist in future when the timing differences reverse"* (Skinner 1987, 249). The aggregated unreversed temporary differences including those originating in the period, is multiplied by the expected future rate to determine the expected future liability. The difference between the expected liability at the end of the period and the expected liability at the beginning of the period is the tax expense of the period.

The main effects of the liability method on the balance sheet have been summarized as follows: *"1. Emphasis is on the recognition and measurement of deferred tax assets and liabilities. Deferred income tax expense is determined residually (i.e., as the difference between the beginning and required ending balances in deferred tax assets and liabilities*

for the period). 2. Deferred tax asset and liability amounts are remeasured when tax rates change to approximate more closely the amounts at which those assets and liabilities will be realized or settled. 3. Deferred tax assets are recognized for operating loss and other carryforwards. Deferred tax assets are subject to reduction by a valuation allowance if evidence indicates that it is more likely than not that some or all of the deferred tax assets will not be realized. Determining this valuation allowance is similar to accounting for reductions in receivables to net realizable value. 4. Disclosure requirements result in the presentation of a significant amount of information in the notes to the financial statements" (Williams 2001, 21.05).[32]

From the above, one may conclude that the basic differences in the two methods, the liability and the deferral method, are limited. Generally, the treatment of changes in tax rates and laws is the only major difference in the two methods. Under the liability method changes in tax rates or laws in subsequent years are recognized, while the consequences of such changes are not reflected before they occur under the deferral method.

Proponents of the liability method and its merits under the A-L view also refer to a difference in nature of the balance sheet items under the two methods as an important difference between the two methods: *"Deferred charges and deferred credits relating to timing differences represent the cumulative recognition given to their tax effects and as such do not represent receivables and payables in the usual sense"* (APB 11.57).

In addition to the two general methods discussed above, two other methods must be considered. Pre-APB 11 practice endorsed a no allocation method (Hendriksen and Van Breda 1992, 702). That is, only tax payable in each period was recognized. In an A-L view, this method may have merits.

Another method that may have merits in an A-L view is the net-of-tax method. As implied by the name of the method, assets and liabilities are valued net of the tax effect associated with it (Hendriksen and Van Breda 1992, 725; Skinner 1987, 249). For example, if a depreciable asset has a cost of 1 000, and the tax rate is 40%, the cost is

considered to be a two-component measure. The cost of future tax benefits is 400 and the cost of future benefits form the use of the asset is 600. Assume the useful life of the asset is four years, and that the asset for tax purposes is amortized by 400, 300, 200, and 100, respectively. The tax benefits at 40% are 160, 120, 80, 40 in the four periods, respectively. Furthermore, assume the cost of the use of the asset is amortized for accounting purposes on a linear schedule. The annual expense associated with the asset is thus 310, 270, 230, and 190 in the four periods, respectively. In the deferral and the liability method, assuming a linear amortization schedule for accounting purposes, the amortization expense and the tax expense in period 1 would be 250 and 60, respectively. The question in the net-of-tax method is whether the expense of 310 in period 1 should be treated as amortization or if amortization should be 250 and the tax expense 60. Most proponents of the method favor the latter approach (SFAS 109.216).

5.3.3.2 The Application of the A-L Definitions

Much may be said about the shift from the deferral method in APB 11 to the liability method in SFAS 96 and SFAS 109, and about it representing a shift from the R-E view to the A-L view. What should be noticed, however, is that the two methods, as interpreted in APB 11 and SFAS 109, will produce identical tax expenses provided that changes in tax rates are handled comparably. Clearly, there are conceptual differences in how the tax expense is derived. However, equally clearly *"(...), the balance sheet and the income statement, articulated as they currently are, are simply mirror images of one another"* (Hendriksen and Van Breda 1992, 722).

Different arguments have been voiced claiming that the deferred assets and liabilities are not meeting the definitions in an A-L view (Skinner 1987, 255). One argument is that deferred tax cannot be liabilities because they are dependent upon future events. Only temporary differences having effect on taxable income should be recognized. At the time of origin, the effect on taxable income will depend on future revenues and costs. The tax effect of the reversal is thus dependent upon future events, not "past transactions or events", and the tax effect cannot represent a liability before that future event has happened. It may be argued that this line of reasoning would change other commonly

accepted practices as well: Warranty provisions depend on future events, the pension cost depends on future events, and even revenue eventually obtained will depend on future events (collection of receivables). Others may argue that the original transaction or event giving rise to the recognition of temporary differences, is the "past transaction or event", and that the rest is just a "measurement issue".

The above issue may be illustrated by a case of different amortization schedules for tax and accounting purposes. Assume an asset is amortized 20% annually for tax purposes and amortized according to a linear schedule over 10 years for accounting purposes. If the cost of the asset was 100, the annual tax amortization the first year would be 20 and the accounting amortization would be 10 leading to a temporary difference of 10. Assuming a tax rate of 30%, the resulting deferred tax liability would be 3. Does the deferred tax liability represent a "probable future sacrifice of economic benefits"? If yes, is it a consequence of a "present obligation to transfer assets or provide services to other entities"? And finally, is it "a result of past transactions or events"?

First of all, there has been no transaction leading to the accrual, and if anything the different amortization schedules must fall under the term "event". Does this event lead to an obligation to transfer assets, tax payable that is, to the tax authorities in the future? It is difficult to comprehend that a technical accounting issue leads to an obligation, particularly when coupled with the first criterion, namely the sacrifice of economic benefits criterion. In other words, can a technicality lead to an economic obligation? No, accounting amortization cannot lead to an economic obligation as little as it can lead to cash flow effects.

Then, in light of the above, can warranty provisions be allowed for in the A-L view? The sale of a defective product has an economic consequence, namely the replacement of the product. The reasoning leading to the rejection of the deferred tax in the A-L view does therefore not necessarily exclude warranty provisions from recognition. Similarly, in the case of pension, as explained in the former section, the entering into a pension agreement qualifies as a past event. Furthermore the pension agreement, unlike the choice of

amortization schedules, has an economic consequence, and the rejection of deferred tax in the A-L view does not lead to rejection of the pension liability.

A second argument is that deferred tax can hardly be a liability since it is never paid off.[33] The idea is that an entity under the going concern assumption will replace assets continuously, and thus excess tax amortizations will all the time be available to offset the reversal on older assets. Several studies have shown that deferred tax credits tend to show a steady increase (Skinner 1987, 256). But all these studies have contributed is a confirmation or indication of growing businesses. Furthermore, the FASB notes that even if the aggregate amount of temporary differences increase in future years, a deferred tax liability will result in a future sacrifice. That is, in the case different tax and accounting amortizations for example, the aggregate amount *"(...) of depreciation differences may become larger in future years because of general price inflation, expansion of enterprise activities, or for other reasons. Nevertheless, the deferred tax consequences of a depreciation difference for a particular depreciable asset ordinarily will result in a sacrifice in future years. There will be a future sacrifice because an INDIVIDUAL difference results in a taxable amount when revenue that recovers the reported amount of the depreciable asset exceeds its remaining tax basis*" (SFAS 109.204).

As explained, the deferral and the liability method generally produce the same results, but uses different computational devices: *"The balance sheet approach, (...), adds a second computational device, but does not add anything at the theoretical level"* (Hendriksen and Van Breda 1992, 707). The arguments above leading up to the rejection of the deferral method may thus as well be applied towards the liability method. An economic liability is not created by methodological constructions: *"The only real world obligation, as far as tax is concerned, is that which is shown on tax assessments, based on profits measured under the tax rules. In contrast, deferred tax is merely an accountant's abstraction, designed to reconcile taxable profit with accounting profit"* (Paterson 2000, 108). Nevertheless, the arguments suggested by the FASB will be considered in the following.

In contrast to what seems to be the case in a majority of the accounting standards issued after the initiation of the conceptual framework project, the FASB has explicitly been concerned with the guidelines in the Conceptual Framework, and in particular, the definitions of assets and liabilities when developing SFAS 109: *"(...), the adoption of the liability approach, is a clear shift in line with the CF's emphasis on the A&L view. And it would seem from arguments presented in the SFAS itself (for example, in the summary and at paragraphs 83 and 184) that this was indeed due to the influence of the CF"* (Gore 1992, 122). The difference in the explicit application of the Framework in SFAS 87 and in SFAS 109 may partly be explained by the fact that SFAS 87 was developed and issued before the completion of the Framework project, while the opposite is true for SFAS 109. In this context it is interesting to note, as explained in chapter 5.2, that the IASB on the other hand makes no references to their framework in IAS 12 (which was issued years after the IASB Framework).

In paragraph 80-86 the FASB carefully considers whether a deferred tax asset meets the definition of an asset in SFAC 6. The first characteristic of an asset is that it *"(...) embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows"* (FASB 1985, 26). The FASB explains that deductible temporary differences and carryforwards at the end of a period will reduce taxable income and taxes payable in future years and therefore contribute indirectly to future net cash inflows. However, deductible differences only reflect the different timing in accounting and taxation, but have no impact on taxable income and taxes payable.

The future economic benefit criteria of the asset definition may be embodied in three values according to SFAC 6 (FASB 1985, 172), exchange value, production value and acceptance value (see chapter 4.2). In many cases, deductible temporary differences and carryforwards may be exchanged for cash or other assets, and one may argue that a tax asset has exchange value and therefore meets the asset definition. However, deductible temporary differences and carryforwards cannot be exchanged as such. The deductible

temporary difference and carryforwards are rather adding to the exchange value of the underlying asset. Therefore, one may argue that the value of deductible temporary differences and carryforwards is merely a residual in an acquisition transaction, and therefore should be accounted for as goodwill (the disadvantage of this solution is that the timing of the income statement effects in subsequent periods will suffer accordingly (goodwill is generally amortized on a linear schedule over a rather arbitrary determined period of time)). Furthermore, deductible temporary differences and carryforwards have no production value. That is, nothing of value to the entity can be produced from tax assets. And tax assets cannot be used to settle the entity's liabilities.

The second characteristic of an asset is that *"(...) a particular entity can obtain the benefit and control others' access to it"* (FASB 1985, 26). According to the FASB an entity has "an exclusive right" to the future benefit that may result from existing deductible temporary differences and carryforwards, and therefore can control others' access to it.

The third characteristic is that *"(...) the transaction or other event giving rise to the entity's right to or control of the benefit has already occurred"* (FASB 1985, 26). The FASB argues that the critical event in this regard is the event that gives the entity a right to or control over the future tax benefits, but limited by a confirmation that sufficient taxable income will be obtained in the future years. In SFAS 96 the critical past event was considered to be the earning of the income that permits realization of the benefit: *"Prior to earning income, deductible temporary differences and carryforwards were considered to be future tax benefits that are not yet recognizable in the financial statements"* (SFAS 109.83). Or as phrased by Hendriksen and Van Breda (1992): *"(...), it is not exactly a true receivable, since there will seldom be a direct claim against the government"* (715). SFAS 96 was criticized, and in particular there was concern that SFAS 96 sometimes would produce results that were not understandable or relevant. The Board therefore chose to reject its prior position in SFAS 109, and produce an interpretation causing fewer objections. If the arguments in the Standard are to be taken seriously, their contribution to the Board's understanding and application of the Conceptual Framework is significant. The only reasonable interpretation of the behavior

of the Board is that qualitative characteristics, in this case relevance and understandability, can in certain cases override the other recognition criteria, or more specifically, the definitions. The FASB view in SFAS 109 was generally supported by the other leading standard setters in the G4+1 project about future events carried out in the mid-nineties. However, interestingly, a minority was of the opinion *"(...) that no asset can be recognized until income is earned because until then no event has occurred giving the entity control over, or access to, future economic benefits"* (Johnson 1994, 36).

To sum up, in this author's opinion a tax asset does not meet the A-L definition of an asset. Temporary differences do not give rise to economic benefits.

In SFAS 109.75-79, the FASB argues that deferred tax meets the liability definition. The first characteristic of a liability is that it *"(...) embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand"* (FASB 1985, 36). The FASB argues that a tax liability results from the requirement of the law. Taxable temporary differences will lead to a tax consequence. Deferred tax liabilities do typically not have a due-date that is "specified". It may to some extent, however, be determinable. Again, as argued above, an accounting technicality resulting in temporary differences cannot give rise to economic effects and has no future tax consequences. For example, the tax charged by the authorities is unrelated to the amortization schedules applied for accounting purposes.

The second characteristic of a liability is that *"(...) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice"* (FASB 1985, 36). The FASB recognizes that an entity may be able to delay the events giving rise to the reversal of the temporary differences, but claims that an entity cannot avoid the future sacrifice. When the FASB acknowledges that the question is when, not whether, the temporary differences will lead to taxable amounts, they put there conclusion on the first characteristic in a somewhat peculiar context: *"For that reason, the Board concluded that the only question is when, not whether, temporary differences will result*

in taxable amounts in future years" (SFAS 109.78). In other words, whether the deferred tax liability meets the first characteristic seems to be unresolved by the FASB arguments.

The third characteristic of a liability is that *"(...) the transaction or other event obligating the entity has already happened"* (FASB 1985, 36). According to the FASB the past event is the same event as gave rise to the temporary differences. In other words, the reasoning is the same as for deferred tax assets.

Gore (1992) answers an unconditional "yes" to the question if the changes from APB 11 and SFAS 96 to SFAS 109 were in line with the emphasis on the A-L view in the Conceptual Framework. Changes seem to have been carried out in order to reduce or eliminate the conflicts with the A-L definitions in the Conceptual Framework, and SFAS 109 is one of the few pronouncements of the FASB in which the direct role of the Conceptual Framework is noteworthy. Gore admits however, in reference to Swieringa (1988), that even if SFAS 109 is in line with the A-L definitions, there is no evidence that the changes were made only because of the A-L focus in the FASB Conceptual Framework: *"But matters are not that simple. Swieringa (1988) charts in detail the development of the standard and makes clear that simply adopting the CF's implications was not the sole reason for the eventual outcome. Other reasons were changes in US tax law, the reaction of those (preparers) affected by the law and the standard, and, once more, a feeling within the Board that an evolutionary, iterative approach should be adopted"* (Gore 1992, 122). Another important issue mentioned by Gore, is that even if SFAS 109 is considered an effective accounting standard in line with the FASB Conceptual Framework, that does not necessarily imply that the Conceptual Framework is as effective as intended.

It has been suggested that the Conceptual Framework will lead to a coherent, consistent set of accounting standards. Even in the eyes of the proponents arguing that SFAS 109 illustrates the impact of the Conceptual Framework, it must be somewhat discouraging that also other methods are believed to be consistent with the A-L view in the Conceptual Framework. In other words, even with a favorable attitude towards SFAS 109, it is not an

example silencing the proponents of the R-E view claiming that the A-L view does not allow for less subjectivity in standard setting than the R-E view.

Dopuch and Sunder have criticized the A-L definitions for being to vague, and argued that *"(...) those who favor the recognition of deferred taxes can adopt a somewhat broad interpretation of the FASB's definition of liabilities and justify the inclusion of deferred taxes (...). In contrast, those who do not could take the FASB's statements literally and just as easily argue against the inclusion of deferred taxes"* (Dopuch and Sunder 1980, 7). The FASB contradictive arguments and conclusions in SFAS 96 and SFAS 109 illustrate the point of Dopuch and Sunder. The point of this author however, is that if the definitions are to be useful, a somewhat literal interpretation of the definitions must be applied, and as such there is clearly a conflict between deferred tax assets and liabilities recognized according to the deferral and the liability methods and the A-L definitions.

If both the deferral and the liability method lead to balance sheet items that are inconsistent with the A-L view, a relevant follow-up question is how may income tax be accounted for in the A-L view? As explained in chapter 5.3.3.1, two other methods of income tax accounting have been proposed.

The often-called no-allocation method refers to a method in which only tax payable in the current period is recognized. Some respondents to the exposure draft preceding SFAS 109 favored this method arguing that (1) the tax return determines the legal liability for income taxes, (2) taxes are levied on aggregate taxable income, and individual events are merely indistinguishable pieces of the overall determination of aggregate taxable income, (3) any tax payments for future years will be solely a consequence of generating taxable income in those future years, (4) notional tax calculations based on the recognition and measurement of events for financial reporting are not appropriate, and (5) all other approaches to accounting for income taxes are too complex (SFAS 109.200). Several of these arguments do not refer to the A-L definitions, but (1) and (3) seem to be based on an A-L view notion. Furthermore, given that both the deferral and the liability method are inconsistent with the A-L view, the no-allocation method may represent a valid

alternative in the A-L view. Clearly though, the no-allocation method has no merits in the R-E view in which matching concept governs expense recognition.

Another possible method that may satisfy both the matching concept and the A-L definitions is the net-of-tax method. The example introduced in chapter 5.3.3.1 may illustrate these properties of the method. A depreciable asset at a cost of 1 000 with a four year useful life is amortized for tax purposes by 400, 300, 200, and 100, respectively. The tax rate is 40%. As explained, under the net-of-tax method, the asset will be amortized for accounting purposes by 310, 270, 230, and 190 in the four periods. The amortization may be separated into an asset component of 250, 250, 250, and 250 in the four periods, and a tax component of 70, 20, (20), and (70) in the four periods. Nevertheless, there will be no tax liability shown on the balance sheet. Rather, the tax effect associated with the asset is considered to be part of the underlying asset, and the balance sheet will only show a depreciable asset of 690, 520, and 190 at the balance sheet date of period 1, 2, and 3 (and zero at the balance sheet date of period 4). In other words, at least at the outset, it seems like the net-of-tax method meets the demand for matching, and at the same time avoids balance sheet items in conflict with the A-L definitions.[34]

The FASB rejected the net-of-tax method believing that the liability method provided a finer information set than the combining of the tax effects with the underlying assets and liabilities: *"Reporting an enterprise's assets and liabilities net of their tax effects would make it difficult to understand an enterprise's overall tax situation, and those tax effects would have to be combined in financial statement disclosures. Financial statement disclosures that refer to income taxes that become payable or refundable in future years, however, would appear to contradict the underlying net-of-tax accounting. The Board believes that if recovery of an asset or settlement of a liability will result in amounts that are taxable or deductible, that fact is better communicated by reporting a deferred tax liability or asset rather than by reducing other assets and liabilities"* (SFAS 109.218). Another practical problem associated with the net-of-tax method is that certain timing differences, for instance timing differences that result from cash basis accounting for tax purposes and accrual accounting for financial reporting and completed-contract

accounting for tax purposes and percentage-of-completion accounting for financial reporting, cannot be identified with a specific asset or liability (SFAS 109.217).

5.3.3.3 Conclusion

In conclusion, the analysis conducted illustrates that the effectiveness of the A-L definitions in income tax accounting of some are believed to be weak. However, it is here argued that the definitions are effective, and that deferred tax assets and liabilities, regardless of methodological approach, deferral method or liability method, do not meet the A-L definitions. Furthermore, the standard setters reject the A-L definitions in income tax accounting, and as such, the analysis, in the case of income tax accounting, rejects that methodological weaknesses can explain the finding in chapter 5.2.

Two alternative methods considered by the FASB, namely the no allocation method and the net-of-tax method both seem to be consistent with the A-L view. However, the former is generally rejected because of the emphasis put on matching in income tax accounting. The latter, however, leads to the same matching as the deferral and the liability method. Nevertheless, the method does not conflict with the conclusion drawn that the A-L definitions are effective in income tax accounting. In the context of the net-of-tax method the effectiveness of the A-L definitions is reflected in the presentation.

In the matrix presented for the analysis in the introduction in this chapter, figure 5-1, income tax accounting falls into the upper right corner.

5.3.4 Goodwill Accounting

> *"Influenced by traditional balance sheet conservatism and inclined to regard good will with suspicion, practicing accountants have generally favored its prompt removal from the accounts. In their anxiety to eliminate good will many accountants believe that it should be written off against future earnings as early as possible and to the extent that such earnings will permit its absorption. This procedure is objectionable, however, since it does not produce commensurable charges against income and because it does not provide for the disposition of good will in the absence of profits. Some accountants contend that good will should be retained on the books as long as the conditions supporting its admission continue to exist. This policy is also unsatisfactory, since the original recognition of good will must be presumed to have related to a terminable period. (...) The most reasonable basis for disposing of good will is to amortize it against income according to the number of years on which its computation was originally based."* (Backer and Bell 1996, 82).[35]

Goodwill is the excess of the cost of a business acquisition accounted for by the purchase method over the fair value of the net assets thereof.[36] Goodwill is a residual value, the rest after allocating the purchase differential to identifiable assets and liabilities.[37] It is common to term this residual value "an unidentifiable value" or "unidentifiable asset", which may be a good way to describe goodwill. The reader should now, given the context, be prompted to ask the question how "an unidentifiable value" could qualify as an asset in the A-L view.

APB 17 Intangible Assets has historically regulated accounting for goodwill in the US. APB 17 was in 2001 replaced by SFAS No. 142 Intangible Assets. Accounting for goodwill is however, partly covered in SFAS No. 141 Business Combinations, which superseded APB 16 Business Combinations.[38]

5.3.4.1 The Methods

Goodwill is for accounting purposes to a great extent ignored. There is however, one situation that does not allow for ignorance, that is when one entity acquires another entity. Under such circumstances something must be done to the cost of goodwill.[39]

As illustrated by the remarks of Backer and Bell (1996) quoted in the introduction to this section, three main approaches to goodwill accounting have been debated for decades: Immediate write-off of goodwill against equity at acquisition, capitalization combined with impairment write-downs, and capitalization combined with amortization over a defined period of time.

Immediate write-off of goodwill was, as late as the mid-nineties, the only allowed treatment according to UK GAAP.[40] Several arguments can be offered to support this solution, but the most common argument is that this solution would secure consistency in the accounting for acquired and internally generated goodwill.[41] If this argument was to be taken seriously, the consequences would be significant given that different treatment of acquired and internally generated assets is more a rule than the exception: *"The Board acknowledged that recognizing only goodwill acquired in a business combination and not goodwill that is generated internally results in differences in financial statements that make comparison more difficult. However, as it did in developing the 1999 Exposure Draft and the 2001 Exposure Draft, the Board concluded that the differences in accounting between acquired goodwill and internally generated goodwill are not unique as they also arise between other assets that are acquired and those that are internally generated"* (SFAS 141.B138). Another practical concern that probably has been of some importance when this approach has been considered by the different standard setters is that the acquirer under certain circumstances will not have enough surpluses to absorb the goodwill.

Others have argued that goodwill is not an asset of the entity: *"The entity cannot manage goodwill or realize upon it by selling it. Rather, goodwill is an asset only to the owners of the enterprise and should be accounted for by them rather than the entity"* (Skinner 1987,

193). On the other hand, one may argue that if the management of an entity has acquired an asset, they should be accountable for it. If goodwill has a definite useful life, it should be amortized. If not, management performance would not be apparent from the financial statements.[42]

The same argument, that goodwill is not an asset, but from a slightly different perspective, takes the A-L definitions into consideration: *"Perhaps the best example of an intangible that is not an economic resource is purchased goodwill. It does not possess service potential, in and of itself, that can be identified"* (AA 1984, 33). Whether goodwill meets the A-L definition of an asset is carefully analyzed in SFAS 141, and will be further discussed soon.

An approach not getting a lot of attention until recently when it was proposed by the FASB in the draft material to SFAS 142, is an approach in which the goodwill is capitalized and left unamortized unless the business to which it is related is sold or the goodwill independently appears to be losing or to have lost its value. The reasoning for this approach is obviously that the goodwill of a business normally is maintained by current operations, and internally generated goodwill is indirectly recognized.[43] In this approach the distinction commonly made between acquired and internally generated goodwill makes little sense. As long as there is acquired goodwill on the books, internally generated goodwill is recognized as an asset, while if there have been no acquisitions giving rise to goodwill, internally generated goodwill is expensed.

Another commonly expressed view is based on a stewardship approach to financial reporting: *"Without amortization of goodwill, the increase in reported earnings as a result of the business acquired can give a misleading picture of management's performance"* (Skinner 1987, 194). An acquisition will typically increase the revenues of the entity, but as long as the costs of these increased revenues are not shown, the performance of the entity is not reflected.

The third approach is the most commonly preferred approach. This approach involves acceptance of the proposition that no intangible assets lasts forever.[44] There seem to be some debate over whether the amortization approach reflects a matching concept or an allocation or nondistortion notion. Until recently, when SFAS 142 was implemented in the US, capitalization combined with amortization over a defined period of time was the only acceptable US GAAP-solution (APB 17). This approach still governs goodwill accounting in most of the leading standard setting countries (Australia, UK, IASB). The ASB in Canada was a partner of the FASB in the development of SFAS 141 and SFAS 142, and has issued similar standards (CICA Handbook – Accounting Section 1581 (Business Combinations) and Section 3062 (Goodwill and Other Intangible Assets), respectively).

5.3.4.2 The Application of the A-L Definitions

The FASB expressed both in the 1999 and 2001 Exposure Drafts that goodwill meets the definition of an asset in the Conceptual Framework, as well as the recognition criteria.[45] Most respondents agreed with the Board on this issue, arguing that goodwill is an asset because future benefits are expected from it in conjunction with the future benefits expected from other assets and that the consideration paid is evidence of the existence of the asset. Many of those respondents referred to goodwill as a special type of asset, one that cannot be separated from the other net assets of an entity (SFAS 141.B101).

The FASB chose in SFAS 141 to replace the traditional definition of goodwill as *"(...) the excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed"* (APB 16.87).[46] According to the FASB, *"That definition describes how the cost of goodwill should be calculated rather than explaining what goodwill is or what it represents. As such, it confuses the substance of goodwill with how goodwill is to be measured"* (SFAS 141.B107).

The FASB describes the nature of goodwill as a set of six components *"(...) that in practice has been recognized as goodwill:*

- *Component 1 — The excess of the fair values over the book values of the acquired entity's net assets at the date of acquisition.*
- *Component 2 — The fair values of other net assets that had not been recognized by the acquired entity at the date of acquisition. They may not have been recognized because they failed to meet the recognition criteria (perhaps because of measurement difficulties), because of a requirement that prohibited their recognition, or because the entity concluded that the costs of recognizing them separately were not justified by the benefits.*
- *Component 3 — The fair value of the "going-concern" element of the acquired entity's existing business. The going-concern element represents the ability of the established business to earn a higher rate of return on an assembled collection of net assets than would be expected if those net assets had to be acquired separately. That value stems from the synergies of the net assets of the business, as well as from other benefits (such as factors related to market imperfections, including the ability to earn monopoly profits and barriers to market entry — either legal or because of transaction costs — by potential competitors).*
- *Component 4 — The fair value of the expected synergies and other benefits from combining the acquiring entity's and acquired entity's net assets and businesses. Those synergies and other benefits are unique to each combination, and different combinations would produce different synergies and, hence, different values.*
- *Component 5 — Overvaluation of the consideration paid by the acquiring entity stemming from errors in valuing the consideration tendered. Although the purchase price in an all-cash transaction would not be subject to measurement error, the same may not necessarily be said of a transaction involving the acquiring entity's equity interests. For example, if the number of common shares being traded daily is small relative to the number of shares issued in the combination, imputing the current market price to all of the shares issued to effect the combination may produce a higher value than those shares would produce if they were sold for cash and the cash then used to effect the combination.*
- *Component 6 — Overpayment or underpayment by the acquiring entity. Overpayment might occur, for example, if the price is driven up in the course of*

bidding for the acquired entity, while underpayment may occur in the case of a distress sale or fire sale" (SFAS 141.B102).

The first and second components are according to the FASB not goodwill, and should be recognized as identifiable assets. The third and fourth components are termed "core goodwill" by the Board. The third component is internally generated and not recognized goodwill and goodwill acquired in an earlier business combination but not recognized, while the fourth component relates to the synergy expected from the present combination. Component five stems from technical errors, while component six represents the difference between the fair value of the acquired entity and the amount paid (excluding errors, that is, component five). In SFAS 141 only components 3,4 and 6 are considered components of the amount to be recognized as goodwill.

An asset has three essential characteristics according to SFAC 6: Future economic benefit, control, and past transaction or event. A future economic benefit is called the "essence of an asset" in SFAC 6: *"An asset has the capacity to serve the entity by being exchanged for something else of value to the entity, by being used to produce something of value to the entity, or by being used to settle its liabilities"* (FASB 1985, 172). Goodwill cannot be exchanged for "something else of value to the entity", and cannot be "used to settle its liabilities". Goodwill is also incapable of producing future net cash inflows, although in combination with other assets it can produce cash flows (SFAS 141.B111). It is thus not surprising that the Board in SFAS 141 concludes, *"(...) goodwill generally is more nebulous and may be less certain than the benefit that is associated with most other assets"* (SFAS 141.B111).

A market price is generally thought of as the most objective evidence of future economic benefits (FASB 1985, 173). The Board implies that goodwill has a market price since an entity is willing to pay a premium over the sum of the fair values of the net identifiable assets of another entity, but does so only indirectly by stating that the fact that goodwill is not priced separately does not preclude it from having future economic benefit: *"(...) anything that is commonly bought and sold has future economic benefit, including the*

individual items that a buyer obtains and is willing to pay for in a 'basket purchase' of several items or in a business combination" (FASB 1985, 173).

Some commentators have argued that exchangeability should be a necessary characteristic of an asset (Schuetze 1993). That is, assets that are not cash or contractual claims to cash or services must be capable of being sold separately for cash. Exchangeability is not a necessary characteristic of the FASB Conceptual Framework. The absence of exchangeability may create recognition and measurement problems, *"(...) but it no way negates the future economic benefit that can be obtained (...)"* (FASB 1985, footnote 62).[47]

It has been advocated that recognizing goodwill as an asset equals costs with assets. Although assets more often than not involve incurring costs, costs are not necessarily associated with future economic benefits. The Board acknowledges this argument, but rejected it *"(...) because it concluded that goodwill has future economic benefit"* (SFAS 141.B117). Such reasoning is confusing and is lacking logical structure. The argument of the critics is that since goodwill is lacking future economic benefits, goodwill cannot be an asset because it would imply that assets are nothing more than costs. The Board refuses this argument simply by claiming that goodwill, in their opinion, has future economic benefit, but fails to explain how it has reached this conclusion.

In this authors opinion the FASB is arguing a difficult case, and the arguments reflect that there is little support for what may seem like a predetermined conclusion.

The future benefit must be in the control of the acquieror for goodwill to meet the definition of an asset. Again, the arguments are unconvincing, and if they are to be considered valid, almost anything may meet the control criterion: *"The Board concluded that control is provided by means of the acquiring enterprise's ability to direct the policies and management of the acquired entity"* (SFAS 141.B115). Let an example illustrate the implications of the FASB interpretation of the control criterion. Assume an entity acquires another one and the acquiring entity choose because of the customer

potential of the acquired entity to pay in excess of the net value of identifiable assets and liabilities. This excess is according to the FASB to be accounted for as goodwill. Whether the excess value is to be realized by the acquiring entity is basically up to the customers. It is their choice whether they decide to buy the products or services of the entity, and goodwill is, in this perspective, therefore essentially out of the control of the acquiring entity. Thus, to accept the inclusion of goodwill on the balance sheet in the A-L view one must adopt an interpretation of the control characteristic that does not contradict the inability to control for example customer potential, as in the example above.

The FASB is careful to point out that its evaluation of goodwill as an asset is limited to "core" goodwill. However, the premium paid in the example above relates to core goodwill (component 3), and is therefore of particular interest.

The ASB in the UK has, in contrast to the FASB, concluded that goodwill is not an asset. Given that the asset definition in the UK conceptual framework is similar to the FASB definition, the UK conclusion is interesting. Nevertheless, the ASB recommends recognition of goodwill in the balance sheet: *"Although purchased goodwill is not in itself an asset, its inclusion amongst the assets of the reporting entity, rather than as a deduction from shareholders' equity, recognises that goodwill is part of a larger asset, the investment, for which management remains accountable"* (FRS 10.Summary). The ASB does not explicitly explain its view of goodwill not meeting the asset definition. However, in explaining the meaning of the controllability criterion in its 1995-draft of the Statement of Principles, the ASB stated that *"(...) items that cannot be separately identified from the business as a whole cannot be individually controlled by the entity and hence are not assets"* (ASB 1995.3.18). Johnson and Petrone (1998) point out that the ASB in its interpretation of its own controllability criterion adds meaning to the definition beyond the wording of the definition. In particular, the ASB definition of an asset does not explicitly state that an asset must be controlled individually. In the 1999-revised draft of the Statement of Principles, the ASB has not used the individual control concept (ASB 1999).

The IASB has also discussed the controllability of goodwill in the "basis for conclusions" appendix in the exposure draft regarding business combinations (ED 3 Business Combinations, 2002). As the FASB does, the IASB also discriminates between "core" goodwill and other components of goodwill in the exposure draft. The IASB concludes that "core" goodwill is controllable. However, the reasoning is not straightforward: *"In considering whether core goodwill represents a resource controlled by the entity, the Board considered the assertion that core goodwill arises, at least in part, through factors such as a well-trained workforce, loyal customers etc, and that these factors cannot be regarded as controlled by the entity because the workforce could leave and the customers go elsewhere. However, the Board agreed that in the case of core goodwill, control is provided by means of the acquirer's power to direct the policies and the management of the acquiree. Therefore, the Board concluded that core goodwill meets the Framework's definition of an asset"* (IASB ED 3.BC99). In other words, as discussed above, the inability to control for example the customer base and the employees, seem to be a concern to the IASB as well. How to interpret the "power to direct the policies and management" argument is therefore not a simple task (the same argument applied by the FASB in SFAS 141). Furthermore, the IASB admits that the components of goodwill not representing "core" goodwill, for example overpayments by the acquirer, do not meet the asset definition. Nevertheless, in reference to the qualitative characteristic of faithful representation and the impracticality of determining the amount attributable to the other components than "core" goodwill, the IASB proposes to recognize the non-asset components in the balance sheet along with "core" goodwill (IASB ED 3.BC102).

The last characteristic of an asset, that it has to be a result of a past transaction or event, is more straightforward in the case of goodwill. The acquisition is the past transaction, and goodwill would therefore qualify as an asset if the past transaction or event criterion was the only characteristic of an asset.

From the above one may conclude that it is not clear whether goodwill meets the asset definition or not. In a top-down approach, one may conclude that goodwill is part of an asset, namely the acquired business. However, when it comes to allocation of cost of

acquisition, one encounters a problem in the A-L view when it comes to the allocation of the excess purchase price.

Regardless of whether one concludes as the FASB and the IASB, that goodwill is an asset, or as the ASB, that goodwill is not an asset, it is difficult to accept that the A-L definitions have served a useful purpose as was intended when they were introduced in the conceptual frameworks. In the FASB and the IASB cases, the A-L definitions prove ineffective (goodwill is capitalized in the R-E view). In the ASB case, the definitions prove effective, but the standard setter chooses to reject them.

In some business combinations, the amounts assigned to the acquired net assets exceed their cost. That excess is commonly referred to as negative goodwill (referred to as "the excess over cost" by the FASB). Negative goodwill is normally believed to be the result of inefficient measurements and has no separate economic meaning.

Negative goodwill will only in special cases be recognized as a liability according to SFAS 141. Generally, negative goodwill must be allocated to all assets acquired in a business combination, except certain financial assets which typically can be assigned a reliable fair market value, on a pro rata basis. If this allocation exercise does not reduce negative goodwill to zero, then the remaining excess shall be recognized as an extraordinary gain. Many respondents to the exposure drafts preceding SFAS 141 rejected the extraordinary gain treatment, and argued that such excess should be deferred and amortized. The FASB rejected this proposal by referring to the A-L definitions arguing that such a deferral would be in conflict with the liability definition. The argument of the FASB is valid, but how the Board at the same time could agree on an exception to this rule is beyond the scope here to investigate. In certain cases, when a business combination involves a consideration contingency that might result in additional cost of the acquired entity, an amount equal to the lesser of the negative goodwill and the maximum amount of the contingent consideration is to be recognized "as if it was a liability", until the consideration contingency is resolved (SFAS 141.B193).

As explained in chapter 5.2.1, the IASB treats negative goodwill differently. Negative goodwill relating to expectations of future losses and expenses should be deferred until these future losses and expenses are recognized (IAS 22.61). Negative goodwill not relating to future losses and expenses should be recognized over the average expected useful life of the acquired assets. However, negative goodwill exceeding the fair value of non-monetary assets should be recognized immediately (not an extraordinary item). Negative goodwill is presented as such on the balance sheet, in the same balance sheet classification as goodwill (IAS 22.64). Thus, negative goodwill is to be deducted against goodwill. Even if the IASB solution represents a different approach, it suffers the same inconsistency as the FASB approach. Balance sheet items not meeting the A-L definitions are recognized. In the proposed new accounting standard on business combinations, ED 3, the IASB proposes to recognize negative goodwill immediately in the income statement.

5.3.4.3 Conclusion

To sum up, even if the FASB is concerned with the A-L definitions in SFAS 141 and SFAS 142, and concludes that goodwill meets the asset definition, important counterarguments exists. Except for the past transaction or event criterion, whether goodwill meets the definition of an asset is questionable. In this author's opinion, the A-L definitions are effective in the case of goodwill accounting, hence implying that the leading standard setters reject the A-L definitions in accounting standards dealing with goodwill.

On the other hand, if the FASB argumentation was adopted, one must conclude that the A-L definitions are ineffective in the case of goodwill, but effective with respect to negative goodwill. Generally though, the other leading standard setters choose to reject the liability definition in their treatment of negative goodwill.

In the matrix presented for the analysis in this chapter in the introduction, figure 5-1, regardless of which of the alternative conclusions one may support, goodwill accounting falls into one of the three not useful corners.

5.3.5 Other Inconsistencies

The application of the A-L view is difficult and conflicting in other areas as well. For instance, Rogers and Menon (1985) argued that the conceptual framework could not be applied in order to achieve a single preferred method of accounting for deferred-payment notes. Tonkin and Robertson (1991) argued that the A-L definitions have proved inappropriate in accounting for brand names, and proposes a measurement approach in which the entities can choose how to measure the brand names, only subject to a true and fair view. The idea of Tonkin and Robertson is that the entities will by applying their approach send important signals to the market by way of actual choices made.

Other areas, in which the A-L definitions have proven to be controversial, include leasing (see introduction to chapter 5.3) and so-called off-balance sheet accounting. Recent developments have put the ability of the current accounting model to capture the underlying economics, under public scrutiny. The A-L definitions provide only the necessary conditions for a resource or obligation to be included in the asset and liability categories, and do not provide for the sufficient conditions. The absence of sufficient conditions limits the usefulness of the definitions (Dopuch and Sunder 1980, 4). For instance, one objection to current leasing accounting is that operating leases create obligations falling within the liability definition, but the liability is not to be recognized according to the leading standard setters.[48]

Revenue recognition represents another area in which the applicability of the A-L definitions has been questioned. In May 2002, the FASB added to its technical agenda a project to develop a comprehensive Statement of Financial Accounting Standards on revenue recognition. In the preliminary works of the decision to take on the project, as well as in the development of the standard, it became clear to the Board there are inconsistencies with the Conceptual Framework as well, and the Board decided that the conceptual inconsistencies in the Framework should be addressed in the revenue recognition project (chapter 4.5.1.1).

Accounting for associates and joint ventures represent another area of inconsistencies (chapter 4.4.2, chapter 4.7, chapter 7.1). All the leading standard setters recommend the use of equity method accounting and a majority allows for proportionate consolidation, leading to balance sheet items clearly in conflict the A-L definitions.

In chapter 4.3.3, it was illustrated that rejection by the IASB of internally generated intangible assets on the balance sheet is inconsistent with the A-L definitions.

In chapter 4.1, the close relationship between measurement and definition application was illustrated by the proposal of the IASB in ED 3 to allow for recognition of contingent liabilities not meeting the liability definition in the Framework in business combinations.

Furthermore, the FASB and the other leading standard setters have over the last decade allowed for certain revenues and expenses to bypass the income statement (Zeff 2002, 52).[49] This include certain gains and losses on foreign currency translations (SFAS 52, IAS 21), gains and losses due to changes in underlying economic and actuarial assumptions in pension arrangements (SFAS 87, IAS 19), and gains and losses relating to non-trading financial instruments (SFAS 133, IAS 39). These examples involve different arguments and reasoning, but most importantly, they illustrate that not all changes in assets and liabilities are considered to be relevant in the income statement. Definition of revenue and expenses based on the balance sheet items is not considered to apply in these cases. Again, the A-L view model seems not to be working.

5.3.6 Concluding Remarks

Schipper noted that *"(...) Concepts Statement No. 5 has not proved to be useful in resolving key standard-setting issues"* (2003, 63). From the above analysis, it is not difficult to agree with Schipper. In particular, the following conclusions may be drawn:

- The A-L definitions are generally ineffective in pension accounting. Furthermore, to some extent, the FASB and the leading standard setters choose to reject the A-L definitions (that is, practices questionable in both the A-L view and the R-E view are recommended).

- The A-L definitions are generally effective in maintenance cost accounting. The standard setters apply the definitions.
- The A-L definitions are generally effective in income tax accounting. However, the FASB and the other leading standard setters choose to reject the A-L definitions.
- The A-L definitions are generally effective in goodwill accounting. However, the FASB and the other leading standard setters are indirectly claiming the opposite, namely that the A-L definitions are ineffective, and are suggesting that they do not reject the A-L definitions in their accounting standards dealing with goodwill accounting. Nevertheless, the FASB and the IASB reject the liability definition when dealing with negative goodwill.

In conclusion, the analysis of these four important and controversial areas suggests that the primary explanations for the findings in chapter 5.2 are that the A-L definitions are effective only in certain cases, and in these cases the standard setters tend to reject the A-L definitions in their policy making process. Maintenance cost accounting is the exception, and one may wonder why the standard setters seem to acknowledge and apply the A-L definitions in certain cases and not in others. As explained, application of the A-L definitions in the case of income tax and goodwill accounting may lead to significantly different timing of the expense recognition. As illustrated in chapter 5.3.2, the effect on net income of the application of the A-L definitions in maintenance cost accounting is generally not significant, and to some extent one may argue that the effectiveness of the A-L definitions in the case of maintenance cost accounting primarily has presentation consequences. From this, one may propose a hypothesis suggesting that the primacy of income measurement to the users of the financial reports tend to make the standard setters reluctant to apply the A-L definitions when they lead to significantly different earnings figures (that is, significantly affects the timing of the revenue and expense recognition). In this context, the suggested interpretation of the FASB's interpretation of goodwill as an asset made by Schipper is interesting: *"Research (e.g., L. Vincent, Journal of Financial Statement Analysis, 1997) has shown that investors appear to view acquisition goodwill as an asset (there is a reliable association with share values), (...). Broad*

inference -> goodwill is an asset (...)" (2002, 5). In other words since goodwill is viewed as an asset by the primary users of financial reports, it has to be accounted for as such. Clearly, this conclusion can be deducted from the decision usefulness objective. The problem however, is that the A-L definitions do not allow for this deduction.

Some commentators refuses to accept that conflicts between accounting standards and conceptual frameworks of the same standard setting body necessarily can be used against the frameworks, arguing that accounting standard setting is more than a conceptual exercise, and involves a political and practical perspective: *"The positions reached simply indicate that the Board as a group has concluded that the costs to it of pursuing a more conceptually pure solution are considered to be too great"* (Wyatt 1990, 86). It is certainly true that accounting standard setting involves assessment of practicality, and sometimes the issue of practicality will have to override conceptual consistency (it is somewhat more difficult to accept the role of politics in accounting standard setting). But when practical concerns dominate over conceptual consistency to the extent illustrated in the analyses in this chapter, little seems to have been achieved by the A-L view in the standard setting process.

5.4 Summary

> *"The definitions of liabilities and equity in conceptual statements are flawed and should be revised"* (Cook 1999, 74).

It has been shown that in a historical cost accounting model, the A-L view adds nothing more to the picture than an overriding recognition criterion, the A-L definitions. In this chapter it has been illustrated that the applicability of these definitions are limited, and, as a result, that the conceptual frameworks have had limited impact on accounting standard setting. It is further illustrated that the definitions represent effective recognition criteria in certain cases, in three of the four cases here studied, and that the standard setters choose to reject the A-L definitions when they in fact are effective. Inconsistencies have here been demonstrated in three controversial areas, namely in pension, income tax, and

goodwill accounting, but these examples are not exhaustive: *"It surely is difficult to make a case that the Board's standards involving restructuring of debt, pensions, other postemployment benefits, marketable securities, and stock options are consistent with the conceptual framework"* (Staubus 2002, 26).

Even though the finding in chapter 5.2 partly is explained as a consequence of the standard setters rejection of the A-L definitions, the effectiveness of the definitions suffer to some extent from the vagueness of the definitions: *"The FASB's definition of an asset is so complex, so abstract, so open-ended, so all-inclusive and so vague that we cannot use it to solve problems. It does not require exchangeability of that which is called an asset; therefore it allows all expenditures to be considered for inclusion as assets. The definition does not discriminate and help us to decide whether something or anything on the margin is an asset. That definition describes an empty box. A large empty box. A large empty box with sideboards. Almost everything or anything can be fit into it. The FASB, (...), is even proposing to put the cost of purchased goodwill into that box. (...) A very large box indeed!"* (Schuetze 2001, 12). Ineffective definitions reduce the usefulness of the A-L definitions as much as the numerous rejections of them by the standard setters: *"(...), these broad definitions will not help resolve the issue"* (Dopuch and Sunder 1980, 7).

An interesting issue not researched here is the standard setters' motivation for rejection of their own A-L definitions. One possible explanation for the rejection of the A-L definitions is that application of them often would lead to less decision useful financial reports. For instance, application of the A-L definitions in the cases investigated in chapter 5.3 where the definitions are rejected, would generally lead to more volatility in reported earnings. The FASB, even though not specifically referring to the role of the A-L definitions, seems to indicate that so-called "application exceptions" have been made to limit the volatility of reported earnings (FASB 2002b, 3), assuming that less volatility facilitates the usefulness of the financial reports. As explained in chapter 4, "smoothing" is rejected in the R-E view as well. The rejections of the A-L definitions analyzed in this chapter may be explained as application exceptions aimed at limiting earnings volatility

and thus increase the usefulness of the financial reports (interestingly, the FASB proposes to eliminate all "application exceptions" (FASB 2002b, 7). Whether the preferences of the users of the financial reports support such application exceptions will be explored in the next chapter.

The intention in this chapter has been to analyze the IASB application of the A-L definitions and to investigate certain controversial areas of accounting with focus on the usefulness of the A-L definitions. The analysis does not reflect the author's opinion as to how these controversies can best be solved.

There are three possible solutions to the problem:

- Enforce the current definitions, for example by lifting the frameworks to the top of the authority hierarchies described in chapter 2.2. This alternative would among other things require a clarification of the past transaction requirement in the definitions. This solution would imply changed accounting practices for several important areas. For instance, abandonment of amortization of gains and losses in pension accounting, a movement towards cash-based tax accounting, and possibly elimination of goodwill as a balance sheet item. The US Security and Exchange Commission has proposed a similar solution in their report on a principles-based accounting system (SEC 2003, 37).

- Impose more narrow definitions, for example by redefining assets and liabilities based on legal premises. This solution would be in conflict with one of the fundamental assumptions, namely the substance-over-form assumption, and even more important, legal definitions would be in conflict with the objective of decision usefulness.[50]

- Widen the definitions, for example along the lines of the APB 4 definitions. In APB 4, an important statement preceding the FASB Framework project, liabilities were defined as economic obligations, but also *"(...) certain deferred credits that*

are not obligations (...)" should be included (APB 4.132). Among others, deferred taxes were listed as an example of deferred credits not being an obligation (Dopuch and Sunder 1980, 6).

---

[1] Cason argued as early as in 1984 that "Conceptual Frameworks Begins to Affect Current Standards", and referred particularly to the then current SFAS 76 Extinguishment of Debt and SFAS 77 Reporting by Transferors for Transfers of Receivables with Recourse (Cason 1984).

[2] It is important to notice that the test conducted in order to disclose whether the IASB uses the definitions of the elements of financial statements as an important recognition criterion, is less relevant to the accounting standards and interpretations not dealing with recognition issues.

[3] Financial reporting according to IAS, as an alternative to US GAAP in the US is discussed bye Dye and Sunder in an article in Accounting Horizon in 2001 (Dye and Sunder 2001).

[4] The IASB and the FASB met in an educational joint Board meeting in September 2002. Although no formal decisions were made, the Board affirmed their commitment to achieve convergence of accounting standards, expressed general support for a short-term project, the objective of which would be to eliminate many existing differences between the IASB and the FASB accounting standards, and expressed general support for coordinating their technical agendas so to avoid creating differences (IASB Update September 2002).

[5] Hudack and McAllister (1994) applied a similar methodology in their study of the usefulness of the qualitative characteristics.

[6] The issuance, revision or reformation dates of all the IAS' and the SIC's are disclosed in Appendix A.

[7] In contrast to the accounting standards of the FASB, the International Accounting Standards do generally not include a separate section dealing with basis for conclusions. The basis for conclusions is explained throughout the text. However, the IASB has made certain important exceptions to this, and basis for conclusions is included in the appendixes in six accounting standards (IAS 19, IAS 22, IAS 36, IAS 38, IAS 40, and IAS 41). The basis for conclusions sections are not considered part of the accounting standards, but are nevertheless important to the analysis conducted. Therefore, in the following, the basis for conclusions appendixes of these six accounting standards is considered to be part of their respective accounting standards. However, other appendixes, for example illustrative examples etc., are not included in the analysis. It should be noted that the IASB in some of these appendixes has applied the A-L definitions explicitly (se for example IAS 37.C).

[8] Such reasoning may be questionable tough, as represented by the logic of McCarthy: One's denial of being a communist spy was taken as evidence that one was a communist spy because a communist spy would deny that he is a communist spy. Transferred to the setting here: Absence of a statement of adoption

of the Framework is evidence that the Framework is not adopted because an accounting standard or interpretation not adopting the Framework would not refer to the Framework at all.

[9] *"A jointly controlled entity is a joint venture which involves the establishment of a corporation, partnership or other entity in which each venturer has an interest"* (IAS 31.19).

[10] *"Nonmonetary assets are similar to those contributed by other venturers when they have a similar nature, a similar use in the same line of business and a similar fair value. A contribution meets the similarity test only if all of the significant component assets thereof are similar to those contributed by other venturers"* (SIC 13.5).

[11] Monson assesses potential conflicts between the A-L definitions in the FASB Framework and the lease assets and liabilities, and he reveals that the conclusion is uncertain: *"When the FASB eventually reconsiders accounting for leases, it must decide how its definitions of assets and liabilities should be applied to the rights and obligations arising out of lease contract"* (Monson 2001, 287). He refers to two lease accounting approaches, the so-called whole asset approach, in which the lease liability include not only the obligation to pay rent but also the obligation to return the leased property to the lessor etc, and the so-called financial components approach, in which two separate lease liability arise from a lease arrangement, one from the obligation to pay rent and one from other obligations included in the lease arrangement, and in his opinion *"The assets and liabilities to be identified and accounted for under both the financial components approach and the whole asset approach satisfy the literal language of these definitions"* (Monson 2001, 278). However, in his opinion, the definitions coupled with the qualitative characteristics make the whole asset approach the one most consistent with the FASB Framework.

[12] Paterson 1995, Gore 1992, Kvifte 1997.

[13] Kripke 1989, Paterson 1995, Gore 1992.

[14] Paterson 1995.

[15] According to the analysis in GAAP 2000 – A survey of National Accounting Rules in 53 Countries, Australia and New Zealand approach the calculation of defined benefit obligations slightly different from the IASB. These differences are not further explored here.

[16] Defined contribution plans and defined benefit plans are defined in a similar, but not identical way in International Accounting Standard No. 19 (Revised 1998), Employee Benefits: *"Defined contribution plans are post-employment benefit plans under which an enterprise pays fixed contributions into a separate entity (a fund) and will have no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay all employee benefits relating to employee service in the current and prior periods. Defined benefit plans are post-employment benefit plans other than defined contribution plans"* (IAS 19.7). The FASB has in other words given defined benefit plans an individual and separate content, while the IASB defines defined benefit plans as a residual term. That is, defined benefit plans are all plans not meeting the criteria of defined contribution plans.

[17] Before the 1998-revision, the Projected Unit Credit Method was only one of several allowed methods according to IAS 19. The IASB chose to follow the FASB on this issue as well, reducing the differences between IAS 19 and SFAS 87.

[18] According to SFAS 87, the corridor is the greatest of 10 percent of the benefit obligation and 10 percent of the fair value of plan assets, and only recognition of unrecognized gains and losses in excess of the corridor is required.

[19] Even if all the leading standard setters seem to agree on pension accounting, there are certain technical differences. Recognition of prior service cost is an area in which the different standard setters have chosen slightly different solutions. For instance, prior service cost for vested active employees and former employees must be recognized immediately under IAS 19, while these costs would be amortized under US GAAP.

[20] The comment made by Barth et al. (1993) may reflect that the authors seem to regard the A-L view as synonymous with current value accounting.

[21] SSAP 24 is to be superseded by Financial Reporting Standard No. 17 (FRS 17) Employee Benefits no later than for accounting periods ending on or after 22. June 2003.

[22] In regard to the Norwegian Accounting Standard on Pension Costs, which is patterned after SFAS 87, NASB states that the R-E view is at work: "Under en fortsatt drift forutsetning vil imidlertid kostnadsføring av pensjonsopptjening baseres på det generelle prinsipp om sammenstilling av inntekter og kostnader" (NRS 6, Ch. 2.2), a view the Accounting Law Committee ("Regnskapslovutvalget") supported in the preliminary works of the current Norwegian Accounting Legislation: "Plikten til å regnskapsføre pensjonskostnader og tilhørende pensjonsforpliktelser i balansen følger av sammenstillingsprinsippet" (NOU 1995:30, 54).

[23] In the IASB's exposure draft, E54, leading up to IAS 19 (Revised 1998), this issue was raised: *"It (IAS 19) generates balance sheet items which may not meet the definition of assets or liabilities in the IASC's Framework for the Preparation and Presentation of Financial Statements ('The Framework')"* (the issue may, however, have had little practical implication: *"Although the old IAS 19 did not deal explicitly with the recognition of retirement benefit obligations as a liability, it is likely that most enterprises would*

---

is a possibility that the benefit may not vest, that difference is an obligation and, in the Board's view, should result in the recognition of a liability at the end of the first year. The measurement of that obligation at its present value reflects the enterprise's best estimate of the probability that the benefit may not vest" (IAS 19 (Revised 1998).A3.14).

[25] It may be added that the EU Commission' and Contact Committee in their examination of the conformity of IAS 19 (Revised 1998) and the European Accounting Directive argued that the corridor approach was in conflict with Article 43.7 of the Fourth Directive. However, now the EU Commission does not object to the corridor approach.

[26] FRS 17 replaces SSAP 24. The mandatory full implementation date of FRS 17 was deferred in November 2002, and it is effective for accounting periods beginning on or after 1. January 2005 (earlier adoption is encouraged, and certain disclosure requirements are effective in earlier periods) (FRS 17.94-95). In this context it is interesting to note the care the ASB took in order to ensure that the deferral of the mandatory full implementation did not indicate a changing view: *'The deferral of the mandatory full implementation of FRS 17 reflects no weakening of the ASB's view that the UK standard is the best approach to pensions accounting'* (ASB Inside Track 34, January 2003).

[27] The exception is the amortization of gains and losses. It should be noted that there is little support for amortization of gains and losses in the R-E view as well. As is discussed in chapter 4, such "smoothing" must not be misinterpreted as matching.

[28] Inconsistencies between IAS 19 and the IASB Framework beyond the amortization approach for gains and losses are explained in chapter 5.2.1.

[29] SSAP 24 is to be superseded by FRS 17 in the UK. The revision of titles reveals the same development as in the case of IAS 19: The title of SSAP 24, "Accounting for pension costs", implies a R-E focus, while the title of FRS 17, "Employee benefits", seems fundamental perspective neutral. Furthermore, the objective of FRS 17 seems more balanced: *"The objective of this FRS is to ensure that:(a) financial statements reflect at fair value the assets and liabilities arising from an employer's retirement benefit obligations and any related funding; (b) the operating costs of providing retirement benefits to employees are recognised in the accounting period(s) in which the benefits are earned by the employees, and the related finance costs and any other changes in value of the assets and liabilities are recognised in the accounting periods in which they arise; and(c) the financial statements contain adequate disclosure of the cost of providing retirement benefits and the related gains, losses, assets and liabilities"* (FRS 17.1).

[30] Samuelson does not reject the A-L view, but he claims that the definitions of the FASB is lacking empirical content, and therefore cannot be applied for practical accounting purposes.

[31] Timing differences refer typically to items of income or expenses, which are entered into the determination of taxable income in periods different than financial reporting income. Temporary differences include timing differences as well as other differences between tax and financial reporting bases of assets and liabilities, for example those arising from business combinations. In IAS 12 (Revised 1996)

Income Taxes temporary differences are defined as *"(...) differences between the carrying amount of an asset or liability in the balance sheet and its tax base"* (IAS 12.5).

[32] Here "probable", as in probable that the tax asset will be realized, and therefore should be recognized, is interpreted as "more likely than not". "Probable" in SFAS 109 and US GAAP in general is understood as being a level significantly greater than 50%. In US GAAP the interpretation is "likely to occur". The interpretation of Miller is, however, in line with the IAS-interpretation (FASB 1999, 151).

[33] Known as the "permanent deferral argument" (Skinner 1987, 255).

[34] Note that the application of the matching concept in income tax accounting is somewhat different than under other circumstances. Costs are matched with before-tax income, not with revenues (Hendriksen and Van Breda 1992, 708).

[35] "Goodwill" and "good will" are generally given different meaning. It would therefore be of some interest to learn why Backer and Bell uses "good will" when referring to "goodwill".

[36] In SFAS 141 goodwill definitions are criticized for confusing the substance of goodwill with how goodwill is to be measured.

[37] The purchase differential is the difference between the acquisition price and the book value of the acquiree.

[38] It is common among standard setters to integrate goodwill accounting issues in accounting standards dealing with business combinations. IAS 22 (Revised 1998) Business Combinations is an example. Accounting for goodwill is a significant part of IAS 22, and is not covered by IAS 38 Intangible Assets. Others, for instance ASB in the UK, have chosen to cover accounting for goodwill as part of their intangible assets standard, FRS 10.

[39] Skinner (1987) explains that it is not surprising that goodwill is not accounted for under other circumstances than acquisitions. In a historical cost model there is really no room for goodwill accounting except in acquisition situations. Goodwill is under other circumstances largely not the result of cash outlay: *"Even if accounting were to adopt a valuation approach in place of the historical cost model, accounting for the value of goodwill would be very difficult. The reason is that goodwill is inseparable from the business carried on. Firm evidence of its value, then, is to be found only when the business is sold. Some think that a value can be derived from the market value of the outstanding securities of an entity. It is not clear, however, that market values for trades in a company's securities can properly be translated into a valuation of the entity as a whole. In any event, that basis of valuation is only available for the minority of entities whose securities are publicly traded. For the rest, valuation of goodwill would be almost completely subjective"* (Skinner 1987, 193).

[40] Goodwill was to be charged to equity according to SSAP 22 Accounting for goodwill. FRS 10 Goodwill and intangible assets replaced SSAP 22.

[41] Internally generated goodwill is generally not accounted for, and any cost incurred in generating it generally is charged to the income statement.

[42] The management performance argument has originated in a stewardship setting.

[43] Some may claim that the real reason for the FASB to propose the impairment approach, and later issue SFAS 142 in which this is the only allowed approach, was the need to come up with compensatory solutions to the decision to ban the pooling method in business combinations (SFAS 141).

[44] FRS 10 in the UK applies the amortization approach. However, it follows from FRS 10 that goodwill may be considered to have an indefinite useful life, with the consequence that goodwill should not be amortized (FRS 10.17). It is interesting to notice that companies' legislation in Britain requires amortization of goodwill over a finite period of time, and that FRS 10 allows for the "true and fair" view to override companies legislation under certain circumstances (FRS 10.18).

[45] In 1999 the original Exposure Draft was issued, Proposed SFAS Business Combinations and Intangible Assets, while an exposure draft known as "the revised" Exposure Draft, a Limited Revision of the Proposed SFAS Business Combinations and Intangible Assets – Goodwill, was issued early in 2001.

[46] The SFAS 141 definition is similar to the definition in IAS 22: *"Any excess of the cost of the acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction should be described as goodwill and recognised as an asset"* (IAS 22.41).

[47] *"Assets commonly have other features that help identify them —for example, assets may be acquired at a cost and they may be tangible, exchangeable, or legally enforceable. However, those features are not essential characteristics of assets. Their absence, by itself, is not sufficient to preclude an item's qualifying as an asset. That is, assets may be acquired without cost, they may be intangible, and although not exchangeable they may be usable by the entity in producing or distributing other goods or services"* (FASB 1985, 26).

[48] The generally accepted practice of leaving operational leasing obligations unrecognized is particularly troublesome since the obligation meets the other recognition criteria as well (Nobes 2003, 14).

[49] The leading standard setting bodies have tended to allow for an increasing number of exceptions from the congruence principle. For instance, certain unrealized gains and losses on financial instruments and foreign currency items are recognized in the balance sheet, even though not recognized in the income statement. The term "comprehensive income" has originated from this tendency. Comprehensive income includes income from the income statement and "other comprehensive income" carried directly to equity. In other words, "other comprehensive income" represents revenues and expenses that bypass the income statement.

[49] Costs to be matched with historic revenues was termed "after costs" by AAA (AAA 1965a, 371).

[50] Schuetze proposed the following asset definition: *"Cash, contractual claims to cash, things that can be exchanged for cash, and derivative contracts having a positive value to the holder thereof"* (2001, 15). Schuetze proposes his definitions and claims it is more meaningful, but one may suspect that his main argument is the argument of practicability and simplicity. The earnings figures resulting from the Schuetze definition would generally be of little usefulness, and as such the definition is by this author not highly regarded.

6. A Survey of the Decision Usefulness of the A-L View to Financial Analysts

> *"Financial reporting is not an end by itself but is intended to provide information that is useful in making business and economic decisions – for making reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities"* (FASB 1978, 9).

The methodology applied in the previous chapters may be characterized as normative. Generally, in the previous chapters I have attempted to address the issues in question within the objectives and concepts adopted in the conceptual frameworks by the leading standard setters. In this chapter, however, a shift in methodology is carried out. Here a descriptive approach is applied. The intention is to observe a user group of financial reports, and to use the findings in the evaluation of the objectives and concepts adopted in the conceptual frameworks.

Thus, in this chapter, the decision usefulness of the A-L view will be researched from the perspective of the users of financial reports. As explained in chapter 3, the decision usefulness of the A-L view implies usefulness in the decision making process of the investors as well as usefulness in the control process (stewardship). In this chapter, decision usefulness refers to decision making in particular.

In order to gain further insight into the decision usefulness of the A-L view and the R-E view, a survey among financial analysts is conducted. In chapter 6.1, introductory comments are presented. The survey and the findings are presented in chapter 6.2, and concluding remarks are offered in chapter 6.3.

6.1 Introductory Comments

> ."*(...), the major objective in accounting today is the measurement of periodic income, and this should not be adversely affected by overemphasis of the balance sheet*" (Backer and Bell 1966, 77).

The decision usefulness objective of financial reporting is explored in a normative setting in chapter 3, and will rather be adopted than further questioned here. However, the question to be addressed in this chapter is whether the A-L view or the R-E produces the more decision useful financial information.

The primary interest of the investors is the ability of an entity to generate favorable cash flows because they invest in entities in order to obtain sufficient cash in return to make the investment economically worthwhile. Regardless of fundamental perspective adopted for the purpose of recognition and measurement, the leading standard setters agree that earnings measures provide the most decision useful information: *"The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings and its components"* (FASB 1978, 43). The legacy of accrual accounting is therefore not disputed within this context.

The use of earnings oriented arrangements to compensate managements illustrates the earnings focus of investors. These arrangements motivate an earnings focus among managements as well regardless of other incentives the managements may have for earnings focus. The focus of independent auditors on earnings measures can partly be explained by the nature of legal actions and lawsuits brought against them (Sprouse 1978, 64). Furthermore, there is ample evidence in conducted research to support the earnings focus of other users of financial reports, including the financial analysts.

One may argue that the focus on earnings measures is misplaced and should be replaced by a better and more meaningful alternative. However, in a normative approach in which communication of decision useful information to investors and their advisors is the primary objective, the information demanded by these groups should be provided. If a

better and more meaningful alternative focus emerges from within these user groups, then it follows from the conceptual framework structure that the alternative should be adopted by the accounting standard setters.

As explained in chapter 4, the primacy of earnings measures is not a conflict between the A-L view and the R-E view. The conflict may rather be explained as two alternative approaches to achieving meaningful measures of earnings: *"Proponents of both views generally consider earnings to be more important in terms of primary interest to users. The question is which view results in the more meaningful measure of earnings"* (Sprouse 1978, 69).

In the eyes of the proponents of the A-L view the R-E view leaves too much room for subjectivity, and comparison of financial reports of different entities is less meaningful. A reasonable assumption is that investors do not have unlimited resources for investment purposes, and therefore have to choose between alternative investment opportunities. The lack of comparability between the different alternatives in the R-E view must therefore be mitigated, according to the A-L view proponents.

From an R-E view perspective, the comparability argument of the A-L view proponents must be appreciated. However, the lack of comparability may result from misuse of the matching principle rather than the matching principle itself (this issue is addressed in chapter 4). Furthermore, according to the R-E view proponents, the introduction of A-L definitions will either lead to less meaningful earnings measures or will not be effective.

One would expect that the introduction of the A-L definitions in recognition would be supported by reference to the decision usefulness objective. However, in SFAC 3, there is no direct link between the objective and the A-L view. Apparently, a link is established in paragraph 9-19, but how the A-L definitions contribute to decision useful earnings measures is not resolved. Schipper notes that *"(...), from a standard-setting perspective, it is taken for granted that an item that meets the definition of a financial reporting element is relevant to investors"* (2003, 62). In other words, the usefulness of the A-L

view must be accepted as a predetermined underlying assumption. The introduction of the A-L view in SFAC 3 may therefore conflict with the normative deductive approach in the Conceptual Framework of the FASB. Whether a linkage between the objective and the A-L view of the conceptual frameworks exists, is, based on the analysis in this paper, doubtful.

It was indicated in chapter 5 that the A-L view would lead to less meaningful earnings measures if effective A-L definitions were to be applied. For instance, the excess cost beyond the cost of identifiable assets and liabilities in an acquisition would either have to be charged to income in the period of the acquisition or directly to equity, leading to inflated earnings measures, and the tax benefits resulting from a loss to be carried forward for tax purposes may not qualify for recognition, leading to deflated earnings measures in the period of the loss, and inflated earnings measures in the periods in which the tax loss was utilized.[1] To avoid such consequences the A-L definitions would have to be defined loosely, generally making them ineffective as recognition criteria.

From the above, one may suggest that the A-L view does not represent a useful alternative to the R-E view. However, the suggestion rests on a critical assumption, namely that effective A-L definitions lead to less decision useful information than the information provided in the R-E view. This assumption is to be tested empirically in the next section.

6.2 The Survey[2]

The user orientation in financial reporting was introduced before the development of the conceptual frameworks, and was adopted in the conceptual frameworks projects. Nevertheless, one may criticize the leading standard setters for ignoring the preferences of the primary users of the financial reports. They have only occasionally been engaged in empirical research to back up the statements of objectives, qualitative characteristics, and recognition. The introduction of the A-L view was more a reaction to the perceived weaknesses of the R-E view than a result of documented findings.

It has been documented that the A-L definitions may be effective but that they the standard setters reject them more often than not (in cases were they provide solutions to accounting problems other than the solutions that would follow in the R-E view). A hypothesis that can explain these findings suggests that the A-L definitions are rejected because they are perceived to lead to less useful financial information. Specifically, the A-L definitions are perceived to produce less meaningful earnings measures.

One way to evaluate this hypothesis is to approach the users of financial reports. The investors and their advisors are singled out as the primary users, and insight into the preferences of the financial analysts will represent an important contribution.

The nature of the financial analyst profession and the time constraints therein and the limited budged of the project would probably not allow for sufficient interest among the respondents to conduct in-depth interviews. A survey approach was therefore adopted. Generally, this approach allows for a large group of respondents to be targeted at a low cost, and is far less time consuming to the respondents. The chance of receiving sufficient feedback to at least make qualified suggestions about the population was therefore considered to be higher if the survey approach was adopted.

Another, more common genre of financial accounting research that may have been relevant in this project is often referred to as value relevance research. Several researchers have tried to demonstrate the decision usefulness of financial reporting information by analyzing the empirical evidence of the relevance of accounting information. However, the ability of empirical accounting research to offer policy-directed insights is inherently limited. The standard setters must evaluate likely reactions to policies not yet enforced, while real-world data only can inform of the reactions to policies that already exists. Furthermore, in spite of advanced methodological techniques, it is difficult to isolate the incremental effect of accounting alternatives (Kachelmeier and King 2002, 219).

6.2.1 Test Design

The findings in the previous chapters suggest that the A-L definitions may limit the decision usefulness of the financial statements. Based on these findings, the intention in this chapter was to further explore these findings by questioning a sample of the primary users whether they find the A-L definitions enhancing the decision usefulness of financial information. However, this objective was deemed to be too ambitious primarily because of the heterogeneity of the users and because of the project's budget constraints, and only one segment of the primary users, the financial analysts, was approached.

The survey idea grew out of the analysis and findings in the previous chapters, and each of the specific questions in the questionnaire relates to issues discussed previously. Furthermore, the analysis and findings in the previous chapters allowed me to develop qualified pre-survey expectations. These expectations are commented on in chapter 6.2.1.4.

6.2.1.1 The Target Population

As explained in chapter 3, the FASB has singled out investors and their advisors as the primary users of financial statements. "Advisors" are not defined in the FASB Conceptual Framework, but is commonly understood as persons and institutions offering investment advice. Financial analysts represent influential members of the investment community, and in the following "financial analysts" will be used as a common term for the advisors of investors as referred to in the FASB Conceptual Framework.

Although investors and the financial analysts are both considered being included in the primary user group of financial reports, it cannot automatically be concluded that the preferences of these two subgroups are identical. The investors themselves make the final investment decisions. The financial analysts' responsibility is to provide the investors with a comprehensive set of relevant and reliable information for the investors to base their investment decisions on. The financial statements may represent the most important of several sources from which the financial analysts gather the information they provide the investors: *"At the top of every analyst's list (of financial reports used by analysts) is*

the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it" (Knutson 1992, 7). The analysts do not necessarily use the financial statements as is, and may choose to alter the information before it is presented to the investors in order to make it more decision useful. For instance, if expenditures on research and development are expensed as incurred, the analyst may adjust the financial statement information by capitalizing the expenditures to provide the investors with earnings numbers that are considered to be more relevant in the investment decision than the unadjusted earnings numbers. Thus, the investor is provided the more decision useful information even though the information cannot be directly pulled out of the financial statements. In this example one may intuitively conclude that capitalization of research and development expenditures represents the preferred accounting treatment according to both groups, the investors and the financial analysts. However, one cannot exclude the possibility that the advisor prefer research and development expenditures to be expensed in the financial statements, leaving the analyst with the task of converting less relevant financial information into more relevant financial information, and thus indirectly increasing the demand for the services provided by the analyst. Put another way, capitalization may represent the most decision useful treatment according to the analysts, but they may nevertheless prefer the expense as incurred treatment to capitalization in the financial statements.

Thus, even though decision usefulness of financial information most likely takes the same form for both the investors and the analysts, the two groups may not have the same preferences with respect to how financial information should be presented in the financial statements. In surveying the decision usefulness of the financial information provided in the A-L view as perceived by one of the groups, one must therefore be careful not to generalize the findings to the other group without further research.

Therefore, based on the above, both investors and their analysts must be surveyed in order to determine the primary users' preferences, and their evaluation of the usefulness of the A-L definitions in particular.

The investors do not represent an easily accessible group for the purpose of a survey. The analysts on the other hand can typically be reached through member organizations. The target population of the survey was thus defined as financial analysts in the US. Accordingly, potential analyst member organizations were identified. The Association for Investment Management and Research® (AIMR®) is the largest and most significant financial analyst organization in the US. The AIMR® has several member societies, the largest of these being the New York Society of Security Analysts (the NYSSA). Since the NYSSA is known to permit member surveys in certain cases (Grinell and Hunt III 2002), a request was made for access to a selected portion of its membership. The NYSSA granted permission to survey its members.[3]

6.2.1.2 Sample Selection, Coverage and Representativity

The NYSSA has approximately 8 700 members, and a screening of the member list based on self-reported titles suggested that a majority of the members fall into the primary user group of financial statements. In order to reach the largest possible number of the members without exceeding the budget constraints of the project, it was suggested that the members should be contacted by email and that the survey should be web-based. However, the NYSSA decided that the survey should be distributed at various scheduled events and seminars the first three months of 2003. This approach soon proved not to be effective (only a few responses were received). Participants at the weekly preparation seminars for Chartered Financial Analyst (CFA) candidates were then singled out, and the survey was introduced at three different CFA-sessions in the beginning of March (two of the sessions were attended by so-called first level candidates (candidates in the first of three years of CFA examination preparation) and one session was attended by third level candidates). This produced 81 responses by the end of March. Due to budget constraints, no further actions were taken to increase the sample.

The use of the survey approach raises questions of coverage and representativity (external validity). An ideal survey design would consist of an unbiased sample of a size sufficiently large to be able to determine whether the A-L view or the R-E view is the

preferred view among the financial analysts and to describe and estimate characteristics of each group. Based on the above, certain limitations must be recognized.

As explained, the ideal target population, "the primary users of financial statements", could not be reached. The target population of the study was therefore defined as financial analysts in the US. Thus, the findings in the survey can by no means be generalized to the other primary user groups.

The demographic and geographical variance within the population of financial analysts in the US may allow for a sampled population representing only a subset of the target population, without biasing the sample enough to make it statistically inappropriate. The NYSSA members may therefore represent an appropriate population for sampling. By distributing the questionnaires by email to all the members, undercoverage would not be a problem. However, as explained, the web-based approach was rejected by the NYSSA, and was replaced by the seminar and event distribution approach introducing the problem of undercoverage. Furthermore, since all but three responses resulted from survey introductions at three particular seminars at which one must expect all participants to be uncertified financial analysts, undercoverage is a serious problem of the sample. In addition, the response rate of approximately 25% (calculated as number of completed questionnaires ("respondents")/number of analysts contacted ("sample")) is at the lower end of what is considered adequate for statistical analysis and reporting (Lohr 1999, 281). The relatively low response rate also raises a question of self-selection bias. On the positive side though, is the close to zero non-response rate within the respondents (with the exception of three respondents, all the respondents completed all the questions in the questionnaire).

Overall, based on the sampling errors and selection biases explained above, the sample and the response rate do not allow for generalizing of the results of the survey (even though the validity of the sample seems to be satisfactory, chapter 6.2.1.3). Thus, the study is exploratory in form and allows only for suggestions about the target population, and the findings do only apply to the sample as such.

6.2.1.3 Demographics of the Sample

The formal educational background of the sample is summarized in table 6-1 (Appendix B). 44% of the respondents have at least a graduate degree and/or a professional certification (Certified Public Accountant or Chartered Financial Analyst) (53% of the NYSSA-members has a graduate degree and 63% are Chartered Financial Analysts). Since close to all respondents participated at the review courses developed by the NYSSA to prepare candidates to the CFA examination, one can assume that close to zero of the respondents were CFA charterholders. In other words, the 44% of the respondents is to be compared to the 53% among the NYSSA-members. The academic background of the sample and the NYSSA-members is in other words similar, but their professional formal education clearly separates the two.

As illustrated in table 6-2 (Appendix B), 49% of the respondents are security analysts, credit analysts, fixed income analysts, and mutual fund or portfolio analysts (as compared to 46% of the NYSSA-members), while 51% report to have other professional positions (stock brokers, equity traders, security product managers etc). A few respondents have professional positions that by themselves may not qualify them as "advisors of investors". However, the respondents in the "other" group are without exceptions CFA-candidates, and were therefore considered to qualify for inclusion in the sample.

32% of the respondents have little experience in their current position (less than three years). However, many of these respondents have experience from other positions in which financial reporting knowledge is essential. Thus, as shown in table 6-3 (Appendix B), 84% of the sample may be considered to be experienced in the application of financial reporting statements under various circumstances.

As illustrated in table 6-4 (Appendix B), 43% of the sample primarily deals with larger businesses (more than $ 1 billion in revenue) in their current positions.

Based on the above, one can conclude that the sample in many respects has the same characteristics as the whole population of NYSSA members does. However, one

modification must be made, it can be assumed that none of the respondents where Chartered Financial Analysts, while 70% of the NYSSA members are CFA charterholders.

6.2.1.4 The Questionnaire[4]

The questionnaire was developed primarily to deal with the main issue in question, namely do the A-L definitions provide useful information to the primary users of the financial reports? However, in the conceptual framework context, this question should not be considered independently of the objective of financial reporting and the qualitative characteristics of financial information. Therefore, the first section of the questionnaire deals with SFAC 1 issues, while the second section deals with recognition issues where the A-L definitions may modify recognition. Furthermore, to enable a more comprehensive analysis of the responses to Section I and II, questions concerning demographics were included in Section III. The questionnaire is included in Appendix C.

In the questionnaire, the objective was not directly revealed. The respondents were asked to address certain questions within the historical cost model and without regard to current accounting legislation and regulation. The historical cost restriction was introduced in order to isolate the recognition issue of the A-L view and the measurement issue. To be sure to get the respondents preferences and not the preferences of the regulatory environment it was necessary to emphasis that the questions should be addressed without regard to current legislation and regulation.

The case questions in Section II were designed to reveal preferences towards an A-L view or an R-E view. In that respect, they had to be simplified in order to make them apprehensible and in order to make the time needed to respond as short as possible. The last aspect was important in order to motivate a higher response rate. Numerical tables were provided for illustration purposes.

In the following, the background for each of the questions in the questionnaire is explained, and pre-survey expectations are discussed.

1. Assuming that the primary objective of financial reports is to provide the users with financial information, rank the importance of the following information in financial reports (1 implying the greatest importance, and 3 the least importance).

___ *Information useful to the investors, creditors, and their advisors in their evaluation of the firms' managers*

___ *Information useful to the investors, creditors, and their advisors in their investment decision process*

___ *Information useful to user groups other than the investors, creditors, and their advisors*

The first question regards the objective of financial reporting and the primary user groups of the financial reports. Given that the choice between the A-L view and the R-E view should be deducted from the objective and the primary users' informational needs, the responses to this question may be useful in the analysis of the questions in Section II of the questionnaire. The two first alternatives imply that the investors and their advisors are the primary users of financial reports, but differ in the objective of financial information. The first alternative puts stewardship information first, while the second alternative focuses on decision useful information. The third alternative rejects investors and their advisors as the primary users of financial reports, but does not specify what "useful information" is. These three alternatives are not necessarily mutually exclusive, and the respondents are therefore asked to rank them.

Considering the selected group of respondents and their role in decision making one would expect in line with the analysis in chapter 3, the second alternative to be the preferred alternative.

2. To achieve the primary objective(s) in question 1, what statement is the most useful to the user?

- ❑ *The income statement*
- ❑ *The balance sheet*
- ❑ *The cash flow statement*
- ❑ *The notes to the financial statements*

In the second question the respondents have to reveal their preferences for one of four components of the official financial statements. The impact of this question is rather subtle, and will not be of interest alone. However, the question is raised in order to reveal whether there is a relationship between the preference for the A-L view and the R-E view and the perceived usefulness of the different components of the financial statements.

Given the emphasis security analysts put on cash flow information and earnings measures one may expect the cash flow statement and the income statement to be the preferred financial statements. Of these two statements, one may, based on documented research findings (Healy and Wahlen 1999, 367), expect a preference for the income statement

3. You are asked to address an exposure draft from an accounting standard setting body. Two alternative policies to a recognition problem are proposed. One policy is supported by reference to relevance, while the other is supported by reference to reliability. In other words, you have to make a trade-off between relevant and reliable financial information in order to make a choice between the two policies in your response to the exposure draft. Which of the two policies would you support?

- ❑ *The more relevant policy*
- ❑ *The more reliable policy*
- ❑ *Both policies should be allowed*

The intention of question 3 is to reveal whether the preference for the A-L view and the R-E view is related to the perceived importance of the two primary qualitative

characteristics, namely relevance and reliability. These two qualities have little meaning in isolation, and the question is therefore formulated as a choice between two accounting policies.

In the report made by the Financial Accounting Policy Committee (FAPC) of the AIMR®, prepared for the 1997 AAA/FASB Financial Reporting Issues Conference, a preference for reliability may be detected. Accountants should produce reliable financial statements, and leave it to the analysts to make the reports relevant. For example, Lees (1981) found that even if information about management's future plans is important to professional investors and analysts, the analysts generally opposed mandatory disclosure of management earnings forecasts. It is not unlikely that this finding reflect a bias against management forecasts motivated by analysts' self-interest. Similarly, a preference for reliability over relevance among analysts may be motivated by the analysts' self-interest.

Based on the above, one may expect to find that the financial analysts prefer reliability to relevance in the third question.

4. Entity A has expenditures of 100 in period 1, and no investments or other expenditures over the entity's lifetime of five years. These expenditures are recognized as expense for accounting purposes and are tax deductible. A earns 20, 30, 40, 50, and 100 in year 1, 2, 3, 4, and 5, respectively. The applicable tax rate is 50%. Assume no temporary or permanent differences between accounting and tax bases. Furthermore, assume full certainty about future revenue and expenses.

Which of the following recognition approaches should be applied for accounting purposes in order to give the most meaningful information to the investors?

- ❑ *The effect of the carry forward tax loss is reflected*
- ❑ *The effect of the carry forward tax loss is not considered to be an asset, and the tax expense is therefore only reflecting the tax payable in each year*

The alternatives included numerical tables illustrating the alternatives. See Appendix C.

The first question in Section II, question 4, simply asks whether the benefit from a carry forward tax loss should be recognized or not in the financial statements. There is no uncertainty as to whether the tax benefit will be realized. In the A-L view, recognition may be denied because the tax benefit does not qualify as an asset.

It follows from the discussion in chapter 5.3.3 that a preference for non-recognition of the tax benefit in this case would reveal a strong indication of A-L view support. In particular, it would represent an unexpected response considering the fact that a tax asset must be recognized according to the FASB. The FASB argued in SFAS 96 that tax assets only under certain circumstances qualify as assets for accounting purposes. However, after considerable pressure from different user groups, the FASB had to shift position and require recognition of tax assets in SFAS 109.

5. Answer question 4 assuming that both revenues and expense numbers are uncertain estimates that may be revised. Nevertheless, it is more likely than not that the tax benefit will be realized.

- ❑ *The effect of the carry forward tax loss is reflected*
- ❑ *The effect of the carry forward tax loss is not considered to be an asset, and the tax expense is therefore only reflecting the tax payable in each year*

The fifth question repeats the case in question 4, but in this question the future realization of the tax benefit is uncertain but likely. The motivation of this question is to screen out the role of the A-L definitions from the other recognition criteria. That is, one may, as several of the leading standard setters have, consider the probability criterion a separate recognition criterion.

As explained in chapter 4, the A-L definitions are only one of several recognition criteria. Thus, non-recognition may be supported because the tax benefit does not meet the asset definition or it may be supported in reference to a prudence concept ("more likely than not" is not sufficient to allow for reflection of the effect of the tax carryforward).

Comparison of the response to this question and the response to question 4 will reveal which of the two explanations apply.

A preference for non-recognition in question 4 is likely to be accompanied by a preference for non-recognition in this question. However, a preference for recognition in question 4 may not be associated with a particular response to this question. A non-recognition response may or may not indicate a preference for the A-L view.

The implications of the wording in this question should be emphasized. "More likely than not" implies that the probability of realization of the tax benefit is more than 50%. The term "probable", which is generally used by the leading standard setters, implies a higher likelihood of realization. Thus, questions 4 and 5 do not perfectly discriminate between the asset definition and the probability criterion as defined by the leading standard setters.

6. Entity B is in the service business. B acquires a customer list for 100 at the beginning of period 1, and has no other investments or expenditures over the entity's lifetime of four years. B earns revenues of 40, 50, 70, and 80 in period 1, 2, 3, and 4, respectively. Assume full certainty about future revenues and expenses, and no tax.

Which of the following recognition approaches should be applied in order to give the most meaningful information to the investors?

- ☐ *The customer list is not considered to be an asset, and the purchase price is therefore expensed in period 1*
- ☐ *The customer list expenditures are capitalized, and amortized according to a linear schedule (impairment tests must be conducted, and may lead to write downs)*
- ☐ *The customer list expenditures are capitalized and amortized according to a schedule developed to achieve a net income measure in each period reflecting the project's internal rate of return (≈ 40) (impairment tests must be conducted, and may lead to write downs.*

The alternatives included numerical tables illustrating the alternatives. See Appendix C.

The sixth question regards recognition of so-called "soft assets", or intangible assets. It may be somewhat unclear whether a customer list meets the A-L definitions (as discussed in chapter 5.3.4). Future benefits may be associated with the customer list, and it is a result of a past transaction. The question is whether the entity can control the future benefits. The customers on the list are not controlled by the entity, and may freely obtain the product or service in demand from other providers. On the other hand, the list as such is under the control of the entity. Nevertheless the example may be useful in determining how analysts evaluate intangibles.

Furthermore, in this question the respondent is given an alternative amortization schedule if capitalization is preferred. In practice, linear amortization is by far the most common amortization schedule. However, as discussed in chapter 4, linear amortization often provides little meaning except as a tool of allocation. The alternative schedule provided in question 6 is based on a matching concept, but may by some be interpreted as a tool to smooth income.

The AIMR® has officially rejected capitalization of "soft assets" and smoothing (i.e. "normalization") (Knutson and Napolitano 1998). One may therefore expect the members of NYSSA to support the non-capitalization alternative. On the other hand, one may assume greater support for capitalization in the case of acquired intangible assets than in the case of internally generated intangible assets.

7. Answer question 6 assuming that both revenue and expense numbers are uncertain estimates that may be revised. However, assume that the estimates are more likely than not.

- ☐ *The customer list is not considered an asset, and the purchase price is therefore expensed in period 1*
- ☐ *The customer list expenditures are capitalized, and amortized according to a linear schedule (impairment tests must be conducted, and may lead to write downs)*
- ☐ *The customer list expenditures are capitalized and amortized according to a schedule developed to achieve a net income measure in each period reflecting the project's internal rate of return (≈ 40%) (impairment tests must be conducted, and may lead to write downs)*

The seventh question repeats question 6, but in this case uncertainty is introduced. The major motivation of this question is therefore two-fold: Does uncertainty decrease the preference among the respondents for the capitalization alternative, and if so, to what extent. Furthermore, a comparison of the choice of amortization schedules among the capitalization supporters in the two questions may provide interesting results. One would expect more linear amortization supporters under uncertainty than in question 6, since one may expect less support for the matching approach to amortization (as opposed to the allocation approach, discussed in chapter 4.5) when uncertainty is introduced.[5] Uncertainty reduces the reliability in the amortization schedule, and thus an increased demand for revision of estimates, and support for linear amortization in the case of uncertainty may therefore not be surprising even if the internal rate of return method is the preferred method in question 6.

8. Entity C starts operations at the beginning of year 1, and stays in business for 5 years. The entity earns 100 in revenues each year, and has expenses before insurance costs of 50 each year. There is no uncertainty associated with these measures. Entity C chooses to be "self-insured", and has no insurance coverage for employee accidents. Assume that the entity knows for certain up-front that one employee accident will happen during the five years of operations, and that the entity will have to pay out 100 in insurance coverage to the employee involved in the accident. However, it is not known up-front when the accident will occur. Assume that the accident occurs in year 3, and assume no taxes. Which of the following recognition approaches should be applied in order to give the most meaningful information to the investors?

- ❑ *The average annual insurance loss, 20, is recognized in each of the five periods.*
- ❑ *The average annual insurance loss, 20, is recognized over the lifetime until the accident occurs. In the period of the accident, year 3, the difference between the provision made in period 1 and 2 and the insurance loss is recognized*
- ❑ *An accrual and/or deferral would be in conflict with the definitions of assets and liabilities, and the insurance loss is therefore recognized in the period it occurs*

The alternatives included numerical tables illustrating the alternatives. See Appendix C.

In question 8 the classic insurance example is introduced. The FASB used this example widely in the preliminary works leading up to the shift from the R-E view to the A-L view (FASB 1976c, 59). The two first alternatives are considered to be R-E view alternatives, while the last alternative is founded on the A-L view.[6] The first two alternatives rely on a matching concept, but the second alternative is modified by a prudence concept.

Again, what to expect is not clear. As commented on several times before, research has shown that accrual accounting is useful in predicting future cash flows. Thus, if this question was presented to the investors, one may expect a preference for the provision alternative. However, with the official report of AIMR® and the self-interest of the analysts in mind, one may find a preference for the A-L view solution.

9. Answer question 8 assuming that the insurance loss only is an expected loss, not a certain loss up-front. In this case, there is full independence between losses. That is, a loss in period 1 for instance, does not affect the likelihood of losses in later periods.

- ☐ *The average annual insurance loss, 20, is recognized in each of the five periods*
- ☐ *The average annual insurance loss, 20, is recognized over the lifetime until the accident occurs. In the period of the accident, year 3, the difference between the provision made in period 1 and 2 and the insurance loss is recognized*
- ☐ *An accrual and/or deferral would be in conflict with the definitions of assets and liabilities, and the insurance loss is therefore recognized in the period it occurs*

Question 8 is repeated in question 9, but in this case uncertainty is introduced. The A-L view supporters are not expected to respond differently to this question. If an accrual and a deferral are in conflict with the A-L definitions under certainty, the same conclusion applies under uncertainty. The first two alternatives are considered R-E view alternatives. However, given full independence between losses, it may be argued that the last alternative should be the preferred alternative in the R-E view as well (see endnote 44 in chapter 4), and that the first alternative is based smoothing, while the second alternative is a compromise between matching (alternative three) and smoothing, relying on a prudence concept. Another argument in favor of the second alternative rests on the matching concept and the internal rate of return method, and the need for recognition of realized cash flows not accounted for when these cash flows do not affect estimated future cash flows.

Again, as the case was in question 8, one may expect financial analyst to be in favor of the A-L view alternative.

To sum up, the second alternative in questions 4 and 5 (tax asset) are here considered to be in accordance with the A-L view. That is, given that a deferred tax asset does not meet the asset definition, a tax expense cannot be accrued. As explained in chapter 5, the net-of-tax method may represent an alternative in the A-L view. However, in the example here there is no alternative to the tax payable method in the A-L view. In questions 6 and

7 (customer list), the first alternative is considered to be in accordance with the A-L view, while the both the second and the third alternatives are considered to be R-E view treatments. In questions 8 and 9 (insurance loss), the two first alternatives are considered to be R-E view treatments, while the last alternative is in accordance with the A-L view.

The questions in Section III were primarily included to be able to give a more comprehensive description of the sample (chapter 6.2.1.1). However, certain relationships between the demographics obtained in questions 10-14 and the preferences revealed in Part I and Part II were investigated.

6.2.2 Findings[7]

In the following, the findings in the survey will be summarized and commented on. Descriptive statistics for each of the variables will be offered, and an analysis of the independence between the variables will be conducted by cross-tabulations and Chi-Square statistics. In the test of independence the objective is to determine whether the two variables in question are independent of each other, or if a relationship between them exists. The Chi-Square test reveals whether the contingency calculations offer statistical significant results. If not, in statistical terms, one must conclude that the variables are independent. Generally, only statistical significant relationships will be commented on. However, in a few cases, an exception is made and insignificant relationships are commented on (chi-square statistics are not provided in these cases).

6.2.2.1 Objectives of Financial Reporting and Qualitative Characteristics

There is a general agreement among the respondents that the investors, creditors, and their advisors are the primary users of the financial reports, and that decision usefulness to these groups should represent the primary objective of financial reporting (table 6-5 (Appendix B)). This opinion is shared by all but 4% (3 respondents). A great majority further believes that decision making is of greater importance than stewardship demand, and that the primary objective of financial reporting should be to provide the investors with information that is useful in the investors' investment decision processes (75%). 21% report that financial reporting primarily should provide investors with information

that is useful in the evaluation of management (stewardship demand). The rest (4%) report that other user groups than the investors, creditors, and their advisors should be regarded the primary users of financial reports.[8] These findings are in accordance with the expectations explained in chapter 6.2.1.2.

This result suggests preference for decision making rather than stewardship demand in accordance with the suggestions made in chapter 3, implying that a conflict may exist under certain circumstances. The FASB acknowledges that decision making demand and stewardship demand in certain cases cannot both be met, and seems to be in agreement with the respondents in that decision making demand in such cases should be emphasized (FASB 1978, 53). However, considering the agenda of the respondents, primarily being engaged in the investment process of the investors, one must be careful not to overemphasize this finding.

The cash flow statement is, according to a majority of the respondents (60%), the most useful statement in achieving the objective of financial reporting as reported in question 1 (table 6-6 (Appendix B)). The income statement is reported to be the most useful statement by 18%, the notes to the financial statements and the balance sheet is regarded the most useful statement by 14% and 8%, respectively. This finding is to some extent in line with the pre-survey expectation in that the cash flow statement and the income statement are considered the two most useful statements (chapter 6.2.1.2). However, the ranking order of these two, and the fact that a great majority of all respondents rank the cash flow statement as the most useful statement, represents a surprising finding. After all, the cash flow statement is generally considered more of a secondary statement in financial reports, and that less than one fifth of the respondents ranks the "primary" statement (the income statement (FASB 1978, 43)) over the cash flow is puzzling. Based on the ranking of the financial statements, one may intuitively expect the respondents to favor alternatives resembling cash flow accounting (the A-L view alternatives) in the three cases provided (questions 4 and 5, 6 and 7, and 8 and 9). However, as will be discussed in the following, the opposite is the case. On second thought, this relationship should not come as a surprise. Given the cash flow statement emphasis, cash flow

information is not needed in the income statement. The findings therefore, may suggest that financial analysts view the cash flow statement as the primary statement of interest (the individually most useful statement), and the income statement as a secondary statement, providing an alternative base to predict future cash flows from. Nevertheless, based on the well-documented and commonly accepted knowledge of accrual accounting superiority in future cash flow prediction (Healy and Wahlen 1999, 367), the finding deserves further attention.

Interestingly, the preference for objective in question 1 does not represent a statistically meaningful discriminator with respect to preference for financial statement in question 2, even though stewardship information preference seems to be associated with cash flow statement preference (75% of the respondents preferring stewardship information prefer cash flow statement information as opposed to 56% of the respondents preferring decision making information).

If the respondents were faced with a choice between an accounting solution focusing on relevant information, an accounting solution focusing on reliable information, and a solution allowing for both, the latter would be preferred by the largest group in the sample (45%) (table 6-7 (Appendix B)). The solution emphasizing reliability would also gain significant support in the sample (35%), while 20% would prefer the solution supported by reference to relevance.

As explained in chapter 6.1.2.1, this finding is not surprising, and confirms the FAPC (1997) opinion that accountants should prepare reliable financial reports, leaving it up to the analysts to make the reports relevant.

The preference for only the relevant or the reliable policy tend to find more support among respondents that favor stewardship information, while the respondents preferring information produced to enhance the decision making process tend to be more sympathetic towards a policy allowing for both alternatives. However, the relationship is not statistically significant.

6.2.2.2 The Decision Usefulness of the A-L Definitions

Under full certainty, 61% of the respondents report that they support accrual of a tax asset associated with a tax carryforward loss (table 6-8 (Appendix B)). Under uncertainty, still a majority find accrual accounting more useful than the alternative (53%), namely the recognition of the tax benefit in the period it materializes in the form of reduced tax payable.

The expectation that the respondents prefer accrual of tax assets is confirmed, but it is nevertheless noteworthy that as much as 39% of the respondents favor recognition of the benefit when it materializes. These respondents clearly take an A-L view approach to income tax accounting. The group favoring this treatment increases when uncertainty is introduced. However, most of the leading standard setters regard the probability of future economic benefits as a separate recognition criterion and not a part of the A-L definitions, and it may therefore be misleading to assume that close to one half (47%) of the sample supports the A-L view approach to income tax accounting. Accrual of tax assets will also in a R-E view depend on the probability of the associated future economic benefits. It is noteworthy that the introduction of uncertainty does not have a greater effect on the support of the accrual accounting alternative (61% support under certainty and 53% support under undertainty).

27% of the sample does not consider the customer list in question 6 to be an asset (table 6-9 (Appendix B)). The introduction of uncertainty does not seem to play a major role in the recognition preferences of the sample, but a slightly higher number prefer expensing of customer list expenditures as incurred when uncertainty is introduced (30%).

As in the former case, the most noteworthy finding is that the introduction of uncertainty seems to have little effect on the support of the accrual accounting alternative. The accrual accounting alternative receives support from 73% under certainty as compared to 70% under uncertainty.

As explained in chapter 6.1.2.1, one may expect that financial analysts would favor the expense as incurred alternative given that a customer list falls under what is generally considered a "soft-asset". It may therefore at first seem somewhat surprising that the respondents that report to be in favor of this alternative do not constitute more than 30% of the sample. However, one must recognize that the customer list in this case results from a transaction with a third party, and therefore may not be perceived as "soft" as internally generated intangibles.

Somewhat more surprising is it to learn that support of the more advanced matching procedure (the internal rate of return method) is reported by as much as 29% and 24% under certainty and uncertainty. It is particularly surprising that the support is almost as strong under the scenario assuming uncertainty as under full certainty when one considers the tendency of financial analysts to prefer reliable financial reports reported in table 6-7 (Appendix B). The internal rate of return method automatically reduces the reliability of the reported numbers since it takes into consideration the expected time profile of cash flows associated with revenues and expenses in future periods in addition to the economic useful life.

The support of the R-E view produced solution is strong in the insurance example as well. 75% and 62% favors accrual of an insurance liability under certainty and uncertainty, respectively (table 6-10 (Appendix B)). In both cases, accrual is clearly in conflict with the A-L view. A linear accrual approach regardless of the timing of the actual loss incident is generally the more favored R-E approach in both cases.

There is a strong a significant relationship ($p<.001$) between the respondents' preferences under certainty and uncertainty within each case. That is, the respondents generally keep their preference for the R-E view alternatives under uncertainty when the R-E view alternatives are preferred under certainty. This implies that the respondents find the less stringent criterion "more likely than not" to meet their demand for likelihood.

This finding may also shed some light on how the financial analysts interpret the reliability concept when asked to choose between two accounting policies each emphasizing primarily relevance and reliability, respectively. A larger proportion of the sample preferred the reliability-based policy than the relevance-based policy (table 6-7 (Appendix B)). These respondents may have associated reliability with "more likely than not" as compared to the more stringent probability criterion adopted by the leading standard setters. However, this relationship was not further investigated.

The respondents preferring the A-L view alternatives under certainty generally favor the A-L view under uncertainty (table 6-11, table 6-12, table 6-13 (Appendix B)). More interesting though, is it that 5% (4 out of the 80 respondents) in each of the three cases support the R-E view treatment under certainty but favor the A-L view treatment under uncertainty. A rational reason for this set of responses is difficult to find. It should be noted that the four "irrational" respondents in each case are not the same, and none of the respondents therefore seems to be consistently "irrational".

As commented on several times above, the introduction of uncertainty in each case does not conceptually make an accrual or deferral more or less consistent with the A-L definitions, even though it may have implications for the recognition of the asset or liability. Therefore, in the discrimination of A-L view supporters and R-E view supporters, it is most meaningful only to look at the scenarios in which certainty is provided.

35% of the respondents are consistent R-E view supporters in all the three cases (that is, these respondents favor one of the R-E view produced solutions in question 4, question 6, and question 8). Only 4% (3 respondents) of the respondents are consistent A-L view supporters.[9]

So far, it has been indirectly assumed that all of the respondents fit in one of two groups, either they are "R-E view supporters" or they are "A-L view supporters". This classification of the respondents may be meaningful when each question in Section II of

the survey is discussed separately. However, as explained, a majority of the respondents is not consistent R-E view supporters or A-L view supporters. The underlying perspective applied by the respondents seems to vary from case to case. Nevertheless, a significant minority is consequent, or "true" R-E view supporters (35%), while the same does not apply to the A-L view (5% (4 respondents)). It may be assumed that the inconsistent respondents do not reject the A-L definitions per se, but may favor an application of them somehow determined by case-specific circumstances. In the following therefore, for the purpose of further analyses, the respondents are classified as either "R-E view supporters" or "Others" (65%), the latter group being sympathetic to the application of the A-L definitions but not necessarily "true A-L view supporters" (table 6-14 (Appendix B)).

The dataset was tested for relationships between the respondent classification and each of the three variables in Section I of the Survey, namely financial reporting objective preference, financial statement preference, and qualitative characteristic preference. With the exception of one, no significant relationships were found, implying there are independence between the R-E view supporters and the Others and their financial reporting objective preference and qualitative characteristic preference.

Even though relatively more R-E view supporters have a decision making information preference (85% versus 75%), the relationship is insignificant. Thus, there is independence between the R-E view supporters and the Others and their objective preferences, suggesting that the decision usefulness of the A-L definitions is independent of the two objective statements.

One would expect to find different attitudes towards the qualitative characteristics of reliability and relevance in the groups. R-E view produced financial information tends to be less reliable. Accordingly, although not statistically significant, the R-E view supporters tend to be more focused on relevance than the two other groups. None of the "true" A-L view supporters report that they prefer the relevant alternative in question 3. Moreover, the R-E view supporters in the sample report a greater preference for relevant

accounting policies than the Others. However, these tendencies are not statistically significant.

The cash flow statement is the preferred financial statement among the R-E view supporters to a greater extent than among the Others (table 6-15 (Appendix B)). 78% of the R-E view supporters prefer the cash flow statement to the other statements, while the same is true only for 52% of the Others. This relationship is statistical significant ($p<.05$).

As discussed in chapter 6.2.3.1, surprisingly the cash flow statement is the preferred statement among the respondents. Given this preference, and the fact that the accrual alternatives in the three cases are preferred by the majority of the respondents it should not come as a surprise that the preference for the cash flow statement is stronger among the R-E view supporters than among the Others. Cash flow information is useful, and when such information is not provided in the income statement (as the case in the A-L view alternatives), one would expect a stronger preference for the cash flow statement. However, this finding does not explain why the respondents consider the cash flow statement the primary financial statement as discussed in chapter 6.2.3.1.

The dataset was tested for relationships between respondent classification and each of the five variables in Section III of the Survey, namely educational background, current position, length of experience, other relevant experience, and typical businesses analyzed. No significant relationships were found, implying that the R-E view supporters and the Others are demographical similar.

6.3 Concluding Remarks[10]

The purpose of the survey was to explore whether the A-L definitions enhance the decision usefulness of financial reporting information. One of the user groups identified as primary users by the FASB and the other leading standard setters, namely the financial analysts, where selected for questioning. The methodology applied assumes that the users of financial reports prefer decision useful information as defined by the FASB (information meeting the decision making demand). This assumption may have to be

modified with respect to the financial analysts, even though 96% of the sample agreed that decision usefulness to the investors and their advisors should be regarded the primary objective of financial information. The financial analysts may define decision usefulness differently than the FASB. The test design does not allow for this issue to be explored.

The consequence of the sampling errors and selection biases inherent in the sampling procedure, does not allow for generalization of the results of the survey to the population of the NYSSA members. Obviously, generalization of the results to the population of financial analysts in the US and/or primary users of financial reports as defined by the FASB, would represent an inappropriate use of the results. Consequently, the survey should be considered an exploratory study from which the findings may be used to suggest financial analyst characteristics that may be tested in future research.

The A-L definitions are vague and it is not always clear whether they are effective in modifying the accrual concept. For instance, as explained, the FASB argues that a tax asset reflecting the effect of a tax carryforward loss meets the asset definition. Similarly, the assumption that capitalization of the customer list expenditures is in conflict with the A-L view may be questioned. On the other hand, the A-L definitions effectively reject the provision for expected future losses in the case of self-insurance. A rejection of the effectiveness assumptions adopted in the survey will obviously lead to a rejection of the findings as well.

The findings in the survey suggests that the A-L definitions does not lead to enhanced decision usefulness of financial reporting information. In each of the cases presented for the sample, a majority preferred an accounting treatment conflicting with the A-L view, and only a few respondents (4%) found the A-L definitions providing the most decision useful information in all three cases. In comparison, more than one third of the sample preferred an accounting treatment in accordance with the R-E view in all of the three cases, indicating that the R-E view is the more decision useful perspective. A majority however, did not reveal a consequent preference pattern, indicating that A-L definitions may be perceived as enhancing the decision usefulness of financial reporting information

in certain cases. Nevertheless, as explained above, a majority in each case preferred the R-E view alternatives.

The implications of the relationship between preferences under certainty and uncertainty represent another important finding. This relationship suggests that the financial analysts find the quantification of the probability criterion as "more likely than not" sufficient for recognition purposes.

The most surprising finding of the survey revealed that the cash flow statement is the single most useful financial statement according to the sample. Based on the well-documented and commonly accepted knowledge of accrual accounting superiority in future cash flow prediction, this finding deserves further attention.

Furthermore, the findings suggest that the R-E view supporters emphasize the decision making component of the decision usefulness objective, the cash flow statement, and the qualitative characteristic of relevance, more than the Others. However, only the second of these three relationships proved to be statistical significant within the sample.

The findings suggest that the financial analysts prefer accruals to be accompanied by simpler forms of matching procedures. Both under certainty and uncertainty, a majority of the respondents favoring one of the two R-E view alternatives prefer a systematic allocation approach to the more direct matching approaches.

---

[1] The assumption that the amortization approach to goodwill accounting is the most meaningful to the investors is not undisputed. For instance, the Financial Accounting Policy Committee (PAPC) of the Association for Investment Management and Research (AIMR) rejects the approach because *"(...) a number that reports the amount of unamortized goodwill simply is irrelevant to investment decisions"* (Knutson and Napolitano 1998, 172).

[2] I am grateful to Lin Therese Hurlen Kvifte for assisting me in the administration of the survey.

[3] I would like to extend my appreciation to the New York Society of Security Analysts (NYSSA) for kindly consenting to distribute my questionnaire among its members, and thus providing me with an appropriate dataset to draw conclusions from.

[4] Several people were involved in the development of the questionnaire, and I am greatful for their contributions. Professor Atle Johnsen, Professor Frøystein Gjesdal, the Norwegian School of Economics and Business Administration, and Professor Brett Trueman, Haas School of Business, UC Berkeley, all gave insightful technical advices. Michael Knie-Andersen, the University of Aarhus, shared his expertise in questionnaire design, and Ina Pettersen and Vivi Stensrud, both Ernst & Young Norway, made the web-based solution possible (unfortunately, the web-based solution was never launched (chapter 6.2.1.1 and Appendix D)).

[5] The last sentence of the introduction in question 7 is poorly written. The intention was to give the respondents an indication of what confidence they could place in the estimated revenue and expense numbers. The fact than none of the respondents commented or questioned the meaning of the wording, may indicate that they were not confused by the sentence.

[6] The wording in the A-L view alternative in question 8 (and 9) is somewhat different than in the two former cases. A direct reference to the A-L definitions is given in question 8 while in the tax asset and the customer list cases the reference is more indirect. The implications of the slightly different wording are unclear. None of the respondents, however, noted the difference.

[7] The data analysis was aided by the application of the computerized Statistical Package for the Social Sciences (SPSS). Researcher Kari Hauge Riisøen, FAFO Institute for Applied Social Science, provided me with technical assistance in the application of SPSS and also let me benfit from her experience with categorical data analyses in the analysis and interpretation of the collected data. Her contributions are greatly appreciated. To facilitate the data analysis, certain guidelines for the analysis had to be developed. These guidelines were formulated in a separate memo. The content of the memo is included in Appendix D. The guidelines developed required certain modifications to be done in the raw data collected, and explanations of the modifications are provided in Appendix D.

[8] In analyses in the following involving the financial reporting objective variable, the respondents favoring other users than the investors and their advisors are excluded. Thus, in the following, only decision making information preference and stewardship information preference are included in the analyses.

[9] If the second case had been excluded (as explained in chapter 6.2.1.2, it is somewhat unclear whether the A-L definitions are effective in this case), the consistent R-E view supporters and the consistent A-L view supporters would increase to 46% and 10%, respectively.

[10] A report summarizing the findings was prepared for the use by the NYSSA and was distributed to the survey respondents. The report is included in Appendix E.

7. Summary of Findings

The findings of the analyses conducted in this dissertation may very well be summarized by the FASBs own evaluation of its conceptual framework: *"Although the FASB has used its conceptual framework in developing accounting standards, that framework has not provided all the requisite tools for resolving accounting and reporting problems. In part, that is because certain aspects of the conceptual framework are incomplete, internally inconsistent, and ambiguous"* (FASB 2002b, 6).

The FASB did in its 2002-proposal (October) regarding a "principle-based approach to U.S. standard setting" recognize several of the concerns raised in this dissertation (FASB 2002b, 6):

1. SFAC 2 *"(...) does not provide conceptual guidance necessary for making tradeoffs among the qualities of relevance and reliability and comparability and consistency"* (Chapter 3),
2. SFAC 5 provides *"(...) little, if any, conceptual basis for analyzing and resolving the controversial issues of recognition and measurement"* and is merely a description of practices existing at the time (Chapter 4 and Chapter 5),
3. the guidance in SFAC 5 is *"(...) in some respects, inconsistent with the guidance in other areas of the conceptual framework; in particular, the definitions of assets and liabilities (and other elements) in FASB Concepts Statement No. 6, (...). Further, the definitions (...), themselves, lack clarity"* (Chapter 4 and Chapter 5), and
4. the conceptual framework does not include a framework for developing disclosure requirements (Chapter 2).

In the following, the findings will be summarized and commented on in the context of the research questions introduced in chapter 1.

7.1 The Conceptual Differences Between the A-L View and the R-E View

The conflict between the A-L view and the R-E view is not about measurement attributes, and it is not about the primacy of the income statement or the primary objective of income measurement. It is rather a conflict about the usefulness of an overriding recognition criterion, namely the A-L definitions.

In the A-L view, assets and liabilities are economic resources and obligations. Economic resources and obligations will typically be included in the balance sheet in the R-E view as well. However, in addition the balance sheet will include certain accruals (accrued costs and revenues) and deferrals (deferred costs and revenues) that do not meet the A-L definitions of the A-L view. These accruals and deferrals typically do not have any "real-world meaning".

Matching is regarded as the basic concept for recognition in the R-E view and is also important in the A-L view. However, matching is typically modified by the asset and liability definitions. In other words, costs should be expensed in the same period as the revenue that results from the expenditure, but only to the extent that the corresponding balance sheet items meet the A-L definitions.

The findings in the analysis indicate that the A-L definitions were introduced as an overriding recognition criterion primarily to mitigate the problem of unqualified smoothing. In a normative and deductive setting as the one provided by the conceptual frameworks, recognition criteria should ideally be deducted from the decision usefulness objective and the qualitative characteristics. One may argue that the A-L definitions were deducted from the reliability characteristic. That is, the A-L definitions were intended to enhance the verifiability, the representational faithfulness, and the neutrality of the financial reports. However, to the extent the A-L definitions does not improve the decision usefulness of the financial reports, a conceptual inconsistency exists. The analysis indicates that the A-L definitions may reduce the decision usefulness of the financial reports.

The importance of the underlying measurement model for the analysis conducted in the dissertation cannot be underestimated, and must here be emphasized. As explained in chapter 4, it is assumed that the decision usefulness objective assumes a cash flow approach to measurement. Furthermore, it is argued that within the normative approach adopted in the conceptual frameworks it can be argued that the transaction based historical cost model is an adequate measurement model, modified in certain circumstances with fair value accounting and direct measurement of cash flows under other circumstances. Also, it is argued that outside of a fair value accounting model, the A-L definitions represent nothing more than an overriding recognition criterion, while in a fair value accounting model the distinction between the R-E view and the A-L view is eliminated. Or more precisely, the R-E view has no meaning within a fair value accounting model.

For instance, proportionate consolidation of joint ventures creates balance sheet items inconsistent with the A-L definitions (chapter 4.4.2, chapter 4.7). The investor clearly does not control a joint venture, and the balance sheet items resulting are therefore conflicting in the A-L view. In the R-E view, the inclusion of the investor's share of the joint venture's revenue and expenses, follows from an application of the earned revenue concept, regardless of the inconsistency with the A-L definitions. However, if effective and reliable market places existed for these investments, as is assumed within a fair value accounting model, the measurement approach would eliminate the need for an application of the earned revenue concept in this context.

7.2 The Effectiveness of the A-L View

Effectiveness of the A-L view assumes that the A-L definitions effectively modify the timing of the recognition and/or classification. An effective modifier will necessarily exclude certain solutions not excluded if the modifier did not apply (the R-E view).

Ideally, in order to make a conclusive finding, all areas of recognition should be investigated. Nevertheless, if one can document the effectiveness in one or certain areas, one can at least conclude that the A-L definitions are not ineffective modifiers as such.

Moreover, by selecting areas that generally are considered to be of great importance in financial reporting, one should be able to draw conclusions from the findings.

Four areas of accounting recognition are investigated in particular in the analysis. These four areas are pension accounting, maintenance cost accounting, income tax accounting, and goodwill accounting. Except for the case of pension accounting, the A-L definitions are considered to be effective modifiers.

However, the A-L definitions are vague, and different interpretations may be given to the definitions. The FASB argumentation in the area of income tax accounting is illustrative. In SFAS 96, the FASB argued that deferred tax assets do not meet the asset definition in the Conceptual Framework, while the same body in SFAS 109 made an argument to support the recognition of deferred tax assets on the balance sheet. This inherent vagueness in the A-L definitions may weaken the effectiveness of the A-L view.

7.3 The Usefulness of the A-L Definitions in Standard Setting

The usefulness of the A-L definitions in standard setting rests on two dimensions, namely the effectiveness of the definitions and the standard setter's application of the definitions. If one of the two dimensions (or both) is not in place, then the A-L definitions have not proven to be useful. In other words, the question that is addressed is whether the A-L definitions have been useful, not whether they are potentially useful. As long as the definitions are effective, they may be potentially useful in standard setting. The potential usefulness is indirectly addressed by the second research question commented on in chapter 7.2.

An analysis of the accounting standards and interpretations of the IASB indicates that the IASB does not apply the A-L definitions consistently in the standard setting process. References to the A-L definitions are rare in both the standards and in the interpretations, and the analysis does not produce evidence supporting the applicability of the A-L definitions.

The finding of the IASB-analysis is supported by an analysis of the application of the A-L definitions by the FASB in pension accounting, maintenance cost accounting, income tax accounting, and goodwill accounting. The FASB rejects the A-L definitions in several cases, and in other cases the FASB produces new interpretations of the A-L definitions apparently to create consistency between the recommended treatment and the A-L view.

This latter form of application can hardly be taken as evidence of the usefulness of the A-L view. Firstly, in the cases where the FASB produces interpretations allowing for the recommended practice, the interpretation typically eliminates the effectiveness of the A-L definitions, and thus the potential usefulness is impaired. Secondly, the A-L definitions, to be useful, must be actively applied in order to derive the recommended practice. To develop recommended solutions, and thereafter adjust the definitions to make them fit the solutions, represents an opposite approach that hardly can be considered useful.

Based on the findings in the analysis, this author is of the opinion that sufficient documentation has been provided to conclude that the A-L definitions have generally not been useful in standard setting.

7.4 The Decision Usefulness of the A-L Definitions to the Financial Analysts

Pre-FASB, the accounting standard setters were criticized for de-emphasizing the users of the financial reports and for developing recognition guidelines leaving the producers of the accounts with too much flexibility hampering the comparability of financial statements over time and across entities. The FASB adopted decision usefulness as the primary objective of financial reporting, and intended to let this primary objective be the overriding criterion for accounting policy development. Furthermore, the FASB introduced the A-L definitions in an attempt to reduce the room for manipulation of recognition.

It is questionable whether the A-L definitions are effective because of their vagueness, and it has been documented that the standard setters tend to reject the definitions in cases

where the definitions would lead to earnings numbers not consistent with the primary concepts of recognition in the R-E perspective, namely the earning and realizability concepts and the matching concept. One possible explanation for these rejections may be that an application of the A-L definitions would lead to less decision usefulness.

To further investigate the relationship between the decision usefulness objective and the A-L definitions, a survey among financial analysts was conducted. The findings in the survey suggests that financial analysts on a case-by-case basis generally prefer unmodified recognition, but a majority of the survey respondents prefer a policy consistent with the A-L definitions in at least one of the three cases tested in the survey. Still, approximately one third of the respondents consistently prefer the policies in which the A-L definitions are rejected, while only four percent consistently prefer the policies in which the A-L definitions modify recognition.

Event though these findings alone cannot reject the decision usefulness of the A-L definitions, they suggest that further research should be conducted in order to determine whether the A-L definitions instead of enhancing the decision usefulness of financial statements rather obscures the decision usefulness.

7.5 Other Findings and Contributions

In addition to the findings summarized above, one other point that has been made that is of a nature that justifies mentioning in this summary concerns the normative deductive approach applied in the development of the conceptual frameworks. It has been argued, primarily in reference to secondary sources, that the guidelines for recognition in the conceptual frameworks are inconsistent with the normative deductive approach. That is, the guidelines for recognition are generally only a description of practice at the time the frameworks were issued. Furthermore, the circular reasoning applied in the A-L definitions, and their dependence on constructed accounting concepts is problematic within the normative deductive approach. For instance, "probable future economic benefits", "control", and "past transactions or events" are important concepts in the asset

definition of the FASB. However, the lack of specification with respect to these concepts impairs their usefulness.

Furthermore, the guidelines for measurement provided in the conceptual frameworks are not deducted in a normative approach. The conceptual frameworks merely list and explain alternative measurement attributes, but do not in a normative deductive approach prescribe what attributes to apply under different circumstances. A normative approach to accounting measurement is proposed in chapter 4 (based on a model of Frakes and Nunamaker (2002)).

The dissertation also offers certain contributions not qualifying as findings. The dissertation represents an attempt to analyze the purpose, the structure, and the content of conceptual frameworks. Others have conducted similar analyses, but the comparative approach applied in this dissertation adds a dimension to the analysis. The analysis has for reasons explained in the introduction in chapter 2 primarily referred to the FASB Conceptual Framework. However, the conceptual frameworks of the other leading standard setters, and the IASB Framework in particular, have also been commented on. Important differences have been pointed out. Furthermore, the elaborated accounting theory framework to evaluate the conceptual framework projects within, and the linking of the conceptual framework projects and the shift in accounting research traditions in chapter 2, may be considered interesting contributions coming out of the dissertation.

The analysis relies partly on a comprehensive research of existing literature. The insight into existing literature on the subject offered by the dissertation is useful.

Finally, the attempt to apply the findings here summarized in a Norwegian context in the following chapter, chapter 8, represents a contribution to the future development of the Norwegian Framework.

7.6 Future Research Opportunities

Three research opportunities of particular interest can be derived from the analysis and findings in this dissertation, namely an elaboration of the analysis of the usefulness of the A-L definitions in accounting standard setting process, an elaboration of the analysis of the decision usefulness provided by the A-L definitions, and an investigation of the R-E view.

As explained in the introduction to this chapter, the FASB has indicated that there are inconsistencies in the Conceptual Framework, and realizes that there is a *"(...) a need to commit resources to a project to improve the conceptual framework"* (FASB 2002b, 6). The FASB specifically draws attention to SFAC 5 and SFAC 6 concerning definitions, recognition and measurement. However, the FASB has yet not committed itself to take on such an improvement project. Furthermore, the FASB has not been particularly concerned with the usefulness of the A-L definitions in the standard setting process or the decision usefulness provided by the A-L definitions to the ultimate users of the financial reports.

Different avenues may lead to an enhanced understanding beyond what the analysis in this dissertation provides on these two issues. The usefulness of the A-L definitions in accounting standard setting may be investigated more directly. For instance, direct observations of the process and/or in-depth interviews with Board members having first-hand experience with the standard setting process, may prove to give useful insights.

Another approach would be to extend the analysis in this dissertation by investigating other areas of accounting recognition. In particular, revenue recognition represents an area in which both the FASB and the IASB realize have not been dealt with conceptually consistent in the A-L view. Furthermore, an extension into lease accounting and other traditionally off-balance sheet items may give important insights. Intuitively one would assume that the A-L definitions should have merits with respect to off-balance sheet accounting. However, the recent accounting scandals prove that the application of the conceptual frameworks have not been successful in closing the loopholes. Whether these

experiences are a consequence of ineffective A-L definitions or a result of rejection of the definitions by the standard setters represents an interesting research question.

A more thorough understanding of the decision making process of the users of financial reports will facilitate the future development of the conceptual frameworks. Decision usefulness is considered an ultimate objective of financial reporting, but one may on the basis of the findings in this dissertation question the impact of the objective on the development of accounting standards. More specifically, it is suggested in this dissertation that the A-L definitions actually impair the decision usefulness of the financial reports. To enhance the understanding of the decision making process, and the impact of the constraints imposed by the A-L definitions on recognition in particular, in-depth interviews with investors and analysts will be useful.

Furthermore, the finding suggesting that financial analysts view the cash flow statement and cash flow information more useful than the income statement and accrual accounting information conflicts with findings in most other studies, and represents an interesting lead for future research. If this finding proves to be valid, it will have significant implications for the development of future financial reporting.

The focus in the dissertation has been on the A-L view. In conclusion, the usefulness of the A-L definitions is questioned. Maybe it is time to revisit the R-E view. Wyatt argued in 1990 that the A-L view would prevail as the fundamental perspective in accounting standard setting and practice in foreseeable future, and that a reversal of the shift from the R-E view to the A-L view was unlikely: *"Clearly, (...) those supporting the position (...) would expect a return to the concepts of matching and income determination primacy that the Board's conceptual framework deemphasizes. Given that conceptual frameworks developed in other countries are consistent in their focus with that of the FASB, it seems doubtful any representative group today would adopt such a conceptual basis"* (1990, 85). The A-L view is apparently relatively undisputed among the leading standard setters, and Wyatt's statement is therefore still relevant. However, as illustrated in this dissertation, the conceptual and practical legacy of the A-L view has flaws, and a new

look at the R-E view, with the experiences of the A-L view as a background, may very well be mandated.

8. Implications for Norwegian Accounting Regulation

> *"In order to progress accounting comparability at a European level and influence the international accounting standardisation process there is an overall need to understand and solve internal inconsistencies in Europe. The survey concludes that, without a framework, it will be difficult and this may prevent the right solutions being found"* (FEE 1997, 11).

In this chapter, the findings in the preceding chapters will be applied in a Norwegian context. First, the Norwegian context is explored in chapter 8.1 and chapter 8.2. In chapter 8.1, the legal framework and the accounting standard setting process are addressed. In chapter 8.2, the Norwegian Framework is explained. The Framework is compared to the conceptual frameworks analyzed in the preceding chapters and the principles constituting the Norwegian Framework are reviewed. The challenges of IFRS 2005 are explored in a Norwegian context in chapter 8.3, and alternatives available in the further development of the Norwegian Framework are evaluated.

8.1 Accounting Regulation in Norway

Financial reporting in Norway is regulated by legislation. The legislative approach to financial reporting regulation goes back to the late eighteen hundreds when certain kinds of businesses were required to keep accounts for the protection of creditors.

Traditionally, accounting rules have been formulated in company legislation. According to the Tax Act of 1911, taxable income was to be calculated on the basis of accounting income, which was to be determined by the accounting rules formulated in the companies legislation (1910). The concept of prudence in valuation was adopted in the Joint-Stock Companies Act of 1910. An attempt to introduce separate accounting legislation was made, but the proposal was never enacted (Johnsen 1993)[1]. Except for this attempt, little progress was made towards separate accounting legislation in the first half of the

twentieth century. A curiosity worth mentioning in this context is the Trade Act of 1935 in which assets were required to be valued at "true value" (Johnsen 1993, 618).

It took almost seventy years after the attempt of the Tax Act Committee in 1911 before separate accounting legislation was enacted in Norway. One may consider the report of the Accounting Act Committee in 1959 as the foundation of Norwegian accounting legislation, even though the Accounting Act was not enacted before 1977. The report of the Accounting Act Committee represented an influential document in the Nordic companies legislation harmonization process initiated by the Nordic Council in 1962, which eventually led to the Joint-Stock Companies Act of 1976. This law included a chapter on annual accounts. The Joint-Stock Companies Act of 1976 replaced the Joint-Stock Companies Act of 1957, in which the regulation of accounts was strengthened by the inclusion of valuation rules and rules on specification of financial statements (Johnsen 1993, 619). As already mentioned, a separate Accounting Act was then enacted in 1977. The implicit framework for interpretation of accounting practices in the report of the Accounting Act Committee of 1959 was also important in the development of the current accounting legislation (the Accounting Act of 1998, implemented in 1999).

8.1.1 The Legal Framework

The Norwegian Accounting Act of 1998 does not contain detailed rules and may best be characterized as constituting a legal framework. The legal framework, as opposed to a set of detailed rules, leaves room for the exercise of professional judgment. The concept of "good accounting practice" (GAP) plays a fundamental role in the framework. A basic principle set out in the legislation is that financial reports should be prepared in accordance with GAP. GAP is a dynamic concept, *"(...) allowing practice to develop as economic conditions change, and as firms undertake new kinds of transactions and face new accountable events. In this dynamic setting, accounting theory and research, both domestic and international, are intended to guide good practice"* (Johnsen 1993, 617). Underlying the GAP concept are accounting principles and concepts developed in a transaction based historical cost model. These basic principles are set out in the Accounting Act. GAP, therefore, implies compliance with the basic principles and other

requirements in the legal framework, as well as general acceptance. In this interaction between legal requirements and practice, the role of general acceptance has been weakened over the years, and today one may find GAP that not necessarily has experienced wide acceptance in practice yet. For instance, the Oslo Stock Exchange expects listed entities to apply exposure drafts issued by the standard setting body even though an exposure draft not necessarily is founded on accepted practice.

General valuation rules supplement the basic accounting principles, requiring current assets to be valued at the lower of cost and fair value and fixed asset to be valued at cost. Fixed assets should be amortized if their useful life is considered to be limited, and an impairment loss should be recognized if the impairment is not considered to be temporary.

The legal framework approach is somewhat modified through certain special valuation rules. For instance, research and development costs are permitted expensed as incurred and unrealized losses on liabilities other than provisions caused by changes in interest rates may not be recognized. Furthermore, small entities are offered options with respect to the compliance with certain of the basic principles and an option to apply simplified valuation rules.

It is important to emphasize that the Norwegian Accounting Act, including the basic accounting principles and the valuation rules as described above, was developed within the restrictions set out in the EC Accounting Directives. That is, the Accounting Act implements the Directives, not necessarily the specific wording of the Directives, but rather the content. Thus, although the intention has been to develop a conceptually sound framework for accounting, the Accounting Directives have throughout the process represented a restriction the Accounting Act Committee of 1990 stayed loyal to.

8.1.2 Accounting Standard Setting in Norway

The legal framework approach assumes an active standard setting body. Norsk RegnskapsStiftelse (NRS, "The Norwegian Accounting Standards Board" (NASB)) is the standard setting body in Norway. NASB was formed in 1989.[2] The Norwegian Institute of State Authorized Public Accountants (NSRF) issued recommendations for GAP before the founding of the NASB (1978-1988). However, these recommendations purported to be no more than guides to good practice (Johnsen 1993, 622). Furthermore, the Oslo Stock Exchange issued recommendations before the NASB. Also the Accounting Advisory Council, appointed by the Ministry of Trade (later the Ministry of Finance), issued statements on GAP before the founding of the NASB. The Norwegian Society of Financial Analysts issued guidelines for the preparation and analysis of financial statements.

Today, in addition to the NASB accounting standards, pronouncements made by the Oslo Stock Exchange are considered authoritative GAP literature. Similarly, pronouncements made by the Norwegian Institute of Public Accountants (DnR) are generally considered to have impact on Norwegian GAP (DnR succeeded NSRF in 1998).

The NASB follows a similar standard setting process as the leading standard setters. Exposure drafts are submitted to a wide range of bodies for comment. The NASB evaluates comments, and issues a preliminary accounting standard after revisions. The preliminary standard usually is published as a final accounting standard after a trial period giving the preparers and users a chance to obtain practical experience with the recommended practices and comment on the experiences.

Norwegian GAP has traditionally drawn on the accounting standards issued by the FASB in the US, the ASB in the UK, and the IASB in the standard setting process. The leading role of US GAAP in international accounting practice has influenced Norwegian GAP. However, the increased importance of the IFRS in the international accounting harmonization process led to a shift in Norwegian approach in the mid-nineties. In the preliminary works of the Accounting Act 1998 the Parliament assumes that

harmonization towards IFRS should be regarded an objective in accounting standard setting (Inst. O. nr 61 (1997-98), 24). The international harmonization process led the NASB to adopt a strategy in which harmonization towards IFRS was the primary objective in 2001. The EU Regulation 2002 requiring all entities in the EU listed in a regulated market to prepare consolidated accounts in accordance with IFRS by 2005, puts a constraint on the development of Norwegian GAP in the future. At the accounting standard setting level this constraint is obvious. However, it is the impact of IFRS 2005 at the conceptual level that will be explored further in the following.

8.2 The Norwegian Framework

> *"At inception, the NASB faced some difficult strategic decisions. Ideally, the new body would have to liked to begin by issuing a statement of basic concepts and principles as did the Accounting Standards Board in Britain"* (Johnsen 1993, 623).

In Norway conceptual frameworks were discussed among academicians in the early 1980s[3], and the NASB considered developing a Norwegian framework at its inception in 1989. Because of the pressing need for substantive accounting standards at the time, the NASB chose to focus their efforts on issuance of specific accounting standards.

The Accounting Act Committee conducted an evaluation of the existing conceptual framework, but concluded that the conceptual frameworks of the FASB, the IASB and the other leading standard setters had yet to prove useful, and the conceptual framework approach of these standard setters was rejected (NOU 1995:30).

Norwegian accounting standard setting has traditionally been based on the R-E perspective. For instance, the Accounting Act Committee of 1959 stated that the primary function of accounting is measurement of periodic income, and that measurement of periodic income best could be achieved in a R-E perspective: *"The focus on income determination requires proper matching of expenses with revenues. The matching*

concept is a key element in the conceptual framework" (Johnsen 1993, 620). This tradition is carried on in the current accounting legislation. The 1998 is based on ten accounting principles assuming a transaction based historical cost model with emphasis on revenue and expense recognition, on which the accounting standards issued by the NASB rely.

The ten accounting principles along with the elaboration of them in the preliminary works of the Accounting Act 1998 (NOU 1995:30) represents the Norwegian Framework: *"Elaboration of the implicit conceptual framework in the report of the Accounting Act Committee and the basic accounting principles in the new Accounting Act constitute the conceptual framework for the standard setting"* (Johnsen and Eiliefsen 2001, 1303).

8.2.1 A Conceptual Framework Based on the R-E View

The Norwegian Framework is somewhat different from the conceptual frameworks of the leading standard setters discussed in the former chapters. As explained, the main objective is to provide a framework for meaningful income measurement. The objective is not explicitly communicated in a separate concepts statement or accounting principle, but is nevertheless implied. The income measurement objective is deducted from a decision usefulness objective, and the Accounting Act Committee of 1959 identified in this process the primary users of financial reports.[4] The objectives of financial reporting and the main user groups have been discussed in the Norwegian accounting literature (Johnsen 1980, Gjesdal 1981, Kinserdal 1983), and decision usefulness as the primary objective of financial reporting is an implied underlying assumption of the Norwegian framework (NOU 1995:30).

Similarly, the qualitative characteristics of decision usefulness are not explicitly stated in a separate concepts statement. Nevertheless, the role of relevance and reliability and the trade-off between these two characteristics are important. For instance, when the fair value modification of the historical cost model requiring fair value measurement of certain marked based financial current assets is explained, the relevance and the reliability of fair value are discussed (NOU 1995:30). Furthermore, one of the basic

accounting principles requires the application of uniform and consistent accounting policies in the financial reports in order to ensure comparability between entities and between accounting periods.

Even if the objectives and qualitative characteristics of the conceptual frameworks of the leading standard setters may be assumed implicit concepts in the Norwegian Framework, the latter is not representing a normative deductive approach, as is the approach of the leading standard setters. Rather, the Norwegian Framework draws on the insights communicated by Paton and Littleton in their monograph (1940), and tries to induce accounting policies from observed accounting practices in the same manner as accounting policies traditionally have been developed by the leading standard setters. The Norwegian Framework may therefore be labeled a descriptive inductive framework. In this context, it is important to emphasize, as explained in chapter 2.1.2, that the normative-deductive and the descriptive-deductive labels refers to two conceptual platforms, but a combination between deduction and induction is relevant within both normative and descriptive frameworks. Furthermore, even though the conceptual frameworks of the leading standard setters are based on the normative platform, they are more descriptive than normative when it comes to recognition and measurement. On the other hand, although the Norwegian approach is descriptive, elements of normative reasoning are present.

An important way the Norwegian Framework departs from the conceptual framework approach of the leading standard setters is obviously the fundamental perspective assumed. There is no overriding recognition criterion represented by A-L definitions in the Norwegian Framework.

Apparently, even though the accounting principles provide an explicit framework (Johnsen og Kvaal 1999, 14), the Norwegian Framework deviates, as explained above, from the conceptual frameworks of the leading standard setters discussed in the former chapters in form and content.

The term "conceptual framework" is generally associated with the normative deductive frameworks of the leading standard setters relying on the A-L view in recognition. In this context, it is important to emphasize, as discussed on several occasions in the previous chapters, that the leading standard setters only to a limited extent have succeeded in the normative and deductive approach. The normative and deductive approach is not applied in the development of recognition and measurement concepts, including the A-L definitions (chapter 4). Rather, guidelines for recognition and measurement have been developed in a traditional descriptive and inductive manner by the leading standard setters, in spite of the normative ambition inherent in the conceptual framework projects.

It is therefore fair to conclude that there is only one significant difference between the conceptual frameworks of the leading standard setters and the Norwegian Framework, namely the reliance on the R-E perspective in the Norwegian Framework. Another and more formal difference between the Norwegian Framework and the frameworks of the leading standard setters is the organization and structure of the frameworks. The conceptual frameworks of the leading standard setters are typically organized and structured as explicit frames of references for accounting concepts and the development of accounting policies, while the Norwegian Framework's role as a frame of reference is somewhat more implicit, with the exception of the accounting principles guiding recognition.

The use of the term "conceptual framework" has in the previous chapters been reserved for the frameworks of the leading standard setters, implying a normative and deductive approach, as well as an A-L view (chapter 2). However, there is no sound reason to reserve the term "conceptual framework" to frameworks founded on the A-L view. Furthermore, based on the analysis conducted in this dissertation it is not meaningful to uphold this terminological reservation, and the Norwegian Framework is as much of a conceptual framework as the frameworks of the leading standard setters. In the following therefore, the term "conceptual frameworks" will be used to refer to both the frameworks of the leading standard setters and the Norwegian Framework.

8.2.2 The Basic Accounting Principles

The transaction principle represents the basic principle for recognition in a transaction-based historical cost model (§ 4-1). According to this principle, transactions shall be recognized at the fair value of the consideration at the transaction date. The principle plays a significant role in the development of Norwegian GAP. For instance, the transaction principle is applied in the determination of acquisition cost in business combinations. It assumes that economic substance rather than legal form determines the accounting. Therefore, except under rare circumstances, business combinations are to be measured at fair value at the time of the acquisition, and the entity representing the shareholders gaining control over the combined entity is to be considered the acquiring party regardless of legal form of the combination. Furthermore, from the transaction principle, one can deduct that legal transactions not representing economic exchanges should not lead to fair value measurement. The transaction principle provides accounting solutions for treasury stocks, demergers, and share based payments, and requires discounting of the nominal amount in interest-free credit transactions if the effect of doing so is material.

The basic principle for revenue recognition requires revenue to be recognized when earned (§ 4-1). The earned revenue principle is elaborated in chapter 4.5. In short, the timing of revenue recognition generally parallels the timing of the underlying transaction. For instance, revenue from sale of goods is normally recognized when the goods are delivered. In certain cases, however, revenue is accrued or deferred. For example, in the case of long-term manufacturing contracts, revenue is accrued to reflect the contract activity, while revenue may be deferred in certain cases when an obligation to render further services at some future time rests on the service provider. Small entities may make exemptions from the earned revenue principle if in accordance with GAP for small entities (NRS 8).

The matching principle is the basic expense recognition principle (§ 4-1). The matching principle is elaborated in chapter 4.5. Costs are to be recognized in the same period as the associated revenue. The link between costs and revenues are in certain cases direct. In

many cases, however, the link between the costs and the revenues are indirect and tenuous. Thus approximations must be made in order to meet the matching principle. This is the case in accounting for fixed assets in which the amortization schedule is developed in order to achieve reasonable matching. Generally though, a linear amortization schedule is assumed to be applicable. Small entities may make exemptions from the matching principle if in accordance with GAP for small entities (NRS 8).

The concept of prudence has traditionally been widely applied in accounting practice, and represents a basic principle in Norway (§ 4-1). However, the concept has historically to some extent been misused to create hidden reserves and to deliberately understate income. The Accounting Act Committee was careful to point out that such an application of the prudence concept is in conflict with the Accounting Act 1998, and therefore not GAP. The concept requires unrealized losses to be recognized. Valuation of assets at the lower of cost and fair value is an application of the prudence concept.

An application of the prudence concept not directly deduced from the concept of prudence as formulated in the Accounting Act is the special valuation rule allowing costs for research and development activities to be expensed as incurred. In this case the prudence concept applies in cases not involving unrealized losses. However, the inherent uncertainty associated with research and development expenditures motivates an extension of the prudence concept. In this case, the prudence concept acts as a modifier of the matching principle. It should be noted however, that the structure of the law does not allow for generalization of this extended prudence concept.

The prudence concept creates asymmetry. Unrealized losses, but not unrealized gains, shall be recognized. Partly to compensate this asymmetry, but more importantly, to reflect economic substance, a basic principle of hedge accounting is included in the Accounting Act 1998 (§ 4-1). According to the principle of hedge accounting, gains and losses on hedging instruments and hedging items shall be recognized in the same period.

Future events play a significant role in accounting. For example, pension accounting, maintenance cost accounting, and income tax accounting, as explained in chapter 5.3, all involves future events (future salary levels, future maintenance costs, future income, etc), and expectations about these future events must be quantified in order for them to be accounted for. The quantification of these future events takes the form of estimates, and a basic principle in the Accounting Act 1998 is that the best estimates shall be applied (§ 4-2). The effect of changes in these estimates shall be recognized in the period the estimate is changed unless GAP allows for deferred recognition. Deferred recognition is allowed for in several cases, for instance in the case of fixed asset amortization and in the case of pension accounting.

The congruence principle, or the all-inclusive income concept, requires all items having an effect on equity, other than contributions from and to the owners, to be included in the income statement (§ 4-3). In other words, all transactions except transactions with owners are considered to be relevant in income measurement. Two exceptions, however, are made in order to bring Norwegian practice in line with international practice. The effects of changes in accounting principles and the correction of material errors should be charged to equity. Moreover, other exceptions shall be made when in accordance with GAP. Small entities may choose to include effects of changes in accounting principles and the correction of fundamental errors in the income statement.

The going concern assumption requires entities to assume that operations will continue into the foreseeable future, except when termination of the operations is probable (§ 4-4). This going concern assumption is primarily a valuation principle. The implication is that the valuation rules in the Accounting Act 1998 cannot be applied unless the assumption holds. How to approach measurement when operations are to be discontinued is dealt with in a separate accounting standard (NRS 12).

The basic principle of uniform and consistent application of accounting principles intends to ensure comparability over time and between similar transactions (§ 4-5). That is, items on the balance sheet must be treated according to the same accounting principles at each

balance sheet date, and similar transactions and events must be accounted for according to the same principles within each accounting period, as well as across different accounting periods. The principle, however, does not prohibit an entity to replace one accounting principle with another when the latter is considered to provide for better income determination. This is of particular importance for small entities having options with respect to the application of the basic principles and the valuation rules (NRS 8).

The concept of GAP is formulated as a basic principle in the Accounting Act 1998 (§ 4-6). As explained above, the development of GAP is primarily in the hands of the NASB. It was assumed in the preliminary works of the Accounting Act 1998 that GAP should be developed in line with IFRS as long as the Norwegian Framework allowed for the IFRS-solutions. The EU Regulation 2002, however, allows for no national modification of IFRS, and potential conflicts between the Norwegian Framework and the IASB Framework and IFRS must be resolved. GAP and GAP for small entities are not identical. The options offered small entities with respect to certain of the basic principles and the valuation rules have led to the development of a separate GAP-concept for small entities (NRS 8).

Let us in the following summarize the Norwegian basic accounting principles in the context of the IASB Framework. The Norwegian basic accounting principles are to a great extent included in the IASB Framework, but in certain cases one must look to IAS 1 and IAS 8 to find an application of the principles in IFRS. Several of the accounting principles and concepts of the Norwegian Framework are elaborated in these two specific accounting standards.[5]

The transaction principle is de-emphasized in the conceptual frameworks. However, as an underlying assumption (IASB 1989, 22), one may interpret the role of the transaction principle in the IASB Framework similar to the role it has in the Norwegian Framework.

The earned revenue principle and the matching principle are also de-emphasized in the conceptual frameworks. In the IASB Framework these two principles are referred to in

the additional recognition guidance. The earned revenue principle is referred to as a pragmatic approach to revenue recognition, while the matching principle seems to be considered more fundamental in expense recognition than the earned revenue principle is to revenue recognition.

The IASB considers the prudence concept as part of the reliability characteristic of accounting information (IASB 1989, 37). The hedging concept is not referred to in the IASB Conceptual Framework. Hedge accounting is nevertheless a crucial part of the IFRS. According to IAS 39 hedging is only to be reflected to the extent certain criteria are met. As a consequence of the system applied in IAS 39, an entity may choose not to reflect hedging relationships by not providing the documentation required (IAS 39.142a), even though a cost-benefit consideration would suggest hedge accounting. The flexibility provided by IAS 39 is not intended to apply under the Norwegian Framework.

The concept of best estimate is important in the Norwegian Framework. The IASB refers to "reasonable" estimates in the Framework (IASB 1989, 86). Also, in IAS 8.23 the IASB refers to "reasonable" estimates. "Reasonable" has been translated to "forsvarlig" in certain contexts (NOU 2003:23, 166). This translation indirectly implies a different content in the two terms. However, it is doubtful that the IASB refers to something else than what is meant by the "best" estimate in the Norwegian Framework when they use the term "reasonable". The IASB is careful to point out that creation of hidden reserves is not allowed because it would reduce the neutrality and therefore the reliability of the financial statements (IASB 1989, 37). Furthermore, the IASB refers to the "best" estimate in other accounting standards: *"The risks and uncertainties that inevitably surround many events and circumstances should be taken into account in reaching the best estimate of a provision"* (IAS 37.42).

The concept of best estimate in the Norwegian Framework also includes treatment of changes in estimates. The effects of changes in estimates are to be recognized in the period of the changes, unless deferred recognition is allowed for under GAP.

Under IFRS, the effects of changes in estimates shall be recognized "prospectively" (ED IAS 8.27). It is somewhat unclear what is meant by "prospectively". The effect of changes in estimates shall be recognized in the period of the change if the change affects that period only, or in the period of change and in future periods if both are affected (ED IAS 8.27). As an example of changes in estimates affecting both current and future periods, the IASB refers to the change in the estimated future life of a depreciable asset (ED IAS 8.28). Similarly, a change in the estimated future life of a depreciable asset is according to ED IAS 16.49 to be accounted for by adjustment of the depreciation rate of current and future periods.

Under the Norwegian concept of best estimate, an increase in estimated future life of a depreciable asset is to be accounted for by recognition of the excess accumulated depreciation expense in prior periods in the period of the change of the estimate. Alternatively, under GAP, an entity may choose to defer recognition of the effect of the change by amortizing the effect over the remaining estimated future life. Both these treatments involve an adjustment of the current and future periods depreciation charges, compared to the original estimated depreciation charges. Therefore, the IAS 8 and IAS 16 "prospective" treatment of changes in estimates seems to be neutral with respect to the two relevant Norwegian GAP treatments.

The congruence, or all-inclusive concept, represents an underlying assumption in all the conceptual frameworks, even though it is not explicitly referred to in the IASB Framework. Guidance concerning the all-inclusive concept is included in IAS 8.

The basic principle of uniform and consistent application of accounting principles is considered a dimension of comparability, which is a qualitative characteristic in the IASB Framework (IASB 1989, 39-42). The application of this basic principle does not prohibit a change in accounting policy if the change results in better income determination. However, the IASB uses a different terminology that may imply a different meaning than the Norwegian interpretation of the principle. According to the IASB, a change in policy is allowed *"(...) if the change will result in a more appropriate presentation of events or*

transactions in the financial statements of the enterprise" (IAS 8.42). In the Improvements Project, the IASB has proposed to replace "more appropriate" with "more relevant and reliable" (ED IAS 8.9b). Thus, whether the change in accounting policy option in the Norwegian Framework is identical with the IASB option is unclear.

The going concern assumption is an underlying assumption in the IASB Framework (IASB 1989, 23). The content of the going concern assumption is described in greater detail in IAS 1.23-24. As explained above, according to the going concern assumption in the Norwegian Accounting Act 1998, going concern shall be assumed unless discontinuance is "probable" ("sannsynlig"). The Accounting Act Committee 2002, has proposed to replace "proabable" with a more qualified probability term ("overveiende sannsynlig"), implying that the exceptions to the going concern assumption should be rarer than the current Accounting Act allows for (the report of the Accounting Act Committee 2002 will be introduced in chapter 8.3.1 and commented on to a greater extent in the following chapters). The drafted amendment is partly grounded on an interpretation of IAS 1. Since the IASB does not apply a probability term in this context and neither "probable" nor the qualified probability term have an unambiguous meaning in the Norwegian terminology, one must conclude that there may be differences between the current and proposed Norwegian going concern assumption and the IASB assumption .

The concept of good accounting practice in the Norwegian Accounting Act 1998 is an implementation of the true and fair view in the EC Accounting Directives (NOU 1995:30, 40). The Norwegian implementation is controversial (NOU 2003:23, 168). A true and fair view is assumed in the IASB Framework in the discussion of qualitative characteristics (IASB 1989, 46). Whether the IASB true and fair view is identical to the true and fair view in the EC Accounting Directives may be questioned. Thus, the Norwegian and the IASB true and fair view may not be the same.

From the above one may conclude that the Norwegian basic principles all play a role in the IASB Framework. However, as should be apparent from the descriptive analysis of the basic accounting principles in the Norwegian Framework above and the analysis of

the conceptual frameworks in the former chapters, the function of the principles in the two frameworks is conceptually different. Moreover, the additional recognition requirement imposed in the form of the A-L definitions in the IASB Framework complicates a comparative analysis.

The Norwegian Framework leaves the NASB and the producers of accounts with flexibility in the development of Norwegian GAP, even though the valuation rules in the Accounting Act 1998 imposes certain restrictions. There are indications of usefulness of the Norwegian Framework to the NASB in its efforts to develop Norwegian GAP. With all the methodological weaknesses discussed chapter 5.1, one indication of the usefulness of a conceptual framework to the accounting standard setter is the frequency of explicit reference to the framework in the accounting standards. A review of the accounting standards of the NASB, effective as of September 2001, indicates that the NASB has applied the Norwegian Framework actively in the standard setting process. In all but four accounting standards, the NASB explicitly refers to one or more basic accounting principles in the accounting standards.[6] The Accounting Act evaluation currently being conducted has revealed that the users consider the Norwegian Framework a useful tool (NOU 2003:23, 161). On the other hand, as illustrated by the analysis in the preceding chapters, the usefulness of the conceptual frameworks can be questioned.

The apparent usefulness of the Norwegian Framework may in part be explained by the formal legal authority of the Framework as opposed to the somewhat unclear authority of the conceptual frameworks. Another explanation may be that the R-E perspective of the Norwegian Framework and the inherent flexibility leaves more room for development of decision useful accounting standards (chapter 6).[7]

8.3 Meeting the Challenge of IFRS 2005

IFRS 2005 represents nothing less than a conceptual challenge when the accounting traditions of Norway, and the Norwegian Framework in particular, are taken into consideration. Obviously, having relied on inductive approaches to accounting standard setting and a R-E approach to recognition issues, implementation of the normative and A-

L view based approach of the IASB will be conceptually challenging. Moreover, based on the findings in the preceding chapters, the implementation may prove to be practically and technically challenging as well.

The intention in this section is, based on the findings in the analysis of conceptual frameworks in the preceding chapters and the Norwegian background explained in chapter 1 and the previous sections of this chapter, to explore the challenge primarily in a conceptual perspective. More specifically, how to deal with the conflict between the Norwegian Framework and the IASB Framework will be addressed.

8.3.1 The Accounting Act Committee 2002

A new Accounting Act Committee was appointed in June 2002. The Committee submitted its final report August 15, 2003. The mandate of the Committee was to evaluate the Accounting Act 1998 and to propose changes in the Act based on the evaluation. More specifically, the mandate of the Committee was three-fold:

1. Assess the impact of IFRS 2005, and the demand for changes in the Accounting Act 1998 to meet the requirements of the EU Regulation 2002.
2. Evaluate the experiences of the application of the Accounting Act 1998, and assess whether the experiences should lead to amendments in the Accounting Act 1998.
3. Propose enforcement rules in accordance with the EU Regulation 2002.

The two latter mandates fall outside of the scope of this dissertation, and it is in the context of the first mandate the findings herein may be useful.

The Committee was requested to address several IFRS-2005 related questions. However, one of these questions is of particular interest in the context of this dissertation. The Committee was requested to evaluate whether the basic accounting principles in the Accounting Act 1998 should be revised or replaced in order to either accommodate these

principles to the IASB Framework or to adopt the IASB Framework. It is this question that will be addressed here.

A meaningful evaluation of the alternatives assumes that the alternative scope delimitations of IFRS 2005 are known.

8.3.2 IFRS 2005 in Norway

Listed entities will as a consequence of the EU Regulation 2002 be required to prepare their consolidated financial statements in accordance with IFRS. However, the EU Regulation 2002 does not apply to other entities or to the separate statements of listed entities, and Norway is therefore left with flexibility in accounting legislation in spite of the EU Regulation 2002.

IFRS compliance is mandatory in the consolidated accounts of listed entities. This will in the following be referred to as the "mandatory scope" of the EU Regulation 2002. There is an option in the Regulation that allows member states to permit or require IFRS-reporting in the separate statements and entities other than listed to prepare consolidated accounts in conformity with IFRS. This will in the following be referred to as the "optional scope". Both the mandatory scope and the optional scope assume adoption of IFRS as is. The fact that the optional scope has two dimensions is important to emphasize. The member states may require IFRS outside the mandatory scope, or the member states may allow IFRS outside the mandatory scope.

In the following, the focus will be on consolidated accounts. The analysis, discussions, and conclusions are in principle equally relevant for the separate statements. However, since the separate statements have certain tax and company legislative implications, the conclusions drawn may not be applicable for the separate statements.

In addition, one may choose an IFRS harmonization approach outside the scope of the EU Regulation 2002. In this approach, the accounting regulation is updated to adopt IFRS and the modernization of the EC Directives. The Directives were revised in May 2003 to

eliminate conflicts between the Directives and IFRS. An extended IFRS harmonization outside the scope of EU Regulation 2002 allows for greater flexibility in that for instance an IFRS-light version can be adopted (the term "IFRS-light" will soon be explained).

An initial question to resolve is whether the benefits to be derived from one single set of requirements exceed the disadvantages. If not, several alternative combinations of the two accounting regimes, IFRS and Norwegian GAP, may be relevant.

The EU Regulation 2002 allows only for one alternative single set of requirements, namely IFRS. One single set of requirements can be achieved by combining the mandatory scope of the EU Regulation 2002 and the option to require the application IFRS-reporting among other entities as well.

The only argument that may be considered supporting this alternative emphasizes uniformity in accounting rules across all entities. Beyond that, most arguments strongly disfavor IFRS across all entities by 2005. The uncertainty associated with future IFRS (the IASB has after replacing the IASC in 2001, yet only issued one accounting standard (IFRS 1 (first-time adoption)), but has announced an ambitious plan to improve existing IAS and to issue IFRS in areas not covered by IAS), the complexity of certain standards (for instance IAS 39), the comprehensive disclosure requirements, and the lack of requirement differentiation across different industries and across entity sizes, are all valid arguments for rejecting this alternative. However, these arguments do not reject the adoption of the optional scope of the EU Regulation 2002 permitting but not requiring other than listed entities to apply IFRS.

In the following therefore, IFRS harmonization outside the scope of the EU Regulation 2002 will be explored. In particular, one may require other than listed entities to comply with a revised version of current Norwegian GAP ("the GAP alternative" in the following ("revised" refers here to the revisions of the Accounting Act 1998)), or one may require other than listed entities to comply with an IFRS-light version ("IFRS Light" in the following).

The GAP alternative and IFRS Light can alternatively be combined with the adoption of the optional scope of the EU Regulation 2002 permitting but not requiring IFRS-reporting among other than listed entities. Furthermore, it may be assumed that small entities should be allowed greater flexibility, and the harmonization alternatives above may be combined, for instance by letting other entities choose between IFRS, GAP, or IFRS Light (small entities will not be discussed in particular in the following).

In this context, IFRS Light means any version of IFRS other than IFRS as is. Several IFRS-light versions exist. In the following, two general classes of IFRS Light, "Simplified IFRS" and the "IFRS Pick-and-Choose" will be explained.

Simplified IFRS refers to light versions in which the accounting standards of IASB is adopted but the standards are simplified by introducing less demanding recognition policies and/or less demanding disclosure requirements. For instance, alternative recognition policies may be allowed or certain mandatory disclosure requirements may be made optional.

IFRS Pick-and-Choose refers to light versions in which an entity can choose to apply individual, but not all accounting standards of the IASB. This version may, but not necessarily, also allow an entity to use an IFRS on certain but not all similar transactions.

In addition, other versions of IFRS Light may exist. For instance, adoption of IFRS without one or more allowed options falls outside both Simplified IFRS and IFRS Pick-and-Choose, but is still an IFRS-light version.

It is important to recognize the fact that the GAP alternative and IFRS Light may not lead to many differences in practice. IFRS harmonization has already for years been important in the development of Norwegian GAP, and the readiness of the IASB to ignore the Conceptual Framework have made it possible for the NASB with a few exceptions to issue accounting standards adopting the IASB solutions (the exceptions apply primarily

to cases where the Norwegian Framework prohibits an IFRS-solution). A comparison of current Norwegian GAP and IFRS therefore illustrates that the two harmonization alternatives are not necessarily very different. Nevertheless, with respect to the principal issue in question, namely whether the Norwegian Framework should be revised or replaced by the IASB Framework, the selection of harmonization alternative has important implications. The relevant combinations of harmonization alternatives and framework alternatives will be discussed in chapter 8.3.2.3. Here, in the following, the harmonization alternatives will be explored, primarily in reference to the proposal drafted by the Accounting Act Committee (NOU 2003:23).

The GAP alternative may be approached by elimination of all conflicts between the Norwegian accounting regulation and IFRS, in order to achieve a revised Norwegian Accounting Act not prohibiting accounting solutions recommended by the IASB. This approach may also be relevant in IFRS Light. It is difficult to support this approach. IFRS is under continuous development, and an elimination of conflicts may not be considered as anything else than a meaningless ex post picture in the future. IFRS will be changed considerably before and after 2005, and the Norwegian Accounting Act will similarly have to be revised in order to allow for IFRS-solutions. The approach may therefore be rejected on practical grounds. The practical limitations may however to some extent be eliminated by allowing for override of the specific rules if an override is necessary in order to be in accordance with IFRS. This override may technically be implemented as a dimension of the GAP-concept in the Accounting Act.

The Accounting Act Committee has proposed to follow an approach not recommended here (NOU 2003:23). In its proposal, the Committee proposes a mix of the GAP alternative and IFRS Light. The proposal allows for both Simplified IFRS and IFRS Pick-and-Choose within the provisions of the Accounting Act. Simplified IFRS is to be achieved through the development of Norwegian accounting standards based on the corresponding IFRS. In addition, according to the Committee, all entities should be allowed to apply one or more international accounting standards (IFRS Pick-and-Choose).

The Committee supports its proposal by arguing that principle-based regulation will reduce or eliminate the need for continuous amendments of the provisions of the Act. Therefore, the Committee proposes, all current conflicts between the Accounting Act and IFRS should be eliminated. That is, all preferred and allowed treatments under current IFRS should be allowed under the Accounting Act. As commented on above, if the Committee had proposed a general IFRS override and thus eliminated the need for continuous Accounting Act amendments, it may have been more difficult to reject the proposal based on practical arguments. The provisions regulating consolidation excemptions (§ 3-8), the going concern assumption (§ 4-5), classification of assets and liabilities (§ 5-1), recognition of research and development (§ 5-6), recognition of negative goodwill (§ 5-7), and the income statement and balance sheet format (§ 6-1 and § 6-2), are some examples of provisions that may need to be amended within a short time horizon.

Comparability has traditionally been considered an important qualitative characteristic in GAP. Comparability is one of the primary qualitative characteristics of the IASB Framework as well. Comparability should be considered a primary qualitative characteristic outside the scope of the EU Regulation 2002. As long as decision usefulness is considered the primary objective, comparability cannot be ignored.

The combination of Simplified IFRS and IFRS Pick-and-Choose will clearly not enhance comparability. It may be argued that investors and other users will be able to make the necessary adjustments in order to make the financial statements of entities applying IFRS Light (Simplified IFRS or IFRS Pick-and-Choose). However, the existence of several options mandated by different accounting standards will make this process complicated and time consuming and assumes a higher level of technical competence among the users than one single accounting standard set does.

If comparability is not considered a necessary qualitative characteristic outside the scope of the EU Regulation 2002, it may be considered an indication of a different user

orientation. For instance, decision usefulness to the investors and the creditors may not be considered the objective of financial reporting outside the scope of the EU Regulation 2002.

In the summary of the main proposals, the Accounting Act Committee states that as a general rule, the provisions of the Accounting Act should not exclude application of IFRS. This rule should only be broken in rare cases, for instance when the need for comparability makes it necessary (NOU 2003:23, 54). Thus, the Committee has rejected revaluation of property, plant, and equipment (IAS 16 Property, Plant, and Equipment) partly in reference to the effect on comparability. More specifically, the reason for this exception is that revaluation is optional under IFRS and thus reduces comparability as well as reliability (NOU 2003:23, 173). However, revaluation of property, plant, and equipment is not the only current option within IFRS and the reliability issue applies for instance to all areas in which fair value measurement is required or allowed. In particular, the Committee de-emphasizes the comparability argument when it proposes to allow for fair value measurement of biological assets (NOU 2003:23, 184). The reason provided for the revaluation exception is therefore not convincing.

Interestingly, the Committee acknowledges that the allowance for both fair value measurement and cost accounting with respect to biological assets reduces the comparability, but finds the argument less convincing "since the comparability is not specifically good anyway" (own translation) (NOU 2003:23, 185). Apparently, the Committee in this statement refers to biological assets in particular, and not to the financial statements as such. Nevertheless, the statement signals an inconsiderate attitude towards comparability.

The Committee has proposed to apply the optional scope of the EU Regulation 2002, allowing all entities to apply IFRS as is in the consolidated accounts. Thus, an entity will be allowed to apply international accounting standards with or without the IFRS Pick-and-Choose option. Furthermore, the dynamic nature of IFRS and the impact of the convergence process taking place currently, and the number of changes to current IFRS

that will be carried out in the near future, does not facilitate IFRS Light. The IFRS Light support of the Accounting Act Committee is therefore puzzling.

The above criticism of the proposal of the Accounting Act Committee may to some extent be refuted in reference to the fact that the legal approach in the proposal is principle based, and the Committee allows the standard setting body some discretion in the development of Norwegian GAP. The NASB may thus restrict the application of some of the choices left open by the Committee in the standard setting process. However, in effect, the proposal denies rejection of current and future options available under IFRS. Furthermore, as will be discussed in chapter 8.3.2.3, the Committee proposes to keep the R-E view based basic accounting principles, and thus the NASB should be restricted from rejecting R-E view based treatments not allowed under IFRS. Nevertheless, as will be discussed in chapter 8.3.2.3, the Committee's proposal effectively prohibits solutions founded on the basic accounting principles if inconsistent with the A-L view based IFRS solutions. Still, the discretion given the NASB does not allow the standard setter to enhance the comparability sufficiently beyond what follows from the proposal of the Accounting Act Committee.

8.3.2.1 The Mandatory Scope of the EU Regulation 2002

Two techniques for the implementation of the EU Regulation 2002 exist. In one technique, the EU Regulation 2002 replaces the Accounting Act, and the entities falling within the scope of the EU Regulation 2002 is effectively lifted out of the Accounting Act. In the other technique, the EU Regulation 2002 is made effective, but the entities falling within the scope of the EU Regulation has to apply the Act if IFRS does not provide guidance on a particular issue. The Accounting Act Committee has adopted the first technique. In the proposal, the EU Regulation 2002 is implemented in § 3-9. Applicable to entities falling within the EU Regulation 2002, in § 3-1, a majority of the provisions of the Accounting Act, including the basic accounting principles, are scoped out.

Listed entities will have to apply IFRS by 2005, and the role of the Norwegian Framework, if any, in the future for these entities poses certain questions that must be addressed separately from the question of what changes, if any, should be made in the basic principles.

As explained in chapter 2.2, even though the IASB Framework is not considered a financial reporting standard, the Framework is explicitly referred to as the Framework to rely on in the absence of other guidance (IAS 1.22). This is a constraint that is imposed from the outside (the EU Regulation 2002), and whether this represent the best solution will therefore not be further explored. On the other hand, the findings in the preceding chapters represent an input in the future revisions of the IASB Framework, which in turn will have an impact on Norwegian listed entities. However, future revisions of the IASB Framework do not currently seem to be a high priority within the IASB.

The Board of the International Accounting Standards Committee (IASC) issued a statement before it handed over the responsibility of setting International Accounting Standards to the IASB in 2000. The purpose of the statement was to *"(...) comment on current work in progress and record some of the thinking of the Board resulting from its work on agenda items in progress and other discussions"* (IASB 2000, summary). Among the issues of importance to consider by the new Board, the IASC Board recommended the Conceptual Framework: *"IASC's Framework document is in need of revision (...)"* (IASB 2000, 1). However, the IASB did not consider revision of the Conceptual Framework a primary issue: *"IASC's Framework is in need of review and revision and although such review may not be the highest priority in itself, it may be possible to take the opportunity to revise parts of it as work takes place on particular projects"* (IASB 2000, 15).

As illustrated in chapter 8.2.2, it appears that the Norwegian basic principles are integrated in the IASB Framework. One alternative may therefore be to include the Norwegian Framework as a supplementary source of guidance for Norwegian listed entities. For instance, neither the transaction principle, the earned revenue principle nor

the matching principle have been elaborated in the IASB Framework. These three principles are nevertheless of particular importance in the solving of accounting problems in practice, also within the IFRS-regime. Given the elaborated guidance these three principles are provided with in the Norwegian Framework, there may be good reasons to provide the listed entities with this additional guidance, at least until the IASB has achieved its objective of providing robust and useful guidance to illustrate the application of the basic principles in each standard and to provide comprehensive basis for conclusions appendixes, and has improved the guidance in the Framework.

8.3.2.2 The Optional Scope of the EU Regulation 2002

As explained, the EU Regulation 2002 allows the member states to permit or require IFRS-reporting among other than listed entities. The option assumes compliance with IFRS as is.

It is difficult to find good arguments for rejecting the application of this option. Entities outside the mandatory scope of the EU Regulation 2002 may have international investors that will demand IFRS-reporting. Furthermore, entities intending to apply for listing in the future may find IFRS-reporting beneficiary before listing. In addition, other entities should be allowed to apply IFRS as is. Similarly, good arguments support an option to apply IFRS in the separate statements. However, as pointed out in the introduction to chapter 8.3.2, the separate statements have certain tax and legislative implications, and no conclusion with respect to the separate statements will be offered here.

Only listed entities should be required to follow IFRS. The uncertainty associated with the technical and conceptual content of future IFRS, the complexity and comprehensiveness of IFRS, and the demand for resources associated with the implementation of IFRS as is, are all arguments suggesting the optional scope only should allow for IFRS-reporting outside the mandatory scope.

Application of the optional scope permitting but not requiring IFRS in the consolidated accounts does not raise any additional legal or conceptual difficulties.

8.3.2.3 IFRS Harmonization Outside the Scope of the EU Regulation 2002

International harmonization has been an important objective of the development of Norwegian GAP and the current accounting legislation. IFRS harmonization outside the scope of the EU Regulation 2002 will, however, require an amendment of Norwegian accounting legislation. In particular, whether the basic accounting principles must be revised or replaced is a question that needs to be addressed. Three framework alternatives exist:

1. The current basic accounting principles apply ("BAP").
2. A revised version of the basic principles modified by the IASB Framework applies ("Modified BAP").
3. The IASB Framework applies.

In BAP the descriptive approach and the reliance on the R-E view for recognition is continued. In Modified BAP, the descriptive approach of the current framework is continued. However, the inconsistencies between the basic principles and the IASB Framework are eliminated by the A-L definitions modifying recognition.

The Norwegian Framework is generally thought to represent an adequate frame of reference in accounting standard setting and in solving specific issues not directly dealt with in GAP-literature (chapter 8.2), and a shift, that is adoption of Modified BAP or the IASB Framework, must therefore be based on strong arguments. The development of the Norwegian Framework was based on experiences with similar frameworks over decades. An implicit descriptive framework relying on the R-E perspective was the foundation of the accounting regulation in effect before the current legislation (the Accounting Act 1977 and the Companies Legislation 1976), introduced by the Accounting Act Committee of 1959. The framework has proven useful in the solving of accounting problems not dealt with in GAP and flexible enough to allow for the solving of accounting problems arising out of a changing economic environment and new types of transactions. Good arguments therefore support the BAP alternative.

The findings in the analysis of conceptual frameworks, summarized in chapter 7, do certainly not encourage a shift from the R-E view to the A-L view. More specifically, the limited usefulness of the A-L definitions resulting from conceptual inconsistencies, vagueness, and hampering of decision useful earnings information, cannot be ignored. On the other hand, the disadvantage of different frameworks for listed and other entities must be considered.

As such, one may consider 2005 as nothing more than one of several equally relevant opportunities to harmonize the Norwegian Framework with the IASB Framework. Given the inherent weaknesses of the current conceptual frameworks and the announced intention of the FASB to revisit the FASB Framework with the expectation of making fundamental changes in the Framework, and the expected impact such a project would have on the IASB improvement agenda, it is difficult to argue in favor of Modified BAP and the IASB Framework at this time.

An evaluation of the three framework alternatives, BAP, Modified BAP, and the IASB Framework, cannot be made independently of an evaluation of the two harmonization alternatives discussed in chapter 8.3.2.

Six combinations of the harmonization alternatives and the framework alternatives exist. It may be useful to organize the combinations in a matrix.

Figure 8-1 ***The Norwegian Framework in IFRS 2005***

	BAP	**Modified BAP**	**IASB Framework**
GAP	Preferred/(proposed)	NA	NA
IFRS Light	NA	Proposed	Alternative

The upper left corner in the matrix represents the combination in which the R-E view traditionally applied in Norwegian GAP is kept as a basis to develop GAP. Harmonization with international accounting standards and practice will be an overall objective even in this combination. However, GAP may deviate from IFRS if necessary to comply with the basic accounting principles. The upper left corner represents the

preferred harmonization approach outside the scope of the EU Regulation 2002 based on the findings in this dissertation.

In chapter 8.3.2, strong arguments were made in favor of the GAP alternative over the IFRS Light alternative. In this section, arguments have been made in favor of the BAP alternative. The GAP alternative and BAP are compatible. That is, Norwegian GAP has been developed based on the basic accounting principles and the combination has proven to be useful.

The upper mid box and the upper right corner represent combinations that are not compatible (and the combinations are therefore not applicable ("NA")). However, as discussed in chapter 8.3.2, current GAP is not very different from IFRS Light. Nevertheless, GAP and Modified BAP are not compatible, and is therefore not a relevant combination. The same applies to the combination represented by the lower left corner.

Adoption of IFRS Light, either as Simplified IFRS or IFRS Pick-and-Choose, necessitates certain modifications of BAP. IFRS Light was rejected primarily in reference to reduced comparability in chapter 8.3.2, but is a relevant alternative according to the Accounting Act Committee. The Committee has proposed certain amendments of the basic accounting principles to achieve compatibility between the harmonization alternative and the Framework.

The lower right corner in the matrix represents an alternative to the combination proposed by the Accounting Act Committee. In this combination, IFRS Light is combined with the IASB Framework instead of the Modified BAP.

The Accounting Act Committee has argued for two combinations, GAP-BAP and IFRS Light-Modified BAP. That is, entities may choose to follow GAP based on the basic accounting principles or IFRS Light based on a modified version of the basic accounting principles. However, in the proposal the Committee has not allowed for the two combinations since the matching principles shall be modified when in accordance with

good accounting practice. Thus, the GAP-BAP combination is not relevant in cases where the IFRS solution conflicts with the matching principle.

In chapter 2.2, the potential benefits of conceptual frameworks are explored. To repeat, conceptual frameworks should:

- Guide the body responsible for establishing standards.
- Provide a frame of reference for resolving accounting questions in the absence of a specific promulgated standard.
- Determine bounds for judgment in preparing financial statements.
- Increase financial statements users' understanding of and confidence in financial statements.
- Enhance comparability

A framework allowing for both R-E view and A-L view founded policies can obviously not be as discriminating as a framework rejecting one of the two. As such, the frame of reference provided to the standard setters, the preparers, and the users is vaguer. Furthermore, the comparability, and thus the users' understanding and confidence in financial statements prepared in accordance with accounting standards derived from the framework will suffer.

In the IFRS Light-Modified BAP combination, the BAP modification itself is conceptually challenging. The challenge of principles modification particularly applies to the earned revenue principle and the matching principle. One obvious approach is to apply the A-L definitions of the IASB Framework as effective modifiers of the principles (either directly or through the GAP principle). The A-L definitions will in certain cases effectively prohibit recognition of earned revenue and costs matched with revenues, and thus introduce a conceptual inconsistency in the Framework. Modified BAP is a R-E view based framework overrid by the A-L definitions.

The proposal of the Accounting Act Committee fits into the IFRS Light-Modified BAP combination. The Committee will allow for both dimensions of IFRS Light, Simplified IFRS and IFRS Pick-and-Choose (in one instance, the Committee also proposes to prohibit an option under IFRS (revaluation in IAS 16)). Simplified IFRS is labeled "GAP", but is in effect the same as Simplified IFRS as here defined. The basic accounting principles must be modified in order to path the way for IFRS Light, and of particular interest is how the Committee proposes to integrate the A-L definitions. A general modification of the matching principle is proposed: Matching shall be modified when in accordance with GAP. This GAP override of the matching principle is principally proposed to deal with situations in which the conflict between the matching principle and the A-L definitions has led the IASB to modify matching (as illustrated in chapter 5, the leading standard setters have historically tended to reject the A-L definitions).

The A-L definitions modify both expense and revenue recognition. The Accounting Act Committee does not propose to allow for modification of the earned revenue concept. Even though it is not explicitly stated in the report of the Committee, the reason for this apparent inconsistency is two-fold: The A-L definitional override is not explicitly expressed in the context of the earned revenue concept (as is the case of the matching principle in both the Framework and in IAS 1), and the IASB is not exercising the override in their own revenue recognition standard (IAS 18). However, as will be elaborated in the next section, the conceptual framework structure and the IASB Authority Hierarchy does not allow for unmodified revenue recognition outside specific pronouncements unless the recognition policy can be derived through the application of pronouncements dealing with similar or related issues.

The challenging task of operating within two conceptually different frameworks as Modified BAP can be illustrated by an example from the report of the Accounting Act Committee. According to IFRS, proposed dividend is not a liability before "the shareholder's right to receive payment is established" (IAS 18.30). Thus, before approved by the General Assembly, no liability is recognized. The Accounting Act Committee

proposes to allow for both the GAP-treatment (liability) and the IFRS-treatment (equity), and the Committee finds it necessary to explicitly state that the GAP-treatment is allowed in the Accounting Act (proposed amendment to § 6-2).

The Committee applies the A-L definitions as modifiers to income recognition, or more specifically, as modifiers of the matching principle, by reference to GAP. The A-L definitions are not included in the law, and thus, the application of the A-L definitions with respect to equity transactions cannot be derived from the Modified BAP alternative proposed by the Committee. Quite opposite, application of the transaction principle would typically lead to recognition of an equity transaction with dividend payable (liability) as the credit at the time of the dividend proposal. Therefore, the proposed provision about dividend is redundant and confusing. If anything, given that the transactions principle is unmodified in the draft, the liability-treatment represents current GAP, and IFRS harmonization is an objective, it may rather be necessary to explicitly allow for the IFRS-treatment.

Furthermore, the Accounting Act Committee argues that the provision about dividend explicitly allowing the GAP-treatment will lead to symmetrical treatment by the investee and the investor (NOU 2003:23, 237). In other words, if proposed dividend is classified as debt by the investee, then the investor recognizes a corresponding asset. However, neither BAP nor Modified BAP allows for this generalization. First of all, the treatment by the investor in BAP will be based on the earned revenue concept, regardless of the treatment in the investee. According to this concept, the investor should only recognize the proposed dividend to the extent the dividend payment is probable. One can conclude that the proposed dividend may qualify as an asset according to the A-L definitions in certain cases, but in most cases the A-L definitions will override recognition according to the earned revenue concept before dividend approval. More specifically, in a case where the investor controls the investee, and thus the dividend approval, and intends to make the approval, asset recognition will follow from the A-L view as well. Thus, the treatment in the investee will not under any circumstances influence the investor treatment. In both BAP and Modified BAP, liability recognition by the investee may or may not be

accompanied by asset recognition by the investor, and equity classification by the investee may or may not be accompanied by asset recognition by the investor. In other words, neither BAP nor Modified BAP allows for a generalized symmetrical treatment system in this case.

The above example illustrates the conceptual and practical complexity of the IFRS Light-Modified BAP combination. If the Accounting Act Committee of unknown reasons choose not to apply it consistently, one cannot expect the preparers and the users to find it useful. Furthermore, the combination will definitely not enhance comparability across different entities.

The IFRS Light-Modified BAP combination will in reality leave Norwegian entities with two different frameworks, in addition to a combination of the two (Modified BAP). Entities within the scope of the EU Regulation 2002 will have to apply the IASB Framework. Other entities will apply the Norwegian Framework (BAP), modified by the A-L definitions in certain cases.

One alternative combination, IFRS Light-IASB Framework may be considered conceptually consistent. Also, this combination would only impose one framework on Norwegian entities. The disadvantage of this combination though, is that it involves the replacement of a framework that apparently has proven to be conceptually consistent and useful with a framework that is both conceptually and practically questionable.[8]

Therefore, if one accepts the usefulness of accrual accounting, including the earned revenue concept and the matching principle, the IFRS Light-Modified BAP combination may represent a relevant alternative. Earnings measurement and meaningful matching is the objective, but one adopts the international accepted A-L definitions to the extent the IASB does.

Nevertheless, in the opinion of this author, there are no convincing arguments that support the IFRS Light-Modified BAP combination over the GAP-BAP combination.

First of all, the first combination is not conceptually consistent. Second, the challenge of modifying the basic accounting principles is difficult, if not impossible. The attempt made by the Accounting Act Committee illustrates the complexity. For example, the modification of the matching principle modifies expense recognition, but does not automatically have consequences for presentational issues, as for example the split between liability and equity. The lack of modification of the earned revenue concept may also prove to create inconsistencies between GAP and IFRS. Third, the importance of comparability across different entities supports the GAP-BAP combination. Fourth, to replace a framework that apparently has proven to be conceptually consistent and useful with a framework that is both conceptually and practically questionable does not represent a meaningful choice.

An argument that at first may seem to favor the IFRS Light-Modified BAP combination emphasizes the harmonization of GAP with IFRS, and asserts that the BAP alternative will lead to unwanted conflicts between GAP and IFRS. The argument is valid only to the extent that IFRS require or permit other accounting solutions than the basic accounting principles allow for. The readiness of the IASB in the past to reject the A-L definitions when their application would contradict the objective of meaningful income measurement reduces the validity of the argument. Furthermore, the significance of the argument is to some extent unclear regardless of the loyalty of the IASB to the Framework. International harmonization is of particular importance to entities that search international capital markets for capital and entities that are doing business internationally. A majority of these entities fall in under the mandatory scope of the EU Regulation 2002. By giving the optional scope of the EU Regulation 2002 application, other entities will always have the opportunity to apply IFRS in their financial reporting. It is unclear how disadvantageous a limited number of IFRS-conflicts are to other entities. Most likely, these conflicts will be of little or no importance.

8.3.2.4 The Implications of the IASB Hierarchy of Sources

In chapter 2.2, the status of the conceptual frameworks, and the IASB hierarchy of sources, often referred to as the authority hierarchy, in particular (IAS 1.22), was

discussed. The authority hierarchy has implications for the approaches to IFRS 2005 discussed in the previous sections, for instance the elaboration of the IASB Framework within the mandatory scope of the EU Regulation 2002 explored in chapter 8.3.2.1. In the following therefore, these implications will be addressed.

Although the EU Regulation 2002 implies that the EU may modify the application of IFRS, it is reasonable to assume that IFRS 2005 will mean compliance with IFRS as is. Thus, an extension of IFRS to include the Norwegian basic principles must be evaluated within the authoritative hierarchy of the IASB. According to the hierarchy, pronouncements of other standard setting bodies may be used in the determination of accounting policies in the absence of specific standards and interpretations, as long as the derived accounting policy does not conflict with the guidance in other standards dealing with similar or related issues and the IASB Framework. It can be assumed that the Norwegian Framework falls under what is referred to as "pronouncements of other standard setting bodies". On the other hand, from IAS 1, one must assume that one cannot require Norwegian entities to regard the Norwegian Framework a higher source of guidance than the guidance produced by other standard setting bodies, for example the ASB in the UK and the FASB in the US. Thus, other than an open reference to the Norwegian Framework as one of several sources of guidance, it seems difficult to formally elaborate the IASB Framework with the Norwegian basic principles.

However, if the proposed changes to IAS 1.22 are adopted (Exposure Draft of Proposed Improvements to International Accounting Standards, 2002 (the Improvements Project)), the Norwegian Framework may not be recognized as an alternative source for further guidance. In the proposal, it is emphasized that "pronouncements of other standard setting bodies" only can be applied for additional guidance if the standard setting body *"(...) use a similar conceptual framework to develop accounting standards"* (ED IAS 8.6). "Similar" is not further defined, and it is unclear whether Norwegian Conceptual Framework relying on the R-E view qualifies as a similar conceptual framework.

If the Norwegian Conceptual Framework is considered a "similar conceptual framework", Norwegian entities within the scope of the EU Regulation 2002 will have to use the basic accounting principles in the Norwegian Framework when IFRS does not provide guidance if the first technique explained in chapter 8.3.2.1 is applied. However, if the other technique, as suggested by the Accounting Act Committee, is applied, the basic accounting principles will only represent one of several additional sources of guidance when IFRS does not provide guidance.

The consequences will be rather odd if the Norwegian Conceptual Framework falls outside what the IASB refers to as "similar conceptual frameworks". If the NASB issues a pronouncement dealing with an issue not covered by IFRS, the wording of ED IAS 8.6 prohibits its application even if not in conflict with the IASB Conceptual Framework. On the other hand, the same treatment may be adopted if the NASB refrains from issuing the pronouncement (if it may be considered "accepted industry practice", see chapter 2.2). This example illustrates that the exposure draft is not thought well through.

Another example illustrating that the authority hierarchy of the IASB is poorly drafted, concerns the requirement to apply the guidance in accounting standards dealing with similar and related issues in the absence of a specific accounting standard or interpretation. For instance, oil exploration expenditures are scoped out of IAS 38 (par. 1). Then , where should one look for guidance in the case of oil exploration expenditures? According to the authority hierarchy in IAS 1, the first source to address is IAS 38 ("dealing with similar and related issues"). As explained, however, oil exploration expenditures are scoped out of IAS 38.

Assuming in the following that the proposed changes to the authority hierarchy do not disqualify the Norwegian Framework as an additional source, one must determine how the A-L definitions override implicates the basic accounting principles. Let the earned revenue concept illustrate this issue. Given the extensive guidance concerning the earned revenue concept in the Norwegian Framework and the lack of guidance in the IASB Framework, it appears to be meaningless to not apply the Norwegian Framework as an

additional source of guidance. The same also applies to expense recognition. However, the IASB explicitly states that matching cannot lead to balance sheet items in conflict with the A-L definitions (IASB 1989, IAS 1). A similar and explicit statement is not made with respect to the earned revenue concept. Thus, it may be argued that the A-L definitions override cannot apply to the earned revenue concept unless explicitly stated in an accounting standard or interpretation. The fact that the revenue recognition accounting standard (IAS 18) does not exercise the override, supports this understanding. Furthermore, it seems reasonable not to enforce the A-L definitions more rigidly than the IASB does under circumstances in which the IASB does not provide guidance. For instance, the US GAAP includes close to one hundred and fifty different revenue recognition pronouncements, many in which the A-L definitions override is not exercised. It is impractical to reject this extensive and widely accepted practice under circumstances in which the IASB does not provide guidance.

However, this interpretation of the role of the A-L definitions in revenue recognition is in conflict with the recognition criteria in the IASB Framework, which do not discriminate between expense and revenue recognition when the A-L definitions are introduced as an overriding recognition criteria. Furthermore, the authority hierarchy in IAS 1.22 apparently does not allow for an exception to the overriding criteria, unless in accordance with an accounting standard or interpretation of the IASB. The conflict between the earned revenue concept and the A-L definitions is further explored in chapter 4.5.1.1.

From the above, one may conclude that it is uncertain whether revenue recognition according to a Norwegian earned revenue concept can be applied when the IASB does not provide guidance.

In conclusion, the IASB authority hierarchy is poorly drafted, leaving the status of the Framework unclear and the potential application of the Norwegian Framework within IFRS 2005 uncertain. The authority hierarchy allows national standard setters some flexibility in the development of national IFRS practice and the ambiguity inherent in the

hierarchy may allow different IFRS practice adopted by the international accounting firms.

8.3.3 A Revised Norwegian Conceptual Framework

Even though the findings in the analysis of conceptual frameworks generally are not favorable, the analysis illustrates the conceptual potential of an explicit framework. The Norwegian Framework includes explicitly or implicitly all the major elements of a conceptual framework, but the organization of the elements follows a different approach. An explicit Norwegian Framework organized similar to the conceptual frameworks of the leading standard setters will reduce the face and to some extent the real gap between the two set of regulations, IFRS and GAP, in IFRS 2005.[9] Furthermore, even though the usefulness of the A-L view is questioned, the findings in the analysis of conceptual frameworks can generally be interpreted as supportive of the conceptual framework approach, and there are no signals indicating that the leading standard setters, the IASB in particular, consider abolishing the conceptual framework approach. Also, future developments may make IFRS-compliance among other entities advantageous, and familiarity with the conceptual framework approach will make a shift in this direction less challenging.

One may argue that the BAP alternative is inconsistent in a normative and deductive setting. In this context, it is appropriate to remind that none of the leading standard setters, including the FASB and the IASB, has succeeded in implementing the deductive approach when it comes to recognition and measurement. The Norwegian basic accounting principles are descriptive, inducted from accounting practices. However, inductive techniques are not necessarily inconsistent with a normative approach (chapter 3.1.4), and the application of both inductive and deductive techniques are apparent in the Norwegian Framework. The objective of meaningful income measurement represents an implicit element of the Norwegian Framework (chapter 8.2), and relevance, reliability, and comparability are considered necessary qualities in order to achieve the objective, even though these qualities, except for the latter one, are not explicitly integrated in the Framework. The objective and the qualitative characteristics together represent a frame of

reference to evaluate accounting policies within. In other words, in the Norwegian Framework accounting policies are derived from accounting practices but modified by the objective of meaningful income measurement and the qualitative characteristics.

Even though it is unclear whether the "Objective Paragraph" proposed by the Accounting Act Committee (new § 3-1) was a result of an attempt to include a complete conceptual framework in the Act, the proposal is not well though through. Regardless of intention, the proposal represents an extension of the Norwegian Framework by explicitly including an objective statement, user groups, and primary qualitative characteristics in the Framework.

The ambition to revise and extend the Norwegian Framework outlined above cannot be achieved simply by introducing some commonly accepted and general statements about objectives, users, and qualitative characteristics. As the analysis and discussions in chapter 3 illustrates, a conceptual framework approach necessitates a careful analysis of the alternative objectives, the different user groups, and the qualitative characteristics. Furthermore, the relationship between them must be researched. Although the international conceptual framework literature is extensive and the Accounting Act Committee seems to imply that the preliminary research has already been conducted (NOU 2003:23, 161), the conceptual framework approach has never been thoroughly assessed in a Norwegian context (chapter 8.2).

First of all, what is the relationship between the objectives and the user groups? Furthermore, what is the relationship between relevance and reliability and between the characteristics and the objectives? What role is comparability supposed to play? Can the basic accounting principles, including the modified matching principle, be deducted from these concepts? The Accounting Act Committee has not even begun to answer these and other relevant questions. The objective of developing a coherent conceptual framework is a more challenging task than what may be anticipated and an accounting act committee is probably not the right body to take on such a task. Rather, the task should be approached by the NASB.

As already pointed out, the "Objective Paragraph" drafted by the Accounting Act Committee is a poor attempt to introduce an objectives and qualitative characteristics statement in the Norwegian Framework. The somewhat superficial approach of the Committee can be further illustrated by a closer look at the relationship between user groups and underlying constraints discussed in chapter 3.2.5. By putting emphasis on the investors and creditors and their demand for decision useful information, the FASB has managed in a deductive manner to conclude that the cost-benefit consideration permits an entity to omit accounting information that would benefit other user groups than the primary users.

The cost-benefit constraint is an underlying assumption in Norwegian GAP. In the Joint-Stock Companies Act of 1957 a so-called "clause of damage" was included (Vårdal and Johnsen 1989, 223). According to this clause, gross reporting of revenue was only required as long as it could be done without damage to the entity. The clause of damage dealt specifically with income statement presentation, but was in nature general and had similar implications for other presentational and disclosure issues. In the Accounting Act of 1977, gross reporting of revenue was mandatory, but relief from this requirement could be achieved under certain circumstances. In the current accounting act, there is nothing left of the clause of damage, except one indirect suggestion in the preliminary works (*"(...) the informational requirements for openness should not result in adverse impact on product development"* (own translation) (Ot prp 42 (1997-98), 17)), and the Accounting Act Committee has not proposed to reintroduce it.

Interestingly, the Accounting Act Committee asserts that the informational requirements in the Accounting Act have been derived in a cost-benefit context (NOU 2003:23, proposed new § 3-1). However, when the Committee introduces an objective statement and lists the potential users with no ranking, the informational demand of all the user groups must be considered equally important. With respect to the cost-benefit constraint, benefits to the investors cannot be considered to override benefits to the suppliers, customers and even competitors. Thus, in principle, the Framework does not allow for

any clause of damage. When no such clause is specifically included, there is no reference in the framework or in the specific accounting rules that allow an entity to omit information that may harm the cash flow potential and thus the value of the entity. Although this consequence is hardly intended by the Committee, it can potentially force an entity to choose between two undesirable alternatives; to disclose information that may have adverse effect on the value of the entity or to withhold information required by the Accounting Act.

The fact that the Committee emphasizes that the Objective Paragraph is not intended to allow entities to override specific requirements in the accounting regulation and GAP, may to some extent prevent the unintended consequences discussed above. Nevertheless, in lack of any other guidance on the cost-benefit consideration applicable to the entities in the preparation of financial statements, the Objective Paragraph will not be considered irrelevant in the preparation of financial statement. In this context, it is noteworthy that the IASB requires entities, not only the standard setter, to apply the cost-benefit consideration in the preparation of the financial statements (IASB 1989, 44).

The somewhat inconsiderate attitude of the Accounting Act Committee towards comparability and the need for comparability across entities outside the scope of the EU Regulation 2002 (chapter 8.3.2), a qualitative characteristic considered primary of the IASB and traditionally an important characteristic in GAP as well, are troublesome, and an analysis of consequences is missing in the report of the Committee. Furthermore, the correspondence between the wide user group approach and the de-emphasizing of comparability does not seem to have been researched by the Committee.

8.3.4 Concluding Remarks

IFRS 2005 represents several challenges in a Norwegian context. IFRS harmonization outside the scope of the EU Regulation 2002 should be an overall objective of GAP. It is in this paper argued, based on the findings in the analysis of conceptual frameworks and the usefulness of the Norwegian Framework that the harmonization should be carried out within the basic accounting principles (BAP).

The Accounting Act Committee mandated to evaluate the current Accounting Act and the implications of IFRS 2005 has addressed the issues explored in this chapter in NOU 2003:23. In the Committee's proposal the current Accounting Act is revised to allow for so-called IFRS Light treatments in combination with a modified version of the basic accounting principles (Modified BAP). This combination is in direct conflict with the recommendations derived from the conclusions in chapter 7. The Committee has proposed to include objectives and qualitative characteristics in the Accounting Act. It is the opinion of this author that the Accounting Act Committee has not succeeded in this respect. In particular, the comparability characteristic is to a great extent ignored and the user group specification may hinder an effective application of the cost-benefit consideration.

In this author's opinion, January 1, 2005 is not a critical date with respect to international harmonization outside the scope of the EU Regulation 2005, and as long as IFRS is a fast moving target and the IASB Framework is filled with inconsistencies and lack of guidance, Norwegian GAP should be based on the current Norwegian basic accounting principles.

The challenge of developing concepts statements dealing with objectives, including user groups, and qualitative characteristics should be passed on to the NASB. In addition, in the same project, the NASB should be mandated to monitor the international efforts to improve the conceptual frameworks and to evaluate the basic accounting principles in this context.

---

[1] This paper, Accounting Regulation in Norway, was published as one of several papers on accounting regulation in Europe in a separate section of the European Accounting Review.

[2] The original constituents of the NASB include the Oslo Stock Exchange, the Norwegian School of Economics and Business Administration, DnR, the Norwegian Society of Security Analysts, and the Norwegian Association of MBA Graduates. Later, in 1997 and 2001, the Confederation of Norwegian Business and Industry and the Norwegian School of Management joined the NASB.

[3] Johnsen 1980, Gjesdal 1981, Kinserdal 1983.

[4] The Accounting Act Committee of 1959 identified investors and creditors as the primary users of financial statements (NOU 1962, 54).

[5] To some extent, IAS 1 and IAS 8 may be considered extensions of the Framework. More specifically, the first 52 paragraphs of IAS 1 are generally an elaboration of the Framework. Furthermore, the remaining part of IAS 1 deals with presentational issues and disclosure. As noted in chapter 2.2, the conceptual frameworks might have benefited by the inclusion of presentation and disclosure.

[6] The findings of the review of the NASB accounting standards are summarized in Appendix F. The analysis of the NASB standards was not as thorough as the analysis of the IASB accounting standards and interpretations presented in chapter 5, and one must be careful to draw conclusions based on the analysis. However, as one of several indications of the usefulness of the Norwegian Framework, the analysis serves a purpose.

[7] One cannot rule out that the Norwegian Framework is less useful than it appears to be. The fact that the usefulness of the Norwegian Framework has not been exposed to criticism to the same extent as the conceptual frameworks, may or may not be an indicator of usefulness, and cannot by any means be regarded as sufficient documentation of the usefulness.

[8] To some extent this disadvantage may be compensated by letting the basic accounting principles supplement the IASB Framework as an additional source of reference in the same manner as in the case of entities within the scope of the EU Regulation 2002 (chapter 8.3.2.1).

[9] The framework may be included in the Accounting Act or in a separate document only referred to in the law (for instance by reference to GAP). It should be noted however, that the latter alternative may conflict with the EC Accounting Directives in which the accounting principles are included.

REFERENCES

Reference to literature is done according to the following system: Journal articles, papers, reports, books etc. is referred to by the name of the author, the year, and a number representing the relevant page, for example "Sprouse 1988, 127". If the relevant document is organized in paragraphs, for example documents of the FASB and the IASB, then the paragraph is referred to, for example "FASB 1985, 83". When referring to accounting standards of any standard setting body, the number of the relevant standard and paragraph, only separated by a period, will be the reference. For example, "IAS 22.12" refers to International Accounting Standard No. 22, paragraph 12. Accounting standards and other authoritative pronouncements, including exposure drafts, are not listed below. However, conceptual framework documents are included in the list.

AA 1984: *Objectives of Financial Statements for Business Enterprises.* Chicago, IL: Andersen & Co.

AA 2000: *GAAP 2000 – A Survey of National Accounting Rules in 53 Countries.* London, UK: Andersen & Co.

AA 2001: *Convergence to International Accounting Standards (IAS) by 2005* (May).

AAA 1936: *A Tentative Statement of Accounting Principles Underlying Corporate Financial Statements.* Sarasota, FL: American Accounting Association.

AAA 1965a: The Matching Concept. *The Accounting Review* Vol. 40 (April): 368-372.

AAA 1965b: The Realization Concept. *The Accounting Review* Vol. 40 (April): 312-322.

AAA 1966: *A Statement of Basic Accounting Theory.* Sarasota, FL: American Accounting Association.

AAA 1977: *Statement on Accounting Theory and Theory Acceptance.* Sarasota, FL: American Accounting Association.

AAA 2001: Evaluaton of the FASB's Proposed Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both. *The Accounting Horizon* Vol. 14 No. 4 (December): 387-400.

AASB 1995: *The Nature and Purpose of Statements of Accounting Concepts.* Policy Statement 5. Australian Accounting Standards Board.

Aboody, D., Barth, M. E., Kasznik, R., 2001a: SFAS 123 Stock-Based Compensation Expense and Equity Market Values. *Working Paper.* Stanford University.

Aboody, D., Barth, M. E., Kasznik, R., 2001b: Do Firms Manage Stock-Based Compensation Expense Disclosed Under SFAS 123? *Working Paper.* Stanford University.

AICPA 1970: *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises.* APB Statement 4.

AICPA 1973: *Report of the Study Group on Objectives of Financial Statements* (Trueblood Report): AICPA.

AICPA 2001: *A Conceptual Framework for Auditor Independence.* Staff Report: AICPA.

Aitken, M. J. 1990: A General Theory of Financial Reporting: Is it Possible?. *International Journal of Accounting* (25, No. 4): 221-233.

Anthony, R. N. 1987: We Don't Have the Accounting Concepts We Need. *CPA Journal* (57): 36-45.

ASB 1995: *Statement of Principles for Financial Reporting – Exposure Draft.* Accounting Standards Board.

ASB 1996: *Statement of Principles for Financial Reporting – The Way Ahead.* Accounting Standards Board.

ASB 1997: *Discounting in Financial Reporting – Working Paper.* Accounting Standards Board.

ASB 1999: *Statement of Principles for Financial Reporting – Exposure Draft.* Accounting Standards Board.

Backer, M., Bell, P. W. 1966: The Measurement of Business Income Part 1 – The Matching Concept, in *Modern Accounting Theory.* Ed. M. Backer. Prentice Hall, Englewood Cliffs, New Jersey.

Barth, M. E., Beaver, W. H., Landsman, W. R. 1993: A Structural Analysis of Pension Disclosures under SFAS 87 and Their Relation to Share Prices. *Financial Analysts Journal* (February): 18-26.

Beaver, W. H., Demski, J. S. 1974: The Nature of Financial Accounting Objectives : A Summary and Synthesis. *Studies on Financial Accounting Objectives* (Supplement to *Journal of Accounting Research*): 170-185.

Bell, P. W. 1966: The Measurement of Business Income Part 2? Price Changes and Income Measurement, in Modern Accounting Theory. E. M. Backer. Prentice Hall, Englewood Cliffs, New Jersey.

Bell, P. W., 1970: On Current Replacement Costs and Business Income. *Asset Valuation and Income Determination.* Ed. R. R. Sterling. Kansas: Scholars Book Co.

Bell, P. W. 1997: *Toward Greater Logic and Utility in Accounting.* New York: Garland Publishing, Inc.

Bevis, H. W., 1965: *Corporate Financial Reporting in a Competitive Environment.* New York: The Macmillan Company.

Bevis, D. J., 1970: Apprasing the Four Schools. *Asset Valuation and Income Determination.* Ed. R. R. Sterling. Kansas: Scholars Book Co.

Borst, D. 1981: Accounting vs Reality: How Wide Is the GAAP? *Financial Executive* (July): 12-15.

Cairns, D., Nobes, C. 2000: *The Convergence Handbook.* London: ICAEW (December).

Cason, R. 1984: Conceptual Frameworks Begins to Affect Current Standards. *Journal of Accounting, Auditing & Finance* (Summer): 369-374.

Chambers, R. J. 1967: Continuously Contemporary Accounting – Additivity and Action. *The Accounting Review* (October): 751-757.

Chambers, R. J. 1996: Ends, Ways, Means and Conceptual Frameworks. *ABACUS* (No. 2): 119-132.

Christensen, J. A., Demski, J. S., 2003: *Accounting Theory – An Information Content Perspective.* New York: McGraw-Hill Higher Education.

CICA 1990: *Financial Statements Concepts.* Canadian Institute of Chartered Accountants (December).

CICA 1991: Establishing a Common Ground. *CA Magazine* (October): 6-7.

Cook, K. 1999: Concepts and Definitions. *Accountancy* (July): 74-75.

Daley, L. A., Tranter, T. 1990: Limitations on the Value of the Conceptual Framework in Evaluating Extant Accounting Standards. *Accounting Horizons* (March): 15-24.

Davidson, R. A, Chrisman, H. H. 1993: Interlinguisitic Comparison of International Accounting Standards: The Case of Uncertainty Expressions. *The International Journal of* Accounting (28): 1-16.

Davies, M., Paterson, R., Wilson, A.1997: *UK GAAP Gennerally Accepted Accounting Practice in the United Kingdom*. London, Ernst & Young.

Defliese, P. H. 1991: Deferred Taxes – More Fatal Flaws? *Accounting Horizons* (March): 89-92.

Delaney, P. R., Adler, J. R., Epstein, B. J., Foran, M. F., 1996: *GAAP 96 Interpretation and Application of Generally Accepted Accounting Principles*. New York, John Wiley & Sons, Inc.

DePree, C. M. Jr. 1989: Testing and Evaluating a Conceptual Framework for Accounting. *Abacus* (September): 61-74.

Devine, C. T., 1960: Research Methodology and Accounting Theory Formation. *The Accounting Review* (July): 387-399.

Dopuch, S., Sunder, S. 1980: FASB's Statements on Objectives and Elements of Financial Accounting: A Review. *The Accounting Review* (January): 1-21.

Dunn, J. 1988: A Framework for a Framework. *Accountancy* (December): 24-26.

Dye, R. A. 1988: Earnings Management in an Overlapping Generations Model. *Journal of Accountaning Research* (Autumn): 195-235.

Dye, R. A., Sunder, S. 2001: Why Not Allow FASB and IASB Standards to Compete in the U.S.? *Accounting Horizon* (September): 257-271.

Eckel, N. 1981: The Income Smoothing Hypotheses Revisited. *Abacus* (June): 28-41.

Egginton, D. A. 1990: Towards Some Principles for Intangible Asset Accounting. *Accounting and Business Research* (Summer): 193.

Elling 1998: *Årsregnskapsteori*. Copenhagen, Denmark: Forlaget FSR. 2. utgave.

Elling 2000: *Årsregnskapsteori i analytisk perspektiv*. Copenhagen, Denmark: Forlaget FSR. 3. utgave.

Ernst & Ernst 1977: *FASB Conceptual Framework Issues and Implications*. Cleveland, Ohio: Ernst & Ernst.

Evans, T. G. 2002: *Accounting Theory – Contemporary Accounting Issues*. Ohio: South-Western.

FASB 1976a: *Definitions of elements of financial statements and their measurement*. Discussion Memorandum. Norwalk, CO: Financial Accounting Standards Board.

FASB 1976b: *Scope and Implications of the Conceptual Framework Project.* Norwalk, CO: Financial Accounting Standards Board.

FASB 1976c: *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement.* Discussion Memorandum. Norwalk, CO: Financial Accounting Standards Board.

FASB 1976d: *Tentative Conclusions on Objectives of Financial Statements of Business Enterprises.* Discussion Memorandum. Norwalk, CO: Financial Accounting Standards Board.

FASB 1978: *Objectives of Financial Reporting by Business Enterprises.* Statement of Financial Accounting Concepts No 1. Norwalk, CO: Financial Accounting Standards Board.

FASB 1980: *Qualtative Characeristics of Accounting Information.* Statement of Financial Accounting Concepts No 2. Norwalk, CO: Financial Accounting Standards Board.

FASB 1980b: *Elements of Financial Statements of Business Enterprises.* Statement of Financial Accounting Concepts No 3. Norwalk, CO: Financial Accounting Standards Board.

FASB 1984: *Recognition and Measurement in Financial Statements of Business Enterprises.* Statement of Financial Accounting Concepts No. 5. Norwalk, CO: Financial Accounting Standards Board.

FASB 1985: *Elements of Financial Statements.* Statement of Financial Accounting Concepts No. 6. Norwalk, CO: Financial Accounting Standards Board.

FASB 1996: *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S GAAP.* Norwalk, CO: Financial Accounting Standards Board.

FASB 1999: *The IASC-U.S. Comparison Project: A Report on the Similarities and Differences between IASC Standards and U.S GAAP.* Norwalk, CO: Financial Accounting Standards Board.

FASB 2000a: *Using Cash Flow Information and Present Value in Accounting Measurements.* Statement of Financial Accounting Concepts No. 7. Norwalk, CO: Financial Accounting Standards Board.

FASB 2000b: Poposed Amendment to FASB Concepts Statement No. 6 to Revise Definition of Liabilities. *Exposure Draft* (October). Norwalk, CO: Financial Accounting Standards Board.

FASB 2001: Why Does the FASB have a Conceptual Framework? *Understanding the Issues* (August). Norwalk, CO: Financial Accounting Standards Board.

FASB 2002: Issues Related to the Recognition of Revenues and Liabilites. *Project Proposal* (January). Norwalk, CO: Financial Accounting Standards Board.

FASB 2002b: Principles-Based Approach to U.S. Standard Setting. *Proposal* (October).

FEE 1997: *FEE Comparative Study on Conceptual Accounting Frameworks in Europe.* Fédération des Experts Comptables Européens.

Flegm, E. H. 1984: *Accounting.* McGraw-Hil, New York.

Flegm, E. H. 1989: The Limiations of Accounting. *Accounting Horizons* (September): 90-97.

Foran, N. J., Foran, M. F., 1987: SFAS No. 12 and the Conceptual Framework. *Accounting Horizons* (December).?

Frakes, A. H., Nunamaker, T. R. 2002: A Normative Approach to Accounting Valuation. *Working Paper.* AAA Western Region Annual Meeting, San Diego (April).

Gambling, T. 1984: *Positive Accounting: Problems and Solutions.* London: Macmillan Press.

Gellein, O. S. 1992: Primacy: Assets or Income? *Research in Accounting Regulation* (vol 6).

Gjesdal, F. 1981: Accounting for Stewardship. *Journal of Accounting Research* (Vol. 19, No. 1, Spring): 208-231.

Gjesdal, F., Johnsen, T. 1999: *Kravsetting, lønnsomhetsmåling og verdivurdering.* Oslo: Cappelen Adademiske Forlag.

Gordon, M. J. 1964: Postulates, Principles, and Research in Accounting. *Accounting Review* (April): 251-263.

Gore, P. 1992: *The FASB Conceptual Framework Project 1973 – 1985: An Analysis.* Manchester University Press.

Gore, P. 1995: The Practical Use of Conceptual Framework for Financial Reporting. *Advances in International Accounting* (Volume 8): 149-176, JAI Press Inc.

Grinnell, D. J., Hunt, H. G. 2002: Financial Analysts' Views of the Value of Environmental Information. *Working Paper*. AAA Western Region Annual Meeting, San Diego (April).

Hayek, F., 1971: Principles or Expediency? *Working Paper*.

Healy, P. M, Wahlen, J. M. 1999: A Review of the Earnings Management Literature and Its Implications for Standard Setting. *Accounting Horizons* (December): 365-383.

Hendriksen, E. S., van Breda, M. F. 1992: *Accounting Theory*. Boston: Richard D. Irwin, Inc.

Hepworth, S. R., 1953: Smoothing Periodic Income. *Financial Accounting Theory I: Issues and Controversies* (Zeff, S. A., Keller, T. F., 1973) (from The Accounting Review (January)): 51-60.

Hersvik, E. 2003: *Regnskapsmessig behandling av usikre forpliktelser og betingede eiendeler*. Høyere avdelings oppgave. Bergen: Norges Handelshøyskole.

Herz, R. H., 2003: A Year of Challenge and Change for the FASB. *Accounting Horizons* (September): 247-255.

Horngren, C. T., 1981: Uses and limitation of a conceptual framework. *Journal of Accountancy* (April): 86-90.

Hudack, L., McAllister, J. P. 1994: An Investigation of the FASB's Application of Its Decision Usefulness Criteria. *Accounting Horizons* (September): 1-18.

Huss, H. F. 1985: A Contingency Approach to Accounting for Income Taxes. *Journal of Accounting, Auditing & Finance* (Fall): 60-67.

Hylton, D. 1965: On Matching Revenue with Expense. *The Accounting Review* (October): 824-828.

IASB 1989: Framework for the Preparation and Presentation of Financial Statements. *International Accounting Standards Committee*. London.

IASB 1997: Accounting for financial assets and financial liabilities. *Discussion Paper*. London (March).

IASB 2000: *Statement by the Board of the International Accounting Standards Committee*. London.

IASB 2001: *IASB Update*. London (October).

IASB 2002: *Exposure Draft of Proposed Improvements to International Accounting Standards*. London (May).

ICAS 1988: *Making Coporate Reports Valuable.* Eidenburgh, GB: The Institute of Chartered Accountants of Scotland.

Ijiri, Y. 1970: A Defense for Historical Cost Accounting. *Asset Valuation and Income Determination*. Ed. R. R. Sterling. Kansas: Scholars Book Co.

Ijiri, Y. 1975: *Theory of Accounting Measurement.* Sarasota, FL: American Accounting Association.

Ijiri, Y. 1983: On the Accountability-Based Conceptual Framework of Accounting. *Journal of Accounting and Public Policy* (Summer): 75-82.

Inst. O. nr 61 (1997-98): *Regnskapslov*. Finanskommitteen.

Johnsen, A. 1980: Målsetninger for finansregnskapet. *Regnskapet i bruk. Jubileumsskrift Norges Statsautoriserte Revisorers Forening*, 16-27.

Johnsen, A. 1993: Accounting Regulation in Norway. *The European Accounting Review* (December): 617-626.

Johnsen, A., Kvaal, E. 2000: *Kommentarer til regnskapsloven.* Oslo: Cappelen Akademiske Forlag.

Johnsen, A., Eilifsen, A. 2001: Norway. *European Accounting Guide*: 1295-1341.

Johnsen, A., Eilifsen, A. 2003: Norway. *European Accounting Guide*:

Johnson, L. T., Storey, R. K. 1982: *Recognition in Financial Statements: Underlying Concepts and Practical Conventions.* Research Report (July), Norwalk, CO: Financial Accounting Standards Board.

Johnson, L. T. 1994: *Future Events: A Conceptual Study of Their Significance for Recognition and Measurement.* Financial Accounting Series, Special Report No. 140-A, Norwalk, CO: Financial Accounting Standards Board.

Johnson, L. T., Petrone, K. R., 1998: Is Goodwill an Asset? *The Accounting Horizons* (Vol. 12 No. 3, September): 293-303.

Joyce, E., Libby R., Sunder, S. 1982: Using the FASB's Qualitative Characteristics in Accounting Policy Choices. *Journal of Accounting Research* (Autumn): 654-675.

Kachelmeier, S. J., King, R. R. 2002: Using Laboratory Experiments to Evaluate Accounting Policy Issues. *Accounting* Horizons (September): 219-232.

Kay, R. S., Searfoss, D. G. 1989: *Handbook of Accounting and Auditing.*

Kennedy, D., Ugras, Y. J., Leuby, B. A., Tavana, M. 1995: An Investigation of the Relative Importance Attached to the Qualitative Characteristics in the SFAC 2 Hiearchy. *Accounting Enquiries* (February): 249-288.

Kinserdal, A. 1983: Regnskapet under prisstigning. *Revisjon og Regnskap* (Nr. 1): 4-14.

Kirk, D. J. 1981: Concepts, consensus, compromise and consequences: their roles in standard setting. *Journal of Accountancy* (April): 83-86.

Kirk, D. J., 1989: Reflections on a "Reconceptualization of Accounting": A Commentary on Parts I-IV of Homer Kripke's Paper, "Reflections on the FASB's Conceptual Framework for Accounting and Auditing". *Journal of Accounting, Auditing & Finance* (Winter): 83-105.

Kirk, D. J., 1990: Future Events: When Incoporated into Today's Measurements. *Accounting Horizons* (June): 86-92.

Kirk, R. J., 1998: The Statement of Principles – A Panacea or a False Dawn? *CPA* (June): 12-16.

Knudson, P. H., Napolitano, G. U. 1998: Criteria employed by the AIMR Financial Accounting Policy Committee in Evaluating Financial Accounting Standards. *Accounting Horizons* (June): 170-176.

Knutson, P., 1992: *Financial Reporting in the 1990's and Beyond.* New York, NY: Association for Investment Management and Research.

Koeppen, D. R. 1988: Using the FASB's Conceptual Framework: Fitting the Pieces Together. *Accounting Horizons* (June): 18-27.

Krasnoff, M. M. 1985: Recognition and Measurement – The End of the FASB's Conceptual Framework Project. *Corporate Accounting* (Summer): 67-71.

Kripke, H. 1989: Reflections on the FASB's Conceptual Framework for Accounting and on Auditing. *Journal of Accounting, Auditing & Finance* (Winter): 3-66.

Kvifte, S. S. 1997: Konseptuelt rammeverk for regnskapsføring. *Beta* (2): 9-31.

Lambert, R. 1984: Income Smoothing as Rational Equilibrium Behavior. *The Accounting Review* (October): 604-618.

Lee, T., 1995: Shaping the US Academic Accounting Research Profession: The American Accounting Association and the Social Construction of a Professional Elite. *Critical Perspectives on Accounting* Vol. 6: 241-261.

Lees, F., 1981: *Public Disclosure of Corporate Earnings Forecasts.* New York, NY: The Conference Board, Inc.

Lennard, A. 1994: An international collaboration on future events. *Accountancy* (November): 95-96.

Lindsay, R. M. 1985: Comprehensive Tax Allocation: What Games Are We Playing? *Cost and Management* (March-April): 24-30.

Littleton, A. C. 1953: *Structure of Accounting Theory.* Sarasota, FL: American Accounting Association.

Lohr, S. L. 1999: *Sampling: Design and Analysis.* Pacific Grove, CA: Brooks/Cole Publishing Company.

Lukka, K., Kasanene, E., 1996: Is accounting a global or a local discipline? Evidence from major research journals. *Accounting, Organizations and Society* Vol. 21 (No. 7/8): 755-773.

Martin, D. R., Wolk, H. I., Beets, S. D. 1989: Accounting for Income Taxes: Illustrations and Critique. *Ohio CPA Journal* (Autumn): 24 -.

Mattessich, R. 1995: *Critique of Accounting – Examination of the Foundations and Normative Structure of an Applied Discipline.* Westport, CO: Quorum Books.

Mavrinac, S. 2002: Tracking the Measures of Matter. *Working Papper* (January).

Milburn, J. A. 1991: Building a better conceptual framework. *CA Magazine* (December): 43-48.

Miller, M. 1985: The conceptual framework for Australian accounting standards: Is it worth the effort? *The Chartered Accountant in Australia* (56): 48-52.

Miller, P. B. W. 1985: The Conceptual Framework: Myths and Realities. *Journal of Accountancy* (March): 62-69.

Miller, P. B. W, Redding, R. J. 1988: *The FASB: The People, the Process, and the Politics.* 2nd edition. Homewood, IL: Irwin.

Miller, P. B. W. 1990: The Conceptual Framework as Reformation and Counterreformation. *Accounting Horizons* (June): 23-32.

Miller, P. B. W., Redding, R. J., Bahnson, P. R. 1994: *The FASB: The People, the Process, and the Politics.* Third edition. Homewood, IL: Irwin.

Moehrle, S. R., Reynolds-Moehrle, J. A., and Wallace, J. S. 2001: How Informative Are Earnings Numbers That Exclude Goodwill Amortization? *The Accounting Horizons* (September): 243-255.

Monson, D. W., 2001: The Conceptual Framework and Accounting for Leases. *The Accounting Horizons* (September): 275-287.

Moonitz, M. 1963: Why Do We Need "Postulates" and "Principles"? *The Journal of Accountancy* (December): 42-46.

Moonitz, M., Littleton, A. C. 1965: *Significant Accounting Essays.* Englewood Cliffs, NJ: Prentice Hall, Inc.

Most, K. S. 1982: *Accounting Theory.* Columbus, Ohio. Grid Publishing, Inc.

Mozes, H. A. 1998: The FASB's conceptual framework and political support: The lesson from employee stock options. *Abacus* (September): 141-161.

Myers, J. H., 1959: The Critical Event and Recognition of Net Profit. *Financial Accounting Theory I: Issues and Controversies* (Zeff, S. A., Keller, T. F., 1973) (from the Accounting Review (October)): 158-163

Nelson, M. W. 2003: Behavioral Evidence on the Effects of Principles – and Rules-Based Standards. *Accounting Horizons* (March): 91-104.

Nobes, C., Parker, R. 1995: *Comparative International Accounting.* Cambridge, University Press.

Nobes, C. 2001: *Asset Measurement Bases in UK and IASC Standards.* London, the Association of Chatertered Certified Accountants.

Nobes, C. 2003: *Liabilities and their measurement in UK and International Accounting Standards.* London, the Association of Chartered Certified Accountants.

Nolan, J. 1972: Wheat Study Members Assess Product. *The Journal of Accountancy* (June).

NOU 1962: Innstilling om revisjon av regnskapslovgivningen. Regnskapslovkomiteen (5 oktober).

NOU 1995:30: *Ny regnskapslov.* Regnskapslovutvalget.

NOU 2003:23: *Evaluering av regnskapsloven.* Regnskapslovutvalget.

NSRF 1986: Anbefaling til god regnskapsskikk (nr. 0) forutsetninger og bakgrunn for NSRFs anbefalinger til god regnskapsskikk.

Nussbaumer, N. 1992: Does the FASB's Conceptual Framework Help Solve Real Accounting Issues? *Journal of Accounting Education* (Spring): 235-242.

NZSA 1993: *Statement of Concepts for General Purpose Financial Reporting.* New Zealand Society of Accountants (June).

Ot prp nr 42 (1997-98): *Om lov om årsregnskap m.v. (Regnskapsloven).* Finansdepartementet.

Pacter, P. A. 1983: The Conceptual Framework: Make No Mystique About It. *Journal of Accountancy* (July): 76-85.

Panozzo, F., 1997: The making of a good academic accountant. *Accounting, Organizations and Society* Vol. 22 (No. 5): 447-480.

Passmore, J. A. 1953: Can the Social Sciences Be Value-Free? *Readings in the Philosophy of Science* (H. Feigl and M. Brodbeck eds.). New York: Appleton-Century-Crofts.

Paterson, R. 1988: Building the Right Framework. *Accountancy* (October): 26-27.

Paterson, R. 1990: Primacy for the P & L account: Have the IASC and David Solomons placed undue emphasis on the balance sheet to the detriment of the profit and loss account? *Accountancy* (August): 80-82.

Paterson, R. 1995: The Statement of Principles: full steam astern? *Accounancy* (August): 81.

Paterson, R. 2000: Deferred tax and the framework. *Accountancy* (July): 108-109.

Paton, W. A., 1922: *"Accounting Theory, With Special Reference to the Corporate Enterprise"* . New York: The Ronald Press Company.

Paton, W. A., Littleton, A. C. 1940: *An Introduction to Corporate Accounting Standards.* Sarasota, FL: American Accounting Association.

Perera, M. H. B., Rahman, A. R., 1995: The Conceptual Foundations of Accounting and Financial Reporting in Australia and New Zealand. *Pacific Accounting Review* (June): 4-23.

Petree, T. R. 1993: Shifting to the Balance Sheet – FASB's Conceptual Framework. *Business Credit* (November/December): 28-30.

Pietroski, J. D. 2000: Value Investing: The Use of Historical Financial Statement Information to Separate Winners from Losers". *Journal of Accounting Research* Vol. 38 Supplement): 1-41.

Rappaport, A., 1964: Establishing Objectives for Published Corporate Accounting Reports. *Financial Accounting Theory I: Issues and Controversies* (Zeff, S. A., Keller, T. F., 1973) (from The Accounting Review (October)): 93-107.

Read, W. J., Bartsch, R. A. J. 1991: The FASB's Proposed Rules for Deferred Tax. *Journal of Accountancy* (August): 44-50.

Reichelstein, S., 2000: Providing Mangerial Incentives: Cash Flows versus Accrual Accounting. *Journal of Accounting Research*, vol 38 No. 2, autumn.

Reither, C. L. 1997: How the FASB approaches a standard-setting issue. *Accounting Horizons* (December): 91-104.

Rogers, R. L., Menon, K. 1985: Accounting for Deferred-Payment Notes. *The Accounting Review* (July): 547-557.

Ronen, J., Sadan, S. 1981: *Smoothing Income Numbers: Objectives, Means, and Implications*. Reading, Massachussets: Addison-Wesley.

Salvary, S. C. W. 1989: *An Analytical Framework for Accounting Theory*. McQueen Accounting Monograph Series, Vol. No. 5. Univsersity of Arkansas, Fayetteville.

Samuelson, R. A. 1996: The Concept of Assets in Accounting Theory. *Accounting Horizons* (September): 147-157.

Schipper, K. 2002: Relating Accounting and Auditing: A Standard-Setting Perspective. *Presentation at EEA in Copenhagen* (April).

Schmalenbach, E. 1959: *Dynamic Accounting*. London: GEE and Company (Publishers) Limited.

Schuetze, W. P. 1983: The Significance and Development of the Conceptual Framework. *Journal of Accounting, Auditing & Finance* (Spring): 254-262.

Schuetze, W. P. 1993: What is an asset? *Accounting Horizon* (September): 66-70.

Schuetze, W. P. 2001: What Are Assets and Liabilities? Where Is True North? (Accounting That my Sister Would Understand). *ABACUS* (Vol. 37, No. 1): 1-25.
Schipper, K. 2002: Relating Accounting and Auditing: A Standard-Setting Perspective. *Presentation at EEA in Copenhagen* (April).

Schipper, K. 2003: Principle-Based Accounting Standards. *Accounting Horizons* (March): 61-72.

SEC 2003: *Study of a Principles-Based Accounting System.* A US Security and Exchange Commission Report. July.

Shackelford, D. A., Shevlin, T. 2000: Empirical Tax Research in Accounting. *Working Paper* (June).

Skinner, R. M. 1972: *Accounting Principles – A Canadian Viewpoint.* Toronto: The Canadian Institute of Chartered Accountants.

Skinner, R. M. 1987: *Accounting Standards in Evolution.* Toronto: Harcourt Brace & Company Canada, Ltd.

Skinner, R. M., Milburn, J. A., 2001: *Accounting Standards in Evolution.* Toronto: Pearson Education Canada Inc.

Solomons, D. 1970: Asset Valuation and Income Determination: Appraising the Alternatives. *Asset Valuation and Income Determination.* Ed. R. R. Sterling. Kansas: Scholars Book Co.

Solomons, D. 1986a: *Making Accounting Policy: The Quest for Credibility in Financial Reporting.* New York: Oxford University Press.

Solomons, D. 1986b: The FASB's Conceptual Framework: An Evaluation. *Journal of Accountancy* (June): 114-124.

Solomons, D. 1995: Criteria for Choosing an Accounting Model. *Accounting Horizons* (March): 42-51.

Sorter, G. H., Gans, M. S. 1974: Opportunities and Implications of the Report on the Objectives of Financial Statements. *Studies of Financial Accounting Objectives (Supplement to Journal of Accounting Research)*: 1-12.

Sprouse, R. T., 1971: The Balance Sheet – Embodiment of the Most Fundamental Elements of Accounting Theory. *Financial Accounting Theory I: Issues and Controversies* (Zeff, S. A., Keller, T. F., 1973) (from Foundations of Accounting Theory): 164-174.

Sprouse, R. T., 1978: The Importance of Earnings in the Conceptual Framwork. *Journal of Accountancy* (January).

Sprouse, R. T., 1987: Commentary on Financial Reporting – Economic Consequences: The Volatility Bugaboo. *Accounting Horizons* (March).

Sprouse, R. T., 1988: Developing a Conceptual Framework for Financial Reporting. *Accounting Horizons* (December): 121-127.

Staubus, G. J. 1958: Accounting and Reporting Standards for Corporate Financial Statements – 1957 Revision. *The Accounting Review* (January).

Staubus, G. J. 1959: The Residual Equity Point of View in Accounting. *The Accounting Review* (January).

Staubus, G. J. 1961: *A Theory of Accounting to Investors.* Lawrence, Kansas: Scholars Book Co.

Staubus, G. J. 1970: The Relevance of Evidence of Cash Flows. *Asset Valuation and Income Determination.* Ed. R. R. Sterling. Kansas: Scholars Book Co.

Staubus, G. J. 1971: *Activity Costing and Input-Output Accounting.* Homewood, Illinois: Richeard D. Irwin, Inc.

Staubus, G. J. 1972: *Objectives and concepts of financial reports.* Melbourne, Australia: Riall Print Pty. Ltd.

Staubus, G. J. 1977: *Making Accounting Decisions.* Houston, Texas: Scholars Book Company.

Staubus, G. J. 1999: *The Decision-Usefulness Theory of Accounting – A Limited History.* New York: Garland Publishing, Inc.

Staubus, G. J. 2002: An Accountant's Education. *Working Paper.* University of California, Berkeley.

Sterling, R. R. 1970: *Asset Valuation and Income Determination.* Kansas: Scholars Book Co.

Sterling, R. R. 1979: *Towards a Science of Accounting.* Houston, Texas: Scholars Book Co.

Sterling, R. R. 1982: The Conceptual Framework: An Assessment. *Journal of Accountancy* (November): 103-108.

Sterling, R. R. 1985: *An Essay on Recognition* (R. J. Chambers Research Lecture). The University of Sydney, Accounting Research Centre.

Storey, R. K., 1960: Cash Movements and Periodic Income Determination. *Financial Accounting Theory I: Issues and Controversies* (Zeff, S. A., Keller, T. F., 1973) (from The Accounting Review (July): 151-158).

Storey, R. K. 1963 *The Search for Accounting Principles*. New York: The American Institute of Certified Public Accountants, Inc.

Storey, R. K., Storey, S., 1998: *The Framework of Financial Accounting Concepts and Standards*. Financial Accounting Series (January), Norwalk, CO: Financial Accounting Standards Board.

Swieringa, R. J. 1988: *An Anatomy of an Accounting Standard: Accounting for Income Taxes*. R. J. Chambers Research Lecture, University of Sydney (1988).

Tonkin, D., Robertson, B. 1991: Brand Names in a Conceptual Framework. *Accountancy* (March): 28.

Trueman, B., Titman, S. 1988: An Explanation For Accounting Income Smoothing. *Journal of Accounting Research* (Vol 26): 126-139.

Vatter, W. J. 1947: *The Fund Theory of Accounting and Its Implications for Financial Reports*. The University of Chicago Press.

Vatter, W. J. 1970: Current Issues about Current Costs. *Asset Valuation and Income Determination*. Ed. R. R. Sterling. Kansas: Scholars Book Co.

Vårdal, P., Johnsen, A. 1992: *Norsk Regnskapslovgivning*. Oslo: Bedriftsøkonomens forlag AS.

Walton, P. 1996: A Framwork with a French Flavour. *Accountancy* (August): 60-61.

Watts, R. L., Zimmerman, J. L., 1978: Towards a Positive Theory of Determination of Accounting Standards. *The Accounting Review* (January): 112-134.

Watts, R. L., Zimmerman, J. L. 1986: *Positive Accounting Theory*. Englewood Cliffs, New Jersey: Prentice-Hall, Inc.

Watts, R. L., Zimmerman, J. L., 1990: Positive Accounting Theory: A Ten Year Perspective. *The Accounting Review* (January): 131-156.

Weil, R. L. 1990: Role of the Time Value of Money in Financial Reporting. *Acconting Horizons* (December): 60-61.

Williams, J. R, 2001: *Miller GAAP Guide – Restatement and Analysis of Current FASB Standards*. New York, Harcourt Professional Publishing.

Williams, K. 1986: Robert N. Anthony: Creating an Accounting Framework (Book Review). *Management Accounting* (May): 22-28.

Wilson, A., Davies, M., Curtis, M., Wilkinson-Riddle, G. 2001: *UK & International GAAP*. London: Butterworths Tolley.

Wolk, H. I., Francis, J. R., and Tearney, M. G. 1989: *Accounting Theory*. Boston, Masachussets: PWS-KENT Publishing Company.

Wolk, H. I., Tearney, M. G., Dodd, J. L. 2001: *Accounting Theory*. Cincinnati, Ohio: South-Western College Publishing.

Wyatt, A. R. 1990: Accounting Standards: Conceptual or Political? *Accounting Horizons* (September): 83-88.

Wyatt, A. R. 1991: Accounting Standard Setting at a Crossroads. *Accounting Horizons* (September): 110-114.

Yu, S C. 1976: *The Structure of Accounting Theory*. Gainesville, FL: The University Presses of Florida.

Zeff, S. A., 1978: The Rise of "Economic Consequences". *Journal of Accountancy* (December): 56-63.

Zeff, S. A., Demski, J., Dopuch, N. 1979: *Essays in Honor of William A. Paton – A Pioneer Accounting Theorist*. University of Michigan.

Zeff, S. A. 1995: A perspective on the U.S. public/private-sector approach to the regulation of financial reporting. *Accounting Horizons* (March): 52-70.

Zeff, S. A., 2002: "Political" Lobbying on Proposed Standards: A Challenge to the IASB. *Accounting Horizons* (March): 43-54.

Zeff, S. A., 2003: How the U.S. Accounting Profession Got where It Is Today: Part I. *The Accounting Horizons* (September): 189-205.

Zhang, Y., 2003: Revenue Recognition Timing and Attributes of Reported Revenue: The Case of Software Industry's Adoption of SOP 91-1. *Working Paper*. University of Southern California.

Appendix A

ANALYSIS OF IAS – "FRAMEWORK" AND "DEFINITIONS"

Current IAS, March 2002

IAS 1 (Revised 1997)	Presentation of Financial Statements
IAS 2 (Revised 1993)	Inventories
IAS 7 (Revised 1992)	Cash Flow Statements
IAS 8 (Revised 1993)	Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Estimates
IAS 10 (Revised 1999)	Events After the Balance Sheet Date
IAS 11 (Revised 1993)	Construction Contracts
IAS 12 (Revised 2000)	Income Taxes
IAS 14 (Revised 1997)	Segment Reporting
IAS 15 (Reformatted 1994)	Information Reflecting the Effects of Changing Prices
IAS 16 (Revised 1998)	Property, Plant and Equipment
IAS 17 (Revised 1997)	Leases
IAS 18 (Revised 1993)	Revenue
IAS 19 (Revised 2000)	Employee Benefits
IAS 20 (Reformatted 1994)	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21 (Revised 1993)	The Effects of Changes in Foreign Exchange Rates
IAS 22 (Revised 1998)	Business Combinations
IAS 23 (Revised 1993)	Borrowing Costs
IAS 24 (Reformatted 1994)	Related Party Disclosures
IAS 26 (Reformatted 1994)	Accounting and Reporting by Retirement Benefit Plans

IAS 27 (Reformatted 1994)	Consolidated Financial Statements and Accounting for Investments in Subsidiaries
IAS 28 (Revised 2000)	Accounting for Investments in Associates
IAS 29 (Reformatted 1994)	Financial in Hyperinflationary Economies
IAS 30 (Reformatted 1994)	Disclosures in the Financial Statements of Banks and Similar Financial Institutions
IAS 31 (Revised 2000)	Financial Reporting of Interests in Joint Ventures
IAS 32 (Revised 1998)	Financial Instruments: Disclosure and Presentation
IAS 33	Earnings Per Share
IAS 34	Interim Financial Reporting
IAS 35	Discontinuing Operations
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39 (Revised 2000)	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property

IAS, issued not effective, March 2002

IAS 41	Agriculture

Current SIC, March 2002

SIC 1 (1997)	Consistency - Different Cost Formulas for Inventories
SIC 2 (1997)	Consistency - Capitalisation of Borrowing Costs

SIC 3 (1997)	Elimination of Unrealised Profits and Losses on Transactions with Associates
SIC 5 (1997)	Classification of Financial Instruments - Contingent Settlement Provisions
SIC 6 (1997)	Costs of Modifying Existing Software
SIC 7 (1997)	Introduction of the Euro
SIC 8 (1998)	First-Time Application of IASs as the Primary Basis of Accounting
SIC 9 (1998)	Business Combinations - Classification either as Acquisitions or Unitings of Interests
SIC 10 (1998)	Government Assistance - No Specific Relation to Operating Activities
SIC 11 (1998)	Foreign Exchange - Capitalisation of Losses Resulting from Severe Currency Devaluations
SIC 12 (1998)	Consolidation - Special Purpose Entities
SIC 13 (1998)	Jointly Controlled Entities - Non-Monetary Contributions by Venturers
SIC 14 (1998)	Property, Plant and Equipment - Compensation for the Impairment or Loss of Items
SIC 15 (1998)	Operating Leases – Incentives
SIC 16 (1998)	Share Capital - Reacquired Own Equity Instruments (Treasury Shares)
SIC 17 (1999)	Equity - Costs of an Equity Transaction
SIC 18 (1999)	Consistency – Alternative Methods
SIC 19 (2000)	Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29
SIC 20 (1999)	Equity Accounting Method – Recognition of Losses
SIC 21 (1999)	Income Taxes – Recovery of Revalued Non-Depreciable Assets

SIC 22 (1999)	Business Combinations - Subsequent Adjustment of Fair Values and Goodwill Initially Reported
SIC 23 (1999)	Property, Plant and Equipment - Major Inspection or Overhaul Costs
SIC 24 (2000)	Earnings Per Share – Financial Instruments and Other Contracts that May Be Settled in Shares
SIC 25 (1999)	Income Taxes - Changes in the Tax Status of an Enterprise or its Shareholders
SIC 27 (2001)	Evaluating the Substance of Transactions Involving the Legal Form of a Lease
SIC 28 (2001)	Business Combinations – "Date of Exchange" and Fair Value of Equity Instruments
SIC 29 (2001)	Disclsosure – Service Concession Arrangements
SIC 30 (2001)	Reporting Currency – Translation from Measurement Currency to Presentation Currency
SIC 31 (2001)	Revenue – Barter Transactions Involving Advertising Services
SIC 32 (2002)	Intangible Assets – Web Site Costs
SIC 33 (2001)	Consolidation and Equity Method – Potential Voting Rights and Allocation of Ownership Interests

IAS	"Framework"*	"Definition"*	Comments
1	2,3, 22	22, 26	In par. 22 the "rank" of the Framework is defined, and the modification of the matching principle is explained in par. 26.
2	-	-	
7	-	-	
8	9	9	Reference to the Framework's definition of income and expense.
10	-	-	
11	Objective	-	Reference to the Framework's recognition criteria.
12	-	-	Implicit reference to the A-L definitions (Introduction)
14	15	-	Implicit reference to the A-L definitions (par. 8). Reference to the Qualitative Characteristics of the Framework.
15	-	-	
16	Objective	Objective	Reference to the recognition criteria and the definitions of the Framework.
17	-	-	
18	Objective	Objective	Reference to the definition of income in the Framework, and implicit reference to the A-L definitions (par. 7).
19	-	-	Several references to the Framework and the definitions in Appendix C (par. 12, 40, 42, 51, 57, 59, 60, and 65).
20	-	-	
21	-	-	
22	-	-	References to the Framework and the definitions in the Appendix (par. 79, 91).
23	-	-	
24	-	-	
26	-	-	
27	-	-	
28	-	-	
29	-	-	
30	-	-	
31	-	-	
32	-	-	
33	-	-	
34	24, 31, 33	30, 31, 33	Reference to the Framework's discussion of immaterial items, and reference to the definitions in general (par 24 and par 31), and the definition of assets and liabilities in particular (par 30 and

			par 33).
35	-	-	
36	-	-	Reference to the Framework in Appendix B (par. 111).
37	-	-	Implicit references to the A-L definitions (Introduction, par. 10).
38	-	-	Implicit references to the A-L definitions (Introduction, par. 7). References to the Framework and the definitions in the appendix (par. 21, 22, 28, and 30).
39	102	-	Reliability versus fair value is discussed.
40	-	-	References to the Framework in Appendix B (par. 63).
41	-	-	References to the Framework in Appendix B (par. 17, 18, 40, 69, and 72).

* The paragraphs in which the explicit references are made.

Note: Several references to "definition" are made in the standards, even if not reflected here. These references refer to the definitions in the actual standard, and do not refer directly to the definitions in the Framework.

SIC	"Framework"*	"Definition"*	Comments
1	4	-	Reference to the Framework's commitment of equal measurement of like transactions and other events (par 39).
2	4	-	Reference to the Framework's commitment of equal measurement of like transactions and other events (par 39).
3	-	-	
5	-	-	
6	Ref., 6,7	-	A general reference to the Framework in the introduction of the SIC. Specific reference to par 89-91 of the Framework and the definitions of assets and liabilities.
7	-	-	
8	-	-	
9	-	-	
10	-	-	
11	-	-	
12	12	-	Reference to the Framework's commitment to the substance-over-form concept (par 35).
13	10,13	10,13	Reference to the income-definition in par 92 of the Framework, and a specific reference to the definitions of assets and liabilities in par 53-64 and 89-91 in the Framework to explain why unrealized gains and losses on non-monetary assets contributed to the JCE cannot be accounted for as deferred items.
14	8	8	Reference to the definition of income in par 92 of the Framework to explain the accounting for compensation receivable from third parties.
15	7,8	-	Reference to the qualitative characteristics of the Framework (par 35), and the accrual basis of accounting (par 22).
16	-	-	
17	10	-	Reference to par 65 and par 94-98 of the framework to explain the presentation of shareholders contribution and the net profit or loss.
18	5	-	Reference to the Framework's commitment of equal measurement of like transactions and other events (par 39).
19	12	-	The Framework (paragraphs 17, 35, 39 and 46) is used to underline the substance over form assumption in the measurement currency choice.
20	-	-	
21	6	6	A reference to the definition of assets is made.

22	-	-	
23	-	-	
24	-	-	
25	-	-	
27	6, 13, 16	6, 14	Refers in 6 to the frameworks definitions to determine whether an investment and the lease payments represent and asset and liability. In 13 the reference to the Framework concerns the substance over form criterion. In 14 the definitions are used to disregard an uncontrolled leasing object as an asset. In 16, reference to par 75 of the Framework is used to conclude that gains are no different in nature from revenue.
28	9	-	Refers to par 100a of the Framework defining historical cost.
29	8	-	Refers to par 21 of the Framework to explain that the objective of decision usefulness may be obtained through additional disclosures.
30	14	-	Refers to par 21 of the Framework to explain the need for supplementary information under certain circumstances.
31	7	-	Refers to par 31 of the Framework to support an argument that fair value measurement of advertising services revenue from a barter transaction is in conflict with the reliability quality if based on the received services.
32	5	-	Refers to the Framework when explaining that expenditure incurred on an internet service provider hosting the entity's web site should be expensed when the service is received.
33	-	-	

* The paragraphs in which the references are made.

Appendix B

TABLES IN CHAPTER 6

Table 6-1

Educational Background

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Graduate Degree/Professional Certification	35	43,2	43,8	43,8
	Undergraduate Degree or Less	45	55,6	56,3	100,0
	Total	80	98,8	100,0	
Missing	System	1	1,2		
Total		81	100,0		

Table 6-2

Current Position

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Security (equity) Analyst	17	21,0	21,3	21,3
	Credit Analyst	13	16,0	16,3	37,5
	Fixed Income Analyst	4	4,9	5,0	42,5
	Mutual Fund or Portfolio Analyst	5	6,2	6,3	48,8
	Other	41	50,6	51,3	100,0
	Total	80	98,8	100,0	
Missing	System	1	1,2		
Total		81	100,0		

Table 6-3

Level of Experience

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Experienced	66	81,5	83,5	83,5
	Inexperienced	13	16,0	16,5	100,0
	Total	79	97,5	100,0	
Missing	System	2	2,5		
Total		81	100,0		

Table 6-4

Typical Size of Businesses

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	More Than $1 Billion in Revenue	33	40,7	42,9	42,9
	Less Than $1 Billion in Revenue	44	54,3	57,1	100,0
	Total	77	95,1	100,0	
Missing	System	4	4,9		
Total		81	100,0		

Table 6-5

Financial Reporting Objective

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Decision Making Information Preference	61	75,3	75,3	75,3
	Stewardship Information Preference	17	21,0	21,0	96,3
	Other Users Preference	3	3,7	3,7	100,0
	Total	81	100,0	100,0	

Table 6-6

Ranking of Financial Statements

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	The Income Statement	14	17,3	17,9	17,9
	The Balance Sheet	6	7,4	7,7	25,6
	The Cash Flow Statement	47	58,0	60,3	85,9
	The Notes	11	13,6	14,1	100,0
	Total	78	96,3	100,0	
Missing	System	3	3,7		
Total		81	100,0		

Table 6-7

Relevance vs. Reliability

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Relevance	16	19,8	20,0	20,0
	Reliability	28	34,6	35,0	55,0
	Both	36	44,4	45,0	100,0
	Total	80	98,8	100,0	
Missing	System	1	1,2		
Total		81	100,0		

Table 6-8

Recognition of Tax Asset

		Count	Count Percent
Income Tax Recognition under Certainty	The R-E View	49	61,3%
	The A-L View	31	38,8%
Total		80	100,0%
Income Tax Recognition under Uncertainty	The R-E View	42	52,5%
	The A-L View	38	47,5%
Total		80	100,0%

Table 6-9

Recognition of Customer List

		Count	Count Percent
Intangible Asset Recognition Under Certainty	The R-E View	58	72,5%
	The A-L View	22	27,5%
Total		80	100,0%
Intangible Asset Recognition under Uncertainty	The R-E View	56	70,0%
	The A-L View	24	30,0%
Total		80	100,0%

Table 6-10

Recognition of Insurance Loss

		Count	Count Percent
Provision Recognition under Certainty	The R-E View	60	75,0%
	The A-L View	20	25,0%
Total		80	100,0%
Provision Recognition under Uncertainty	The R-E View	48	61,5%
	The A-L View	30	38,5%
Total		78	100,0%

Table 6-11

Dependence Between Preferences Under Certainty and Uncertainty – Income Tax

			Income Tax Recognition under Uncertainty		
			The R-E View	The A-L View	Total
Income Tax Recognition under Certainty	The R-E View	Count	38	11	49
		% within Income Tax Recognition under Certainty	77,6%	22,4%	100,0%
	The A-L View	Count	4	27	31
		% within Income Tax Recognition under Certainty	12,9%	87,1%	100,0%
Total		Count	42	38	80
		% within Income Tax Recognition under Certainty	52,5%	47,5%	100,0%

Pearson Chi-Square = 31.822

Table 6-12

Dependence Between Preferences Under Certainty and Uncertainty – Customer List

			Intangible Asset Recognition under Uncertainty		
			The R-E View	The A-L View	Total
Intangible Asset Recognition Under Certainty	The R-E View	Count	52	6	58
		% within Intangible Asset Recognition Under Certainty	89,7%	10,3%	100,0%
	The A-L View	Count	4	18	22
		% within Intangible Asset Recognition Under Certainty	18,2%	81,8%	100,0%
Total		Count	56	24	80
		% within Intangible Asset Recognition Under Certainty	70,0%	30,0%	100,0%

Pearson Chi-Square = 38.800

Table 6-13

Dependence Between Preferences Under Certainty and Uncertainty – Loss Provision

			Provision Recognition under Uncertainty		
			The R-E View	The A-L View	Total
Provision Recognition under Certainty	The R-E View	Count	44	16	60
		% within Provision Recognition under Certainty	73,3%	26,7%	100,0%
	The A-L View	Count	4	14	18
		% within Provision Recognition under Certainty	22,2%	77,8%	100,0%
Total		Count	48	30	78
		% within Provision Recognition under Certainty	61,5%	38,5%	100,0%

Pearson Chi-Square = 15.282

Table 6-14

Classification of Respondents

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	True R-E View Supporter	28	34.6	35.0	35.0
	Others	52	64.2	65.0	100.0
	Total	80	98.8	100.0	
Missing	System	1	1.2		
Total		81	100.0		

Table 6-15

Dependence Between Fundamental Perspective and Financial Statement Preference

			Financial Statement Preference		
			Other Statements	The Cash Flow Statement	Total
Total	Count		30	47	77
	row %		39.0%	61.0%	100.0%
Classification of Respondents	True R-E View Supporter	Count	6	21	27
		row %	22.2%	77.8%	100.0%
	Others	Count	24	26	50
		row %	48.0%	52.0%	100.0%

Pearson Chi-Square = 4.899

Appendix C

COVER LETTER AND QUESTIONNAIRE

Visiting Scholar Steinar Sars Kvifte
Walter A. Haas School of Business
University of California
545 Student Services Building 1900
Berkeley, CA 94720

January 15, 2003

Survey Respondents

Survey of the Decision Usefulness of Financial Reporting Information

My name is Steinar Sars Kvifte. I am a doctoral student at the Norwegian School of Economics and Business Administration, a Research Fellow at the Agder University College in Norway, a Fulbright Fellow, and a Visiting Scholar at HAAS School of Business, UC Berkeley.

The major topic in my doctoral research is the implication of the recognition guidelines provided in accounting standards for the decision usefulness of the financial reports. The accounting standard setting bodies around world, including the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), are striving to develop accounting standards that will provide the primary users of the financial reports with decision useful information. Investors and their advisors are singled out as primary users. Thus, the usefulness of the financial reports to you, the financial analysts, is a major concern in accounting standard setting, and your opinions and preferences are therefore of significant interest in my research. The recent accounting scandals have put the current accounting model under public scrutiny. In this context, the topic dealt with in the survey is of particular interest.

I kindly ask you to take a few minutes to address the questions in the enclosed questionnaire. Please read the introductory comments carefully. Your response is crucial to the applicability of the survey and is highly appreciated.

The survey is designed to provide the respondents with full anonymity. The results of the survey will be reported in my doctoral dissertation, and may be published in the form of a paper in an accounting journal. If you respond, you may request a summary of the report emailed directly to you by providing me with your email address at the end of the questionnaire.

I would like to extend my appreciation to the New York Society of Security Analysts for kindly consenting to distribute my questionnaire to an appropriate responding audience. However, questions and comments should be directed directly to me at the address provided above, or by fax at 510 643-1412 or by email at kvifte@haas.berkeley.edu.

Please return the completed questionnaire in the enclosed envelope by February 20, 2003.

Sincerely,

Steinar Sars Kvifte
Visiting Scholar HAAS School of Business, UC Berkeley

Encl: Questionnaire

Survey of the Decision Usefulness of Financial Reporting Information - Questionnaire

The intention of this survey is to analyze the preferences of the primary users of financial statements.

You are to consider the questions within a *historical cost model.* The answers should be given without regard to current accounting legislation and regulation. In other words, your knowledge of current accounting standards is not the subject of the survey.

The questionnaire consists of three parts and includes fourteen questions. Part I concerns objectives of financial reporting and qualitative characteristics. Part II concerns the balance between reporting of financial performance and financial position. In this part of the questionnaire, for research purposes, several simplifying, and to some extent unrealistic, assumptions are made. Tables illustrating the relevant accounting numbers are provided. However, the respondent may without a careful evaluation of the accounting numbers address the questions in this part as long as the principal differences between the alternatives are appreciated. Part III concerns the respondents' demographics.

In all the questions, except for question 1, you should choose among several alternatives by making a check in the relevant box provided. If explicitly stated, you may select more than one alternative. If not, only one alternative should be selected in each question.

Estimated time to finish the questionnaire is 12-15 minutes.

All responses will be treated anonymously.

PART I: Objectives of Financial Reporting and Qualitative Characteristics (Questions 1-3)

1. **Assuming that the primary objective of financial reports is to provide the users with financial information, rank the importance of the following information in financial reports (1 implying the greatest importance, and 3 the least importance).**

___ *Information useful to the investors, creditors, and their advisors in their evaluation of the firms' managers*

___ *Information useful to the investors, creditors, and their advisors in their investment decision process*

___ *Information useful to user groups other than the investors, creditors, and their advisors*

2. **To achieve the primary objective(s) in question 1, what statement is the most useful to the user?**

- ❑ *The income statement*
- ❑ *The balance sheet*
- ❑ *The cash flow statement*
- ❑ *The notes to the financial statements*

3. **You are asked to address an exposure draft from an accounting standard setting body. Two alternative policies to a recognition problem are proposed. One policy is supported by reference to relevance, while the other is supported by reference to reliability. In other words, you have to make a trade-off between relevant and reliable financial information in order to make a choice between the two policies in your response to the exposure draft. Which of the two policies would you support?**

- ❑ *The more relevant policy*
- ❑ *The more reliable policy*
- ❑ *Both policies should be allowed*

PART II: Reporting of Financial Performance and Position (Questions 4-9)

In question 4-9 the issue is how to provide the investors and their advisors (analysts) with the most decision useful information, regardless of your response to question 1 in part I.

---

4. **Entity A has expenditures of 100 in period 1, and no investments or other expenditures over the entity's lifetime of five years. These expenditures are recognized as expense for accounting purposes and are tax deductible. A earns 20, 30, 40, 50, and 100 in year 1, 2, 3, 4, and 5, respectively. The applicable tax rate is 50%. Assume no temporary or permanent differences between accounting and tax bases. Furthermore, assume full certainty about future revenue and expenses.**

   Which of the following recognition approaches should be applied for accounting purposes in order to give the most meaningful information to the investors?

- ❑ *The effect of the carry forward tax loss is reflected*

Income Statement	**1**	**2**	**3**	**4**	**5**	**Sum**
Income (Loss) Before Tax	(80)	30	40	50	100	140
Tax	(40)	15	20	25	50	70
Net Income (Loss) After Tax	(40)	15	20	25	50	70
Balance Sheet	**1**	**2**	**3**	**4**	**5**	
Tax Asset	40	25	5	0	0	
Tax Payable	0	0	0	20	50[1]	

- ❑ *The effect of the carry forward tax loss is not considered to be an asset, and the tax expense is therefore only reflecting the tax payable in each year*

Income Statement	**1**	**2**	**3**	**4**	**5**	**Sum**
Income (Loss) Before Tax	(80)	30	40	50	100	140
Tax	0	0	0	20	50	70
Net Income After Tax	(80)	30	40	30	50	70
Balance Sheet	**1**	**2**	**3**	**4**	**5**	
Tax Payable	0	0	0	20	50	

[1] In the distributed questionnaire, the tax payable in period 5 was by accident given as 25. Even though the typo did not have any relevance for the issue in question, it may have caused confusion. However, none of the respondents commented on the typo, and there is therefore nothing that indicates that the typo had any implications for the responses given.

Comments:

---

5. **Answer question 4 assuming that both revenues and expense numbers are uncertain estimates that may be revised. Nevertheless, it is more likely than not that the tax benefit will be realized.**

   - ❑ *The effect of the carry forward tax loss is reflected*

   - ❑ *The effect of the carry forward tax loss is not considered to be an asset, and the tax expense is therefore only reflecting the tax payable in each year*

   Comments:

---

6. **Entity B is in the service business. B acquires a customer list for 100 at the beginning of period 1, and has no other investments or expenditures over the entity's lifetime of four years. B earns revenues of 40, 50, 70, and 80 in period 1, 2, 3, and 4, respectively. Assume full certainty about future revenues and expenses, and no tax.**

Which of the following recognition approaches should be applied in order to give the most meaningful information to the investors?

- ☐ *The customer list is not considered to be an asset, and the purchase price is therefore expensed in period 1*

Income Statement	**1**	**2**	**3**	**4**	**Sum**
Revenue	40	50	70	80	240
Expenses	100	0	0	0	100
Net Income	(60)	50	70	80	140
Balance Sheet	**1**	**2**	**3**	**4**	
Customer List	0	0	0	0	

- ☐ *The customer list expenditures are capitalized, and amortized according to a linear schedule (impairment tests must be conducted, and may lead to write downs)*

Income Statement	**1**	**2**	**3**	**4**	**Sum**
Revenues	40	50	70	80	240
Expenses	25	25	25	25	100
Net Income	15	25	45	55	140
Balance Sheet	**1**	**2**	**3**	**4**	
Customer List	75	50	25	0	

- ☐ *The customer list expenditures are capitalized and amortized according to a schedule developed to achieve a net income measure in each period reflecting the project's internal rate of return (≈ 40) (impairment tests must be conducted, and may lead to write downs).*

Income Statement	**1**	**2**	**3**	**4**	**Sum**
Revenues	40	50	70	80	240
Expenses	0	10	33	57	100
Net Income	40	40	37	23	140
Balance Sheet	**1**	**2**	**3**	**4**	
Customer List	100	90	57	0	

(Rounded to nearest full number)

Comments:

____

____

____

7. **Answer question 6 assuming that both revenue and expense numbers are uncertain estimates that may be revised. However, assume that the estimates are more likely than not.**

- ❑ *The customer list is not considered an asset, and the purchase price is therefore expensed in period 1*
- ❑ *The customer list expenditures are capitalized, and amortized according to a linear schedule (impairment tests must be conducted, and may lead to write downs)*
- ❑ *The customer list expenditures are capitalized and amortized according to a schedule developed to achieve a net income measure in each period reflecting the project's internal rate of return (≈ 40%)(impairment tests must be conducted, and may lead to write downs)*

Comments:

____

____

____

8. Entity C starts operations at the beginning of year 1, and stays in business for 5 years. The entity earns 100 in revenues each year, and has expenses before insurance costs of 50 each year. There is no uncertainty associated with these measures. Entity C chooses to be "self-insured", and has no insurance coverage for employee accidents. Assume that the entity knows for certain up-front that one employee accident will happen during the five years of operations, and that the entity will have to pay out 100 in insurance coverage to the employee involved in the accident. However, it is not known up-front when the accident will occur. Assume that the accident occurs in year 3, and assume no taxes.

Which of the following recognition approaches should be applied in order to give the most meaningful information to the investors?

- ☐ *The average annual insurance loss, 20, is recognized in each of the five periods.*

Income Statement	**1**	**2**	**3**	**4**	**5**	**Sum**
Revenues	100	100	100	100	100	500
Expenses (before insurance)	50	50	50	50	50	250
Insurance Expense	20	20	20	20	20	100
Net Income	30	30	30	30	30	150
Balance Sheet	**1**	**2**	**3**	**4**		
(Accrued Insurance)/Deferred Insurance	(20)	(40)	40	20	0	

- ☐ *The average annual insurance loss, 20, is recognized over the lifetime until the accident occurs. In the period of the accident, year 3, the difference between the provision made in period 1 and 2 and the insurance loss is recognized*

Income Statement	**1**	**2**	**3**	**4**	**5**	**Sum**
Revenues	100	100	100	100	100	500
Expenses (before insurance)	50	50	50	50	50	250
Insurance Expense	20	20	60	0	0	100
Net Income	30	30	(10)	50	50	150
Balance Sheet	**1**	**2**	**3**	**4**		
(Accrued Insurance)/Deferred Insurance	(20)	(40)	0	0	0	

- *An accrual and/or deferral would be in conflict with the definitions of assets and liabilities, and the insurance loss is therefore recognized in the period it occurs*

Income Statement	**1**	**2**	**3**	**4**	**5**	**Sum**
Revenues	100	100	100	100	100	500
Expenses (before insurance)	50	50	50	50	50	250
Insurance Expense	0	0	100	0	0	100
Net Income	50	50	(50)	50	50	150
Balance Sheet	**1**	**2**	**3**	**4**		
(Accrued Insurance)/Deferred Insurance	0	0	0	0	0	

Comments:

____

____

____

9. **Answer question 8 assuming that the insurance loss only is an expected loss, not a certain loss up-front. In this case, there is full independence between losses. That is, a loss in period 1 for instance, does not affect the likelihood of losses in later periods.**

- *The average annual insurance loss, 20, is recognized in each of the five periods*

- *The average annual insurance loss, 20, is recognized over the lifetime until the accident occurs. In the period of the accident, year 3, the difference between the provision made in period 1 and 2 and the insurance loss is recognized*

- ❑ *An accrual and/or deferral would be in conflict with the definitions of assets and liabilities, and the insurance loss is therefore recognized in the period it occurs*

Comments:

___

___

___

PART III: About the Respondent (Questions 10-14)

10. What kind of formal financial accounting education do you have (more than one alternative may be selected)?

- ❑ *Undergraduate business major other than accounting*
- ❑ *Undergraduate accounting major*
- ❑ *Graduate business major other than accounting*
- ❑ *Graduate accounting major*
- ❑ *Doctoral degree in business other than accounting*
- ❑ *Doctoral degree in accounting*
- ❑ *Certified Public Accountant*
- ❑ *Certified Financial Analyst*
- ❑ *Other, specify* ________________
- ❑ *None*

11. What is your current position?

- ❑ *Security (equity) analyst*
- ❑ *Credit analyst*
- ❑ *Fixed income analyst*
- ❑ *Director of research*
- ❑ *Mutual fund or portfolio analyst*
- ❑ *Other, specify* ________________

12. How long have you worked in your current or similar positions?

- ❑ *0-2 years*
- ❑ *3-5 years*
- ❑ *5-10 years*
- ❑ *More than 10 years*

13. What other professional experiences in which understanding of financial accounting is essential do you have (more than one alternative may be selected)?

- ❑ *Auditing*
- ❑ *Financial reporting (producer of financial reports)*
- ❑ *Other financial services*
- ❑ *None*

14. What is the typically size of the businesses you deal with in your current position?

- ❑ *Less than $ 10 million in revenue*
- ❑ *Between $ 10 million and $ 100 million in revenue*
- ❑ *Between $ 100 million and $ 500 million in revenue*
- ❑ *Between $ 500 million and $ 1 billion in revenue*
- ❑ *More than $ 1 billion in revenue*

I request a copy of the Survey Report to be sent to the following email address:

....

Thank you. Your participation is highly appreciated.

Appendix D

PRE- AND POST-SURVEY ACTIVITIES

The pre- and post-survey activities were numerous. The intention of this appendix is to provide the reader with information about these activities beyond the scope of chapter 6.

D1. Pre-Survey Activities

The planning, preparation and coordination of the activities necessary to conduct the survey in chapter 6 were time consuming and demanding. The process may be divided into five general steps:

1. Idea generation and testing

   Chapter 6 was not part of the original proposal (Appendix F). The idea was gradually developed, and may best be described as a by-product of the analysis in the preceding chapters. The idea was formulated into a research proposal, which in turn was informally tested on certain people believed to be able to evaluate the potential of the idea. Lastly, the research proposal was presented for the Reading Committee.

2. Questionnaire Development

   The questionnaire development involved a technical qualitative evaluation among accounting academics as well as a technical evaluation by a questionnaire expert. The feedback received from these capacities was instrumental in the development of the final questionnaire (Appendix C).

3. Sample Selection

   The research proposal specified financial analysts as the target respondents. After a research process in which other surveys among financial analysts were identified, it became clear that a contact with a financial analyst association had to be established in order to gain access to an appropriate sample. The New York Society of Security Analysts (the NYSSA) was approached because of its large membership as well as its apparent positive attitude towards member surveys.

4. Questionnaire Distribution

Originally, it was decided that a web-based distribution to all members of the NYSSA that deal with financial analyses in their current positions according to self-reported titles, should be conducted. A web-based questionnaire was therefore developed. However, the NYSSA changed its position on this issue, and because it believed distribution at various events (seminars, conferences etc) had greater response rate potential, and the event distribution approach was selected.

5. Response Collection

   The questionnaire was distributed along with a prepaid postage envelope addressed directly to me. Only a few responses were collected through the passive event distribution approach. I therefore chose to participate at three selected events to promote the survey. Furthermore, a survey lottery was established, in which three gift cards (total value of $ 250) were to be drawn among the respondents. By the end of the predetermined deadline eighty-one responses had been collected.

D2. Post-Survey Activities

The data analysis represents the post-survey activities. In the following, the framework for the data analysis (it was necessary to develop a draft analysis framework before the questionnaire was developed (pre-survey activity), but the analysis framework was finalized as a first step of the data analysis (post-survey activity)). Furthermore, to make the analysis in chapter 6 more readily available, the modifications of the raw data are explained.

D2.1 The Framework for the Data Analysis

Based on the background for the survey, the particular issues to be analyzed from the data obtained in the survey "Decision Usefulness of Financial Reporting Information" are explained in the following.

D2.1.1 Part II

Part II of the questionnaire represents the primary focus of the survey. That is, the questionnaire is designed to reveal the preferences of financial analysts on one particular subject; do they prefer A-L view produced information or R-E view produced information?

The following table illustrates which alternative goes with which view (for practical reasons alternatives denoted by Arabic letters even though this denotation is not used in the questionnaire (the first alternative is a, the next is b, and so on)):

Question	A-L view	R-E view
Q4 a		X
Q 4 b	X	
Q 5 a		X
Q 5 b	X	
Q 6 a	X	
Q 6 b		X
Q 6 c		X
Q 7 a	X	
Q 7 b		X
Q 7 c		X
Q 8 a		X
Q 8 b		X
Q 8 c	X	
Q 9 a		X
Q 9 b		X
Q 9 c	X	

Question 4 and 5 are similar but the former questions assume full certainty about future revenues and costs while the latter does not impose this restriction. Similarly, question 6 and question 8 assume full certainty, while question 7 and question 9 do not.

As one can conclude from the table above, four of the case questions (Q 6, Q 7, Q 8, and Q 9) have three alternatives. However, two of the alternatives in these questions represent the R-E view, and thus for the purpose of the analysis explained above, these two

alternatives may be treated as one alternative, leaving each case question with only two alternatives. I will only need a simple descriptive statistic of the relationship between the two R-E view alternatives in each of the four questions (that is, what percentage preferred each R-E view alternative).

The following relationships may be determined:

- Q 4 and Q 5 – that is, is their preference for one of the two views in question 4 correlated with their preference in question 5?
- Q 4 and Q 6 – that is, is their preference for one of the two views in question 4 correlated with their preference in question 6?
- Q 4 and Q 8 - that is, is their preference for one of the two views in question 4 correlated with their preference in question 8?
- Q 5 and Q 7- that is, is their preference for one of the two views in question 5 correlated with their preference in question 7?
- Q 5 and Q 9 - that is, is their preference for one of the two views in question 5 correlated with their preference in question 9?
- Q 6 and Q 7 - that is, is their preference for one of the two views in question 6 correlated with their preference in question 7?
- Q 6 and Q 8 - that is, is their preference for one of the two views in question 6 correlated with their preference in question 8?
- Q 7 and Q 9 - that is, is their preference for one of the two views in question 7 correlated with their preference in question 9?
- Q 8 and Q 9 - that is, is their preference for one of the two views in question 8 correlated with their preference in question 9?

By doing this exercise, one may be able to detect whether preference for one view in one case, for instance the case in question 4 and question 5, is correlated with the preference for the same view in another case, for instance question 6 and question 7. However, such relationships are not alone sufficient to address the question of interest, namely whether the respondents primarily favor R-E view produced or A-L view produced information.

Nevertheless, this exercise is necessary in order to tell whether the certainty restriction represents a significant factor in the respondents' preferences. Thus, cross-tabulations across the different cases are not deemed necessary (with the exception explained below). However, cross-tabulations within each cases must be carried out.

The above cross-tabulations may give me important indications of relationships of interest, but will not alone be useful to determine the financial analysts' preferences for R-E view produced information versus A-L view produced information. To address this primary issue of the survey, and to be able to apply the data produced by the first and the third part of the questionnaire, R-E view supporters and A-L view supporters must be defined. A "true" R-E view supporter will choose the R-E view produced solution in each of the three questions assuming certainty, question 4, 6, and 8. Similarly, a "true" A-L view supporter will choose the A-L view produced solution in each of the same three questions. A screening of the dataset indicates that the there is a significant group of "true" R-E view supporters, while the "true" A-L view supporters are few (3). The others, those not being consistently R-E view friendly or A-L view friendly, represent of a majority of the respondents. There are some unresolved issues related to the effectiveness of the second case, and it may therefore be necessary to disregard question 6 for the purpose of defining "true" R-E view and "true" A-L view supporters. If question 6 is disregarded, the "true" R-E view supporters increase to approximately 50% of the sample, while the "true" A-L view supporters increase to a little less than 10% of the sample (6). Still the "true" A-L view supporters are too few to use as a separate group for the purposes of the analysis, and I have therefore decided to include all the three cases for the purpose of defining R-E view supporters.

Based on the above, the following exercise is necessary: Determine what respondents selected 4a, 6b or 6c, and 8a or 8b (the "true" R-E view supporters). Determine what respondents selected 4b, 6a, and 8c (the "true" A-L view supporters).

The next step will then be to cross-tabulate the "true" R-E view supporters with "the rest" with respect to the questions in Part I and Part III.

D2.1.2 Part I

Secondly, whether the respondents ranking of the three information sets in question 1 has an impact on the preferences in part II of the survey is of interest. A scanning of the survey results indicates that one of two ranking alternatives is chosen by nearly all of the respondents, somewhat limiting cross-tabulations. Several possible approaches to this part of the analysis can be applied. One approach may be to cross-tabulate question 1 against each of the questions in part II. Another approach, may be to only cross-tabulate the ones being consistent over the three cases. That is, the two relevant ranking choices in question 1 is cross-tabulated against the "true" R-E view supporters and the rest.

The same applies to the second and third questions. Whether there are any correlations between the preference for statement in question 2 and in question 3 and the preferences for the two information sets in part II need to be evaluated.

Even though not a primary issue in the survey, I want to analyze the three first questions for any correlations. That is, does each of the two ranking alternatives in question 1 correlate with any of the alternatives in question 2 and question 3? And, is there any correlation between the alternatives in question 2 and question 3?

D2.1.3 Part III

Part III of the questionnaire deals with demographics. This information is primarily obtained in order to be able to describe the sample, and at this point in time I do not plan on doing extensive analyzes on the findings in the first two parts with respect to the respondents' demographics. However, three relationships may be of interest. Does higher education correlate with one of the two views in part II? I will for this exercise define all alternatives in question 10 but the two first and the two last alternatives as higher education. Similarly, is there a correlation between level of experience and the preferences for the two views in part II? I will for this exercise divide the alternatives in question 12 in two, less than three years, and more than three years. Furthermore, respondents with other relevant professional experience, the three first alternatives in

question 13, may be considered more experienced. Lastly, is there any correlation between the sizes of business the respondents analyze and the preferences for one of the two views in part II? For this exercise, I will divide the alternatives in question 14 in two, less and more than $ 1 billion in revenue.

The same applies for possible approaches in the analysis of part III questions as part 1 questions. A cross-tabulation against each of the questions in part II is one possibility, while the other is to only cross-tabulate the "true" R-E view supporters and the rest. The latter alternative is preferred at this time.

D2.1.4 Statistical Inference

See chapter 6.2.1.2.

D2.1.5 Summary

Based on the above, I have in the following listed fourteen questions that the data analysis should address.

1. Definitions: "True" R-E view supporters: 4a, 6b/6c, 8a/8b
   "True" A-L view supporters: 4b, 6a, 8c
   "Others": Neither "true" R-E view supporters nor "true" A-L view supporters

2. Is the difference between the number of "true" R-E view supporters and "true" A-L view supporters statistical significant?

   For the remaining analysis, only two categories, the "true" R-E view supporters and "the rest" are employed.

3. Do the "true" R-E view supporters assume a different primary objective of financial reporting than the rest (question 1, 2-1-3 vs 1-2-3)?

4. Do the "true" R-E view supporters put more emphasis on one particular statement than the rest (question 2).

5. Do the "true" R-E view supporters put more emphasis on one particular qualitative characteristic than the rest (question 3, here "relevance" should include both 3a and 3c, while "reliability" should include both 3b and 3c)?

6. Is there a correlation between question 1 and question 2, that is, is the emphasis of objective in question 1 (2-1-3 vs 1-2-3) correlated with emphasis on a particular statement in question 2)?

7. Is there a correlation between question 1 and question 3, that is, is the emphasis of objective in question 1 (2-1-3 vs 1-2-3) correlated with emphasis on a particular qualitative characteristic in question 3)?

8. Is there a correlation between question 2 and question 3, that is, is the emphasis on a particular statement in question 2 correlated with the emphasis on a particular qualitative characteristic in question 3)?

9. Is educational background correlated with the respondents belonging to the "true" R-E view supporters and the rest category (two first and two last alternatives in question 10 represent "lower" education, while the remaining alternatives represent "higher" education)?

10. Is level of relevant experience correlated with the respondents belonging to the "true" R-E view supporters and the rest category (the first alternative in question 12 coupled with the last alternative in question 13 represents "inexperienced" respondents, while the three last alternatives in question 12 and the first alternative in question 12 coupled with one of the three first alternatives in question 13 represent "experienced" respondents)?

11. Is type of business analyzed by the respondents correlated with the respondents belonging to the "true" R-E view supporters and the rest category (for the purpose of this cross-tabulation the four first alternatives are considered one "type" of business, while the fifth alternative is considered the other "type" of business)?

D2.2 Raw Data Modifications

The following modifications were made in the raw data before registering in SPSS.

Question 1

With three exceptions, all the respondents agreed that the ranking 2-1-3 or 1-2-3 represented the best priority sequence. Therefore, the raw data in question 1 is modified to reflect this finding. Thus, Q1a represents 2-1-3, Q1b represents 1-2-3, and Q1c represents other preferences.

Question 6-9

Since these four questions have three alternatives, where two fall into the same classification, "R-E view supporters", the two alternatives representing the R-E view are combined into one cell. In other words, 6a and 7a represent the A-L view, while 6b and 7b represent the R-E view, and 8a and 9a represent the R-E view, while 8b and 9b represent the A-L view.

Question 10

For the purposes of the analysis, the respondents are categorized into two groups with respect to educational background, those with at least a graduate degree or a certification as public accountants or chartered financial analysts (higher education) and those without such higher education (undergraduate degrees or no degrees). Thus, 10a represents higher educational background, while 10b represents lower educational background.

Question 11

This question will only be used in order to describe the sample, and will not play any role in the data analysis. For descriptive purposes, only the first choice of the respondents having selected more than one alternative is registered in the modified dataset.

Question 12

For the purpose of the analysis, the respondents are categorized into two groups with respect to their experience, those with at least three years of experience in their current positions, and those with less experience in their current position. Thus, 12a represents those with more than three years experience in the current position, while 12b represents the others.

Question 13

For the purpose of the analysis, the respondents are categorized into two groups with respect to their earlier experience, those with experience from auditing, financial reporting, or other financial services are considered to have other relevant experience, while the others do not. Thus, 13a represents those with other relevant experience, while 13b represents the others.

Question 14

For the purpose of the analysis, the respondents are categorized into two groups with respect to the size of the businesses they analyze. One group, 14a, analyze businesses with more than $ 1 billion in revenues, while the other group, 14b, analyze businesses with revenues up to $ 1 billion. A few respondents have classified their typical customers into both the $ 500 millions to $ 1 billion group and the more than $1 billion group. These respondents are classified into the more than $ 1 billion group.

Appendix E

THE NYSSA-REPORT

The Decision Usefulness of the Asset and Liability Definitions – A Survey Among Financial Analysts

A report by Steinar Sars Kvifte[1][2]

The following report summarizes the findings obtained in a survey conducted among the members of the New York Society of Security Analysts (NYSSA) in February and March of 2003. The report is prepared for the NYSSA and may be used as deemed appropriate by the organization. In addition, a copy of the report will be distributed directly to the survey respondents. The author may publish the results in another context.

The survey was designed to provide insights into the financial analysts' preferences with respect to the decision usefulness of the asset and liability definitions in accounting recognition. The usefulness of the asset and liability definitions in accounting standard setting and their decision usefulness to the users of financial accounts are the two main research topics in the author's doctoral research, and the findings will therefore represent an important contribution to the finalization of the project.

I would like to extend my appreciation to the NYSSA for kindly consenting to distribute my questionnaire among its members, and thus providing me with an appropriate dataset to draw conclusions from.

[1] Kvifte is a doctoral student at the Norwegian School of Economics and Business Administration (NHH), a research fellow at the Agder University College (HiA) in Norway, and was at the time of the survey a Visiting Scholar at Walter A. Haas School of Business, UC Berkeley (returned to Norway in June 2003). He is on leave of absence from his position as technical advisor accounting in Ernst & Young, Norway.

[2] Questions and comments the reader may have with respect to the report should be directed directly to the author by e-mail to the following address: steinar.s.kvifte@ey.no.

1. Introduction

Financial statements should represent a useful tool for decision makers according to the Financial Accounting Standards Board (FASB): *"Financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions"* (FASB 1978, vii), and the decision usefulness objective has been adopted as the primary objective of financial reporting by the FASB and the other leading standard setters around the world. The FASB singles out the investors, the creditors, and their advisors as the primary users of financial statements.

The decision usefulness objective was adopted by the FASB in the conceptual framework project initiated in 1973. The conceptual framework project represented a shift from the so-called "Revenue-Expense view" (R-E view) to the "Asset-Liability view" (A-L view). The accounting practices at the time the shift was initiated were not uniform, and revenue and expense recognition was flexible to the extent that it was difficult to separate manipulation from proper application of the accounting rules. The FASB was concerned with the inability of the R-E view to give rise to objective recognition criteria, and attempted to solve the recognition problem by introducing a conceptual framework with emphasis on asset and liability definitions (A-L definitions). The reliance on the A-L view is common in the conceptual frameworks of the other leading standard setters as well.

The objective of financial reporting can more specifically be explained as the providing of *"(...) information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts (...)"* (FASB 1978, 37). The straight forward recognition of cash flows are not the most informative way of meeting this objective: *"Current earning, which reflect management reporting judgment, have been widely found to be value-relevant and are typically better predictors of future cash flow performance than current cash flows"* (Healy and Wahlen 1999, 367). Accrual accounting with an emphasis on earning and realizability in revenue recognition and on matching in expense recognition have traditionally been considered value relevant and thus decision useful. Earning, realizability, and matching are all

concepts playing an important role in the FASB Conceptual Framework. However, revenue and expense recognition should, according to the FASB, be modified by the A-L definitions. In the R-E view, on the other hand, there is no such modification of the accrual concept.

Whether the A-L definitions have proven to be successful in the efforts of the FASB and the other leading standard setters to develop objective recognition criteria is an open question, and will not be further investigated in this report. Regardless of the answer to the question, whether the A-L definitions represent a meaningful recognition criterion that can be deduced from the objective of decision usefulness is unclear. Literature dealing directly with this latter issue is scarce. The intention of this project was to provide relevant documentation about the relationship between the decision usefulness objective and the A-L definitions.

Several researchers have tried to demonstrate the decision usefulness of financial reporting information by analyzing the empirical evidence of the relevance of accounting information. However, the ability of empirical accounting research to offer policy-directed insights is inherently limited. The standard setters must evaluate likely reactions to policies not yet enforced, while real-world data only can inform of the reactions to policies that already exists. Furthermore, in spite of advanced methodological techniques, it is difficult to isolate the incremental effect of accounting alternatives (Kachelmeier and King 2002, 219).

An alternative approach to assessing the decision usefulness of the A-L definitions was chosen in this project. A survey in which a primary user group of the financial statements were asked to consider what kind of financial information they preferred in the financial statements; financial information prepared according to the A-L view or financial information prepared according to the R-E view, accompanied by illustrating examples, was developed. The survey was presented to a sample of financial analysts. Financial analysts may represent the most influential group of the primary users, with the exception of the investors themselves, and insight into their financial reporting preferences may

prove useful to the accounting standard setters. Also, from the perspective of the financial analysts, the financial statements are generally considered a particular valuable source of financial information: *"At the top of every analyst's list (of financial reports used by analysts) is the annual report to shareholders. It is the major reporting document and every other financial report is in some respect subsidiary or supplementary to it"* (Knutson 1992, 7).

The remainder of this report is organized as follows. In the next section, section 2, the survey design is explained, and in section 3 the findings are summarized. In section 4, concluding remarks are offered.

2. Survey Design

The survey design was questionnaire based. The questionnaire was presented to a sample of financial analysts.[3] The questionnaire design is commented on in section 2.1, and the sample procedure and the final sample are commented on in section 2.2.

2.1 The Questionnaire[4]

The questionnaire was developed primarily to deal with the main issue in question, namely do the A-L definitions provide useful information to the financial analysts? However, as explained above, in the conceptual framework context, this question should not be considered independently of the objective of financial reporting and the qualitative characteristics of financial information. Accordingly, the first section of the questionnaire dealt with general decision usefulness issues, while the second section dealt with recognition issues where the A-L definitions may modify recognition. Furthermore, to enable a more comprehensive analysis of the responses to the first and second sections, questions concerning demographics were included in the third section. The questionnaire is included in the Appendix B.

In the questionnaire, the objective was not directly revealed. The respondents were asked to address certain questions within the historical cost model and without regard to the current accounting legislation and regulation. The historical cost restriction was introduced in order to isolate the recognition issue of the A-L view and the measurement issue. To be sure to get the respondents preferences and not the preferences of the regulatory environment it was necessary to emphasis that the questions should be addressed without regard to current legislation and regulation.

[3] Lin Therese Hurlen Kvifte assisted me in the administration of the survey. I would also like to thank Sheila Panzavecchia and Curtis Harwell, both at the NYSSA, for their assistance in the questionnaire distribution process.

[4] Several people were involved in the development of the questionnaire, and I am greatful for their contributions. Professor Atle Johnsen, Professor Frøystein Gjesdal, the Norwegian School of Economics and Business Administration, and Professor Brett Trueman, Haas School of Business, UC Berkeley, all gave insightful technical advices. Michael Knie-Andersen, the University of Aarhus, shared his expertise in questionnaire design.

To investigate the decision usefulness of the A-L definitions, three cases in which the A-L view and the R-E view would lead to different recognition guidelines if the two views were applied rigorously, were developed. Each case was presented under two different conditions, certainty and uncertainty. Generally, the leading standard setters do not include a probability criterion in the A-L definitions, but rather as a separate recognition criterion. Two questions dealing with the same case, but under different conditions, were therefore introduced to be able to separate those who rejected a certain solution because of uncertainty and those who rejected the same solution because of it's A-L definitions inconsistency. The cases had to be simplified in order to make them apprehensible and in order to make the time needed to respond as short as possible. The last aspect was important in order to motivate a higher response rate. Numerical tables were provided for illustration purposes.

The three cases in the questionnaire involved income tax recognition, intangible asset recognition, and provision recognition.

More specifically, the first case involves the recognition of the effect of a tax carryforward loss. Even though the FASB argues otherwise in SFAS 109, recognition of a tax asset in the A-L view is questionable. Given the fact that tax asset recognition is in accordance with US GAAP, one may expect the respondents to be in favor of tax asset recognition in this case. Recognition of a tax asset is here considered to be in accordance (conflict) with the R-E view (the A-L view), and the non-recognition of a tax asset is considered to be in accordance (conflict) with the A-L view (the R-E view).

In the second case the question is whether expenditures associated with the purchase of a customer list should be capitalized and amortized or expensed as incurred. It is somewhat less clear whether a purchased customer list meets the A-L definitions, but the example is nevertheless useful in determining how analysts evaluate "soft assets" or intangibles. Furthermore, in this case two alternative amortization schedules were suggested if capitalization represented the preferred treatment. In practice, linear amortization is by far the most common amortization schedule. On the other hand, linear amortization

schedules are often difficult to support conceptually, except as a tool of cost allocation. The alternative amortization schedule is based on a matching concept, but may by some be interpreted as a tool of income smoothing. However, which of the two different amortization schedules is the preferred one is of lesser interest with respect to the primary issue in question here, and both will for simplicity only be referred to as two alternative approaches to capitalization in this report.

The Association for Investment Management and Research® (AIMR®), has officially advised against the capitalization of "soft assets" and smoothing (i.e. "normalization") (Knutson and Napolitano 1998). The non-capitalization alternative is here considered to be in accordance (conflict) with the A-L view (the R-E view), while the two capitalization alternatives are considered to be in accordance (conflict) with the R-E view (the A-L view).

In the third case a classic insurance example is introduced. The FASB used this example widely in the preliminary works leading up to the shift from the R-E view to the A-L view (FASB 1976, 59). The question is whether a self-insured entity should provide for expected future losses, or if the entity only should recognize losses if and when they actually occur. Two provision alternatives are introduced. However, with respect to the main issue in question here, these two alternatives are considered two equally relevant alternatives in the R-E view. Considering the rejection of the provision alternative by the FASB and the advise against smoothing policies by the AIMR, one may expect financial analysts to prefer the expense as incurred alternative. The expense as incurred alternative is here considered to be in accordance (conflict) with the A-L view (the R-E view), while the provision alternatives are considered to be in accordance (conflict) with the R-E view (the A-L view).

2.2 The Sample

Ideally, investors, creditors, and their advisors should all be approached in order to address the ultimate research question. However, neither the investors nor the creditors can easily be accessed, and budget constraints left these two groups out of the survey. On

the other hand, financial analysts are more readily accessible, for example through the financial analysts member organizations. A request was made to access a portion of the New York Society of Security Analysts (NYSSA), and permission was granted.

The NYSSA has approximately 8 700 members, and a screening of the member list based on self-reported titles suggested that a majority of the members fall into the primary user group of financial statements. It was decided to distribute the questionnaire at seminars and events the first three months of 2003, inviting all seminar and event participants to participate in the survey by allowing the participants to pick up the questionnaire at the registration desk. The response rate was at first close to zero. Therefore, participants at the weekly preparation seminars for Chartered Financial Analyst (CFA) candidates were singled out, and the survey was introduced at three different CFA-sessions in the beginning of March 2003. Furthermore, a survey lottery was established, in which three gift cards were to be drawn among the respondents. This produced 81 responses by the end of March. Due to budget constraints, no further actions were taken to increase the sample.

A demographical description of the sample is provided in tables 1-4 (Appendix A)

The formal educational background of the sample is summarized in table 1. 44% of the respondents have at least a graduate degree and/or a professional certification (Certified Public Accountant or Chartered Financial Analyst) (53% of the NYSSA-members has a graduate degree and 63% are Chartered Financial Analysts). Since close to all respondents participated at the review courses developed by the NYSSA to prepare candidates to the CFA examination, one can assume that close to zero of the respondents were CFA charterholders. In other words, the 44% of the respondents is to be compared to the 53% among the NYSSA-members. The academic background of the sample and the NYSSA-members is in other words similar, but their professional formal education clearly separates the two.

As illustrated in table 2, 65% of the respondents are security analysts, credit analysts, fixed income analysts, and mutual fund or portfolio analysts (as compared to 46% of the NYSSA-members), while 35% report to have other professional positions (stock brokers, equity traders, security product managers etc). A few respondents have professional positions that alone may not qualify them as "advisors of investors". However, the respondents in the "other" group are without exceptions CFA-candidates, and were therefore considered to qualify for inclusion in the sample.

32% of the respondents have little experience in their current position (less than three years). However, many of these respondents have experience from other positions in which financial reporting knowledge is essential. Thus, as shown in table 3, 84% of the sample may be considered to be experienced in the application of financial reporting statements under various circumstances.

As illustrated in table 4, 43% of the sample primarily deals with larger businesses (more than $ 1 billion in revenue) in their current positions.

The use of the survey approach to determine preferences in a population raises questions of coverage and representativity. Within a given population, here the financial analysts, a sample not biased towards a particular group of financial analysts with zero non-response errors in the data would be ideal. Consequently, an ideal survey design would consist of an unbiased sample of a size sufficiently large to be able to determine whether the A-L view or the R-E view is the preferred view among the financial analysts and to describe and estimate characteristics of each group. As explained above, it was not possible to carry out an ideal sampling procedure. However, it may be assumed that the demographic and geographical variance within the population of financial analysts in the US is not enough to bias the sample enough to make it inappropriate. Nevertheless, the consequence of the sampling errors and selection biases inherent in the sampling procedure, does not allow for generalization of the results of the survey to the population of the NYSSA members. Obviously, generalization of the results to the population of financial analysts in the US and/or primary users of financial reports as defined as the

FASB, would represent an inappropriate use of the results. Consequently, the survey should be considered an exploratory study from which the findings may be used to suggest financial analyst characteristics that may be tested in future research.

3. Findings

In all the three cases, the financial analysts revealed a preference for the R-E view alternatives both under certainty and uncertainty (tables 5-7 in Appendix A). Surprisingly, the preference for the R-E view alternative is lowest in the income tax case. When future revenue and expense numbers are uncertain (as in the real world), close to 50% of the respondents rejected the policy established in SFAS 109 which have been in effect in more than ten years. With respect to income tax accounting, thus, the support of the A-L view is significant but not dominant. In the intangible asset case, the R-E view alternatives received more than 70% support under both conditions (certainty and uncertainty). More than 60% supported the R-E view alternatives in the provision case under both conditions, even though a greater number than in the former case shifted their preference from a R-E view alternative to the A-L view alternative when certainty was replaced by uncertainty (13%).

Not surprisingly, the A-L view alternatives received consistently greater support under the uncertain conditions than under certain conditions. However, this finding is not necessarily relevant with respect to the issue in question here, namely whether the A-L definitions enhance the decision usefulness of financial information. As explained in section 2, the uncertainty associated with future events is generally accounted for by a separate recognition criterion, and is not considered to be a component of the A-L definitions. Interestingly, the relationship between the responses to each case under certainty and uncertainty conditions is statistically significant, implying that "more likely than not" with respect to the uncertainty involved exceeds the preferred probability criterion of the sample.

This finding may also shed some light on how the financial analysts interpret the reliability concept when asked to choose between two accounting policies each emphasizing primarily relevance and reliability, respectively. A larger proportion of the sample preferred the reliability-based policy than the relevance-based policy. These respondents may have associated reliability with "more likely than not" as compared to

the more stringent probability criterion adopted by the leading standard setters. However, this relationship was not further investigated.

To be able to analyze the data further, the respondents were classified as R-E view supporters, A-L view supporters, and inconsistent respondents. The R-E view supporters (the A-L view supporters) included the respondents preferring the R-E view alternatives (the A-L view alternatives) in all of the three cases under certainty. Respondents preferring both A-L view alternatives and R-E view alternatives were classified as inconsistent respondents. 35% of the respondents qualified as R-E view supporters while only 4% (three respondents) fell under the A-L view supporter classification. Thus, the A-L view supporter group was too little to be useful in any form of analysis. It may be assumed that the inconsistent respondents do not reject the A-L definitions per se, but may favor an application of them somehow determined by case-specific circumstances. In the following therefore, the respondents are classified as either R-E view supporters or Others, the latter group being sympathetic to the application of the A-L definitions but not necessarily "true" A-L view supporters.

Whether the respondents' preferences with respect to financial reporting objective, financial statements (income statement, balance sheet, cash flow statement, and notes), and qualitative characteristics (relevance and reliability) are associated with their preference for underlying perspective, and thus may be useful in explaining why certain financial analysts are R-E view supporters while others are not, was tested for.

All, but four respondents agreed that decision usefulness to the investors and their advisors should be regarded the primary objective of financial reporting. A majority of the respondents seems to find one of the two views more decision useful in certain cases, while the other view provides more decision useful information in other cases. A majority of the respondents prefer information meeting the decision making demand to information meeting the stewardship demand (75% and 21%, respectively, table 8 in Appendix A). However, no relationship between these two subsets of the decision usefulness objective and the two groups of respondents was detected. Similarly, no

relationships were found between preference for qualitative characteristics and the two groups (the preferences for qualitative characteristics in the sample are summarized in table 9 in Appendix A).

The most surprising finding suggests that financial analyst prefer cash flow statement information to earnings information (the preferences for financial statements in the sample are summarized in table 10 in Appendix A). The cash flow statement is, according to a majority of the respondents (60%), the most useful statement in achieving the objective of financial reporting as reported in question 1 while the income statement is reported to be the most useful statement by 18%. This finding is to some extent in line with the pre-survey expectation in that the cash flow statement and the income statement are considered the two most useful statements. However, the ranking order of these two, and the fact that a great majority of all respondents rank the cash flow statement as the most useful statement, represents a surprising finding. After all, the cash flow statement is generally considered more of a secondary statement in financial reports, and that less than one fifth of the respondents ranks the "primary" statement (the income statement (FASB 1978, 43)) over the cash flow is puzzling. Based on the ranking of the financial statements, one may intuitively expect the respondents to favor alternatives resembling cash flow accounting (the A-L view alternatives) in the three cases provided (questions 4 and 5, 6 and 7, and 8 and 9). However, the opposite is the case. On second thought, this relationship should not come as a surprise. Given the cash flow statement emphasis, cash flow information is not needed in the income statement. The fact that R-E view supporters tend to have a stronger preference for the cash flow statement than the Others is in line with this assumption (the R-E view supporters favor accrual accounting in the income statement). The findings therefore, may suggest that financial analysts view the cash flow statement as the primary statement of interest (the individually most useful statement), and the income statement as a secondary statement, providing an alternative base to predict future cash flows from. Nevertheless, based on the well-documented and commonly accepted knowledge of accrual accounting superiority in future cash flow prediction (Healy and Wahlen 1999, 367), the finding deserves further attention.

Tthe two groups did not differ with respect to demographical characteristics. The two groups were similar with respect to educational background, current position, length of experience, other relevant practice, and typical businesses analyzed. In other words, the demographics of the respondents do not seem to be an explanatory variable with respect to their preference for A-L view or R-E view produced financial information.

4. Concluding Remarks

The purpose of the survey was to explore whether the A-L definitions enhance the decision usefulness of financial reporting information. One of the user groups identified as primary users by the FASB and the other leading standard setters, namely the financial analysts, where selected for questioning.

One must be careful not to generalize the findings beyond the sample. The sampling errors and selection biases make generalization inappropriate. Nevertheless, the suggestions about financial analyst financial reporting preferences indicated by the findings should not be disregarded.

The A-L definitions are vague and it is not always clear whether they are effective in modifying the accrual concept. For instance, as explained, the FASB argues that a tax asset reflecting the effect of a tax carryforward loss meets the asset definition. Similarly, the assumption that capitalization of the customer list expenditures is in conflict with the A-L view may be questioned. On the other hand, the A-L definitions effectively reject the provision for expected future losses in the case of self-insurance. A rejection of the effectiveness assumptions adopted in the survey will obviously lead to a rejection of the findings as well.

The methodology applied assumes that the users of financial reports prefer decision useful information as defined by the FASB (information meeting the decision demand and the stewardship demand). This assumption may have to be modified with respect to the financial analysts, even though 96% of the sample agreed that decision usefulness to the investors and their advisors should be regarded the primary objective of financial information. The financial analysts may define decision usefulness differently than the FASB. The test design does not allow for this issue to be explored.

The findings of the survey suggest that the A-L definitions do not lead to enhanced decision usefulness of financial reporting information to the financial analysts. In each of the cases presented for the sample, a majority preferred an accounting treatment

conflicting with the A-L view, and only a few respondents (4%) found the A-L definitions providing the most decision useful information in all three cases. In comparison, more than one third of the sample preferred an accounting treatment in accordance with the R-E view in all of the three cases, indicating that the R-E view is the more decision useful perspective. A majority however, did not reveal a consistent preference pattern.

Although these findings alone cannot reject the decision usefulness of the A-L definitions, they suggest that further research should be conducted in order to determine whether the A-L definitions instead of enhancing the decision usefulness of financial statements rather obscures the decision usefulness.

The FASB is currently, jointly with the International Accounting Standards Board (the IASB), evaluating revenue recognition policies and intends to eliminate conflicts between revenue recognition guidelines in authoritative literature and the liability definition in the Conceptual Framework. The FASB seems to be determined to reach its objective within the A-L view. The findings reported here suggest that the FASB should broaden the scope of the project and initially evaluate the decision usefulness of the A-L definitions.

The most surprising finding of the survey revealed that the cash flow statement is the single most useful financial statement according to the sample. Based on the well-documented and commonly accepted knowledge of accrual accounting superiority in future cash flow prediction, this finding deserves further attention.

References

FASB 1976: *Conceptual Framework for Financial Accounting and Reporting: Elements of Financial Statements and Their Measurement*. Discussion Memorandum. Norwalk, CO: Financial Accounting Standards Board.

FASB 1978: *Objectives of Financial Reporting by Business Enterprises*. Statement of Financial Accounting Concepts No 1. Norwalk, CO: Financial Accounting Standards Board.

Healy, P. M, Wahlen, J. M. 1999: A Review of the Earnings Management Literature and Its Implications for Standard Setting. *Accounting Horizons* (December): 365-383.

Kachelmeier, S. J., King, R. R. 2002: Using Laboratory Experiments to Evaluate Accounting Policy Issues. *Accounting* Horizons (September): 219-232.

Knutson, P., 1992: *Financial Reporting in the 1990's and Beyond.* New York, NY: Association for Investment Management and Research.

Knudson, P. H., Napolitano, G. U. 1998: Criteria employed by the AIMR Financial Accounting Policy Committee in Evaluating Financial Accounting Standards. *Accounting Horizons* (June): 170-176.

Appendix A - Tables

The tables are referred to in chapter 6 as well and are included in Appendix B.

Appendix B – Cover Letter and Questionnaire

The cover letter and questionnaire is included in Appendix C.

Appendix F

ANALYSIS OF NORWEGIAN ACCOUNTING STANDARDS – "GRUNNLEGGENDE REGNSKAPSPRINSIPP" AND "PRINSIPP"

Accounting Standards, Exposure Drafts and Discussion Memos Prepared in Accordance with Current Legislation, September 2001

NRS 1 (1992/revidert 1998)	Varelager	(Inventory)
NRS 2 (1992/revidert 2000)	Anleggskontrakter	(Construction Contracts)
NRS 3 (1992/revidert 2000)	Betingede utfall og hendelser etter balansedagen	(Contingent Events and Events After the Balance Sheet Date)
NRS 5 (1989/revidert 1999/2000)	Ekstraordinære poster mv	(Extraordinary Items Etc.)
NRS 6 (1994/revidert 2000)	Pensjonskostnader	(Pension Costs)
NRS 7 (1997/revidert 2000)	Resultat pr aksje	(Earnings Per Share)
NRS 8 (1999/revidert 2000)	GRS for små foretak	(Small Enterprises)
NRS (F) (1992/revidert 1993/1999)*	Resultatskatt	(Income Tax)
NRS (F) (2000)*	Opplysninger om segmenter	(Segment Reporting)
NRS (F) (1999)*	Fusjon	(Mergers)
NRS (F) (1999)*	Investering i tilknyttet selskap og deltakelse i felles kontrollert virksomhet	(Associates and Joint Ventures)
NRS (F) (2000)*	Usikre forpliktelser og betingede eiendeler	(Uncertain Liabilities and Contingent Assets)

NRS (F) (1999)*	Årsberetningen	(The Directors' Report)
NRS (HU) (2000)*	Avvikling og avhendelse av virksomhet	(Discontinuing Operations)
NRS (F) (2000)*	Fisjon	(Demergers)
NRS (HU) (1998)* Financial	Finansiell risiko og finansielle instrumenter	(Financial Risk and Instruments)
NRS (F) (1996/revidert 2000)*	Delårsrapportering	(Interim Reporting)
NRS (F) (2000)	Immaterielle eiendeler	(Intangible Assets)
NRS (HU) (2000)	Transaksjoner og regnskap i utenlandsk valuta	(Foreign Currency)
NRS (D) (2000)	Kontinuitetsgjennomskjæring	(Group Transactions)
NRS (F) (2000)	Leieavtaler	(Leasing)
NRS (HU) (1999)	Nedskrivning av varige driftsmidler og immaterielle eiendeler	(Impairment)
NRS (F) (1999)	Konsernregnskap	(Consolidated Statements)

* These are referred to by numbers given to them in the chronological order they are listed above. NRS (F) Resultatskatt is NRS 9, while NRS (F) Konsernregnskap is NRS 24.

N GAAP	"Grunnleggende regnskapsprinsipp"	"God regnskapsskikk"*	"Prinsipp"**
1	1	0	2
2	2	0	4
3	0	0	0
5	0	6	1
6	0	1	2
7	0	0	0
8	13	>10	>10
9	0	3	7
10	0	1	0
11	0	3	3
12	0	1	0
13	1	4	9
14	0	1	0
15	0	2	0
16	0	0	5
17	1	1	0
18	6	4	0
19	0	0	0
20	0	7	9
21	1	1	5
22	1	1	2
23	0	0	0
24	0	2	1

* Is not accounted for if used as a reference to "God regnskapsskikk for små foretak", with the exception of NRS 8.
** "Prinsipp" is only accounted for if it is used to describe a "grunnleggende regnskapsprinsipp".

Note: As opposed to in Appendix A, here the numbering in each column, except for the N GAAP-column, refer to the number of times the reference is made in the document.