Understanding International Accounting Standard Setting

–

A case study of the process of revising IAS 12 (1996), *Income Tax*

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HANDELSHÖGSKOLAN I STOCKHOLM

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Understanding International Accounting Standard Setting – A case study of the process of revising IAS 12 (1996), *Income Tax*

Anja Hjelström

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In memory of my grandmother and best friend, Sonja

Preface

This report is a result of a research project carried out at the Center for Accounting and Managerial Finance at the Economic Research Institute at the Stockholm School of Economics.

This volume is submitted as a doctor's thesis at the Stockholm School of Economics. As usual at the Economic Research Institute, the author has been entirely free to conduct and present her research in her own ways as an expression of her own ideas.

The institute is grateful for the financial support provided by Rune Höglunds Minnesfond and Bankforskningsinstitutet.

Stockholm in February 2005

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ACKNOWLEDGMENTS

All things said and plenty done[i], all that remains is for me to write the very first words that some may read if and when they pick up the result of more or less ten years of labour. With this task before me, I'm first dumbfounded, empty of words, tired of writing. Pausing in this astonishment the first thing that comes to mind is a warning to presumptive readers. A casual reading of my conclusions – which I present in the form of suggestions as how the process of (international) accounting standard setting may be understood, and the implications thereof – might give the impression of a rather sombre picture of the prospects of such endeavours. I do not believe this is necessarily the only conclusion to draw from the material in this book. In this thesis I analyse some aspects of one means of bringing uniformity to accounting practices; problems associated with this alternative should not lead one to automatically look to other alternatives: the grass may only appear to be greener elsewhere.

After this, however, I am above all filled with gratitude to all those who have made the research project that lies behind this book possible – to those who have – again and again – lent me a hand, an ear, a word, an idea, a thought, an opportunity, financing, a smile and, sometimes, just a break from it all. This thesis is the work of one author, yet it is also a reflection of the input of many people, to whom I remain forever indebted.

Most of all I must express my gratitude to my tutor Professor Lars Östman. I have always wanted to travel – to see the World - for real and not just *in a Grain of Sand*[ii]. Over the years, Lars has shown me a different kind of travelling, always ready to offer me a different perspective on the World. So, although I've been stuck in one place for so many years, I have never once felt stuck. Often Lars' perspective has been about taking a larger picture into consideration, again and again making me realise that *a little learning is a dangerous thing*[iii] indeed.

Although I'm sure some will object, I'm glad that my time as a doctoral student at the Stockholm School of Economics has not just been about completing this thesis. However, when it has been, Lars has always provided a sharp intellect (including a strong sense for what might be interesting to pursue), practical guidance in how to proceed as well as infinite support and

encouragement to do this. Without him, this thesis would have been much less interesting and writing it would have been much less rewarding.

I am, of course, also very grateful to the other members of my thesis committee, Professor Jan Löwstedt and Professor Walter Schuster. Both have, in their own ways and with different focus points, challenged various aspects of my thinking. Especially in the final phase, they have also contributed significantly to the writing process, proposing improvements to both the overall structure and detailed presentation.

Special thanks are also owed to Authorised Public Accountant Sigvard Heurlin, whom I first met through my employment in 1991 – 1993 with what was then Öhrlings Reveko (now Öhrlings PriceWaterhouseCoopers). It was through his involvement in the work of the International Accounting Standards Committee (IASC) that I was first made aware of the existence of an extensive process proceeding the issuance of international accounting standards. This knowledge then provided what seemed like an interesting idea when I was looking for a research project. At the outset Sigvard also provided useful advice in how to proceed. Over the years he has also consistently cheered me on, always asking "How's it going?", inciting me to have a positive answer, next time.

For a long time, Professor Sidney Gray (now, Sydney University) also played that role. He also spent many, many hours with me, at the very outset, discussing alternative projects and plausible ways forward. Somewhat later on in the process, discussions with Professor Michael Power (London School of Economics) also proved enormously encouraging.

I must also express many thanks to the various people that have contributed to this research by generously answering my queries about their experience with the IAS 12 project. Without this input, I would never have attained the richness that I believe the material now has. Not to be forgotten is, of course, the generosity of the International Accounting Standards Committee, through its Secretary-General, Sir David Carsberg, in allowing me access to the IASC's internal files on which so much of this research project rests. I'm sure some of the IASC staff that I met in the spring of 1997 believed me to be a little bit crazy, spending – as I did – days doing nothing but getting in their way and clogging up their copying facilities. I'm sure that, to a certain extent, I was.

A special thank you must also be directed to those that have generously provided financial support for this thesis. Such support was initially obtained from Rune Höglunds Minnesfond and later from Stiftelsen Bankforskningsinstitutet. Many thanks also to those who have helped me with the practicalities relating to applying for such financing.

Many thanks are also due to all my colleagues the Stockholm School of Economics for general companionship, as well as input and encouragement. Professor Sven-Erik Johansson has read a summary of some of the ideas presented in this thesis and, as always, our discussions in relation to this have stimulated new thoughts and ideas. Niclas Hellman has read what I believed to be a final draft of the thesis and provided countless insightful comments on that; I only wish I had been able to accommodate more of them. Anna-Karin Brettel-Grip also deserves special recognition; many discussions with her have immensely clarified my own thinking. A special thanks must also be extended to Kalle Kraus who, over a lunch, not only challenged me, but also helped me, to summarise my thinking in a figure. Catharina Pramhäll, Hans Hällefors and Mikael Runsten have, more than anything, been good friends. As long as he was at the school, Christer Johansson was a reliable source not only of daily encouragement, but support and practical advice. In the final years, many early morning conversations with Acting professor Johnny Lind have also significantly contributed both to the pleasures involved in coming into the office and to my personal development.

Not to be forgotten are also my former colleagues at the Accounting Group (technical department) of what is today Öhrlings PriceWaterhouseCoopers. For the record it must be stated it was primarily Kerstin Fagerberg, Sten-Eric Ingblad and Professor Erling Peterrsohn who originally encouraged me to return to the Stockholm School of Economics with the objective of writing a doctoral thesis. It was also in working with these accounting experts that I was exposed to, and intrigued by, matters of accounting policy choice, accounting principles and the development of accounting standards. One regret is possibly that they will be disappointed, as this thesis is not really about “accounting” (however, you might check out Appendix 2 & 3).

Continuing along some kind of reversed chronology Professor Kenth Skogsvik must also be mentioned. In encouraging me (in 1990) to write my minor thesis about preferences relating to accounting standards/policies, he might be held responsible for setting the direction for my future path. Before

him, in turn, a team of teachers at Manshead Upper School, Dunstable, England (probably the best school I ever attended) deserve a long overdue thank you: Thank you for opening my mind, encouraging me to think and instilling in me a desire to aspire! Or maybe that latter part should be attributed to my parents.

Friends, family and others outside the walls of the Stockholm School of Economics have, of course, also contributed immensely to this project in a multitude of ways. Of these, Halldór Halldórsson must be thanked especially for helping me with the design of the cover.

In the end, the one person who has perhaps both contributed and endured the most, is my husband, Tomas. He has suffered endless discussions of all kinds of matters, at all sort of hours, too many drafts as well as too many other requests for practical assistance. Often smiling, always loving, never complaining: *you stay the course, you hold the line, you keep it all together*[iv]…. Next to Tomas comes, of course, our children, probably still too young to realise that, too often, their parents talk of weird stuff indeed. They will be happy that this ordeal is over, but I guess that so far they are only impressed by the cover! This is the day *I* (and you) *have been waiting for!* [i]

Whoever thinks a faultless piece to see,
Thinks what ne'er was, nor is, nor e'er shall be.[iii]

Stockholm, February 1st 2005

Anja Hjelström

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i Butterfly Boucher (2004), 'Life is short', *Flutterby*
ii William Blake (1803-6, 1863), *Auguries of Innocence*
iii Alexander Pope (1711), *An Essay on Criticism*
iv Sarah McLachlan (2004), 'Push', *Afterglow*

CONTENTS

PART I
INTRODUCING THE RESEARCH PROJECT 1
1 INTRODUCING THE THESIS..... 2
2 BACKGROUND 6
2.1 Introduction 6
2.2 Accounting and accounting policies..... 6
2.3 The desirability of standardisation 9
2.4 Arguments for (and against) regulation..... 12
2.5 Accounting regulation 13
2.6 A historical perspective 16
2.6.1 A historical perspective on accounting 16
2.6.2 A historical perspective on accounting regulation 18
2.7 The research issue..... 25
3 PRIOR LITTERATURE & RESEARCH OBJECTIVE..... 30
3.1 Introduction 30
3.2 A chronological overview of previous literature on accounting rule-making..... 30
3.2.1 Introductory summary..... 30
3.2.2 An initial focus on accounting policy choice..... 31
3.2.3 A subsequent focus on accounting rule-making 35
3.3 A thematic overview of previous literature on accounting rule-making 47
3.3.1 Introduction..... 47
3.3.2 Interests 48
3.3.3 Participation in the formal lobbying process 52
3.3.4 Content of formal comment letters..... 56
3.3.5 Relative influence 57
3.3.6 The role / impact of formal lobbying 64
3.3.7 The implications of relative influence / the political aspects of accounting rule-making..... 65
3.3.8 The rule-making process 66
3.4 Concluding comments & research objective 77
4 METHODOLOGY 80
4.1 Introduction 80
4.2 Methodological considerations..... 80
4.2.1 Some fundamental considerations..... 80

4.2.2 The research approach 82
4.2.3 A grounded theory approach? 84
4.2.4 The availability of data 85
4.3 The choice of a standard setting process 87
4.3.1 Selection criteria 87
4.3.2 The IASC's standard setting process in general 90
4.3.3 Main characteristics of the identified processes 97
4.4 Data collection and analysis 99
4.4.1 Introduction 99
4.4.2 The documents 99
4.4.3 Constructing a time-axis 100
4.4.4 Distilling a chronological description 102
4.4.5 Asking questions 104
4.4.6 The Interviews 107
4.4.7 The thematic analysis 114

PART II
THE SPECIFIC CASE 116
5 INTRODUCING THE CASE 117
5.1 Introduction 117
5.2 Accounting for deferred tax – the issues 117
5.3 The original Standard 120
6 1981 – 1990 THE FIRST ED 123
6.1 Introduction 123
6.2 1981 – 1984 The IASC Working Party on Deferred Tax 123
6.2.1 Introduction 123
6.2.2 The issues 125
6.2.3 The Working Party 125
6.2.4 The level of application of deferred tax 129
6.2.5 Perspectives on the process 131
6.3 1986 – 1988 Project initiation 131
6.3.1 Onto the agenda 131
6.3.2 Setting up a Steering committee 133
6.4 1988 Developing the first Exposure Draft (E33) 135
6.4.1 Introduction 135
6.4.2 The issues 139
6.4.3 Level of application [I-2] 142
6.4.4 The criteria for partial application [I-2p] 144
6.4.5 Revaluations [I-10] 146

6.4.6 Tax loss carryforwards [I-7] 148
6.4.7 Choice of liability method [I-3] 149
6.4.8 Perspectives on the process 150
6.5 1989 The comment period 154
6.5.1 Concurrent developments 154
6.5.2 The comments to E33 155
6.6 1989 – 1990 After the comments to E33 160
6.6.1 Introduction 160
6.6.2 How to proceed with the project 161
7 1992 – 1994 THE SECOND ED 165
7.1 Introduction 165
7.2 1990 – 1992 Reactivating the project 165
7.3 1992 – 1994 Developing a second ED (E49) 167
7.3.1 Introduction 167
7.3.2 The issues 170
7.3.3 The choice of liability method [I-3] 173
7.3.4 Revaluations [I-10] 185
7.3.5 Investments in subsidiaries, associates & joint ventures [I-8] 187
7.3.6 Intra-group profits [I-9] 193
7.3.7 Government grants [I-22] 197
7.3.8 Non-deductible assets [I-19][I-16a] 199
7.3.9 Recognition issues [I-5][I-7] 205
7.3.10 Issues of procedure 209
7.3.11 Perspectives on the process 209
8 1994 – 1996 THE REVISED STANDARD 218
8.1 Introduction 218
8.2 October 1994 – May 1995 Comments to E49 218
8.2.1 Concurrent developments 218
8.2.2 The comments 219
8.3 June 1995 – October 1996 Developing IAS 12 (revised) 228
8.3.1 Introduction 228
8.3.2 The issues 231
8.3.3 The choice of the balance sheet liability method - A non-issue? [I-3] 235
8.3.4 Issues relating to the definition/nature of tax base and, related to that, the drafting of the standard 237
8.3.5 Exceptions 256
8.3.6 Disclosures 270
8.3.7 Due process considerations [I-41] 273

8.3.8 Perspectives on the process 275
9 THE PARTICIPANTS AND THEIR ROLES 285
9.1 Introduction 285
9.2 The decision-makers 286
9.2.1 Introducing the IASC Board 286
9.2.2 Board activities 287
9.2.3 Significance of the Board 294
9.2.4 Discussion of observations 295
9.3 The task force 297
9.3.1 Introducing the IAS 12 Steering Committee 297
9.3.2 Steering Committee activities 298
9.3.3 The Steering Committee Chairman 300
9.3.4 Significance of the task force 301
9.3.5 Discussion of observations 304
9.4 The Staff 305
9.4.1 Introducing the IASC staff 305
9.4.2 The Project Managers 306
9.4.3 The Secretary-Generals 312
9.4.4 The Technical Directors 313
9.4.5 Discussion of observations 313
9.5 The Observers 319
9.6 The formal consultants 322
9.7 The commentators 324
9.7.1 Introducing the commentators 324
9.7.2 Comments received 325
9.7.3 Significance of comments received 326
9.7.4 Discussion of observations 328

PART III
THE FINDINGS 335
10 BEYOND THE SPECIFICS 336
10.1 Introduction 336
10.2 A model of accounting standard setting 338
10.2.1 Introduction 338
10.2.2 The political process 339
10.2.3 The learning process 346
10.2.4 The executive process 352
10.2.5 Interactions 356
10.3 Conditional factors 358
10.3.1 Introduction 358

10.3.2 The issue 358
10.3.3 The individuals..... 364
10.3.4 The organisation of the process..... 367
10.3.5 The agenda, strategy and external events..... 368
11 SUMMARY & DISCUSSION..... 370
11.1 Introduction 370
11.2 Summary..... 370
11.2.1 Part I – The Introduction..... 370
11.2.2 Part II – The specific process..... 374
11.2.3 Part III – The Findings..... 375
11.3 Discussion of the suggested findings in relation to previous literature..... 379
11.3.1 Introduction..... 379
11.3.2 The model of accounting standard setting 379
11.3.3 The political process 381
11.3.4 The learning process 383
11.3.5 The executive process 384
11.3.6 Conditional factors..... 384
11.3.7 The issues..... 385
11.3.8 The individuals..... 387
11.3.9 The organization of the process 391
11.3.10 Agenda, Strategy & external events..... 391
11.4 Concluding discussion..... 392
11.4.1 The research objective revisited..... 392
11.4.2 Implications of proposed findings..... 394
11.4.3 Discussion of future research topics 397
11.5 Concluding comment..... 400

APPENDIX 402
A1 IDENTIFIED ISSUES 403
A1.1 Introduction 403
A1.2 The sorted list of identified technical issues..... 404
A2 THE ISSUES..... 407
A2.1 Introduction 407
A2.2 Differences between financial and tax accounting policies..... 408
A2.2.1 Timing and permanent differences..... 408
A2.2.2 Temporary differences 409
A2.3 Fundamental issues..... 411
A2.3.1 Introduction..... 411

A2.3.2 Method of accounting for deferred tax effects [I-3]..... 411
A2.3.3 The level of application of tax effect accounting [1-2].. 418
A2.3.4 Discounting [I-4]..... 419
A2.3.5 Recognition criteria for deferred tax liabilities and assets [I-5] ..... .420
A2.4 Detailed issues 422
A2.4.1 Introduction..... 422
A2.4.2 Revaluation of assets [I-10] 422
A2.4.3 Temporary differences arising on initial recognition [I-19][I-21][I-22]..... 423
A2.4.4 Fair value adjustments arising on business combinations [I-16a]..... 424
A2.4.5 Goodwill arising on business combinations [I-16b] 425
A2.4.6 Negative goodwill arising on business combinations [I-16c]..... 426
A2.4.7 Investments in subsidiaries, associated companies and joint ventures [I-8]..... 426
A2.5 Issues relating to financial statement presentation 428
A2.6 Issues relating to tax losses and credits [I-7]..... 429
A3 NUMERICAL EXAMPLES 431
A3.1 Introduction 431
A3.2 The base case..... 431
A3.3 The extended base case..... 434
A3.4 Example 1 – Revenue is taxed when realised..... 436
A3.5 Example 2 – Expense is tax deductible when paid 447
A3.6 Example 3 – Accelerated depreciation 457
A3.7 Example 4 – Revaluations 473
A3.8 Example 5 – Non-deductible asset 480
A3.9 Example 6 – Government grants 488
A3.10 Example 7 – Pre-paid non-tax deductible expense 497
A3.11 Example 8 – Fair value adjustments arising on business acquisitions..... 503

REFERENCES 517

PART I

INTRODUCING THE RESEARCH PROJECT

The first part of this thesis is essentially concerned with detailing the undertaken study. Apart from a short introduction (chapter 1) it also contains three chapters covering the background to the research project (chapter 2), prior literature and research objective (chapter 3) and methodology (chapter 4).

1 INTRODUCING THE THESIS 2

2 BACKGROUND..... 6

3 PRIOR LITERATURE & RESEARCH OBJECTIVE 30

4 METHODOLOGY 80

PART I

CHAPTER 1

INTRODUCING THE THESIS

This thesis is about an important phenomenon in our world today: the regulation of financial accounting information. More specifically it is about how a significant form of such regulation – accounting standards[1] – comes into being, i.e. the standard setting process.

Why is this important? Because such regulations affect the production of financial accounting information which, in turn, is seen to affect most of us. In fact, many would argue that today few, if any, persons remain unaffected by the numbers reported in various financial accounting reports.

Furthermore, standardisation of accounting practices is generally perceived as both desirable and important for an efficient capital market. The main vehicle of attaining this has been seen, and continues to be seen, to be through regulation (rulemaking). In fact, considerable energy and resources continue to be expended on accounting regulation, particularly standard setting. This holds true both at the national level and, more recently, at the international, even global, level. Despite this, however, there is continuing dissatisfaction with what has been achieved, criticism being expressed over the standard setters, the standard setting processes, as well as the standards being produced. In the wake of such criticism, there are also continuing reforms, old standard setting efforts being replaced by new ones.

There is a large body of writings on accounting regulation in general and accounting standard setting in particular, both by academics and by practitioners. In summary this literature basically says that accounting rule-making is complicated because it is political. That is, it is complex because it involves bargaining/compromising between different interests in society. Previous literature does not, however, venture very far beyond this, discussing issues such as what this means in practical terms for the standard setting process and/or for the standards.

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1 Accounting standards are a common form of accounting regulation, generally developed through some form of private sector committee. See section 2.5 (pp. 13f).

This thesis reports a research project which was set up with the objective of achieving a better understanding of the nature of the (international) accounting standard setting process. Such an understanding, it was hoped, might shed light on the various criticisms that continue to be directed towards standard setting efforts.

More specifically this thesis reports the findings of a detailed case study of one international accounting standard setting process: the process of developing International Accounting Standard *IAS 12* (revised), *Accounting for Taxes on Income*. This standard was issued by the International Accounting Standards Committee (IASC) in 1996. This case is interesting in itself, not only because income tax constitutes a considerable expense for many reporting entities (hence significantly affecting the reported accounting information), but because when issued, it suggested a change in financial accounting practices in most countries in the world.

A significant part of this book, at least in terms of pages, tells the story behind the IASC's decision to require the balance sheet liability method of accounting for deferred tax effects. However, as noted above, the primary ambition with the project has not been to draw up a historical account. Instead, the project was undertaken with the aspiration of an improved understanding of the nature of the accounting standard setting. The fundamental research questions for this project have thus been phrased in terms of: *How are standards set? What factors and forces affect the standard setting process? How? With what consequences?*

Since the project was set up the IASC has been replaced by the International Accounting Standards Board (IASB). However, this does not diminish the relevance of this report. Instead it is suggested the findings – the understanding (theory) – that have emerged from the project relate to accounting standard setting in general and are not specific to the IASC, or even to the setting of *international* accounting standards.

Apart from its international focus, the research reported in this thesis differs from much previous research into accounting standard setting in several other important aspects. First, while most published research in this area is also empirical, this tends to rely primarily on official comment letters, sometimes in combination with interviews. This study, however, relies heavily on non-public material from the standard-setter's archives. In-depth interviews with individuals are also an important source of data. Second, this

material is used in an inductive approach. In contrast, most prior studies have explicitly assumed some kind of theoretical framework (often on the topic that the standard setting process is political). Third, this study focuses as much on developments *within* the standard setter as on developments *outside* the standard setting body. Few prior studies appear to have addressed the former aspect.

This report has three parts:

- Part I is essentially concerned with detailing the undertaken study. It includes three chapters covering the background to the research project (chapter 2), prior literature and research objective (chapter 3) and methodology (chapter 4).

- Part II contains an account of the studied standard setting process. Following an introduction to the specific case (chapter 5) this part consists primarily of a chronological account of process (chapters 6, 7 & 8). A final chapter (chapter 9) complements this account by addressing the roles played by various participants in the process.

- Part III presents (chapter 10) and discusses (chapter 11) the findings, i.e. the understanding of the accounting standard setting process generated by the review of the process of revising IAS 12. In short it is suggested that the process of setting accounting standards may be understood in terms of the developments of, and interplay between, three sub-processes. It also suggests that a number of conditional factors can be seen to affect the nature of these processes in the specific case.

Some may find the above disposition somewhat "unorthodox", with five chapters (219 pages) devoted to the case (the data) and only two chapters (67 pages) devoted to the conclusions. This composition may lead one to ask two questions: *Why include so much detail from the case? Is this all?*

My reply to the first question would first be that it is the very nature of the in-depth investigation into the empirical case that has allowed me to think freely about the research questions, i.e. how standards are set and what factors and forces affect the standard setting process etc. If I had not presented the data on which my suggestions are based, I would have expected criticism relating to the credibility of my conclusions.

In addition I would also emphasise that the account provided in part II, despite its length, remains a summary account of a very complex process spanning over 16 years. As is noted in chapter 4 the time-axis documents on which the analysis is based consist of almost 2,000 pages. The conducted interviews add almost another 400 pages. Even so, these documents do not represent a complete picture. I would also argue that the account in part II cannot only be characterised as "mere description", it is an interpretation (based on an analysis of various data) of a complex process. Moreover, each of the chronological chapters also includes sections that reflect on the observations ("Perspectives on …"). The discussions in these sections form the basis for chapter 10. Chapter 9 is similarly a mix of data, analysis and conclusions.

Part of my response to the second question has already been given; chapter 10 must be seen as a summary of the suggestions in part II. Furthermore, although the findings of the study may not seem much when presented as they are in chapter 10, it is argued in chapter 11 that they highlight some very fundamental problems involved in accounting rule-making and raise some fundamental questions about the prospects of accounting standard setting.

PART I

CHAPTER 2

BACKGROUND

2.1 Introduction

The purpose of this chapter is to specify the research objective and to set out the problem background, i.e. to explain why the regulation of financial accounting in general, and the setting of international accounting standards in particular, is an important and fascinating subject for financial accounting research.

The chapter starts (2.2) by defining accounting and by setting out two characteristics of accounting that are fundamental for understanding the problem background: that the production of accounting information involves choosing between alternative accounting policies and that such choices are often controversial. The following two sections develop the problem background by arguing that standardisation of accounting policy choices is generally perceived to be desirable (2.3) and that some form of accounting regulation is generally perceived to be necessary to achieve this (2.4).

Section 2.5 sidesteps the main argument somewhat, pausing to reflect on the meaning of accounting regulation. In particular this section discusses the term accounting standards. The following section (2.6), however, takes us closer to the research problem by providing a historical perspective on accounting and accounting regulation. The research issue is then specified in section 2.7.

2.2 Accounting and accounting policies

Accounting is often said to be the language of business with its own set of terminology and grammatical rules (Kinserdal, 1995: ix). More formally, accounting is often defined in terms of being a system for recording, measuring and communicating (reporting) the financial aspects of an entity, its activities (transactions) and other events.

Traditionally a distinction has often been made between financial (external or public) accounting and management (internal or non-public) accounting. However, significant inter-relationships between the two exist. For example,

it is generally argued that publicly reported accounting information cannot be ignored in internal communications. Nevertheless the focus of this project is on the regulation of financial accounting. Furthermore, in order to avoid unnecessary repetitions the term *accounting* is used in this meaning.

Today the information generated by accounting is normally communicated in the form of annual and interim *reports*, in particular in the form of various *financial statements* (an income statement, a balance sheet, a cash flow statement and, more recently, a statement of changes in equity) and related (footnote) *disclosures.* In fact, the "great strength" of accounting is often seen to lie

> in its ability to aggregate and organize masses of disparate data into understandable form. (Who but an accountant could compress the worldwide operations of Exxon into a half-dozen pages?)
> (Gerboth, 1987: 2)

Traditionally accounting information has been seen as performing two functions, both of which can be understood in terms of reducing uncertainty. Under the *stewardship* function financial statements are understood in terms of facilitating the evaluation of managements' stewardship by reporting on past performance. This, in turn, is seen to facilitate the contracting between various parties. With the growth of capital markets, accounting information has also come to play an important role for investors in the selection of alternative investments. Under this view, accounting information is seen to reduce the uncertainty of expectations of future performance, or more accurately, future cash flows. The term *decision usefulness* is often used to denote this function of accounting information.

Many have written on and about this distinction . For example, quoting Ijiri (1993) Gorelik argues that, whereas the focus under the stewardship function is on "a fair system of information flow between the accountor and the accountee" (1994: 99), the focus under the decisions-usefulness approach is solely on the users right to know: "there is no need to balance the interests of information suppliers and receivers" (ibid).

More recently Östman (2004, 2003) has added to the discussion of the role of accounting information by noting that there appears to be two, fundamentally different, flows of such information today. On the one hand, various entities provide extensive and voluminous accounting reports that meet the requirements set up by various regulatory efforts. On the other

hand, both external and internal parties seem to focus on a few select accounting measures that may be more or less decoupled from the regulated accounting information. For example, recently there has been a tendency to focus on performance measures that do not correspond to those reported in the official income statement, such as operating income before goodwill amortizations. Östman further suggests that it is this information that plays the decision-usefulness role and that the regulated information has lost some of this role, gradually becoming more of a legal document to be referred to in the case of disputes. He thus suggests that time and effort invested in the production of this information can be seen as a form of insurance expense (2004: 17).

A fundamental characteristic of accounting is that the production of accounting information gives rise to a large number of choices between alternative accounting policies, i.e. between alternative ways of reflecting transaction and events. A distinction is often made between policies of *recognition* (when to reflect a transaction / event in the accounting), *measurement* (by how much) and *disclosure* (what information to provide).

A key issue in accounting practice and accounting theory thus concerns how such choices are/should be made. A fundamental characteristic of accounting is that it is often not possible to argue that one accounting policy is necessarily *better* than another, neither in terms of producing more *accurate*[1] measures, nor in terms of producing more *useful*[2] information.

Another fundamental characteristic of accounting is that even if it were possible to determine accounting policy choices on a technical basis (i.e. on the grounds of producing more accurate or useful numbers), such choices would nevertheless tend to be controversial. This is because different parties in the accounting environment are likely to have both different preferences regarding the choice of accounting policies and incentives to contend these choices. The mainstream explanation for why different parties may have different preferences with regard to accounting policy choice is based on a combination of an assumption of self-interests and the recognition that different policies may have significantly different *economic consequences*[3] for various parties. An alternative, or perhaps complementary, explanation is

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1 See discussion in relation to the true-income approach on page 33.

2 See discussion in relation to the decision-usefulness approach on page 33.

3 See explanation on page 35.

provided by institutional theory, suggesting that accounting policy preferences are determined by rules about how society works or should work (a logic of appropriateness). The foremost advocates of this perspective are perhaps Laughlin and Puxty. They have suggested the concept of *worldviews* as an alternative to *interests*:

> Thus it will be clear that there are fundamental differences between the constructs of interest and worldview. The former is based upon the individual and gains its legitimacy from the view of the individual as a self-seeker. Members of interests groups are those with common interests. The latter is a social perspective, and understands the individual as a member of society rather than seeking to understand the social process as the result of individual preferences. (1983: 459)

2.3 The desirability of standardisation

Notwithstanding the lack of generally accepted criteria for choosing accounting polices the literature contains a number of arguments as to why it is desirable that the accounting policies of different reporting entities are standardised, so that like transactions and events are reported in the same way. Although the arguments for standardisation of accounting practices were originally made in a national context they have, parallel to the increasing globalisation of business - particularly the growth of the multinational enterprise (MNE) - and the related globalisation of the finance market, been extended to apply on an international bases.

The most prominent arguments for standardisation is perhaps that uniform accounting polices are necessary for financial accounting information to be useful, particularly comparable and credible[4]. A modern version of the credibility argument is, for example, found in the following quotation in respect of the information provided when the German based company Daimler Benz was listed in New York:

> Investors were undoubtedly confused by these disclosures, and, no doubt, asked themselves the question: which set of accounting rules produced the correct figures; US GAAP, with a loss of DM 1,839 million or the German rules with a profit of DM 602? They probably concluded that neither figure was to be trusted. Certainly the whole episode did great damage to the credibility of accountants. (Flower, 1997: 284)

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4 The IASC Framework for the Preparation and Presentation of Financial Statements (1989d) lists four qualitative characteristics that make accounting information useful: understandability, relevance, reliability and comparability. However, it can also be argued that information that is not credible, is not useful.

Another common argument is that standardisation is necessary to raise the *quality* of financial accounting information (by eliminating "bad" and "less good" accounting policies in favour of "better" accounting treatments).

These arguments are normally extended by arguing that more comparable / credible / higher quality accounting information reduces users' information-gathering costs *and* their uncertainties and hence their demands for risk premiums. Standardisation of applied accounting policies is, in other words, argued on grounds of increasing the efficiency of the financial markets. These arguments apply both in a national and international context. Arguments that international accounting diversity constitutes an important impediment to the efficient functioning of the international capital market(s) and that a reduction of such diversity would increase the efficiency of these markets (this market) by allowing a free(er) flow of capital to the most efficient business and lowering the cost of capital are often found in the literature (e.g. Samuels & Piper, 1985: 75; Meek & Saudagaran, 1990: 167).

Other arguments for standardisation of accounting practices are also based on a notion of increasing the efficiency of the economy. For example, standardisation is also argued on the basis of decreasing various costs of reporting enterprises. These costs include costs that multinational groups incur in having to deal with different accounting practices being used by different subsidiaries and other affiliates, both in preparing consolidated financial statements and in controlling these entities. Identified costs also include direct and indirect[5] costs for multi-listed enterprises having to prepare dual (or more) sets of accounts (e.g. Samuels & Piper, 1985: 77).

A third type of argument for standardisation of accounting practices is based on the notion of creating level competitive playing fields. It has, for example, frequently been argued that UK based entities enjoyed an "unfair" advantage when they, in contrast with companies in many other countries, were allowed to write off goodwill on consolidation directly to equity. Another version of this argument is that standardisation of accounting requirements is necessary to avoid potential negative consequences of (nation) states, or capital markets, competing to offer the most favourable

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5 Direct costs include those for the preparation and auditing of dual reports. Indirect costs include the disadvantages associated with having to report alternative measures of performance (see above quotation from Flower, 1997).

reporting requirements (Flower, 1994: 14-16). This is, for example, believed to be the case of US state regulations a hundred years ago:

> Company law being a state and not a federal matter, certain states sought to attract companies to their territory by the enactment of very favourable (i.e. non restrictive) laws on company accounts. It is generally agreed that this competition was won by the state of Delaware, which explains why, to this day, many important companies, such as the Coca Cola Corporation, are resident in this state, despite it being the smallest state in the Union (ibid: 16)

More recently, from a Nordic perspective, there were discussions at the end of the 1990s of Finnish companies enjoying an (unfair) advantage, Finnish accounting principles being more lenient towards the pooling of interest method. In this period it was noted that several business combinations / mergers where Finish companies were involved were arranged so that Finnish accounting principles were to be applied, thereby avoiding significant goodwill amortizations affecting reported net income, e.g.:

> Finnish and Swedish accounting standards differ with respect to acquisition and pooling of interests accounting. These differences relate to the application of the purchase method to share exchange transactions and the pooling method to the unitings of interests.
> … Goodwill arising from the combination of Tieto and Enator in 1999 …... With an estimated useful life of 20 years the calculated annual goodwill amortisation would have been EUR 30 million during 2003 and the unamortised balance would have been EUR 467 million at 31 December 2003. This annual amortisation would have affected earnings per share by EUR 0.74. (http://www.tietoenator.com/)

To be noted, however, is perhaps that the assumption that the application of standardised accounting policies will increase the comparability, credibility and quality of accounting information is neither straight-forward nor undisputed, as evidenced by a US uniformity / flexibility debate in the 1960s[6], by the more recent harmonisation debate and, even more recently, the debate on accounting regulation following various accounting scandals.

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6 Writing in 1965 Keller noted that "(t)he controversy ... over 'uniformity' versus 'flexibility' has probably attracted more attention to the practice of public accounting than any other debate since the enactment of the Securities Act of 1933 and the Securities and Exchange Act of 1934". For an account of this debate, refer to e.g. Langenderfer (1967) and Bevis (1966).

A key concern in this discussion is what is to be considered as like events and transactions, i.e. of identifying which differences in circumstances justify the application of different accounting policies. Other concerns include the issue of transaction being designed so that they conform to the rules in fact, but not in spirit, thus restricting genuine comparability (e.g. Johansson & Östman, 1995: 82).

2.4 Arguments for (and against) regulation

Notwithstanding these counter-arguments many argue that some form of standardisation is desirable and, in turn, that some form of active co-ordination, some form of accounting regulation, is necessary to achieve this. Grounded in economic theory, proponents of regulation have argued that the solution (the information provided) in an unregulated context will be either inefficient (because of market-failures due to public good qualities of the information, information asymmetry and speculation problems) or unfair (e.g. Beaver, 1989: 179f).

Arguments against the desirability/necessity of accounting regulation, on the other hand, also tend to be grounded in economic theory, suggesting either that an unregulated market will allocate financial information efficiently (or at least satisfactorily) or that it is not enough to argue that the unregulated market will fail to meet the objectives of efficiency and equity, that it is also necessary to show that regulation can be expected to be the best way to achieve these objectives. Some writers argue that proponents of accounting regulation fail to do this; that their analyses are incomplete and subject to the *grass-is-always-greener* fallacy[7] and/or the fallacy of *not-knowing-how-to-identify-the-colour-of-the-grass*[8]. [9]

Another type of argument against regulation is based on capture theory. These arguments suggest that – contrary to the view that regulation exists to promote public interest (or even to protect the investors) – the prime beneficiaries of regulation are those being regulated (e.g. Walker, 1987:

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7 This fallacy signifies that the alternative solution, regulation, is not investigated to the same extent as the market solution (e.g. Leftwich, 1980: 195).

8 The failure to show that the theoretical optimum to which the market solution is compared can be produced under a set of feasible institutional arrangements (Leftwich, 1980: 194-7).

9 This literature is referred to in chapter 3 under the heading “information economics” (p. 36).

281). This may be conceived to be the reporting companies / the preparers (e.g. Beaver, 1989: 183) or the accounting profession (auditors & preparers) in general (Walker, 1987: 283).

Another argument, which might be construed as an argument against accounting regulation, is the suggestion that such regulation tends to be crises-oriented and reactionary, rather than pro-active. Linked to this is also the suggestion that the true concern of accounting regulation (in the US) may not be the efficiency of capital markets in the broad sense outlined above, but the restricting of financial fraud:

> There is some evidence that Congress in creating SEC mistook accounting for auditing – and auditing for fraud detection. The historical record suggests that the real concern of Congress was, and still is, financial fraud, which neither financial reporting nor auditing is intended to catch. (Hendriksen & van Breda, 1992: 246)

The literature discussing the desirability/necessity of regulation is very rich. Several authors have also previously tried to summarise it (e.g. Beaver, 1989; Bromwich, 1992; Hendriksen & van Breda, 1992; Taylor & Turley, 1986; Watts & Zimmerman, 1986). For the purpose of this text, however, it seems sufficient to note that since the early 20th century accounting regulation is an important element of the accounting environment in most countries, suggesting a general acceptance of the arguments for standardisation as well as for regulation to achieve this. Taking off in the 1970s, international accounting regulations have also appeared, suggesting a general acceptance of the arguments for international standardisation and regulation to achieve this.

2.5 Accounting regulation

This section sidesteps the main line of reasoning somewhat, pausing to reflect on the meaning of the key concept - accounting regulation - introduced in the last section. Two points need to be made in relation to its usage in this text.

The first is that a narrow definition of accounting is adopted; the focus is on regulation aimed at co-ordinating accounting policy choices.[10] The second is

[10] An alternative definition of accounting regulation may, for example, include all regulation aimed at co-ordinating various aspects of the *supply* and *use* of accounting information.

that regulation is interpreted broadly; encompassing many types of rules with the objective to co-ordinate accounting policy choices. This is because the literature suggests that each country / region has its own system of financial accounting regulation consisting of a mixture of rules issued by a number of regulatory bodies with varying levels of authoritative backing and sanctions.

The adopted definition of accounting regulation corresponds roughly to the definition suggested by Taylor and Turley:

> the imposition of constraints upon the preparation, content and form of external financial reports by bodies other than the preparers of the reports, or the organizations and individuals for which the reports are prepared. (1986: 1)

Taylor and Turley suggest that there are three fundamental approaches to accounting regulation:

- by the accounting profession through convention, precedent and training;
- by private sector regulatory institutions, for example, associated with the accountancy profession or the stock exchange; and
- by public sector institutions, e.g. through company law (1986: 3).

Flower and Ebbers (2002: 78), however, distinguish between no less than six types of accounting rules (figure 2.1). On the one hand their hierarchy of rules is useful in that it clearly demonstrates the richness of the phenomena encompassed by the term regulation. On the other hand, it can be criticised for not adequately reflecting some of the difficulties associated with categorising various types of regulations. For example, while they suggest that the rules on the top two levels are rules which must be obeyed and the rules on the lower levels "are included in the system of rules because, to varying degrees, they are complied with" (ibid: 80), it must be noted that varying degrees of authority seem possible on several levels in their pyramid of rules.

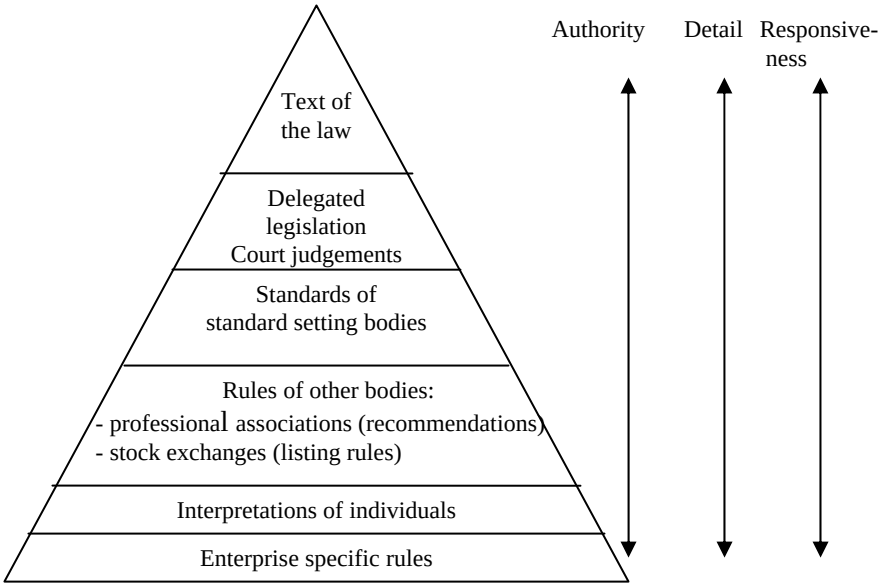

Figure 2.1 The hierarchy of rules (From Exhibit 3.2 in Flower & Ebbers, 2002: 78)

To be noted is also that the rules on the two bottom levels are not generally encompassed by the term accounting regulation. Furthermore, on the other hand, accounting regulation is sometimes seen to also include "generally applied accounting practices" (e.g. Flower, 1994: 20), something that is difficult to fit into the above hierarchy[11].

A third point of criticism is that the distinction between standards, recommendations and listing rules – which is based what type of body (other than a legislator) sets the rule – is not generally used. Instead, presumably for the sake of simplicity, it is often assumed that there are two basic types of regulation: laws (rules set by a legislator) and standards (rules set by others, often private sector committees). The reader is warned though that terminology in this field is far from standardised[12] and that also this latter distinction is not without problems. For example, in some cases the law may

11 In Sweden, however, the application of "good accounting practice" is required by the law (Jönsson & Marton, 1994: 197). Hence, it might be argued that it is included in the above.

12 For example, van der Tas defines standards as "any financial reporting rule published by either the government or a private standard setting body" (1988: 157). Under this view, a law is a standard.

be so constructed that rules developed by bodies independent from the legislator may have the force of law. This is the case with the EU Regulation[13] which requires that, beginning in 2005, all publicly listed companies domiciled in the EU prepare their consolidated financial statements in accordance with (endorsed) international accounting standards.

In this context it is perhaps interesting to note that that the term standard "originally stood for a banner whose purpose was to orient and gather the scattered forces in a battle" (Gorelik 1994: 100) and that the term accounting standard appeared in the US as late as in 1973, following the report of the Wheat Committee[14] criticising the term previously used in the US: accounting principles (ibid: 98, 101, 102). The term was adopted in the UK and Canada in 1969 and 1982 respectively (ibid: 102).

2.6 A historical perspective

Accounting and accounting regulation are human activities and as such they have changed in response to the development of society at large (e.g. Jönsson, 1988: 1). This section takes us closer to the research problem by providing a historical perspective on accounting and accounting regulation.

2.6.1 A historical perspective on accounting

Accounting, in the sense of records of economic activities, has been traced back thousands of years to the first signs of written language. Grandell (1972: 1) refers to a finding from 3,500 BC. The double-entry book keeping system on which accounting of today is based has been traced to north Italian cities in the 13th - 15th century, from where it spread internationally during the following centuries (ibid: 13). The practice to close the accounting books periodically (to draw up income statements and balance sheets), however, only developed in the 17th century (Jönsson, 1988: 2).

Although today's accounting thus extends back many centuries, several authors emphasise that it "has a recent history and a checkered past" (Fogliasso et al, 1991) taking off in the wake of the Industrial Revolution – with its increase in the scale of business activity and the rise of the limited liability corporation – in mid-nineteenth-century Britain and in the late

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13 Regulation (EC) No 1606/2002, see e.g.: http://europa.eu.int/comm/internal_market/accounting/ias_en.htm.

14 The Wheat Committee was set up in 1971 by the American Institute of Certified Public Accountants to study the process by which accounting standards should be set (e.g. Fogliasso et al, 1991).

nineteenth/early twentieth century in the US. In short, the separation of ownership interest from that of management is seen to have created a need for accountability of management to the owners and this, in turn, created a need to record in order to report (and a need to audit in order to trust and to analyse in order to understand) (Littleton and Zimmerman, 1962: 255 in Gorelik, 1994: 99). It has also been argued that the financial accounting that emerged for this new type of business entity was based on the concurrent estate accounting model and, as a result of this, had a distinct stewardship orientation and was firmly rooted in the principles of historical cost and conservatism (Beattie, 2002: 95).

Those familiar with accounting practices of today will find that descriptions of those of the early 20th century suggest that much has then happened in the past century:

> Early 20th century financial statements were not very informative, usually consisting of a very condensed balance sheet and only sometimes a brief income statement. Many companies changed accounting policies, such as depreciation and capitalization, from year to year, in order to meet their profit goals. Residual equity accounts, then called surplus, often included appraisal surplus from writing up assets to appraised values, paid-in surplus, donated surplus, as well as earned surplus and any other surplus which might exist. Dividends were paid out of the common surplus account, regardless of its source. Losses and writedowns were commonly charged to the surplus account so that income would not be affected. (Fogliasso et al, 1991)

Apart from the Industrial Revolution the 20th century saw a number of other developments in society at large which also had profound effects on accounting. Most importantly, perhaps, is that the beginning of the 20th century saw the development and growth of active markets for shares. As noted previously (p. 7), it has been argued that this brought a new function for accounting information, that of assisting investors in the selection of alternative investments.

Over the years, the capital markets have not only grown in importance, but the focus has shifted from being mainly a national, to an international, even a global concern (e.g. Flower & Ebbers, 2002: 18). In addition to the growth of the capital markets, the 20th century also saw the development of the

MNE [15], which also posed new challenges for financial accounting. In 1965 Mueller reflected on this, arguing that that "accounting is ill-prepared for comprehensive data accumulation and interpretation on an international scale" (ibid: 388). Both as an item of curiosity, and to provide a historical perspective, it is noted that it was only one year prior to this that IBM for the first time reported earnings on a world-wide consolidated basis (ibid: 387).

Since then the rapid developments in information technology have lessened the strains imposed by such comprehensive data accumulation. More recently, some authors have suggested that developments in information technology may also mean that the financial accounting system as we know it, with one-for all audited financial statements based on one set of accounting policies, may drastically change as a result of developments in information technology (e.g. Kinney, 1996).

Nevertheless, it has also been suggested that the increased complexity of business transactions has made it more difficult to account for the operations of a business entity on a short term periodic basis in the concise manner as suggested in the quotation at the start of this chapter (p. 7). Östman (2003) mentions, for example, the prevalence of various financial instruments, the increasing importance of intangible assets, as well as the increasing complexity of business acquisitions and other forms of co-operations between legal units.

2.6.2 A historical perspective on accounting regulation

The development of accounting regulation is closely related to that of accounting itself. Although the first (European) accounting law has been traced to 1673[16], accounting regulation (primarily standard setting) seems to be primarily a 20th century phenomenon. Initially, accounting regulation seems to have consisted mainly of governments acting "through corporation laws and companies acts" (Moonitz, 1974: 64). However, in most countries accounting regulation of today consists of a complex mix of public and private sector regulation, laws being supplemented by various types of

[15] Mueller refers to "a new form of business organization", which is "internationally owned and controlled" and has "a truly international orientation for all of its business functions, including management, production, marketing, and finance" (1965: 388). Taylor (1987: 161) also refers to enterprises which have both international operations and ownership.

[16] The 1673 Savary ordonnance, a French decree required, amongst other things, all merchants in France to keep accounting records (a journal) and to draw up an "annual inventory" (Walton, 1995: 5) (Flower & Ebbers, 2002: 140).

standards. Although significant differences between regulatory systems in different countries remain, there seems to be a general trend toward the use of accounting standards. However, at the same time there also seems to be a trend towards (legally) requiring conformity with these standards, making the former statement problematic. More recently, an increasing role of international accounting standards in the national context further complicates matters.

Accounting standard setting appears to be closely related to the growth of capital markets, appearing in the US in the 1930s (following 1929 Wall Street crash), but really taking off after the Second World War in the US, the UK and Canada, but also in other countries. For example, in Sweden recommendations on good accounting practice started being published in 1957 (Zetterlund, 1998: 4).

The literature contains numerous accounts of the specific developments in various countries. Generally, it appears that, over time, dissatisfaction with previous efforts have led to repeated replacements of standard setting bodies with new bodies. For example, in the US the Committee on Accounting Procedure (CAP) was replaced by the Accounting Principles Board (APB) in 1959, which in turn was replaced by the Financial Accounting Standards Board (FASB) in 1973. In the UK the Accounting Standards Committee (ASC) was similarly replaced by the Accounting Standards Board (ASB) in 1990. A summary of such these developments is provided figure 2.2a. Similar summaries of the developments in Australia and Canada are attempted in figures 2.2b and 2.2c. To be noted is, however, that data within this field is often both scarce and inaccessible to an outsider, so the information in the figures should be read with reservations. A fourth figure summarises information of developments in Sweden and internationally (figure 2.2d).

Gorelik has suggested some common trends in the developments relating to accounting standard setting in Canada, the UK and US up until the 1990s. With respect of the standard setting bodies, he suggests a general movement from diffused to compact bodies, i.e. to smaller bodies with full-time, salaried members (1994: 120). A related development is that the newer bodies tend to have larger independence from the accounting profession (ibid). With respect of the standards Gorelik suggests a movement towards stricter standards allowing fewer alternative policies. With regard to the process by which the standards are set, finally, Gorelik suggests a movement

from an incremental approach to more extensive use of due process and reliance on conceptual frameworks (ibid).

<table>
<tr><th>US</th><th>UK</th></tr>
<tr><td>1939 – 1959
Committee on Accounting Procedure (CAP)
Statements on accounting principles</td><td rowspan="3">1942 – 1969
Council of the Institute of Chartered Accountants in England and Wales
Recommendations</td></tr>
<tr><td>1959 – 1973
Accounting Principles Board (APB)
Accounting Bulletins</td></tr>
<tr><td rowspan="2">1973 –
Financial Accounting Standards Board (FASB)
Statements of Financial Accounting Standards (SFAS)</td><td>1969 – 1990
the Accounting Standard Committee (ASC)
Statements of Standard Accounting Practice (SSAP)</td></tr>
<tr><td>1990 –
Accounting Standards Board (ASB)
Financial Reporting Standards (FRS)</td></tr>
</table>

Figure 2.2a Summary of regulatory developments in the US and UK

Since the early 1970s national regulations have been topped with international accounting standards. The main initiative in this area has, until recently, been the efforts of the *International Accounting Standards Committee* (IASC), issuing some 40 *International Accounting Standards* (IASs) between 1974 and 2000. In 2001 the IASC was superseded by the *International Accounting Standards Board* (IASB), which is set to issue *International Financial Reporting Standards* (IFRSs). [17]

Other international initiatives include efforts by the EU, the UN and the OECD (e.g. Haller & Walton, 2003: 14-9 & Rahman, 1998). To be noted is perhaps also that the IASC was preceded by the Accountant's International Study Group (AISG), formed in 1966 by the institutes in Canada, the UK and the US (e.g. Choi & Bavishi, 1982: 161).

[17] More details on the IASC are provided in section 4.3.2 (pp. 90f).

Australia	
1946 1965- 1965	Institute of Chartered Accountants in Australia (ICAA) *Recommendations on Accounting Principles* *Statement on Accounting Principles and Recommendations on Accounting Practice (Statement on Accounting Practice)* ICAA and Australian Society of Accountants (ASCPA) set up the Australian Accounting Research Foundation (AARF), to undertake research into accounting and to draft accounting standards
Early 1970s 1974	*Statement of accounting standards* issued jointly by ICAA and the Australian Society of Accountants (ASA), separate committees, technically each body "issued" the same statements. Above committees amalgamated into Accounting Standards Committee with the AARF.
1978 – 1988	Accounting Standards Board (AcSB) within the AARF *Australian Accounting Standards (AAS),* technically still issued by the two professional bodies.
1984	Corporations law changed to require companies to comply. Federal Government established Accounting Standards Review Board (ASRB) to 'approve' those AAS applicable to companies (i.e. no longer self-regulation, support of State & Federal Law).
1988 - 1991	ASRB merged with AcSB to become responsible for ASRB standards applicable to corporate reporting entities (within AARF).
1988 - 1999	Public Sector Accounting Standards Board (PSASB) created within AARF to be responsible for AAS Standards (for public sector and non-corporate reporting entities).
(1989) 1991 - 1999	ASRB reconstituted to become Australian Accounting Standards Board (AASB), mixed membership, technical support from AARF. (ICAA and CPA Australia both still technically responsible for issuing AASB and AAS Standards.)
2000 - …	AASB kept name but major changes to Corporations Act removed control of ICAA and CPA Australia, set up AASB as statutory body independent of AARF (but under control of government-appointed Financial Reporting Council (FRC)), and made AASB responsible for issuing all accounting standards.
2002	The FRC directed AASB to adopt all IASB Standards by 2005 (but position of AASB not changed).

Figure 2.2b Summary of regulatory developments in Australia (Craswell, 2001: 117- 8; Stoddart, 2000; Walker, 1987)[18]

[18] Much information in this table from e-mail communication (041129) with Dr. Ellen K. Stoddart, Senior Project Manager - Australian Accounting Standards Board.

Canada
1938 – 1941 Research Committee of the of the Canadian Institute of Chartered Accountants (CICA)
1941 – 1946 Accounting Research Committee of the CICA
1946 –1973 Committee on Accounting and Auditing Research of the CICA *Recommendations for good accounting practices* (issued as bulletins) 1968 – Recommendations organized into the CICA Handbook & Recommendation that deviations from the Handbook be specified (this recommendation recently withdrawn) 1972 - Security administrators issued national policy statement that GAAP defined as compliance with the CICA Handbook
1973 – 1982 Accounting Research Committee (ARC) of the CICA *Recommendations* in the CICA Handbook
1982 – 1991 Accounting Standards Committee (AcSC) of the CICA *Recommendations* in the CICA Handbook
1991 – Accounting Standards Board (AcSB) of the CICA *Recommendations* in the CICA Handbook Structure has changed over the years, e.g. Board downsized from 13 to nine members in 1999.

Figure 2.2c Summary of regulatory developments in Canada (e.g. Beechy, 2001: 537-40) [19]

[19] Much information in this table from e-mail communication (041130) with Peter Martin, CA, Director, Accounting Standards, The Canadian Accounting Standards Board.

<table>
<tr><th>Sweden</th><th>International</th></tr>
<tr><td>1957/1964 – 1989
Redovisningskommitté (Accounting Committee) of the professional institute for certified auditors (FAR) [20]
Recommendations</td><td></td></tr>
<tr><td>1976 –
Bokföringsnämnden (BFN)
(the Accounting Standards Board)[21]
Recommendations</td><td rowspan="2">1973
International Accounting Standards Committee (IASC)
International Accounting Standards (IAS)</td></tr>
<tr><td>1989
Redovisningsrådet (RR, the Swedish Financial Accounting Standards Council)[22]
Recommendations</td></tr>
<tr><td></td><td>2001
International Accounting Standards Board (IASB)
International Financial Reporting Standards (IFRS)</td></tr>
</table>

Figure 2.2d Summary of regulatory developments in the US and UK

The replacement of the IASC with the IASB follows the previously identified trend of national standard setters moving from diffused to compact bodies with larger independence from the accounting profession.[23] The identified trends with regard to the *standards* and the standard setting *process* also seem to fit the history of the IASC. For example, the first standards issued were, in similarity with many initial national standards, criticised for being mainly descriptive and too flexible to achieve

[20] After February 2001 FAR is the professional institute for authorised public accountants (*auktoriserade revisorer*), approved public accountants (*godkända revisorer*) and other highly qualified professionals in the accountancy sector in Sweden.

[21] The BFN is a state agency originally established in connection with an Accounting Act, it did not replace the Accounting Committee of the FAR, rather the two bodies existed alongside.

[22] This was established in co-operation by the BFN, the FAR and the Confederation of Swedish Enterprise. However, the BFN has also remained.

[23] Although the IASC Board was a relatively small body in terms of seats/votes, it was a large body in physical terms (pp. 90 & 92). In contrast the IASB consists of 14 individuals. Most of the seats on the IASC Board were occupied by Member Bodies (i.e. representatives of professional accountancy bodies). The members of the IASB, however, should be selected so that the IASB "will comprise a group of people representing … the best available combination of technical skills and background experience of relevant international business and market conditions in order to contribute to the development of high quality, global accounting standards" (Information on http://www.iasb.org.uk/).

standardisation (Choi & Bavishi, 1982: 163; Daley & Mueller, 1982: 45; Rivera, 1989: 325; Chandler, 1992: 226; Nobes, 1990: 85 and Salter & Roberts, 1996: 22). However, in the late 1980s the IASC announced a change in strategy, adopting a more normative approach by raising its ambitions to produce strict standards.[24] Also in similarity with such trends the IASC has shown concern with its due process and adopted a Framework for the Preparation and Presentation of Financial Statements (1989).

Over the years, the IASC came to enjoy greater significance. Part of this has been attributed to the explicit support received by the International Organization of Securities Commissions and Similar Organisations (IOSCO)[25]. More recently, the developments within the European Union have also given new significance to IASs/IFRS (p. 16). In addition, proposals to require IASs/IFRSs have also been made in Australia (all companies starting 2005) and New Zealand (listed companies starting 2007) (Pacter, 2003). Pacter concludes that by 2005 IFRS will be required for listed companies in at least 60 countries and permitted in another 21 countries, noting also that an even larger number of countries will allow IFRS for foreign issuers.

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[24] This shift was clearly signalled by the adoption of the Comparability Project, with the objective of reducing the number of allowed accounting policies in previously issued IASs. This project was adopted in 1987 and the first stage of this undertaking was completed in January 1989 when Exposure Draft E32, *Comparability of Financial Statements* was published. Following a review of comments to this exposure draft, the project was extended to also deal with other improvements in the affected standards and hence it became known as the Comparability / Improvements Project. This project, in turn, was completed in 1994, when ten revised IASs were published to become effective at the beginning of 1995.

[25] The IOSCO was formed in 1983 through the transformation of the Interamerican Conference of Securities Agencies and Similar Organisations (1974) into an international body. Wallace states that this change was made in response to a desire to extend the co-operation to other countries, especially Japan (1990: 18). The first securities regulators to join the membership from outside the Americas were from France, Indonesia, Korea and the United Kingdom (1984). In 1987, when the IOSCO joined the IASC's Consultative Group, 35 countries were represented on IOSCO (IASC, 1987b). Today the IOSCO has 181 members regulating more than 90% of the world's securities markets (http://www.iosco.org/about/about.cfm?whereami=page15).

Another recent development affecting the status of the IASB has its origins in the recent US accounting scandals. The US Sarbanes-Oxley Act[26] requires that the US standard setter (the FASB)

> considers, in adopting accounting principles … the extent to which international convergence on high-quality accounting standards is necessary or appropriate in the public interest and for the protection of investors (Pacter, 2003).

Following this, the IASB and the FASB have issued a joint memorandum of understanding, formalising their commitment to the convergence of US and international accounting standards (ibid). Although it remains to be seen what will come of this agreement, it has been described as a landmark (Barker, 2003).

2.7 The research issue

Reflecting on US developments in 1989 Beaver noted that, in an era otherwise marked by significant deregulation of the economy, calls for additional accounting regulation were "an all time high" and financial reporting requirements were being issued at an "unprecedented rate" (ibid: 1). He also foresaw that:

> Rapid growth in additional financial reporting requirements and rapid changes in existing requirements are likely to continue to be permanent features of the financial reporting environment. (ibid: 1-2)

A few years later, Johansson and Östman similarly noted that:

> There has been increasing emphasis in recent years on the content and design of accounting information in the public domain. … Considerable energy is being expended in giving the public more uniform accounting information, both at national and international levels. (1995: 1)

Both statements still seem to hold, the trend of increased regulation of accounting seemingly unaffected by recent trends in deregulation of commerce (Brown & Tarca, 2001: 268). Indeed, the various recent accounting scandals in the US, and elsewhere, have led to renewed attention to, and calls for, increased regulation of accounting. Implicit in such suggestions is dissatisfaction with present arrangements.

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[26] This Act, also known as the Corporate Accountability Act, applies to publicly owned companies in the US. It was enacted to "protect investors by improving the accuracy and reliability of corporate disclosures" (Abrams & Yellin, 2003).

This time, the main focus seems to be on the need for corporate managers to take responsibility for the truthfulness of their financial statements (e.g. Berube, 2002) and on the audit aspect of the supply of accounting information. The spotlight, however, has also been on the nature of the standards being issued, particularly, but not exclusively, by the US standard setting body, rekindling earlier discussions of *standards overload*:

> The term "standards overload" is one that has been used off an on over the years by the FASB's various constituent groups to describe their concerns about not only the volume of accounting rules and the level of complexity and detail of those rules, but also the resulting profusion of footnote disclosures and the difficulty of finding all the accounting rules on a particular subject. (FASB, 2002a)

Although this is not a new issue, it has now been linked more firmly to the issue of international harmonisation of accounting regulations. For example, a 2002 article in the Wall Street Journal contrasts the (at the time) 34 existing IASs with the output of the FASB:

> The FASB has, at last count, enshrined generally accepted accounting principles into three volumes comprising some 4.530 pages. Some of the FASB rules run to over 700 pages on how to book a single transaction. It should surprise no one that two skilled accountants, looking at the booking of the same transaction and using their knowledge of the same rules, come out with different results. (Wriston, 2002)

It is in this context that the concept of a *principles-based approach* to standard setting (which is contrasted to a rule-based approach) seems to have become the latest buzzword in the accounting regulation debate. This discussion is grounded in concerns that detailed (rule-based) accounting standards are not only difficult and costly to implement, but that they

> allow for structuring transactions that meet the literal requirements of the rules, but ignore the intent and spirit of the standards (FASB, 2002b).

The IASC, in turn, has also received its fair share of criticism, even following the shift towards stricter standards in the late 1980s. One often cited criticism concerns the perceived strong influence of Anglo-American accounting practices on IASs (e.g. Chandler, 1992: 225). While there are those who argue that IASs are (nothing but) a "Trojan Horse concealing the Anglo-Saxon accounting enemy inside a more respectable international façade" (Nobes & Parker, 2000: 75), others have settled at criticising the IASs for reflecting an Anglo-American approach to financial reporting at the expense of other approaches, e.g.:

> For the first twenty years of its existence, the IASC did not issue a single standard that was in fundamental opposition to US GAAP. On the other hand, the IASC has issued many standards which prescribe accounting treatments that are not permitted under the ruled of Continental European countries … (Flower, 1997: 289)

More recently (1996), the US Securities and Exchange Commission criticised the IASC for not having issued enough standards (covering core issues) and that the standards were not of sufficient quality (resulting in comparability and transparency)[27]. Other critics have focused on the IASC's standard setting processes. Initially, it was criticised for its lack of a conceptual framework (e.g. Rivera, 1989: 321). Such a framework, however, was approved in 1989. More recently, Flower reports criticism of the IASC's standard setting process being perceived as superficial:

> Denny Beresford, the chairman of the US Financial Accounting Standards Board, has made very similar comments. At an international meeting of standard setters in June 1996, he was very critical of the IASC's procedures, suggesting that it needed to spend more time on research, adding 'there is a serious danger of very superficial standard-setting or a perception that some members are voting on conclusions that they don't understand… Can there really be credibility to a process when there is a serious possibility that some of the materials are read for the first time on the plane to the meeting?' (1997: 302).

In 1997 the IASC set up a Strategy Working Party, to consider what IASC's future strategy and structure should be. As already noted, this has led to the replacement of the IASC with the IASB.

In short the situation can thus be summarised as follows:

- Accounting policy choice is complicated by a combination of two factors:
  a) it may not be straight-forward from a technical perspective and
  b) it may be controversial since different parties in the accounting environment may have *both* different preferences *and* incentives to contend for these preferences.

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[27] These were conditions set up by the SEC on its acceptance of IASs for foreign companies listed on American Stock Exchanges. See, e.g. Flower (1997: 299). In response to the first criticism, the IASC started a *Core Issues Project* and in response to the second, the IASC set up the *Standard Interpretations Committee* (SIC), beginning operations in 1997.

- Standardisation of (international) accounting practices is believed to be both desirable and important.
- The main vehicle of attaining this has been seen, and continues to be seen by many, to be through regulation, particularly through (international) accounting standard setting.
- Considerable energy and resources have been, and continue to be, expended at accounting rulemaking, particularly standard setting.
- Despite this, there is continuing dissatisfaction with what has been achieved, criticism being expressed over the standard setters, their process of developing the standards as well as the standards being produced.

Against this background it is suggested that research contributing to the understanding of accounting regulation, especially international accounting standard setting, is highly motivated. In particular it is hoped that an improved understanding of the nature of the standard setting process can shed light on the various criticisms that continue to be directed at standard setting efforts.

Over the years, repeated calls for research in this field have been made. For example, following the explicit recognition of economic consequences of accounting policies Gerboth (1973: 479) suggested that the fundamental concern of accounting inquiry should be how rules for computing income and wealth should be determined. A number of authors have also argued that our understanding of accounting regulation / standard setting is not what it should be. With increasing significance attached to efforts to standardise accounting policy choice on an international (or global) level, calls for research into accounting regulation have been extended to apply to international accounting standard setting, e.g.

> … But if our understanding of national processes of change are minimal, that of the factors implicated in national diversity, its consequences and the preconditions for its reduction is even less. (Hopwood, 1986: 5)

> … our understanding of many key aspects of international accounting is more rudimentary than many people think and than some would want us to believe. The processes of institutionalisation in the area are poorly understood. The emergence of interests in international accounting has not been explored. Little is known to outsiders of the complex and shifting politics that pervade the area.

> There is a dearth of serious and analytical research on almost all aspects of supranational accounting…
> (Hopwood, 1994: 250-1)

In 1995 Kenny and Larson argued that although the IASC "is recognized as the leader in the movement to harmonize international accounting and reporting standards" (ibid: 238), its standard setting process had not been extensively researched. In 1998, Rahman similarly noted that the issue of international standard setting "has been largely neglected in the literature" (ibid: 594). In 2002 Flower and Ebbers similarly argued that there has been "very little research on how the IASC set standards" (ibid: 281).

As noted in chapter one, the overall objective for the research project reported in this thesis has been to further contribute to the understanding of the international accounting standard setting process. This objective is further discussed at the end of the next chapter (3.4, p. 77). This is preceded, however, by a review of previous literature on accounting regulation in general, and (international) standard setting in particular. The objective of this review is to determine what this literature tells us about accounting rulemaking and (international) accounting standard setting.

CHAPTER 3

PRIOR LITERATURE & RESEARCH OBJECTIVE

3.1 Introduction

The literature on accounting regulation is, to say the least, vast. This chapter attempts to answer the question: What does (and doesn't) this literature tell us about accounting rule-making in general, and standard setting in particular? The primary purpose of this chapter is thus to further elaborate on the background to the adopted research objective by describing the present theoretical framework of accounting rule-making / standard setting.

The chapter starts with a broadly chronological overview of previous literature on accounting rule-making[1]. The objective of this section (3.2) is to identify various trends in the literature and placing these developments in a broader context. The main body of the chapter then presents what is considered to be the most relevant literature from a thematic perspective. The objective of this part (3.3, p. 47) has been to summarise what the previous literature tells us about accounting rule-making (standard setting). The chapter closes (3.4, p. 77) with some concluding comments reflecting on this issue and on the implications for the research reported in this thesis.

3.2 A chronological overview of previous literature on accounting rule-making

3.2.1 Introductory summary

In short this section identifies the 1950s as a kind of starting point for academic research and literature on accounting and accounting rule-making. It further describes how this literature was initially (≈ 1950 - 1960s) focused on the criteria for accounting policy choices, but then (≈ 1970s) more or less turned its back on this issue, focusing instead of the process of accounting

[1] It is not unlikely that some literature in other fields – e.g. on decision-making in organizations – might shed some light on the issue of accounting regulation. Given the amount of literature specifically addressing accounting regulation, however, the focus has been on this literature.

rule-making. This literature, in turn, is discussed in three sub-sections differentiating between: deductive writings, more empirically oriented research and contributions by accounting practitioners.

3.2.2 An initial focus on accounting policy choice

Identifying a starting point

Section 2.6.1 suggests that today's accounting has its more recent roots in the mid/late 19th century (pp. 16-17). Roughly at the same time accounting (indeed mercantile subjects) entered into the academic world. Engwall (1992: 4) dates the first more advanced school of business to 1820 (École Supérieure de Commerce, Paris). The first university level course in accounting has been traced to 1883 to the newly (1881) established Wharton School of Finance and Commerce at the University of Pennsylvania, USA (Flower & Ebbers, 2002: 122). This seems to have been followed by a break-through for this type of institution, several business schools at university level being established around the turn of the century and in the first twenty years of the twentieth century (Engwall, 1992: 5).

The first accounting academics (including the first professors) seem to have been part-time accounting professionals. Writing on UK accounting history Whittington suggests that this might explain a shortage of academic research in the first decades of the last century:

> At the end of the Second World War, there were no full-time professors of accounting in the United Kingdom, all chairs in the subject to that date having been occupied on a part-time basis by practitioners, and conesquently there was little academic research in the subject. (1995: 252)

On a similar theme, a US report argues that:

> …, academic accountants prior to the 1950s were a dichotomous lot. Most accounting professors in American Universities were far more oriented towards practice than towards academic research. Many were former practitioners or were contemporaneously engaged in accounting practice. A comparatively small number of academics possessed doctorates.
> (AAA, 1977: 6)

Doctorates (PhDs) in accounting[2] (or indeed in business administration) – and hence what might be perceived as (academic) research in accounting – seem to have started becoming more frequent in the US, but also elsewhere[3], in the 1950s[4] (AAA, 1977: 6; Gaffikin, 1988: 23).

However, there were significant writings relating to accounting both before the mid/late 19th century and the mid 20th century. From a Swedish perspective it is, for example, noted that in 1912 and 1915 respectively, Sillén published two practically oriented texts on short cuts and control methods in (business) arithmetic and modern accounting methods (Engwall, 1992: 209).The second of these writings seem to have been fundamental to Sillén being offered a chair in business administration at the Stockholm School of economics in 1915 (Wallerstedt, 1988: 140).

From an international perspective the early part of the 20th century is marked by Schmalenbach's publications on *Grundlagen dynamischer Bilanzlehre* in 1919 and Schmidt's *Die organische Tageswertbilanz* in 1921 (e.g. Potthoff & Sieben, 1995; Clarke & Dean, 1995). Both of these books enjoyed several reprints throughout the 1920s. Schmalenbach also continued to make contributions in related areas (e.g. cost accounting and standard chart of accounts) through the 1930s and 40s (e.g. Potthoff & Sieben, 1995: 87-94).

In the US, significant texts on accounting theory also started appearing in the 1920s. A 1977 report lists thirteen US contributions dating from the 1920s onward[5] in the category *the first /classic US theoretical tradition* within accounting (AAA, 1977: 5). Quoting Chambers (1965: 33), this report also argues that these early writings cannot be characterized in terms of "development", but constitute "a series of disconnected episodes".

The AAA report also suggests that, in similarity with the previously identified European writings, the early US contributions can be seen to represent two types of writings. Some of these are identified as positive and inductive, dealing with (identifying, summarizing, comparing, rationalizing)

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2 It seems that many early accounting academics had doctorates in economics.

3 The fist Swedish doctorate theses on the subject of accounting has been identified as one defended by Västhagen in 1950 (Engwall, 1992: 177).

4 However, Paton's 1922 book *Accounting Theory* was reportedly (based on) his doctoral thesis (Hendriksen & van Breda, 1992: 97).

5 Paton's thesis from 1922 is the first, see previous footnote. Most of the identified works are from the 20s and 30s, but two are from the 50s, three from the 60s and one from 1975.

accounting practices. Others are identified as normative and deductive, concerned with the construction of a coherent accounting theory from a number of explicitly identified premises. Or, in other words, others are concerned with identifying logical criteria for accounting policy choices. Given that many of these early accounting academics had a background in economics, a natural starting point for this search was (neoclassical) economic theory. In other words, attempts were made to deduce the best accounting policies from the theoretical concepts of wealth and income. Sometimes these writers are thus referred to as advocates of "true income" theory[6].

That these authors, however, disagreed on how to make these theoretical concepts "operational" (AAA, 1977: 7). With time, this approach was also restricted by the general recognition that the theoretical constructs are not well defined other than in situations of perfect and complete markets. In other words, in realistic situations there is often no accounting policy that is clearly best from a measurement perspective (e.g. Beaver, 1989: 5).

Decision usefulness

In the late 1950s attention (of primarily US research) switched to choice criteria based on the notion of decision usefulness. The 1977 AAA report suggests that this switch may have been stimulated by "a strong user-oriented movement" in the concurrent managerial accounting literature (ibid: 11), also arguing that by 1973 it had achieved broad exposure and recognition, the Trueblood Report[7] stating that "the basic objective of financial statements is to provide information useful for making economic decisions" (ibid).

Although intuitively appealing, this approach to deducing the best accounting policies also suffers from several problems. It is thus vulnerable to the same criticism as the true income approach: it often fails to identify the most appropriate accounting polices. In particular it is noted that the decision usefulness approach relies on the possibility of identifying the

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6 The 1977 AAA report suggests that this name comes from the fact that most of these deductive theorists "concluded that income measured using a single valuation base would ideally meet the needs of all users" (ibid: 6).

7 The Trueblood Committee was set up in 1971 by the American Institute of Certified Public Accountants to investigate the objectives of financial statements (e.g. Fogliasso et al., 1991). It was set up parallel to the Wheat Committee (footnote 14, p. 16).

qualities of accounting information that makes it useful. However, there is a lack of both normative and descriptive models of users' decision making (e.g. Hendriksen & van Breda, 1992: 134f). Related to this is also the issue of whether to rely on normative or descriptive models (AAA, 1977: 14) and the complication imposed by the recognition that identification of a decision model is not always enough:

> … assume that a specific model can somehow be singled out. The parameters to be predicted are the probabilities that the various state-dependent cash-flows will occur. No amount of inspection of that model alone will reveal what (if any) financial statement data may be useful in assessing these probabilities (Beaver & Demski, 1974: 178).

A second drawback with the decision usefulness approach is the contention that, for financial accounting information to be of maximum value, it might need to be "tailor-made for each decision-maker and for each of his different decisions" (Gorelik, 1994: 103-4) (AAA, 1977: 15).

Despite these problems, this approach to accounting policy choice still enjoys a high degree of acceptance. It is, for example, the basis for several existing frameworks for accounting. These identify a number of qualities which accounting information must posses in order to be useful (see e.g. footnote 4 on p. 9). These qualities are not derived from any specific user situation or decision model, but represent a-priori hypothesis as to what qualities are necessary for accounting information to be useful. Many of these qualities were also discussed "long before the decision usefulness objective was explicitly adopted by accounting theorists" (AAA, 1977: 15).

A problem with this approach is that the identified qualities may constitute contradictory demands on the information. For example, it is widely acknowledged that in practice it is often necessary to find a balance between relevance (e.g. timeliness) and reliability (e.g. verifiability).

Today the decision-usefulness approach to accounting theory (or theorising) appears to be represented by two strands of empirical research. On the one hand we find empirical research into (individual) user behaviour, research which is sometimes referred to as behavioural accounting research (e.g. AAA, 1977: 17-19). On the other hand, there is also a large body of empirical accounting research that focuses on the issue of decision usefulness of accounting information on an aggregate basis, particularly the extent to which accounting information leads to aggregate user responses (ibid: 19-21).

3.2.3 A subsequent focus on accounting rule-making

In the late 1960s and early 1970s the (US) standard setting literature began to recognise that accounting policy choices have *economic consequences*. This, in turn, led to accounting research refocusing on the process of accounting rule-making, particularly with a view of this being political.

The recognition of economic consequences

In 1968 Moonitz answered the question – *Why is it so difficult to agree upon a set of accounting principles?* – in terms of accounting having economic consequences:

> The stake of non-professionals in the consequences of any given set of principles is too great for them to accept the decisions of a body of technical experts on a voluntary bases no matter how eminent these experts or how persuasive the research support for their findings. (ibid: 631)

The recognition of economic consequences has been attributed primarily to 1962 and discussions in the US of how to account for an investment tax credit. However, the examples referred to in the literature go back as far as the early days of (US) accounting regulation (at least to the 1940s).

The term *economic consequences*, however, does not appear to have been coined until 1978, when Zeff defined it in terms of "the impact of accounting reports on the decision-making behavior of business, government, unions, investors and creditors" (1978: 56). More generally, economic consequences can be understood in terms of they way we describe the past affecting future wealth distributions. Such economic consequences may arise in a number of ways, but a key linkage arises from the role accounting information plays in various contracts (e.g. debt agreements and management compensation schemes, i.e. through its stewardship function). It has also been suggested that accounting policies may have economic consequences by affecting a reporting entity's information gathering and bookkeeping, as well as, political costs. Today the nature of economic consequences has been extensively discussed (see e.g. Rappaport, 1977: 89; Beaver, 1989: 17, 43; Taylor & Turley, 1986: chapter 7).

The explicit recognition of economic consequences in the (US) literature in the late 1960s/early 1970s has been suggested to constitute a "veritable revolution in accounting thought" (Zeff, 1978: 56). The revolution being the recognition that there is more at stake in determining appropriate accounting

policies than what is considered under the true income or usefulness approach (e.g. Beaver, 1989: 5).

In the following year (1979) Watts and Zimmerman published another seminal paper, the "market for excuses" paper. Firmly rooted in the notion of self-interests and economic consequences of accounting standards the paper suggests that:

> not only is there no generally accepted accounting theory to justify accounting standards, there will never be one (ibid: 301).

Following this the focus of academic accounting literature seems to have all but turned its back on issues of appropriate accounting policy choice. Many researchers have, however, chosen to develop the ideas of positive accounting theory. This tradition, which was launched in another paper by Watts and Zimmerman (1978), differs from previous (normative) accounting theory in that it aims to explain/predict actual accounting choices (rather than to prescribe what choice should be made) by identifying the role accounting information plays in different contracting processes (and hence its economic consequences for various individuals).

At the same time, many accounting researchers have turned their attention to the issue of accounting rule-making, discussing whether accounting rule-making is, should or must be political in the sense that rule-making decisions have to be reached through some kind of struggle among divergent interests. The following sub-sections attempts to provide an over-view of this literature, focusing fist on deductive and then (p. 40) on more empirical/inductive writings.

Deductive theorising on accounting rule-making

"Information economics"

The third fundamental theoretical approach to financial accounting identified in the 1977 US report was that of information economics[8]. As in one of the strands of the classical approach this approach has its roots in economic theory. This approach, however, is characterized by thinking about accounting information as a commodity. It is here we find the theoretically

[8] The first being the classical (true income and inductive) approaches to constructing accounting theory and the second being decision usefulness.

based discussions on the necessity and desirability of regulation referred to in section 2.4 (pp. 12-13).

Demski's Impossibility Theorem / social choice theory

Also in the realm of economic theory a related strand of deductive writings addresses the issue of accounting regulation from the perspective of social choice. Starting from arguments put forward by Arrow (1963), Demski argued in 1973 that it is impossible to develop accounting-rules that satisfy reasonable conditions for collective decision-making. In 1984 Johnson and Solomons reflected on the impact of this suggestion arguing that:

> A spectre has stalked the classrooms and seminars of accounting academia for over a decade. This spectre, Demski's Impossibility Theorem (Demski, 1973), has been interpreted by many as proving that there is no feasible method of selecting financial accounting standards that are, in general capable of ensuring the consent of the affected parties. (ibid: 65)

The basic argument is explained in the 1977 AAA report as follows:

> … the problem as posited by Arrow (1963) is one of moving from individual to social preferences. … Arrow imposed four conditions that this relationship should satisfy: … Difficulty arises because these conditions are mutually inconsistent. No such method of moving from individual to social preferences exists. (ibid: 37)

Following this, some researchers have - grounded in a deductive framework of rational choice theory - sought to provide a more optimistic view by violating some minor aspect of the conditions set up in the original analysis. Others have argued that the worldview on which the above works rest, is largely irrelevant, not least because majority voting is generally accepted as a choice device by many societies e.g.:

> Feasibility is, in other words, essential to the assessment of legitimacy since the legitimacy of infeasible processes is irrelevant. Therefore, due to the inherent inability of any real world accounting standard-setting process to meet Arrow's conditions, Demski's Impossibility Theorem is largely irrelevant to the assessment of the legitimacy of a process like the FASB. (Johnson & Solomons, 1984: 166)

Public vs. Private sector regulation

Another largely deductive strand of the literature on accounting regulation discusses the advantages/disadvantages with different types of accounting regulation, focusing primarily on the issue of public versus private sector

regulation (laws versus standards). The fact that financial accounting regulatory systems tend to be mixed, however, suggests that private sector regulation may not only be seen as an alternative to public sector regulation, but also as a complement to such regulation (Bromwich, 1992: 271-2). Taylor and Turley suggest that there is a potential agency role of private standard setters (1986: 28-9). Horngren uses a different language, but seems to be making a similar point when he writes of a US government agency (the SEC) as top management having delegated the duty of regulation to the lower management of the private sector (the APB) (1972: 38).

Deductive writings on the implications for the nature of rule-making

Another strand of the accounting rule-making literature, which is also largely deductive (normative), has focused on the implication of the political aspects of accounting rule-making, discussing various survival strategies for accounting rule-makers. Solomons (1983), for example, has suggested three types of strategies for a rule-making body to achieve acceptability / legitimacy. His suggestions include:

- *the educational strategy;*
  i.e. to educate away from bottom line mentality and to convince the constituents[9] of the financial reporting environment that they will be better off if they accept the constraints imposed by the standard setter than if they do not (ibid: 112).

- *the conceptual strategy;* and
  i.e. to develop a "coherent theoretical base from which standards might be derived" (ibid).

- *The structural strategy*.
  i.e. to adopt a "machinery for setting standards" that commands "wide support within the business community" (ibid: 116).

Another example of writings on the implication of the political aspects of accounting rule-making is provided by Johnson and Solomons (1984),

[9] The (US) accounting rule-making literature often uses the word constituency and constituents. Tandy and Wilburn suggest that the word constituency was used in a 1977 report on the structure of the FASB, where it was defined in terms of "all who have an interest in financial accounting and reporting" (1992: 47). It is often presumed that the majority of the constituents of an accounting rule-maker can be categorised into three groups: *users* of financial accounting information (investors & creditors), *preparers* of financial accounting information (corporate management) and *attesters* of financial accounting information (auditors / public accounting (or auditing) firms.)

arguing that an accounting rule-making body (and it products) will only be accepted by its constituency if it satisfies three criteria:

- *sufficient authority*;
  This, it is argued, is achieved through a proper delegation of power and institutional competence (i.e. level of expertise).

- *substantive due process; and*
  This, it is argued, requires that the standard setter justifies each exercise of its authority and provides adequate rationale for each ruling.

- *procedural due process.*
  This, it is suggested, involves permitting all interested parties a reasonable and timely opportunity to be heard and providing them a reasonable opportunity to influence the rule-making process.

Since then much has since been written on the need for and role of conceptual frameworks and various inclusive procedures, such as open due process procedures and inclusion of a broader range of expertise in the standard setting body, but also of other strategies to obtain acceptability. To be noted with regard to the emphasis of role of conceptual frameworks is perhaps that, somewhat ironically, the explicit recognition of economic consequences of accounting policy choices would seem to have re-emphasised the need to develop logical criteria for accounting policy choice. As suggested above, however, academia does not seem to have regained interest in this task.

Although the political aspects of accounting rule-making tend to be emphasised in the literature following the recognition of economic consequences, some of this literature recognises that an accounting regulator cannot base its decisions solely on the preferences of various constituents. In short it is argued that its task is further complicated by the fact that it must also take technical/theoretical considerations into account, in order to preserve the credibility of financial accounting as a measurement system (Solomons, 1978: 69). This literature suggests that accounting regulation can thus be understood in terms of a dual balancing act, requiring a balancing of both technical (theoretical) and political considerations. Sometimes this situation is described in terms of constituting a (rule-makers) dilemma:

> The board is thus faced with a dilemma which requires a delicate balancing of accounting and nonaccounting variables. Although its decisions should rest – and be seen to rest – chiefly on accounting

> considerations, it must also study – and be seen to study – the possible adverse economic and social consequences of its proposed actions. (Zeff, 1978: 63)

To a large extent the debate on international accounting regulation mirrors that on accounting regulation in a national context. However, the problems are perceived to be greater in that there is perceived to be less unity of purpose / more disparate goals than at a national level (Samuels & Piper, 1985: 89). For example, since a reduction of international diversity implies the elimination of a number of (national) solutions, a key concern is often which alternatives are to be "sacrificed". Although the objective is often very much regarded as a "good thing", the literature strongly suggests that each country would like the international/global system to be patterned after its own system (thereby minimising the negative economic consequences of having to change):

> ... the French would like to have the new global system patterned after the French system, the Germans after the German system, the Americans the American. Each country believes its system is the best and is reluctant to adopt a system that it perceives to be inferior or unsuitable. (Arpan & Radebaugh, 1981 in Samuels & Piper, 1985: 106)

Empirical research on accounting rule-making

In addition to these mainly deductive (and normative) writings, a large body of research emerging in the wake of the recognition of economic consequences has been empirical (and descriptive). With a few exceptions, this research tends to assume that accounting rule-making is political. In this chronological overview this research is presented distinguishing between two primary categories of such research: (1) lobbying studies and (2) process studies.

Lobbying studies

The main body of empirical research on accounting rule-making relies on publicly available submissions to various proposals by accounting rule-making bodies[10]. These lobbying studies address the issue of relative influence of various parties over the process/outcome, as well as a number of

[10] In most regulatory environments interested parties can formally lobby rule-makers by submitting comments on various types of discussion papers and exposure drafts. Sometimes they can also participate in the rule-making process by attending public hearings.

related concerns, such as the existence of interests and interest groups and lobbying behaviour.

A general criticism against this strand of empirical research concerns its reliance on submitted comment letters. It has, for example, been suggested that less overt lobbying may be significant (Sutton, 1984: 93; Hope & Gray, 1982). In a critical analysis of lobbying research, Walker and Robinson (1993) propose two further caveats with using written submissions to study the rule-making process: (1) that the rule-making bodies may not have relied on these submissions in making their decisions and (2) treating submissions as votes when "(e)ven counting the number of submissions may require arbitrary assumptions" (ibid:12). Further criticisms directed at lobbying studies concern the sincerity of written responses (do they convey the true preferences of the writers) and the extent to which respondents can be assumed to be representative for the larger population of users, attesters and preparers.

Walker and Robinsson (1993: 4) also criticise lobbying research for focusing too much on issues that have been put on the agenda of a specific rule-making body, forgetting to investigate (a) the way certain issues gain admission to the agenda of the rule-making body (while others don't) and (b) the factors that lead to the creation of a particular set of regulatory arrangements. Hope and Gray (1982) discuss partly the same issues in the context of the three dimensions of power suggested by Lukes (1974):

> Lukes, while acknowledging the pluralist approach to be the most common (and in many situations most useful) method of analysing power in the social sciences, is concerned to show that it may also be too narrow to offer a complete analysis of any situation in which power is exerted. He does this by specifying three different levels at which the investigation into the exercise of power might be undertaken. These are the three dimensions of power. (Hope & Gray, 1982: 535)

The first dimension of power focuses on the "behaviour in the making of decisions on issues over which there is an observable conflict of (subjective) interests" (Lukes, 1974: 15 in Hope & Gray, 1982: 535). This is what is also referred to as the "pluralist approach" to the study of power and essentially the one adopted by the overwhelming majority of research into the accounting regulatory process. This focus, however, is blind to the ways in which the political agenda is controlled by:

- preventing decisions from being taken on issues where there is an observable conflict (the second dimension of power); and
- keeping potential issues out of politics (the third dimension of power) (ibid : 535-6).

Process studies

Recognising the various limitations of the lobbying studies, some investigations into accounting rule-making attempt to take a more comprehensive view of the process, both with respect of the material used and the questions asked. Most of this empirical research appears to be based on one-case case studies where the author(s) analyse the developments pertaining to a specific standard setting project or accounting issue. A characteristic of this body of research – which is called *process studies* in this presentation – is that it remains quite dispersed. In most cases some kind of model/theory is used to structure the analysis of the rule-making processes. Based on this, no less than seven main groupings of process studies have been identified. Notably, these groupings remain rather small, each containing only a few studies which also tend to address the same regulatory environment (see also figure 3.1):

(1) An innovation model of standard setting;
(2) The decisional method of studying power;
(3) Organisational decision-making models;
(4) A cyclical model of standard setting;
(5) Competing regulatory agencies and models of agenda entrance;
(6) The public choice model; and
(7) Inductive research.

In addition to these main categories of research, it is noted that one study (Jönsson, 1988) has approached the issue of accounting rule-making by attempting to identify the power-structures within this field.

Author(s) and Title	Focus:	Research Objectives/Questions, method, major findings
(1) An innovation model of standard setting		
Hussein (1981) "The innovative process in financial accounting standards setting"	US FASB 1980s	To describe and illustrate the proposition that change in financial accounting standards is a social process that approximates a diffusion and adoption of innovation process. Proposes a model of standard setting as an innovative process based on previous model. Empirical study develops 5 hypothesis based on model, tested empirically through a questionnaire survey.
Jönsson (1988) "Accounting regulations and elite structures"	Sweden BFN 1970-80 2 projects	To understand the development (emergence and change) of accounting norms. Interviews and articles in the press. Process study + elite study (below). Findings interpreted against Hussein's model (modifications suggested).
Zetterlund (1998) "Swedish Accounting Standard Setting"	Sweden RR 1990-91 1 project	To raise the knowledge of and the understanding of the policymaking process for accounting issues. Examines the deliberations of RR using a modified version of Hussein's model to structure the analysis of data obtained through analysis of working drafts of the standard and through interviews. Model also later modified. Swedish standard setting process is largely an adjustment process, deliberations are mainly concerned with whether proposed standard is compatible with IAS and Swedish law. Board accommodates to comments on ED on issues that had not been subject to a lot of debate within the board.
(2) The decisional approach to the study power		
Hope & Gray (1982) "Power and policy making: the development of an R&D standard"	UK ASC 1975- 78 1 project	To introduce one analytical framework of power from sociology and political science to standard setting literature. Based on analysis of formal submission seek to identify interested parties and their formal (and informal) views on key issues and to assess their influence on the standard. Business pressures important, particularly from two industries. One of these did not make formal submissions. Identification of one key individual (chairman of the standard setter) that may have significantly affected the process.
Diggle & Nobes (1994) "European Rule-making in Accounting: The Seventh Directive as a Case Study"	EU 1970-1983 1 project	To propose a framework for understanding the setting of Directives, to analyse the evolution of the 7th Directive and to suggest why particular national influences seem to have dominated. To identify interested parties, key issues and eventual decisions. Started with German model, moved closer to UK version by substitution or addition. Influence attributed to those with experience of topic, being influenced by multinational companies, multinational accounting firms and US practice. Possible because a) civil law country representatives relaxed and b) UK representatives uncompromising.

Rahman (1998) "International accounting regulation by the United Nations: a power perspective'"	UN 1970-1990 1 project	To develop the existing power literature by examining the political nature of the standard setting process at an international level through the use of an explicit model of power. To understand why an overwhelming majority of member nations failed to effect a desired change
(3) Organisational decision-making models		
Belkaoui (1983) "Standard Setting for Oil and Gas Accounting: …"	US FASB 1970s 1 project	To explain FASB decisions in terms of Allison's decision-making models. Interpretation of observed processes (public information). All three models explain the process relating to SFAS 19.
Cheshire & Feroz (1989) "Allison's models and the FASB statements no's 2, 5, 13 and 19"	US FASB 1970s 4 projects	To build on Belkaoui (1983) by looking at a cross section of standards. Interpretation of observed processes (public information). FAS 5 & 13 are "better explained by the rational actor model" and FAS 2 & 19 "are better explained by the organizational process model" (p. 125).
(4) A cyclical model of standard setting		
Nobes (1991) "Cycles in UK Standard Setting"	UK, ASC 1970-1990 5 projects	Suggest the existence of cyclical patterns in standard setting in the degree of standardisation. Existence explained in terms of pro- and anti-standardisation forces.
Skerrat & Whittington (1992) *"Does the Nobes Cycle Exist, and if so, What does it Signify?"*		*To provide an alternative analysis of evidence discussed by Nobes (1991)*
Nobes (1992a) *"The Existence and Significance of Cycles: A Reply"*		*A reply.*
Nobes (1992b) "A political history of goodwill in the UK"	UK, ASC 1970-1990 1 project	To analyse the goodwill case as an illustration of the cyclical model.
Gordon & Morris (1996) "The Equity Accounting Saga in Australia: Cyclical Standard Setting'	Australia different standard setters, 1968-1995 1 issue	To explain why the Australian accounting profession has deliberated for so long over equity accounting / to identify forces opposing /promoting standardisation. Regulation of equity accounting in Australia appears to have followed a cyclical patter. Forces favouring standardisation: a) awareness of weaknesses in the statutory rules, b) overseas developments and c) pressure from business. Forces opposing standardisation: d) legal impediments to one of the proposed solutions and e) conceptual problems with the proposed solution.

(5) Competing regulatory agencies and models of agenda entrance		
Walker (1987) "Australia's ASRB. A Case Study of Political Activity and Regulatory 'Capture'"	Australia - 1984-1986 -	The paper reviews the new standard setting arrangements (the establishment of the ASRB) and outlines the activities of the ASRB during its first 2 years. Based on this it is argued that the ASRB was "captured by the profession, within only 24 months" (p. 282).
Walker & Robinson (1994a) "Related Party Transactions: A Case Study of Inter-organizational Conflict over the 'Development' of Disclosure Rules"	Australia - 1982-1989 1 issue	To contribute to a better understanding of regulatory processes by presenting a case study of inter-organisational contests between government and the profession. Public material and other materials made available by interest-groups and interviews with key participants. Debate took place in a complex organisational setting; the most critical events arose from interaction between the government and the profession (and other bodies); the activities of the profession's standard setting body were hardly consistent with the pluralist ideal.
Walker & Robinson (1994b) "Competing Regulatory Agencies With Conflicting Agendas: Setting Standards For Cash Flow Reporting In Australia"	Australia, - 1984-1991 1 issue	To examine the contest between government agencies and the profession in the agenda entrance phase. The profession's standard-setting body was unable to control the overall agenda for accounting rule-making as a consequence of the intervention of another body (the Stock Exchange); the agenda was ultimately shaped by the interactions between regulatory agencies.
Klumpes (1994) "The Politics of Rule Development: A Case Study of Australian Pension Fund Accounting Rule-Making"	Australia, - 1974-1993 1 issue	To describe the politics surrounding accounting rule development. Agenda entrance model of Cobb & Elder (1972). Focus on competition between the accounting profession and other interests. The accounting profession failed to control the global agenda to another profession due to lack of technical expertise, too radical proposals, lack of access to government and/or misjudgement of government agency.
Young (1994) "Outlining regulatory space: agenda issues and the FASB"	US FASB 1970-1990 3 projects	To examine the process of enacting change in accounting recognition practices. Regulatory space methaphor & logic of appropriateness (institutional theory): actions of the standard setter and other are constrained by expectations that exist about their role and purpose. Accounting conditions must be constructed as accounting problems, accounting problems must be constructed as appropriate for standard setting action, solutions must be constructed as appropriate …
(6) The public choice model		
Rahman et al. (1994) "Public Choice and Accounting Standard Setting in New Zealand: An Exploratory Study"	New Zealand - 1980s 1 issue	To trace the political activity and the nature of constituent participation. Based on a combination of a) media reports, b) discussions with key people and c) documents from the standard setters archives. The most concerned constituents were the auditors. Informal means of communication brought the issue onto the agenda. There were no blocks based on affiliations of the interested parties. Big-8 accounting firms followed by the preparers seem to have greater participatory capacity (Big-8 accounting firms representation close to or more than 50 per cent of the membership, preparers 22%).

(7) Inductive research		
Flower (1998)	IASC - 1 issue	Majority of the time taken up with processes within the IASC. Focus on role of and interaction between the Board, the Steering Committee and the Staff. Board: "is clearly the ultimate authority". Steering Committee did not play "a decisive role". Staff: a central role.
Cottingham & Hussey (2001)	UK 1981-1995 1 issue	To study the full reality of the standard setting process. Grounded theory. Five intervening factors hindering the process (priority, resources, legal impediments, changes in regulatory arrangements and external events). Two factors advancing the project: additional resources & major scandal.
Others		
Hope & Briggs (1982) "Accounting Policy Making – Some Lessons from the Deferred Taxation Debate"	UK ASC 1967 (73) - 1978 1 project	To explain the issues of the deferred taxation debate & to explain why criticism of ASC's incremental process is invalid. Traced UK developments based on publicly available information, including comment letters. Key issue was not technical, but pragmatic/political. Importance of structural features of standard setter. Pressure from business was the primary stimulus for the ASC's reconsideration of the topic. Importance of external events beyond the control of the standard setter.

Figure 3.1 An overview over identified process studies

The writings of accounting practitioners

Before concluding this overview of literature on accounting rule-making, it must also be noted that, just as accounting practitioners played an important role to developments long before accounting became an academic subject, accounting practitioners have continued to contribute to the accounting debate. In particular, members and staff of the FASB (the US standard setting body since 1973) have, from time to time reflected on their accounting standard-setting experience in writing.

3.3 A thematic overview of previous literature on accounting rule-making

3.3.1 Introduction

The objective of this section is to summarise what the previous literature tells us about accounting rule-making, particularly standard setting. The main body of the relevant literature is focused on the political aspects of this phenomenon, investigating issues relating to:

- interests (3.3.2);
- participation in the formal lobbying process (3.3.3);
- content of formal comment letters (3.3.4);
- relative influence (3.3.5);
- the role / impact of formal lobbying (3.3.6); and
- the implications of the political aspects (3.3.7).

Much of this literature is based on lobbying studies and is thus open to the criticism directed at this approach (p. 41). Even without this criticism, however, it may be argued that few general conclusions can be found in this literature.

A second, much smaller, body of literature takes a broader perspective to the phenomenon by focusing on the nature of the rule-making process (3.3.8). In summary this body of literature provides a rich, but incomplete understanding of this phenomenon.

Before embarking on this second overview, however, it must be noted that, with the exception of the very first writings, the identified literature on accounting regulation in general, and the empirical research within this field in particular, has long had a distinct US dominance. More recently however,

more and more contributions have been found addressing accounting rule-making in other nations and in an international perspective. Because variations in findings may relate to the fact that different regulatory systems are studied, this dimension needs to be kept in mind in considering previous literature on accounting regulation. This has also been the ambition in the following thematic review.

3.3.2 Interests[11]

This section attempts to summarise what the previous literature tells us about interests. Much of this literature is empirical, focused on the lobbying efforts of corporations (i.e. preparers of financial accounting) and, to a much smaller extent, accounting firms (i.e. attesters of financial accounting, i.e. auditors). As such, much of this research is also closely associated with efforts to develop positive accounting theory (p. 36). The issue of interests and interest groups has not been extensively addressed in an international context.

The interests of preparers of accounting information

Following the original paper by Watts and Zimmerman (1978) a very large number of papers have been published extending both the theory, and related empirical research, suggesting that a manager's opinion with regard to an accounting policy choice (and decision to lobby on accounting rules) is made on the basis of the economic consequences of the proposed rules for the manager (self interests). This body of research has already been extensively reviewed. Conclusions appear to vary from the mildly optimistic referring to "(t)he most consistent results" having been obtained for firm size variables and leverage variables (Tandy & Wilburn, 1992: 49), to more sceptic positions suggesting that few general conclusions can be drawn from the findings of these studies. Saemann concludes:

> Evidence from these studies reveal statistically significant relationships between surrogates for contracting and monitoring costs and management decisions to lobby in the standard-setting process, … More specifically,

[11] In section 2.2 (pp. 8-9) it is argued that accounting policy choices are likely to be controversial because different parties in the accounting environment are likely to have different preferences regarding the choice of accounting policies and to have incentives to contend these choices. Two explanations for such preferences were suggested: that of (self)-interests (based on the recognition of economic consequences of accounting policy choice) and worldviews (based on institutions). This latter distinction, however, is not generally made. It is also not made in this text; interests and preferences are accordingly used somewhat interchangeably disregarding the underlying explanation for the position.

> the results indicate that managers of more highly leveraged or smaller companies tend to favour accounting methods that increase reported income and net assets, as do managers whose compensation is more directly linked to reported income. There is also some evidence that managers use accounting methods to smooth reported income over time. (1992: 3)

It does not appear as if anyone has attempted to distinguish between studies based on US and other empirical data.

The interests of auditors

A smaller strand of empirical lobbying research has focused on the interests of auditors. Originally the focus seems to have been on the extent to which (US) auditor opinion is dominated by client opinion (e.g. Haring, 1979; Puro, 1984 & 1985) and to be related to allegations in a 1976 US report[12] suggesting that the (at that time) "Big-8" public accounting firms and their clients dominated the FASB. Again, the findings seem somewhat mixed and inconclusive (e.g. MacArthur, 1988b: 63; Walker & Robison 1993: 33-4).

MacArthur examines the degree to which auditor and client lobbying is related in a UK context. These findings reportedly "support the view that auditors were independent of their clients" (1988b: 63).

Some further evidence on the interests of various constituent groups

Most of the published research with a focus on identifying interests tends to focus on either preparers or auditors and to have its origins in the late 1970s / 1980s. A more recent, somewhat different and more comprehensive contribution relating to the issue of the interests of various constituent groups is provided by Saemann (1999).

Based on a review of previous literature on the interests of preparers, users and attesters this paper provides a list of hypothesised preferences differentiating between five dimensions of accounting policy choice (see figure 3.2). In short Saemann suggests that there are reasons to believe that preparers "oppose requirements that increase uniformity, disclosures and

[12] The Metcalf Staff Report: *The Accounting Establishment: A Staff Report*, by the U. S. Congress, Senate Subcommittee on Reports, Accounting and Management of the Committee on Government Operations (Newman, 1981a: 247, 262).

volatility, regardless of the nature of existing contracts and monitoring activities" (ibid: 4). In addition Saemann suggests that "corporate views on conservatism" are likely to be different for politically visible and other firms (ibid). Users are hypothesised to favour uniformity and full disclosure (ibid: 4-5). Several theories are identified as asserting alternative hypothesis for attesters:

Constituent group: Dimension:	Preparers and attesters [a]	Users and attesters [b]	Attesters [c]
Uniformity	Oppose	Support	Oppose
Costly disclosures	Oppose	Support	Support
Other disclosures	Oppose	Support	None
Volatility	Oppose	None	None
Conservatism	None	None	Support

Several theories assert alternative hypothesis for attesters:
a) Agency theory asserts alignment between attesters and preparers
b) Responsibility to the public suggests alignment between attesters and users.
c) Economics of regulation theory suggests attesters favor audit-increasing standards. The risk of litigation motivates attesters to support conservative accounting mandates.

Figure 3.2 Table 1 in Saemann (1999: 6)

The empirical parts of the paper are based on the contention that four US "institutional organisations" can be assumed to represents the interests of various constituent groups. The Financial Executives Institute (FEI) and the Institute of Management Accountants (IMA) are assumed to represent the views of preparers. The Association for Investment Management and Research (AIMR) is assumed to represent the views of users and the American Institute of Certified Public Accountants (AICPA) the views of attesters.

The comments of these organisations in their submissions to twenty controversial FASB standard setting projects are then contrasted with the above list of hypotheses. In summary it is reported that, overall, the comments presented by the designated user- and preparer- organisations were consistent with those hypothesised. Saemann thus concludes that "there are marked differences between the views of the user and preparer representatives", suggesting also that this introduces controversy to the standard setting process (ibid: 18). In this respect her findings thus confirm the general understanding that there are controversies over accounting policy choice. With regard to the comments from the AICPA (representing

attesters) these were reportedly "diverse, as hypothesized", however, also suggesting that this organisation "aligned most closely with users overall" (ibid: 2-3).

The existence of "interest groups"

An interesting aspect of Saemann's findings is that they indicate a certain amount of diversity in the views presented by the various organisations. The only instances where all responses from one organisation were consistently classified was user responses (i.e. responses from AIMR) with regard to uniformity and costly disclosures. In other words, the respondents were generally not consistently for/against/indifferent to proposals that entailed changes in uniformity, disclosure levels, volatility or conservatism. Saemann suggests that this opens up the grounds for reaching agreement:

> Although the organizations that represent preparers tended to oppose greater uniformity, fuller disclosures and volatility, they also supported approximately one-fourth of these requirements. This is important because it shows that preparers do not unequivocally oppose accounting changes of that type. It also suggest that, given the right circumstances, an accounting standard-setting body can gain support from its most dissenting constituent for changes that improve the usefulness of financial reporting. (ibid: 18)

Another implication of this finding, however, is that it gives rise to uncertainty regarding the existence of "interest groups" based on affiliation to various constituent groups.

This issue is also addressed in a few other papers, all of which seem to point in the same direction. Within the lobbying research tradition, for example, two papers from the early 1980s bring further evidence relating to this from the US arena:

- Hussein and Ketz (1980) report that the unity of opinion expressed by the "Big-8" US accounting firms in written responses to eight FASB proposals (1974-1976) was low.
- Brown similarly concludes that written responses to early FASB proposals suggests that there are no "strong and consistent coalitions of respondents" (1981: 241).

Haring also reports that the US standard setter (the FASB) has argued that undue influence by various interest groups does not exist because of significant diversity of opinion within each such group (1979: 508). Based on an analysis of formal (written) submissions to a standard setter in New Zealand with regard to a specific issue, Rahman *et al.* (1994: 114) similarly report that groups based on affiliations to constituent groups were divided on contentious issues.

Interests in an international context

Within the field of international accounting regulation the existence of interests and interest groups appears to have been addressed by one study only and then from a different perspective. Guenther and Hussein use publicly available responses to two EDs issued by the IASC during the process of revising IAS 2 to investigate preference with regard to methods for inventory valuation. In short their findings indicate that the support for the LIFO method was confined to those countries in which this method was allowed for tax reporting (i.e. to those countries where it is associated with significant tax benefits) (1995: 132). The authors thus argue that the link between financial and tax reporting in many countries may be "(o)ne of the biggest impediments" to the achievement of international harmonisation (ibid).

3.3.3 Participation in the formal lobbying process

A second theme in the literature on accounting rule-making concerns participation in the formal lobbying process. With regard to this issue Tandy and Wilburn suggest that (wide) participation in the accounting rule-making process is considered essential for two reasons:

> First, the due process procedures of the FASB provide a systematic approach to problem solving. … Input from interested constituents can assist the FASB in each of the decision-making steps and can help prevent standards that are unworkable in application, overtly costly, or even inconsistent with basis concepts. …
>
> Second, participation in the standard-setting process is necessary to ensure the ‘legitimacy of the FASB’. (1992: 47)

Of the two suggested reasons, the second is the one that is normally emphasised in the literature (see the suggestions that an accounting rule-making body will only be accepted if has *procedural due process*, p. 39).

In a theoretical paper from 1984 Sutton presents three hypotheses regarding who will lobby in an accounting rule-making process. In short, he suggests that (large) preparers of accounts (not users and not attesters), will lobby:

> (1) Producers of financial statements are more likely to lobby (i.e. find the activity more profitable) than consumers of such statements;
> (2) Large producers are more likely to lobby than small producers;
> (3) Undiversified producers are more likely to lobby than diversified producers. (ibid: 93)

The paper also argues that the level of producer lobbying will depend on the cost of not complying with the standard and, accordingly, that raising (lowering) the cost of non-compliance will thus increase (reduce) the level of producer lobbying (ibid).

In line with these suggestions a number of empirical papers, based primarily on US and UK (but also on Australian) data, suggest a general dominance of preparer responses coupled with a paucity of user responses (Mezias & Chung, 1989; Tandy & Wilburn, 1992; Tutticci *et. al*, 1994; Weetman *et. al.*, 1996; Gilfedder & Ó hÓgartaigh, 2001). Reviewing prior research with this focus, Weetman *et al.* conclude:

> Although the specific groupings vary from one paper to the next (), the common features are that the corporate respondents (preparer of accounts) comprise from one-third to a half of all responses and that users do not generally feature in such groupings. (1996: 62)

These findings in themselves, although based on a review of overt lobbying only, have given rise to concern over *preparer dominance* over accounting rule-making and *regulatory capture* (section 2.4, p. 13).

Research on overt lobbying behaviour has also produced some other interesting findings. For example, large differences have been found in the absolute number of comment letters received, both between rule-makers and between different proposals. Perhaps not surprising, in general the US standard setter (the FASB) seems to have received the largest number of comments. Tandy and Wilburn (1992) report that the number of comments received in response to its first 100 standards ranged from 10 to 1 435, the average being around 130.

Another issue concerns the *relative participation* of various constituent groups. In their study of submissions to the FASB, Tandy and Wilburn also

report that the highest level of relative participation[13] was only 0.077 percent. Significant differences between constituent groups were also found in terms of absolute and relative participation. In particular it was noted that different constituent groups ranked different depending on which measure was used:

> Although the highest total number of comment letters was received from the industry constituent group, relative participation was low compared to other constituent groups – only 0.002 percent of the population submitted comment letters. In contrast, the academe constituent group participated at a low level in absolute terms, but that was one of the more active groups in relative terms, with 0.043 percent of the population responding to EDs. (1992: 53).

Addressing the issue of the lack of user participation in written responses in the UK Weetman et al. (1996) interviewed 20 users of financial statements (fund managers and analysts) that had not submitted a formal response. Although the paper reports that "(o)nly one respondent was able to articulate clear reasons for [its] non-response", it also states that "it many cases, it appeared to be primarily attributed to a tradition" and that in "some cases" the failure to respond was attributed to low priority (ibid: 73).

Also on the issue of non-participation, some researchers have compared lobbyist with samples of non-lobbyist. These studies are again closely associated with efforts to develop a positive accounting theory (p. 36). In summary they appear to support the second hypothesis stated above: that lobbyists tend to be larger than non-lobbyists. There is also some support for hypothesis that lobbying companies tend to be more highly geared, have higher income volatility and more likely to have management compensation schemes tied to post-tax earnings than were companies that do not lobby. [14]

Three papers from the 1990s report on overt lobbying behaviour vis-à-vis the IASC (Kenny & Larson, 1993; 1995 & Larson, 1997). The findings reported in these papers contrast somewhat with those based on national data. One marked difference relates to the number of comments received; the

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[13] Relative participation is defined as: the number of respondents from each constituent group in relation to the population of that constituent group at the time each exposure draft was issued (ibid: 51, 53).

[14] *Australia:* Morris (1986) & Ang *et al*. (2000). *UK:* Gilfedder & Ó hÓgartaigh (2001). *US/Accounting firms*: Puro (1985).

average number of comment letters to EDs issued by the IASC being around 50:

- Kenny and Larson (1995) review comments to 16 EDs issued from 1989 – 1992 (but not E33). The largest number of comments was received for E32 (139). The second largest for E38 (56). The lowest for E34 (32) (ibid: 289).
- The follow up paper by Larson extends the study and encompasses comments to 17 EDs issued from 1989 – 1992 (but not E33) plus three DSOPS. Again most comments were received for E32. The second and third largest were for E48 (82) and E40 (74), both of which related to financial instruments. Two DSOPs issued in 1994 received 67 and 65 comments respectively. The lowest was still for E34 (32) (1997: 183).

There were also marked differences with regard to the identity of those that commented. In contrast with the findings based on material from national standard setting processes, the most prolific respondents were member bodies of the IASC (i.e. professional accountancy bodies) and not preparers (Kenny & Larson, 1993, 1995). Whereas member bodies accounted for 31 percent of all responses, responses from preparers (only) accounted for 23 percent of the total responses (ibid: 1995).

In similarity with the findings in national studies, it is reported that lobbying firms tended to be large. In addition, they also tended to be listed on at least one foreign stock exchange and traded in the US. Corporate respondents were also mainly from the US (42% of corporate responses) and the UK (15% of these responses) (Larson, 1997).

An interesting finding reported by Kenny and Larson's is that there would appear to have been a core group of regular respondents to the IASC. Approximately 40 respondents contributed about 60 percent of all responses (the member bodies representing 40 percent of those organisations and 25 percent of total responses) (1995: 283, 291). Focusing on preparer responses only, Larson similarly noted that although over one hundred corporations from 15 countries responded to at least one of the documents encompassed by the study, only 17 corporations accounted for 55 percent of these responses (1997: 187-8).

Larson also raises the issue of country differences, noting a predominance of corporate responses from the US[15], the UK[16], Switzerland, Australia, (Japan)[17] and Canada (ibid: 187). However, this paper also reports that corporate responses from some countries increased during the investigated period and that responses from some of the less well-represented countries only appeared in the final year of the study (ibid: 189).

3.3.4 Content of formal comment letters

The third identified theme in the previous accounting rule-making literature concerns the content of comment letters submitted to various standard setters. For example, based on an analysis of corporate submissions to the ASC (UK) MacArthur suggests that these responses may be driven by the discussion in the EDs (1988a: 216). Also using UK data (responses to an ED issued by the ASB) Weetman *et al.* (1996) report that negative responses by otherwise positive respondents are common. They also report no support for the hypothesis that preparers employ user-oriented arguments to strengthen negative responses; instead they report that positive preparer respondents were more likely to give user-specific responses when supporting an idea. Thirdly, following an analysis of responses to an Australian ED Tutticci *et al.* report that respondents tend to present varying positions on different issues within the exposure draft and often (but not always), and particularly when disagreeing with an issue, provide supporting arguments (1994: 102):

> Supporting arguments were provided for more than half of the positions presented by respondents… Most of the supporting arguments applied were conceptually based. (ibid: 97)

Although respondents were reported to predominantly present positions without using strong language and/or lengthy argument, the authors also note that respondents who disagreed with the proposals were "most likely to strengthen their positions" (ibid: 98, 102). Tutticci *et al.* also report significant differences in the average length of submissions from different constituent categories. In particular, they note that "accounting firms produced the longest submissions and addressed the greatest number of issues" (ibid: 101).

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15 27 % of the responding corporations, 42 % of the comments received

16 15 % of the responding corporations, 15 % of the comments received

17 All of the Japanese firms wrote in response to E48 only... Furthermore, Larson suggests that these responses were part of a campaign.

3.3.5 Relative influence

The next identified theme in the literature on accounting rule-making concerns the relative influence of various constituent groups on (the outcome of) the rule-making process. Following the recognition of economic consequences of accounting policies this has been a fundamental concern of both research and other literature on accounting rule-making. This section thus presents an attempt to sort out what a relatively large body of research in fact does tell us about this issue.

Most of this research has focused on the relative influence of various constituent groups over specific accounting rule-makers. This literature is presented in a first, rather extensive, section. A much smaller body of research address the issue of *how* such influence/power comes about/is exercised. This literature is summarised in a second, much shorter, section discussing influence (power) bases. More recently some, mainly Australian studies, have focused on the issue of competition between rule-making bodies, a topic that can also be seen to relate to the issue of the relative influence of various constituent groups.

(1) Relative influence of various constituent groups

In line with general developments within this field, the early studies addressing the relative influence of various constituent groups are focused on developments in the US, can be seen to belong to the lobbying tradition and are largely quantitative and statistical. The findings of these studies are outlined in a first sub-section. With time, this issue has also been addressed in a number of process studies, focusing on developments outside the US and relying on different types of qualitative data. These are described in a second-subsection below.

These latter studies can be seen as variations of what Hope and Gray (1982) call the "pluralist approach" to the study of power (pp. 41-2). Quoting Dahl (1961: 336) they describe this method as follows:

> .. to determine for each decision which participants had initiated alternatives that were finally adopted, had vetoed alternatives initiated by others, or had proposed alternatives that were turned down. (1982: 534)

Also inspired by the sociological literature, Jönsson (1988) uses the term the *decisional method* to describe this basic approach of studying power.

Jönsson (ibid) also introduces another fundamental approach to investigating power: the *reputational method*. This involves identifying power-structures by asking various informed individuals to identify who is influential. Noting also suggestions in the sociological literature that the choice of approach tends to influence the findings, Jönsson adopted a dual approach in his investigations into the relative influence over accounting rule-making in Sweden. His findings are the subject of a third sub-section below (p. 61).

Hope and Gray (1982) also describe a third approach to the study of power[18]: the typological approach. This is related to the literature discussing various types of power. They report an initial, but unsuccessful, attempt to apply this approach, suggesting that it may require a better understanding of the rule-making process

> The typological approach represented the authors' first attempt to research the effect on power on the policy setting process, but it was concluded that empirical investigations of this approach, while providing possible insights, was highly speculative. More specifically, although one was able to tentatively reject the null hypothesis "the ASC takes cognizance only of legitimate and competent authority", one was quite unable to develop further and to suggest exactly which forms of power the ASC *did* in fact acknowledge. This suggests that at least, some model of the ASC policy making process was required before the typology approach could be adopted. Hence attention was turned to the 'model literature'. (ibid: 534)

No study has been found to apply this approach.

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18 Many categorisations of approaches to the study of power appear in the literature. For example, March (1966) refers to the decisional method and the reputational methods as variations of "community studies". This, in turn, is identified as one of three approaches to the study of power. The other two are experimental and institutional studies. The latter group is identified as "the basis of much of descriptive political science" (ibid: 330). Another example is found in Rahman, who discusses the previous literature on power (in the political science literature) in terms of two fundamental theoretical and methodological frameworks: the structural theories and the action (coercion) theories (1998: 595- 6).

Only one study has been identified as addressing the issue of relative influence over the IASC. It can be seen as a variant of the decisional approach to the study of power and it also bears some resemblance to the early US quantitative studies on this issue. It is, however, presented separately in a forth sub-section below.

(i) Early quantitative US studies

A number of studies addressing the relative influence over the standard setting process in the US appeared at the end of the 1970s/beginning of the 1980s. The first set of these seems to have been triggered by allegations that the members of the US standard setting body at the time (the APB), being part-timers, lacked independence. Meyer (1974) and Rockness and Nikolai (1977) both investigate whether there existed any relationship between the APB members' employment categories (as an indication of their affiliation) and their voting records. Both failed to find such a dependency.

Rockness and Nikolai, however, did find something else. Multi-dimensional scaling of the (fifty) APB members' votes on all thirty-one APB Opinions yielded clusterings that could be interpreted in terms of, not employment background, but two other dimensions. One of these was interpreted to display a *time* component, suggesting systematic changes in the APB's voting patters over time. Further analysis led to the suggestion of a "strong central voting block on early issues, divided groups in the middle stages of the APB's life and relatively unsystematic voting patterns in the last stages" (1977: 167).

A second (albeit weaker) dimension was interpreted in terms of representing a *conceptual-pragmatic* divide, indicating that while certain individuals approached the accounting policy formulation from a conceptual theoretical perspective, others had a more pragmatic approach. These theorists and pragmatists, in turn, were reportedly "dominated by a larger central grouping which, …, might be characterized as more political than conceptual or pragmatic" (ibid). Hence, the authors concluded that "during the life of the APB, accounting policy making was a political exercise constrained by the views of theorists on one side and pragmatists on the other (ibid).

The second wave of early research on relative influence over the standard-setting process in the US was again triggered by allegations in the US in 1976 that the "Big-8" public accounting firms and their clients dominated the FASB (p. 49). The published findings vary. For example, although

Haring (1979) reports that the likelihood of FASB support for a rule varied directly and significantly with the strength of FASB sponsoring-organization and accounting firm preferences, and inversely with the strength of academic and corporate preferences, Brown (1981) suggests that the FASB tended to take an outlier position. Hussein and Ketz (1980) and Newman (1981a) similarly discredited allegations of accounting firm domination over FASB in its early years.

(ii) Process studies

Two other papers also from the early 1980s address the issue of relative influence, but in a UK context and based on a qualitative (rather than quantitative/statistical) analysis of two standard setting processes (deferred tax and development expenditures): Hope and Briggs (1982) and Hope and Gray (1982). Both studies suggest that the standard setting body (ASC) was highly responsive to the views of preparers in the observed cases.

A peculiarity with the paper by Hope and Gray is that it draws on "the established sociology and political science literature" (1982: 531) relating to the issue of influence/power[19] and how to approach it empirically in the context of accounting rule-making. Adopting what they describe as *Dahl's pluralist approach* to the study of power (p. 57), they identify interested parties and their formal (and to a certain extent informal) views on key issues with respect to a specific standard setting process and then attempt to assess their influence on the final standard.

The approach adopted by Hope and Gray to study relative influence has also been used by Diggle and Nobes (1994) in analysing national influences on the development of the 7th EC Directive on group accounting. Based on their review they conclude the developments can be attributed to the influence of multinational companies, multinational accounting firms and US practice.

Based on a combination of media reports, discussions with key people and documents from the standard setter's archives relating to a standard setting process in New Zealand Rahman *et al.*, on the one hand, conclude that the standard was not consistently aligned with the preferences of any one group of constituents. On the other hand, the authors also argue that the Big-8 accounting firms and preparers "had more scope to influence the standard

[19] In line with this study the concepts of influence and power are used interchangeably (ibid: 532).

setting process" (1994: 112) and that they had "greater participatory capacity in the standard-setting process" (ibid: 114). Rahman *et al*. also note that, in similarity with "most other English-speaking countries, the scope of participation" in the standard setting process has been institutionalised (ibid). A similar idea, but in a US context, is expressed by Young (1994), arguing that the US standard setting process is highly institutionalised and limited to attesters and preparers.

(iii) A combined study of process and power structures

As noted above (p. 58) Jönsson (1988) applies a dual approach to investigate power and influence with regard to accounting-rule making in Sweden. His findings were also seen to confirm prior suggestions regarding the dependence between findings and adopted approach. In short, while the decisional method (his case studies) was seen to suggest pluralistic participation in the rule-making process, the part of the investigation that sought to identify an accounting elite by reputation, suggested the existence of a small accounting elite. This apparent discrepancy Jönsson explained as follows:

> If only the case studies had been done, the image of the accounting elite would have been different even if the names from the top of the 'ranking list' would have been included in the accounts. The cases give a strong impression that there is a pluralistic participation in the work on accounting norms. If on the other hand the elite study and the case studies are considered together it is quite clear that they support each other. …. The very top people are actually not seen very much as direct debaters in the standard setting process. ' The elders' do not like to participate in the battle itself but observe the process and can be mobilized if needed. …. (1988: 227-8)

Empirically the search for an accounting elite consisted of three parts conducted in 1980-1982: preliminary interviews, a questionnaire survey to identify accounting authorities and interviews with identified parties. Notably, all of the preliminary interviews suggested that there existed a stable and relatively small group of people with a considerable influence over the development of accounting practice in Sweden. Size estimates ranged between 10 and 40. The follow up questionnaire survey generated a list of "people who are important to accounting practice" consisting of 39 names (ibid: 64). Among these, there existed a clear top-elite of about five people. A characteristic of this group was that each member was mentioned as influential in a number of roles (e.g. as an accountant, auditor, opinion leader and rule-maker).

(iv) Relative influence over the IASC

Based on the IASC Board's decisions on accounting alternatives in the Comparability Project (footnote 24 p. 24) and survey information on accounting practices in 25 countries Salter and Roberts (1996) use statistical analysis to test four competing hypotheses: that the IASC chose practices used in a) Board Member countries; b) countries which provided higher levels of financial support; c) countries with active stock markets; and d) countries which share a similar culture. While they report no support for the first three hypotheses, their findings suggest support for the cultural hypothesis[20]. The authors thus argue that *either* the IASC had a culture that affected its policy decisions *or* that it was influenced by a culture (ibid: 41). They further note that the accounting policies promoted by the IASC tend to mirror the accounting culture associated with the Anglo-American accounting sphere.

(2) Influence (power) bases

Although the focus of prior accounting standard setting research is very much on the relative influence of various constituent groups, only a few studies address the issue of *how* such influence (power) comes about/is exercised. The notion that some groups (may) have more scope to influence the standard setting process because their involvement in the rule-making process is institutionalised has already been mentioned (previous page). However, this roughly translates to arguing that those that are involved, have (an opportunity to) influence.

Rahman (1998: 595) addresses this issue more directly in examining why, in an "ostensibly democratically constituted organisation" (the UN), an overwhelming majority failed to effect a desired change (for the UN to regulate the financial reporting by trans-national companies). Rahman explains the observed paradox in terms of the minority "successfully" using their "base values (economic influence and control over TNCs) to compel the [majority] to abstain from exercising their base values (voting power)" (ibid: 615). In short, Rahman argues that the influential have something ("*base values*") that the others do not have, but desire or need:

> However, in a political bargaining situation, reasons and rationales can often be accepted or rejected depending on the possession of non-possession and deployment of some social, economic, and political resources by the respective groups involved in the negotiations (Lasswell

[20] The estimated relationship explained about 40 percent of the variance (1996: 40–41).

> and Kaplan, 1950). Prevailing in a decision-making process is, therefore, a phenomenon that identifies the powerful. More importantly, that phenomenon or outcome reveals the possession and use of some economic and political resource by the "winner". These are likely to be the resources which are in short supply to the group defeated. Every actor in a society (national or international) may be thought of as controlling, by his/her actions and decisions, some amount of values (or resources) in relation to others, so that the controlling actor can increase or decrease the resource position (both pecuniary and non-pecuniary) of those others by his/her actions or decisions. The values, resources or interests that are desired by other people, but controlled by the actor, may be called his/her power base or "base values" (Lasswell and Kaplan, 1950). Similarly, some of his/her desired values, resources and interests (called "scope values") may be controlled by one (or more) other actors. In a bargaining situation, other actors can be induced to give up control over some of those resources in consideration of, or exchange for, any units of base values over which the first actor has political influence owing to this/her base value position. According to this theory, the power base for actor A (where A could be a person, a country or group of wither) is an amount of values or resources under A's control which is needed by B. (1998: 613-4)

Another perspective on the issue of influence (power) bases in accounting rule-making is provided by Jönsson's (1988) study of the Swedish accounting elite (p. 61). Jönsson argues that his findings support each of three such bases discussed a-priori: *professional competence*, *institutional position* and *communicative competence*. His discussions of this topic strongly suggest that these three characteristics may be interrelated because of the following conditions:

> It seems safe to say that individuals gain prominence by being able to present the viewpoints of their group forcefully. This carries with it a good chance of being included in committees or working parties. By being capable as a representative of his group an individual gradually widens his competence and can in time lay claim to a position at the top (as independent authority). (1988: 241)

(3) Competition between rule-making bodies

A number of studies have addressed the issue of competition between rule-making bodies in Australia in the 1980s. Based on a review of the ASRB's (p. 21) activities during its first two years, Walker concludes that within these 24 months, this new regulatory body was effectively "'captured' by the profession" (1987: 262), i.e. auditors and preparers (p. 13).

Also focusing on accounting standard setting in Australia in the 1980s Walker and Robinson (1994a, b) conclude that "the pattern of interactions between *government* and the *profession* was consistent with efforts of individual organizations to manage, defend or maintain their 'domains'" (1994a: 19, emphasis added). In the first study, the *accounting profession* was seen to have prevailed. On the other hand, in the latter study the authors report that "the *profession's* standard-setting body was unable to control the global agenda for accounting rule-making as a consequence of the intervention of another body, the Australian Stock Exchange" (1994b: 119).

Klumpes also investigates competition between various groups in the financial reporting environment over rule-making in Australia:

> Whereas Walker and Robinson (1994[b]) examined interactions between regulatory agencies, this study concerns competition between the accounting profession and other interests, as each sought 'legitimacy' for its rules within the wider community. Again the accounting profession failed to control the 'global agenda for accounting rule-making' (….). An alliance of another profession (actuaries) and industry groups gained official support for its rules from a public sector agency … (1994: 154).

Klumpes explains the 'failure' of the accounting profession in terms of (1) lack of technical expertise, (2) presenting too radical proposals, (3) the alliance having greater access to government and (4) misjudging the role of a government agency.

3.3.6 The role / impact of formal lobbying

Moving on to the fifth identified topic of the previous literature on accounting rule-making – the role / impact of formal lobbying - it is noted that although much research has been based on formally submitted comment letters, this issue remains largely unexplored. In fact, only two studies have been identified as reflecting on this issue.

First, as noted previously, Hope and Gray (1982) conclude that preparer pressures - particularly from two industries - were important. However, they also noted that one of these had not made any formal submissions. The authors suggest that "most likely" the standard setting body "took account of informal (possibly anecdotal) evidence from the [..] industry" (1982: 552). In the extension, they argued that this might suggest, "that the practice of

issuing exposure drafts for general comment may be no more than an (expensive) charade" (ibid).

Second, in investigating claims that the US Securities and Exchange Commission decided not to accept a standard issued by the FASB as a result of political pressure Gorton comes to discuss the role of lobbying. Based on an analysis of interviews with principal participants, he suggests that although lobbying played a role in this case, "it was not the role generally assumed for it" (1991:41), i.e. it did not "force" the SEC to rule as it did. Instead, Gorton argues, the lobbying opened up a possibility for the SEC to do "what it hoped to do and which it otherwise might have been unable to do" (ibid) (to question the relevance of historical cost accounting for decision-making).

3.3.7 The implications of relative influence / the political aspects of accounting rule-making

A sixth theme in the literature on accounting rule-making concerns the implications (for the process and the outcome) of the political aspects of accounting rule-making process. However, only one, relatively small, strand of previous research, seems to address this issue.

Nobes (1991) argues that the co-existence of pro- and anti- standardisation forces in the financial reporting environment leads to cycles in the degree of standardisation, i.e. that preliminary material from rule-makers (e.g. discussion papers and exposure drafts) will tend to be followed by less prescriptive rules, which in turn, will tend to be followed by later documents which are again more prescriptive. As a result, it is suggested that once an issue "has been 'settled' by the issue of a standard it is then unsettled" (1992a: 381), i.e. that an accounting rule-maker will only temporarily resolve accounting controversies (Gordon & Morris, 1996: 155).

What has become know as the *cyclical model of standard setting* has been criticised by Skerrat and Whittington for lacking an explicit theory specifying, e.g., why the theory of opposing forces should lead to a *cycle* rather than a *trend* in the direction of the more powerful (1992: 174). Skerrat and Whittington also provide an alternative explanation for why preliminary documents should tend to be followed by less prescriptive documents, suggesting that this follows from the standard setters' mode of operations (due process approach with a number of consecutive documents).

The original paper (Nobes, 1991) includes five cases from the UK standard setting history to illustrate the proposed model. For each issue, an impressionistic graph over various EDs and standards is plotted, with time along the x-axis and degree of standardisation along the y-axis. In a later paper Nobes (1992b) provides a more detailed account of the developments and arguments pertaining to the history of goodwill in the UK.

This model has also been used in analysing the Australian standard-setting experience vis-à-vis equity accounting (Gordon & Morris, 1996).

3.3.8 The rule-making process

The final section in this thematic review focuses on a smaller body of literature addressing the nature of the rule-making process. This is presented in three main sub-sections discussing:
(1) organisational decision-making models;
(2) models of the accounting rule-making process; and
(3) factors affecting the rule-making process.

(1) Organisational decision-making models

Belkaoui (1983) and Cheshire and Feroz (1989) discuss whether the policy decisions of the FASB (US) can be explained in terms of three conceptual models of decision-making borrowed from decision-making theory[21]:

- *the rational actor model*
  This model assumes that the decision-maker makes rational choices in the sense that it seeks to maximise its goals/values/objectives by identifying the (dis)advantages associated with every alternative.

- *the organisational process model*, and
  Decision-making is assumed to be guided by pre-established (standard) operating procedures (standard patterns of behaviour).

[21] The three models are attributed to Allison (1971).

- *the political actor model*.
  Decisions are assumed to be reached through a *bargaining process* based on *compromise* among actors with divergent interests.

Belkaoui (1983), who focuses on one FASB standard setting project in particular, but also refers to three other projects, argues that all three models can be seen to be applicable. Cheshire and Feroz, on the other hand, although focusing on the same projects, de-emphasise the relevance of the political actor model by arguing that two of their cases are "better explained" by the rational actor model and the other two by the organisational process model (1989: 125,127).

In view of these disparate findings Belkaoui discusses a number of weaknesses of the adopted approach, suggesting that "three different interpretations may be the rule rather than the exception" (1997: 93). It is argued, for example, that it may be difficult to distinguish between the three models because,

> (i)f there is no possible alternative capable of creating consensus of acceptance between the various players, any choice is a political choice (ibid: 94).

Along the same lines, March (1994: chapter 3 & 4) identifies politics as a general model of decision-making for multiple-actor situations.

To be noted is also that both of the above analyses rely on a definition of a *comprehensive* rational actor model. It has, however, been argued that this model represents an idealisation of decision-making and that policy making in a variety of societal contexts (regrettably) must be *incremental*:

> If the incremental approach has virtue, it is because it offers help to policy-makers when the comprehensive approach offers only utopianism. (Gerboth, 1972: 46) [22]

Other authors within this field use the concept of *the limited rationality model* (March, 1994: 1, 8f) and *boundedly rational* (Simon, 1972 and Williamson, 1975 quoted in Cheshire & Feroz, 1989: 127). The fundamental argument is that the comprehensive rational actor model is unrealistic in its requirement of clearly defined objectives, a theoretical framework for

[22] In contrasting the *comprehensive rationality approach* with *the incremental approach* to decision-making, Gerboth (1972) borrowed from Lindblom (1959).

analysing the problem and full knowledge of all consequences of all alternatives.

In discussing the role of power in organisations, Pfeffer (1981) argues that the bureaucratic and the political models of decision-making – just as the incremental/ limited rationality model – arise from the relaxation of one or more of the criteria of the fundamental comprehensive rational model. Under this view, the bureaucratic model is based on the recognition that the substantial information processing requirements of the rational decision models may be unattainable/unrealistic (ibid: 22). Similarly, as noted above, the political model can be seen to apply when there is diversity in interests / goals (ibid: 27).

Pfeffer (1981) also discusses a forth category of organisational decision-making models (not discussed in the above accounting literature). This is *the decision process models*. As described by Pfeffer, these models depart even further from the rational decision model "by removing the presumption of predefined, known preferences" (ibid: 25). Under this view, decisions are not primarily linked to intentions/goals through value-maximization (rational-choice) or bargaining (political process) or even from rules (bureaucratic models), but are seen as the result of the actual intersection of persons, solutions and problems (ibid: 31):

> In decision process theories it is presumed that policy is the outcome of a choice made by one or several decision-makers. Which choice is made is determined by the situation in which the decision-maker finds himself. This situation is, in turn, largely caused by the process preceding the choice. (ibid: 25)

Pfeffer's category of *decision process models*, appears to have much in common with March's (1966) *decision-making model*[23]. As described, however, there seems to be a difference with regard to the issue of preferences:

> We assume that the components in the system have preferences with respect to social choices, and that the system has a procedure for

[23] This is a sub-category of process models, which is one of six suggested types of models of social choice: (1) chance models, (2) basic force models, (3) force activation models, (4) force-conditioning models, (5) force depletion models and (6) process models (ibid: 333). Whereas the first category emphasizes the role of *chance*, the next four categories can be perceived as variants of the *political model*, the sixth category is described in terms of encompassing choice systems where the choice is "not random" (ibid: 338), but where "the concept of power does not contribute much to our understanding" (ibid: 340).

> rendering choices. The system and the components operate under two limitations:
> 1. Overload: They have more demands on their attention than they can meet in the time available.
> 2. Undercomprehension: The world they face is much more complicated than they can handle.
>
> Thus, although we assume that each of the components modifies its behaviour and its preferences over time in order to achieve a subjectively satisfactory combination of social choices, it is clear that different parts of the system contribute to different decisions in different ways at different times. This general type of system is a familiar model of complex organizations. (ibid: 339)

(2) Models of the accounting rule-making process

In a largely theoretical paper Hussein (1981: 27) argues that technical and political considerations may not be the only factors influencing the (non-) adoption of accounting changes. Using a model of organisational innovation by Zaltman and Wallendorf (1973) as a basis, Hussein proposes that the rule-making process can be seen to consist of three phases: (1) knowledge and awareness (of a performance gap), (2) formation of attitudes and (3) implicit bargaining (see figure 3.3). By outlining *primary communication channels* (top) and *important factors* (bottom) for each phase, the model of the accounting rule-making process proposed by Hussein also encompasses some interesting propositions regarding these stages. For example, it is suggested that attitudes depend not only on the perceived characteristics of various solutions, but also on the social structure and norms of various groups.

The description of the third phase in terms of *implicit bargaining* indicates that Hussein, in similarity with so many others, have assumed that the rule-making process is political. It is suggested that important factors affecting this stage include the relative power of various groups, the presence of coalitions, inter-personal relationships between leaders as well as other parties in the environment.

Hussein's model has, in turn, been used in two studies exploring accounting rule-making in Sweden. It was first used in Jönsson's (1988) study of standard setting in Sweden in the 1970s and 1980s (p. 61). Following this it was also used by Zetterlund (1998) in his investigations into the deliberations of the newly established Swedish Financial Accounting Standards Council concerning its first standard in the early 1990s.

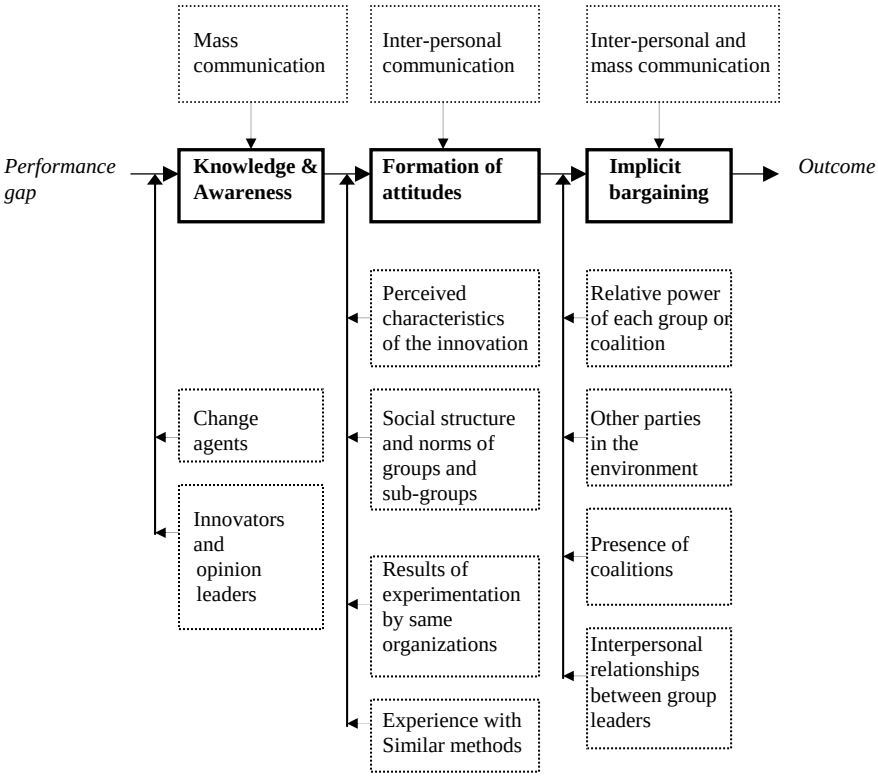

Figure 3.3 *The process of financial accounting standard setting as proposed by Hussein (1981: 29)*

Both Jönsson and Zetterlund have suggested various modifications to the original model. Jönsson, for example, clearly distinguishes between *before* and *after* an item is added to the agenda of a rule-making body. Once and issue has been added to the agenda, the rule-making process is suggested to consist of two phases: *attitude formation* and *implicit bargaining*[24] (figure 3.4). These are the same phases as suggested by Hussein.

[24] In fact Jönsson (1988: 241) uses the term *legitimisation*. This term was also used by Hussein (1981) as an alternative expression to implicit bargaining.

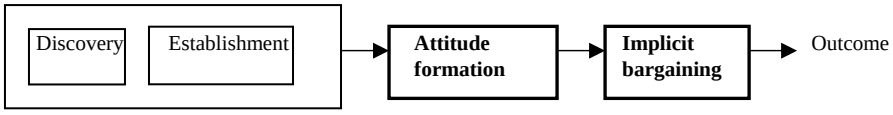

Figure 3.4 *The process of financial accounting standard setting as proposed by Jönsson (1988: 241)*

With respect to attitude formation Jönsson emphasises the role of personal contacts, noting especially that they occur "all over the business community in many places at the same time" (1988: 242). As a result, this phase is suggested to be slow and difficult to survey and control (ibid). Jönsson also suggests that the transfer from the attitude formation stage to the implicit bargaining phase is "almost undetectable to outsiders" (ibid: 243).

In line with this latter suggestion Zetterlund a priori draws a revised model (figure 3.5) where the attitude formation and implicit bargaining phases are not distinguished. Instead he hypothesises that it is reasonable to expect that each member of the rule-making body will form his/her opinion in conjunction with the other members of the rule-making body as it deals with the related issues (1998: 42). Also a-priori, Zetterlund suggests that the process of implicit bargaining can be seen to consist of two sub-phases: internal negotiations (i.e. negotiations involving the members of the rule-making body) and external influence (the influence of external parties) (ibid: 44). Important factors affecting both the formation of attitudes and the internal negotiations are suggested (a priori) to include the worldviews of the members of the rule-making body, the characteristics of alternative accounting solutions and personal relationships.

Zetterlund's findings de-emphasise the *knowledge and awareness* stage, arguing that the knowledge and awareness of alternative solutions were good as the issues encompassed by the observed case had already been discussed for a long time. With respect of the combined *formation of attitudes/internal negotiations* stage, Zetterlund's report focuses particularly on the characteristics of alternative solutions that were discussed, noting that *compatibility with international standards* and *with Swedish law* were particularly discussed. Both of these findings are explained in terms of the task of the Swedish standard setter being one of adaptation (to IAS). Hence it mainly has to deal with issues that have already been dealt with by other

standard setters and its actions are restricted by international standards and national legislation.

With respect of his final phase - dealing with external pressures - Zetterlund (1998) argues that the standard setter did listen to some of the comments received, but that the tendency to make changes to the proposals was less for issues that had already been extensively discussed.

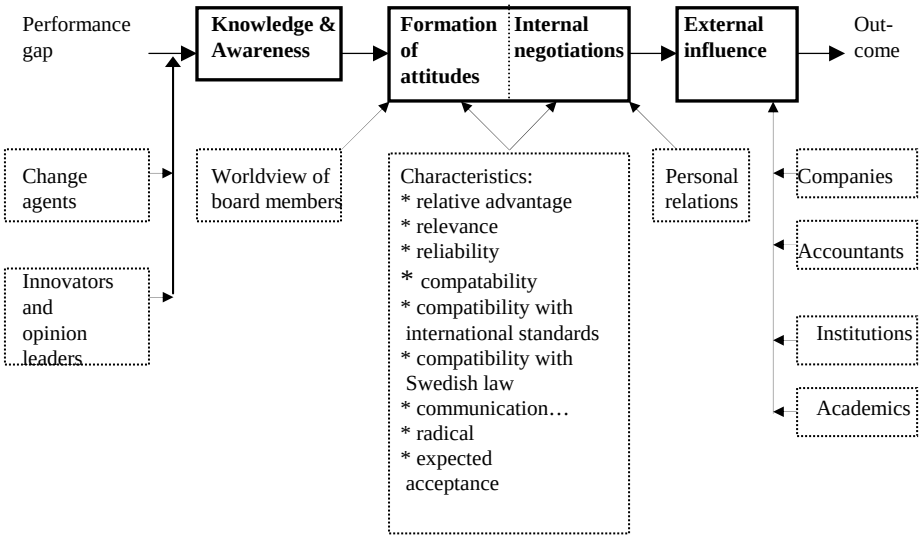

Figure 3.5 *The process of financial accounting standard setting as proposed a-priori by Zetterlund (1998: 41)*

A main contribution of this strand of the rule-making literature seems to be the suggestions that the rule-making process might be seen to consist of a number of *phases* including:

- a starting point, consisting of the discovery / establishment / construction of the need for change and the establishment of the issue on the agenda of a rule-making body;
- a phase during which knowledge and awareness of alternative solutions is developed;
- a phase where attitudes are formed; and
- a phase where a decision is reached (presumably through internal and external negotiations).

The notion of phases in the rule-making process also appears in some other writings. Focusing on the issue of agenda entrance, for example, Walker and Robinsson (1994b) and Klumpes (1994) suggest this is preceded by two further phases: *issue creation* and *issue expansion*.

(3) Factors affecting the rule-making process

Two studies have been identified as addressing the nature of the accounting standard setting process without the guidance of preconceived theories. These studies suggest a multitude of factors affecting the rule-making process (and its product). These relate to conditions within and outside the standard setter as well as to the issues being considered. To a certain extent the suggested factors overlap and in a number of instances it is noted that other authors have also touched on related issues.

The account in this section is structured around the two empirical studies referred to above. A third sub-section introduces the suggestions of institutional theory on the issue of factors affecting the rule-making process. A fourth and final sub-section considers an additional aspect of the rule-making process suggested by standard setting practitioners.

(i) Factors affecting the development of a standard by the ASC (UK)

Based on a grounded theory analysis[25] of the development of a standard by the ASC in the UK, Cottingham and Hussey (2001) identify a number of factors affecting the development of that specific standard. The causal condition – the event that triggered the standard setting body to set up the project – is identified in terms of the IASC's decision to develop a standard on this topic. Five factors - "intervening conditions"- are then identified as, on their own and in combination, having hindered advancement of the project:

(1) the low level of priority assigned to the project, both internally and externally;
(2) scarcity of (secretarial) resources;
(3) expected amendments to, and later lack of clarity in amendments of, UK legislation;
(4) the highly controversial nature of the subject; and
(5) the replacement of one standard setting body with another.

[25] The study relies on an analysis of non-public material from the standard setter's archives, in-depth interviews and participant observation.

Two factors are identified as having contributed to advancing the project:

(6) the intervention of another party providing secretarial resources; and
(7) the impact of a major scandal on public opinion (priority assigned to the issue by its constituents).

- External events (6 & 7)

Both of the latter two factors can be characterised as events outside the control of the standard setter creating changes in one of the factors previously identified as hindering the advancement of the project. In recognition of this potential impact of (non-controllable) external events, Cottingham and Hussey seem to argue that *time management* may be an essential factor in the standard setting process:

> For the ASC, it was not a matter of refusing to give the project high priority but ensuring that it remained on the agenda until there was some convergence of opinions and, perhaps more importantly, a change in public perception towards the need to disclose related party transactions. (ibid: 113)

The significant role attributed to such external events is not unique to this study. For example, Walker and Robinson (p. 64) similarly highlight the "way in which external events may focus attention on specific issues" (1994b: 120). Unfortunately this argument is only made in passing. It appears, however, that they are referring to the stock market crash of 1987 and the release of a US standard on cash flow reporting. Both events were (again) seen to affect the (Australian) opinion from opposition to support of cash flow reporting. Gordon and Morris (1996) (p. 66) similarly refer to overseas development as a factor affecting the Australian process on equity accounting.

- Resource availability (2 & 6)

Resource availability (2), and later changes in this regard (6), is identified an important factors affecting the standard setting process. Nobes (pp. 65-6) has similarly argued that the (speed with which the various (UK) standard-setting processes progressed seemed "to be explicable on the basis of whether resources were being tied up in other areas" (1991: 271). This paper also specifically refers to staff shortages delaying developments.

- The nature of the issues (4)

The discussions of the fourth factor - the highly controversial nature of the standard setting issue - suggest that this has two components: technical and political difficulties. The authors argue that the number of draft versions drawn-up during the process and the many discussions of these drafts suggest that technical issues were important. In addition, they also argue that the standard setter was constrained by difficulties in identifying proposals that would be acceptable to the constituents.

(ii) Factors affecting the development of a standard by the IASC

Using non-public material from the standard setter's archives and interviews Flower (1998) maps the process of developing IAS 37. Although the emphasis is on providing a detailed factual account of the specific process, the paper can be seen to identify two themes with regard to factors and forces affecting the process: the organisation of the standard setting body and the individuals taking part in the process:

- The organisation of the standard setting effort

The main emphasis of Flower's discussion is on the role of and interaction between three bodies within the IASC. With respect to the IASC Board (the body that formally agreed on an IAS), Flower concludes that it "is clearly the ultimate authority", noting that "(i)t does not simply rubber stamp texts proposed by the Secretariat and the Steering Committee" (ibid: 17). The Steering Committee (a task force), on the other hand is suggested not to have played "a decisive role" (ibid). A central role, however, is also assigned to the staff of the standard setter, suggesting that they were "in a strong position to influence" the process (ibid).

Related to this discussion it is also noted that Swieringa has described the FASB as a complex "maze of overlapping organizations and networks" (1987: 1), where people are frequently frustrated by what they cannot do:

> People become frustrated by their limited control or limited role in the process. Board members are constrained by fellow board members and others, the staff is constrained by the board and task forces, and advisory groups are constrained by both the staff and the board. (ibid: 2)

It is also noted that the role of FASB's technical staff has been a frequent topic in the writings of FASB members and staff. Beresford and van Riper, for example, list the "widespread misapprehension that the staff exercises undue influence over the board's decision making" (1992: 82) as one of a number of aspects of the FASB that they believed are frequently misunderstood. This issue is also addressed by Swieringa:

> A recent article … focused on the assertion by some pension advisory task force members that "FASB staff assigned to the project had decided on the standard about 10 years before it was adopted and ignored opposition views along the way". (1987: 2)

The topic of activities (and impact) of FASB staff is also addressed by Miller and Redding[26] (1988, chapter 2). In summary they suggest that the Project Manager's most difficult task is one of diplomacy, finding the compromises by serving as "go-between" (1988: 46). This too suggests an important and potentially influential role for the staff.

- The role of the individual

The second, but not emphasised, theme in Flower's (1998) account is related to the suggestions that certain *individuals* were influential:

> … although the Steering Committee *as a committee* played a relatively minor role, this comment does not apply to individual committee members. Four members in particular were very active in communication their views … (ibid: 17-8).

The potentially important role of individuals in the accounting rule-making process has also been mentioned in some other papers. For example, Hope and Gray (1982: 551) (pp. 60, 64) briefly refer the role of "crucially placed" individuals for the development of the process investigated. Moreover, Walker and Robinson (1994b: 120)(p. 64) argue that the study reported by Walker and Robinson (1994a) highlights the role of key players (in this case Staff members of the standard setter) in shaping the way in which issues were presented to members of regulatory agencies.

(iii) An institutional perspective

A somewhat different perspective on the issue of factors affecting the accounting rule-making process is provided by Young (1994). The paper

[26] Miller and Redding are both accounting academics.

explores the issue of agenda entrance in the context of the US using a framework inspired by institutional theory. In line with this Young argues that agenda entrance requires a combination of three factors:

- the construction of an accounting issue as an accounting *problem*,
- the interpretation of actions as *appropriate* by the accounting rule-maker; and
- the construction of solutions as *appropriate*.

(iv) Accounting standard setters deal with a mosaic of issues

Swieringa has described the work at the FASB's in terms of numerous people involved dealing with numerous issues, most of which are "of little or no interest for most people most of the time" (1987: 1) . In relation to this Johnson and Swieringa (1996) provide some interesting facts by detailing the percentage of staff and board time spent on various projects. In the particular case they focus on 11,000 staff hours in the period 1990 – 1994 represented about three percent of total staff time in those years. Commenting on this, Kinney emphasises that:

> The issues surrounding [that project] were never the primary issues of the day, but were merely part of the mosaic of the items on the FASB's agenda at any one point. Thus, in evaluating the process and the outcome, one must keep in mind the competing demands for the Board's attention, and the need to balance and integrate various aspect of this project in the overall agenda. (1996: 182)

In an appendix Johnson and Swieringa detail the sequence of events for one FASB project. For the uninitiated, the facts that this list contains no less than 111 events from May 1986 to November 1995 (38 of which are board meetings) may be quite thought provoking. Kinney's (1996: 181) comment that this process was not unique in this aspect only serves to emphasise this aspect of the rule-making process.

3.4 Concluding comments & research objective

In a 1993 review of the literature on political activity and accounting rule-making Walker and Robinson conclude that:

> The priorities reflected by the subject of published research to date seem to have been shaped by the availability of data, and the formal statement of some rather crude hypotheses reflecting naïve, pluralist models of the political process. Yet the political process is more complex than

> hypotheses about "size", "managerial incentives" and (formal) lobbying would suggest. (1993: 32)

To a limited extent this criticism has been alleviated by a number of process studies, particularly in their attempts to see beyond the formal lobbying efforts. Even so, it seems that the understanding of accounting rule-making reflected in the academic (research based) literature remains limited.

For example, despite the general recognition that accounting rule-making involves a complex balancing of theoretical and political considerations, little attention seems to have been paid to this aspect of the process. Instead the focus seems to have been almost exclusively on the political aspects, investigating the interests of various constituent groups and the relative influence of such groups (often following allegations that certain groups have "undue" influence).

Despite numerous studies our understanding of both of these issues, however, seems to remain limited. As noted previously, the majority of the empirical research on interests is based on assumptions of self-interests and closely associated with efforts to develop a positive accounting theory. Previous reviews of this large body of research suggest that few general conclusions can be drawn. In fact, various sources suggest that there is uncertainty regarding the existence of interest groups based on affiliation to various constituent groups.

Findings reported with regard to the relative influence of various constituent groups also seem inconclusive. While some studies report that one or other such group appears to have been influential, others suggest no such consistent influence. These contradictory findings may be related to the fact that different regulators, in different countries, at different times, have been studied. In addition, it is recognised that, in similarity with the previous group of studies, most of these studies have relied on publicly available submissions to various proposals by accounting rule-making bodies. Several caveats with this approach have been noted.

Furthermore, although we thus have some indications regarding the interests of various constituent groups and their relative influence in various countries at various times, it has been noted that the role of formal lobbying remains unexplored, as does the issue of how power/influence over the rule-making process arises and is exercised. In other words, it appears that a

comprehensive understanding of the actual rule-making process eludes us. The research accounted for in section 3.3.8 (pp. 66f), however, suggests that it may be fruitful to also take other factors and forces affecting the rule-making process into consideration. In other words, the previous review suggests that there is a need to *both* investigate further how political factors affect the rule-making process *and* to look beyond such factors. Moreover, despite the more recent emphasis of international, even global, regulation of accounting, research on accounting rule-making with an international perspective is still very limited.

The 1993 review of the literature on accounting regulation referred to above includes a number of suggestions with regard to research on actual standard setting processes. Suggestions include to look at how "the way issues are described and presented in discussion memoranda and exposure drafts" may influence the way others respond to those proposals and the role of staff and members of the rule-making body in the process (Walker & Robinson, 1993: 10). The obvious obstacle hindering such research, however, was identified as the availability of evidence. Nevertheless, in order to move on and learn more about accounting rule-making, it seems necessary to try to look beyond written submissions and take a comprehensive view of the standard setting process.

Against the combined background presented in chapters two and three, the overall objective for the research project reported in this thesis was formulated in terms of contributing to the understanding of the (international) accounting standard setting process. This objective was understood in terms of developing the present theory of (ideas on) accounting standard setting beyond general suggestions that this is political, or even that it constitutes a balancing of technical and political considerations. The fundamental research questions for this project were thus phrased in terms of: *How are international accounting standards set? What factors and/or forces affect the standard setting process? How? With what consequences?*

CHAPTER 4

METHODOLOGY

4.1 Introduction

The stated research objective – *to contribute to the understanding of the international accounting standard setting process* – has been approached through an empirical (longitudinal) study of one case of setting an international accounting standard: IAS 12 (revised), *Income Taxes*. In practical terms the undertaken research can be seen to have consisted of three general steps:

- mapping (reconstructing/interpreting) the specific process through a study of documents relating to the project and in-depth interviews with thus identified key individuals;
- using this map (description/interpretation) as a basis for generating ideas about (theory on) the standard setting process in general; and
- contrasting these ideas with previous writings in this subject-area.

This chapter first explains why an inductive approach based on qualitative data from a case study was chosen (4.2). It then describes how the case was chosen (4.3, p. 89) and how data was collected and analysed (4.4, p. 99).

4.2 Methodological considerations

4.2.1 Some fundamental considerations

The purpose of ("scientific") research is often described in terms of advancing the understanding of the real world (Smith & Schalchi, 1981: 28), or more simply: to learn more. It is often presumed that this knowledge should be *objective* in the sense of being "without distortion by personal feelings, prejudices, or interpretations" (http://www.m-w.com/). At the same time, however, the view that we can only know the real world, our environment, through our senses and our constructs (i.e. theories and concepts) has been increasingly accepted. This is the view of the real world being a construction or, in other words, of reality being socially constructed.

Many scholars of the philosophy of science have written extensively and eloquently on the topic of the consequences of this for the purpose, methodology and possible achievements of research. A fundamental argument seems to be that all facts are inter-pretations. As a consequence, subjectivity is unavoidable and objectivity unattainable. In other words, under this worldview, the objective of research can only be to interpret reality, i.e. to strive to achieve an understanding of reality, recognising also that different interpretations are possible. As a further consequence, the literature suggests that the criterion of objectivity must be replaced by intersubjectivity. This concept signifies that outsiders should be able to understand how and why a researcher has reached certain conclusions. Also subsumed in this concept is that others should interpret the findings in (at least roughly) the same manner (Lundquist, 1993: 52).

Another fundamental argument is that, if reality is socially constructed, it is also continuously reconstructed. Related to this, and adding further to the complexities of research in the social sciences, is the recognition that people (the object (reality) studied) are "independent subjects who independently assign meaning to their environment and, to a certain extent, are capable of changing their behaviour according to their wishes" (ibid: 73, translation). Under this view, there can be no universally applicable laws/regularities. In other words, recognition of the context is critical, both objectively (as it really is) and subjectively (as it is perceived) (ibid). This, in turn, has implications for the issue of whether (or the extent to which) findings from empirical research in the social sciences can be reasoned to have more general applicability, i.e. for the issue of generalisation.

Having written extensively on the problems of empirical research in social sciences, Alvesson and Sköldberg argue that it is tempting to conclude that there is no point in trying to undertake such research:

> Following the insight of how difficult or impossible it can be to describe and interpret the "objective reality" (or people's inter-subjective, socially constructed reality …) one can choose to give up empirical research… (1994: 316 translation)

However, they argue strongly against this conclusion, "stubbornly" insisting that it is "pragmatically fruitful to assume that there exists a reality outside the researcher's ego and the research society's ethnocentricity" (1994: 10) and that researchers are able to say something insightful about this reality. In line with this, the (stubborn) objective of this research project has been to try

to say something insightful about the process of setting international accounting standards, a process that is presumably complex as it arises through human action and interaction, constituting a reality that is both inter-subjective and socially (re-)constructed.

4.2.2 The research approach

Two reasons might be put forward for why an inductive, qualitative, case based[1] research approach seemed appropriate. First, it might be argued that the initial review of prior literature suggested that the pre-understanding of accounting rule-making (as suggested by the literature) is incomplete and/or imprecise. As noted in chapters two and three, the literature suggests that this process is political but does not really move beyond this fairly general statement. In the absence of a theory on which hypothesis can be generated and tested, it seemed reasonable to strive to generate theory from empirical data. However, as noted by Alvesson and Sköldberg (1994: 44), hypotheses could be made up.

A stronger argument for the adopted approach is that the very nature of the phenomena under investigation – its perceived complexity and lack of control – makes it ill suited for hypothesis testing even if there were a (more explicit) theory to base these on. Using the terminology of Ryan *at al.* (2002: 145-51) this argument would seem to be an expression of an interpretative research approach (this is contrasted to the positive research tradition)[2]. Under this view, the objective is not to generate hypotheses to be tested at a later point in large-scale statistical studies, but to generate understanding. In practice, however, everybody may not be quite so categorical, e.g.:

> Because of growth in the extent and importance of public policy decisions in accounting, and particularly the growth of regulation, researchers have become increasingly interested in understanding the processes by which these decisions are made. These processes are complex, for a variety of factors are involved. Many different parties participate in the decision-making process, and the number of involved in

---

1 It is not apparent what label to use, different authors ascribing different connotations to these descriptions. For example, Patton (1990: 39-62) argues that *qualitative research* connotes research that practices naturalistic inquiry, inductive analysis, a holistic perspective and uses qualitative data (to mention just four of 10 characteristics).

2 Other writers use different terminology and distinctions. For example, Patton (1990: 37) discuss logical-positivism and phenomenological inquiry as two competing methodological paradigms.

> one decision will probably differ from that involved in another. Each party can approach the problem in a number of different ways and with more or less commitment, which perhaps accounts for different degrees of lobbying. Because policy issues seem to arise independently of each other, the social scientists work from no identifiable structure. Yet *at least initially* he is obliged to work from the complex reality instead of abstracting from it and hence simplifying it, as the experimental scientist does, because he cannot control the conditions of the observations. Without this control he must find alternative ways of explaining events. (Lowe *et. al.*, 1983: 19, emphasis added)

Reflecting on the prospects of an interpretative approach these authors acknowledge that the findings will "tend to be messy, hedged with qualifications, and severely limited in its predictive power", but nevertheless support it as the only way forward (ibid: 20).

As already noted, under an interpretative research approach the focus is not on statistical generalisations, but on theoretical generalisations. With regard to this issue Alvesson and Sköldberg (1994: 41) argue that an important weakness with such an approach is inherent in the leap from observed specifics to the suggestion of a general rule, namely that underlying structures or contexts are not adequately taken into consideration. Later they re-phrase this in terms of not being able to generate theory but only empirical regularities.

As a remedy to this they suggest *abduction*, which they describe as something more than a mere combination of induction and deduction (ibid: 42). Although the precise nature of their reasoning remains somewhat elusive[3], they seem to suggest that, in contrast to pure induction, previous theorising plays a key role in abduction, e.g.:

> The empirical analysis can thus very well be combined with, or be preceded by, studies of prior theory in the literature: … as a source of inspiration for the discovery of patterns that generate comprehension (ibid, translation from Hellman, 2000: 50)

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3 Initially they argue that abduction, like induction has its base in empirical facts, but in contrast to pure induction does not reject theoretical a-priori hypotheses. Later, however, they argue that abduction starts with the empirical regularities, i.e. that abduction takes-off where induction ends, lifting the empirical regularities to the level of theories. (ibid: 41-4)

With respect to these concerns, it is noted that this research started with an initial reading of previous literature on accounting rule-making. Essentially this reading suggested that standard setting is political. Over the years, the body of previous literature was extended. It is therefore unavoidable that the ideas presented in previous writings may have affected the interpretation of the empirical material and the generation of ideas about (theory on) the standard setting process in general. However, it must be emphasised that, for a long time, the ambition was to remain inductive in the sense of letting data speak and that the in-depth review of prior literature was not made until the time had come to make comparisons with prior research.[4]

4.2.3 A grounded theory approach?

Today it seems almost impossible to conduct inductive qualitative research without relating to the notion of *Grounded Theory* (GT). GT is not a theory, but a way of conducting inductive empirical qualitative research with the objective of generating (discovering) theory that is "grounded" in empirical data. Since its inception[5] GT has been refined and developed in subsequent publications. As a result, there is not one way of doing GT research, but several. However, fundamental to this approach is the use of a systematic set of procedures for interpreting and conceptualising data and relating the concepts to form a theory. These procedures include systematic comparisons, various types of coding of the empirical material and the use of theoretical notes.

The undertaken research does not make claims to have followed a GT approach. However, the adopted approach also aims at letting the findings emerge from the empirical data. It must also be acknowledged that both the analysis of the case, and the attempts to generate ideas about the accounting setting process from this case, have been inspired by some of the ideas presented by two writers on GT: Strauss and Corbin. In particular, *asking questions* has been extensively used as a basic means of analysing the data:

> To discover theory in data we need theoretical sensitivity, the ability to "see" with analytical depth what is there. Later in the research project, theoretical sensitivity develops from working with the materials

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4 As a result it is acknowledged that some of the understanding presented in the chapter on previous literature has evolved both parallel and subsequent to the findings suggested in part III.

5 GT was originally made popular in a book by Glaser and Strauss (1967).

> themselves. But in the early analytical stages, we need ways of opening up our thinking about the phenomena we are studying. (Strauss & Corbin, 1990: 76)
>
> There are certain general questions that can be raised quite automatically about the data. Each question is likely to stimulate a series of more specific and related questions, which in turn lead to the development of categories, properties, and their dimensions. The basic questions are: Who? When? Where? What? How? How much? And Why? (ibid: 77)

Their repeated emphasis of the need to *conceptualise* (rather than to summarise) data also provided guidance when it came to consider the findings of the undertaken research, as did two of their suggested techniques for moving from concepts to theory. The first of these was to continuously write *theoretical memos* (including attempts to draw diagrams relating various concepts based on their rationalistic "coding paradigm"[6]). Although the importance of these memos, which were often scraps of paper with a few words jotted down, should not be exaggerated, they did provide a very concrete starting point for the analysis. The second suggested technique that proved useful was to strive to identify a main "story line" (ibid: 116-122). This has been applied both in the presentation of the findings with regard to the specific case (part II) and with regard to the suggested findings from the research project (part III, chapter ten).

4.2.4 The availability of data

The concluding discussion of the previous chapter suggests that some of the shortcomings of prior research may be ascribed to limitations in the availability of data relating to accounting rule-making (pp. 77-9). These limitations are of two kinds. First, in the case of the IASC at the time the research was undertaken, only a small part of its process was open to the public. For example, in similarity with many other standard setters, only certain documents were made public (see figure 4.4 p. 96).[7] Another limiting factor is that standard setting processes tend to be extended both in time and

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6 Strauss Corbin suggest that the analysis may be aided by trying to identify the conditions that give rise to a phenomenon (causal conditions), the context of the phenomenon, intervening conditions, the strategies by which it is handled and the *consequences* of those strategies (ibid: 96-9).

7 More recently there have been significant changes in this area. In March 1999 the IASC Board meetings were opened up to observation by the public (IASC, 1999: 4).

space, making observation of an actual process a less suitable strategy even if it were a possible strategy.

Because of these dual conditions, the availability of data was a fundamental methodological consideration for the undertaking of a research project with the stated objective. It was recognised, however, that a specific characteristic of standard setting processes is that they tend to leave a significant trail of documents[8]. This makes this phenomenon perhaps more suitable for document analysis than many other processes, provided access to these, often non-public[9], documents is achieved. A key requirement for the undertaken research was therefore the co-operation of the IASC. Fortunately, the Secretary-General of the IASC at the time, Sir Bryan Carsberg responded positively to a request to gain access to the IASC's internal files. One condition was stated: that I "…would not name any individual board member or member of IASC committees or the staff, as holding a particular opinion, or in any other way without the explicit consent of that person" (Letter from Sir Bryan Carsberg, October 31st 1996).

Even in the case of a well documented process, however, there are likely to be many gaps in the documents. Some of these can be addressed through interviews with knowledgeable individuals (i.e. individuals having taken part in the process). Another condition therefore, was the co-operation of informed individuals in terms of sharing their knowledge of the actual processes. Although this co-operation could not be assured beforehand, it is believed that the co-operation of the IASC in the first place may have helped to open some doors.

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8 See figures 4.3 and 4.4 below (pp. 95-6) and add to this draft versions of the various documents and other material prepared before and after the many meetings.

9 Again even more recently there have been significant changes in this area, the IASB posting several documents on the IASB homepage (http://www.iasb.org/).

4.3 The choice of a standard setting process

4.3.1 Selection criteria

A key design issue in the initial stages of the project concerned the choice of cases - standard setting processe(s)[10] - to investigate. The background presented in chapter two suggested that the nature of international accounting standard setting process subsequent to the IASC's adoption of a more normative approach in 1987 (pp. 23-4) would seem to be the most interesting. Between 1987 and the end of 1996 (when the empirical part of the research began) 27 standard setting processes were initiated by the IASC. Three of these were merged with other projects, thus reducing the population to 24 (figure 4.1). Ten of these were new standards project, ten of these were part of the Comparability / Improvements Project[11] and four were other revisions of previous standards.

A number of criteria were considered as a basis for choosing one or more cases. The most fundamental of these was that the projects had been completed by the time of the data collection. This criterion was set up in recognition of the fact that standard setting processes tend to be extended in time in combination with the intentions to study complete processes.

13 of the 24 projects had been completed by the end of 1996/beginning of 1987. Ten of these were part of the Comparability / Improvements Project. These were generally considered less suitable because slightly different due process procedures had been applied for these processes.[12] However, owing to the small number of other projects, they were not completely ruled out.

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10 The choice of definition of a case was between standard setting projects and specific issues (accounting policy choices) subject to standard setting. The first definition was found to be more appropriate under the assumption that an issue is normally not treated as a distinct entity, but as part of a larger process (a standard).

11 See footnote 24 p. 24.

12 The due process for the Standards affected by the Comparability / Improvement Project did not include *Point Outlines* and *Statement of Principles*. The comment periods were also shorter than usual. In addition, the standards were treated as a set, the acceptance of each pending the approval of the whole package. (e.g. IASC, 1992a: 6; 1992c)

	IASC project	Added to agenda	Completed by beg. of 1997
A	***New Standards:***		
1	Financial Instruments	1988	No
2	Intangible Assets	1989	No
3	Cash Flow Statements[13]	1989	IAS 7 (R) 1992
4	Earnings per Share	1990	No
5	Presentation of Financial Statements	1991?	No
6	Agriculture	1994	No
7	Interim Reporting	1995?	No
8	Discontinuing Operations	1995	No
9	Provisions & Contingencies	1995	No
10	Impairment of long-lived assets	1996	No
B	***Comparability / Improvements project:***	1987	1993
1	Research and Development Costs		
2	Inventories		
3	Borrowing Costs		
4	Revenue Recognition		
5	Construction Contracts		
6	Property, Plant and Equipment		
7	The Effects of Changes in Foreign Exchange Rates		
8	Business Combinations		
9	Extraordinary items, Fundamental Errors and Changes in Accounting Policies		
10	Retirement Benefits		
C	***Revision of other IASs:***		
1	Income Taxes	1987	IAS 12 (R) 1996
2	Reporting Financial Information by Segment	1993	IAS 14 (R) 1997
3	Employee Benefits	1993	No
4	Leases	1996	No
(5	Research and Development Costs	1995/6	Merged with A2)
(6	Goodwill	1995/6	Merged with A2)

Figure 4.1 Projects undertaken between 1987 – end 1996, final column notes whether the projects had been completed by January 1997.

Much has been written on the selection of cases. Some of the confusion in this area, however, is dispelled by the suggestion that the demands on, and reasoning about choice criteria and the general approach to the selection

13 This project has been categorised as a new project despite the fact that the resultant IAS replaced an existing IAS.

process differ between the positive and interpretative traditions (p. 82) (Patton, 1990: 169; Ryan et al., 2002: 145-151). Whereas concerns of selecting random and/or representative samples are appropriate for a case study based in the positive tradition, with the aim to make statistical generalisations, the logic within the interpretative tradition is quite different. Patton uses the concept of *purposeful sampling* and *information-rich cases:*

> The logic and power of purposeful sampling lies in selecting information-rich cases for study in depth. Information-rich cases are those from which one can learn a great deal about issues of central importance to the purpose of the research, thus the term purposeful sampling. (ibid)

The GT literature similarly speaks of *theoretical sampling*, arguing that the emerging theory should dictate subsequent choices (Glaser & Strauss, 1967: 47) (Strauss & Corbin, 1990: 176, 181, 185, 187).

What then should dictate the choice of the first case? Numerous strategies for selecting cases are mentioned in the literature. Ryan et al. (2002: 151) suggest that selecting an *extreme* case may be suitable in situations where there is little available theory. On the other hand, they also argue that the selection of a case in such a situation is relatively unimportant. Patton (1990: 169-183) discusses no less than 16 possible strategies, without making any specific recommendations. Two suggestions, however, seemed particularly useful: (1) to think through what cases you expect to learn the most from (ibid: 170) and, in the case of limited resources, (2) to look for a *critical case*:

> Critical cases are those that can make a point quite dramatically or are, for some reason, particularly important in the scheme of things. A clue to the existence of a critical case is as statement to the effect that "if it happens there, it will happen anywhere," or, vice versa, "if it does not happen there, it won't happen anywhere." (ibid: 174)

Based on the pre-understanding that accounting standard setting is essentially about resolving conflicts it was argued that cases that appeared to be relatively *more controversial* were more likely to provide insight into the process of setting an accounting standard. This could be interpreted either as a case of selecting *extreme* or *critical* cases.

In order to identify candidate projects based on this main criterion, previously identified projects were studied in more detail (based on publicly available information) to outline the main characteristics of the identified

processes. First, however, as a background, a basic understanding of the IASC's standard setting process in general was sought based.

4.3.2 The IASC's standard setting process in general

Introducing the IASC

Even a brief introduction to the IASC standard setting process pre-supposes a general understanding of the IASC. This section thus begins by introducing this standard setter and its various bodies.

The Committee and the Board

The IASC – the International Accounting Standards Committee - was founded by the professional accountancy bodies of nine countries in 1973. It was thus a private sector standard setting initiative. Over the years the membership grew. In 1998 the number of countries with IASC members passed 100 (http://www.iasb.org/about/history.asp)[14] . As of January 1999, it had 133 members, five associated and four affiliate members in 103 countries (IASC, 1998a: 14).

The *Committee*, which was made up of representatives from all of the numerous Member Bodies, met rather infrequently (once every two and a half years). Its powers were also limited. Instead all the IASC's executive powers, including the setting of International Accounting Standards (IASs), were delegated to the IASC *Board*. The size and composition of the Board varied over the life of the IASC. However, it was a much smaller body, consisting (at the end) of 16 *Board Members*, 13 of which were IASC Member Bodies[15] (figure 4.2, p. 96).

Although in one sense a relatively small body, the Board was a rather large body in physical terms. This was because each Board Member was entitled

14 Since 1983 the members of the IASC have been the same as those of the International Federation of Accountants (IFAC) (IASC, 1998a: 14). At the same time it was also agreed that the "IASC would have full and complete autonomy in setting international accounting standards and in publishing discussion documents on international accounting issues" (ibid).

15 The Board comprised 13 so called country Members appointed by the Council of the IFAC and up to four co-opted Members (organisations having an interest in financial reporting) appointed by the Board itself (IASC Constitution, 1992 in e.g. IASC, 1997: 18).

to be (and normally was) represented by two *Board Representatives*[16] and, in some cases, a *Technical Adviser* (IASC, 1997: 18). Although mainly selected following geographic representation[17], the Constitution of the IASC stated that the Board Representatives should "not regard themselves as representing sectional interests" but should be "guided by the need to act in the public interest" (ibid). Also to be noted is that the Board Representatives (and their Technical Advisers), from the IASC point of view, were part-time volunteers.

The Board conducted its business by formal *Board Meetings*. These were held three/four times a year in various locations, each meeting generally lasting three-four/five-six days[18]. During these days the Board dealt with a number of agenda items. Apart from various standard setting projects, agenda items also included other non-technical (e.g. strategic) matters. All discussions were held in English.

In addition to the various Board Representatives and Technical Advisers, Board meetings were also attended by various members of the IASC Staff (see below) and so called Observers[19], increasing the number of participants significantly. Flower and Ebbers report that in 2000 "the total number of persons attending Board meetings … regularly exceeded 70" (2002: 247-8).

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16 Each Board Member was free to determine its own Representatives, however, at least at the end the Board "encouraged" each Board Member to "include in its delegation at least one person working in business and one person who is directly involved in the work of the national standard setting body" (IASC, 1998b : 63).

17 At the end it was specifically set out that the 13 country seats should include "(a) at least nine of the most significant countries in terms of the status and development of the accountancy profession or that are of significant importance to international commerce or trade: and (b) preferably, not less than three developing countries" (IASC, 1998b: 62).

18 In 1996 the Board agreed to accelerate its work programme increasing the number of meetings and days (IASC, 1998b: 64).

19 A number of Observers were, at the invitation of the IASC Board, entitled to attend Board meetings with the right to speak but not vote. At the end of the IASC's life the list of Board Observers included the IFAC, the European Commission, the US standard setting body the FASB, the International Organization of Securities Commissions (IOSCO), the Public Sector Committee of the IFAC and China (IASC, 1998b: 63).

Years: / Members:	73	78	83	84	86	88	93	95	96
Founding members:									
Australia	X	X	X	X	X	X	X	X	X
Canada	X	X	X	X	X	X	X	X	X
France	X	X	X	X	X	X	X	X	X
Germany	X	X	X	X	X	X	X	X	X
Japan	X	X	X	X	X	X	X	X	X
Mexico	X	X	X	X	X	~~X~~		X	X
The Netherlands	X	X	X	X	X	X	X	X	X
UK & Ireland	X	X	X	X	X	X	X	X	X
USA	X	X	X	X	X	X	X	X	X
Other country seats:									
India							X	~~X~~	
India & Sri Lanka								X	X
Italy			X	X	X	X	X	~~X~~	
Korea						X	~~X~~		
Jordan						X	X	~~X~~	
Malaysia								X	X
Nigeria		X	X	X	X	~~X~~			
Nordic Federation						X	X	X	X
South Africa		X	X	X	X	X	X	~~X~~	
South Africa & Zimbabwe								X	X
Taiwan				X	X	~~X~~			
Other seats:									
International Co-ordinating Committee of Financial Analyst / International Council of Investment Associations					X	X	X	X	X
Federation of Swiss Holding companies								X	X
International Association of Financial Executives Institutes (IAFEI)									X
	9	11	12	13	14	14	14	15	16

Figure 4.2 *Summary of Board make-up during 1973- 1996*
The Board was expanded to 11 countries in 1977. It was then expanded to 13 countries + four other organisations with an interest in financial reporting in 1982. These other (non-country) seats, however, were only slowly filled.

In addition to the Board, the IASC also encompassed a number of other bodies including the *Consultative Group*, the *Advisory Council*, numerous *Steering Committees*, the *Standing Interpretations Committee* (SIC) and the *Executive Committee* (IASC, 1998b: 61). Of these, the Consultative Group and the Steering Committees, as well as certain members of IASC Staff seem to have participated in the IASC's standard setting process[20]. These two bodies and the IASC Staff are briefly introduced below.

The Consultative Group

The Consultative Group was established in 1981. It included representatives of international organisations of preparers and users of financial statements, stock exchanges and securities regulators etc. (IASC, 1998b: 66). The tasks of the Consultative Group were described in terms of "advising" the Board on technical issues in specific standard setting projects, on the IASC's plans and priorities (work programme), on the likely acceptability of the IASC's standards and on the IASC's strategy (ibid: 67).

Steering Committees

For each standard setting project the Board normally appointed a Steering Committee, a (small) task force[21], with the objective to direct preliminary research on the project and to prepare drafts of various documents to be submitted to the Board (ibid: 65). The tasks of the Steering Committee are further described in the next section (i.e. in the introduction to the IASC's standard setting process).

Each Steering Committee was chaired by a Board Representative. Some early information suggest that each Steering Committee usually included member from at least three other countries and, sometimes, members

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20 The Advisory Council was established in 1995 to promote generally the acceptability of IASs and to enhance the credibility of the IASC's work (ibid: 64). The SIC was formed in 1997 to "consider, on a timely basis, accounting issues that are likely to receive divergent or unacceptable treatment in the absence of authoritative guidance" (ibid: 65). The SIC developed Interpretations, which constitute a different type of standard/statement published by the IASC. The Executive Committee, finally, managed various "administrative matters" (ibid: 67).

21 Steering committee is defined as "a managing or directing committee; *specifically* **:** a committee that determines the order in which business will be taken up in a U.S. legislative body" (http://www.m-w.com/). Task force is defined as "a temporary grouping under one leader for the purpose of accomplishing a definite objective" (http://www.m-w.com/).

representing preparers and users of financial statement and other organisations represented on the Board or the Consultative Group, or which are expert in the particular topic (IASC, 1993a: 2). Later information states that a Steering Committee usually had six to eight members, noting also that most Steering Committee Members were "neither Board Representatives nor members of their national standard setter" (IASC, 1998b: 65).

The IASC Staff

The IASC (its various bodies) was supported by a Secretariat based in London. The Staff, which was headed by a Secretary-General, consisted at of both technical and other support staff.

Introducing the standard setting process

The IASC standard setting process can be seen to have consisted of two stages: an initiation process leading up to the adoption of the topic to the IASC's agenda and the subsequent process of developing an IAS.

The decision to add a topic to the agenda was taken by the Board. The process preceding this decision was not generally defined:

> Board Representatives, Member Bodies, members of the Consultative Group, other organisations and individuals and the IASC staff are encouraged to submit suggestions for new topics … From time to time, the staff prepares project proposals which set out the reasons why particular topics should be added to the current work programme. These proposals are considered by the Board. (IASC, 1994a: 9)

Once a topic had been added to the agenda, however, the IASC followed a specified "due process". Although amendments were made to this process over time it generally consisted of the following steps:

- the appointment of a Steering Committee (see above),
- the development, approval and circulation of a:
  - Point Outline (PO),
  - Draft Statement of Principles (DSOP),
  - Statement of Principles (SOP),
  - Exposure Draft (ED); and finally,
  - a standard (IAS).

More detail on this process is provided in figure 4.3:

Following the adoption of a topic to the IASC's agenda, the process of developing an IAS consists of several steps. The exact nature of the process depends on the circumstances. However, the process normally includes the following basic steps:

- preliminary research (identifying and reviewing the accounting issues associated with the topic, considering the IASC's conceptual framework as well as national accounting requirements and practices).
- the development of a *Point Outline (PO)* clarifying the scope of the project;
- the development and circulation of a *draft Statement of Principles (DSOP)* (or other *discussion document*) setting out the underlying accounting principles that will form the basis for the preparation of the Exposure Draft, describing the alternative accounting solutions considered and the reasons for recommending their acceptance or rejection[22];
- the development of a *Statement of Principles (SOP)*[23];
- the development of a draft International Accounting Standard exposed to public opinion through the publication of an *Exposure Draft (ED)*.
- the development and publication of an *International Accounting Standard (IAS)*.

Figure 4.3 The IASC's due process (IASC, 1993a: 3; 1993c; 1994a: 9-11, 1998b: 65, 69)

The major deficiency of this description of the standard setting process is that it says very little about the actual production of the documents listed above. As noted in the previous sub-section, the actual standard setting work of the IASC was conducted by the Board, the Steering Committee and its Staff. Comments were requested at various stages from the public and from the Consultative Group. Based on public descriptions of the IASC's due process an alternative description of this process has been drawn up in figure 4.4. However, even this description represents a simplification of the actual process. For example, it seems likely that there are also various forms of informal discussions between various meetings.

A further limitation of the above representations is recognised by acknowledging that the specific standard setting process was said to depend on the circumstances in each case; that

> the Board may decide that the needs of the subject under consideration warrant additional consultation or would be better served by issuing a Discussion Paper for comment. It may also be necessary to issue more than one Exposure Draft before developing a draft International Accounting Standard. (IASC, 1994a: 11)

22 The Board may instruct the Steering Committee to skip this stage.

23 Available to the public on request, not separately published.

Document	Staff	SC	Board	Consultative Group	Public
Proposal	Develops		Discusses / approves project	Comments? [24]	
Preliminary Research	Carries Out	Directs			
PO	Prepares material & draft	Approves for submission to the Board	Discusses, comments & approves	Comments?	
DSOP	Prepares material & draft	Discusses, comments, approves and publishes	(Board approval not require)	Comments?	May comment (exposure period 3 months)
SOP	Prepares material & draft	Discusses, comments and approves draft SOP for submission to the Board	Discusses, comments & approves	Comments?	
ED	Prepares material & draft	Discusses, comments and approves draft ED for submission to the Board	Discusses, comments & approves (two thirds majority)	Comments?	May comment (exposure period 6 months)
IAS	Prepares material & draft	Discusses, comments and approves draft IAS for submission to the Board	Discusses, comments & approves (three quarters majority)	Comments?	

Figure 4.4 Alternative description of the process of developing an IAS

24 Exactly what the Consultative Group was asked to provide input on is not clearly identified in the literature.

4.3.3 Main characteristics of the identified processes

Based on a review of IASC newsletters[25] and annual reviews the IASC's standard setting activities between 1987 and 1997, the main characteristics of the previously identified standard setting processes were identified. The findings are summarised in figure 4.5, which lists the [expected] length of the projects, the documents issued and other special characteristics.

A first observation was that the standard setting processes were generally quite complex, often encompassing a number of issues and involving a number of individuals and organisations. A related observation was that the processes did not seem to rigidly conform to the model process portrayed in the previous figures, with the implication that no two standard setting processes were alike. In particular, they were often less straight-forward than the model: drafts were revised again (and again) before being approved, revised EDs were published as projects were split, merged, restricted, deferred and reinitiated. Some processes included the full range of documents; others only encompassed a selection of these and/or include additional items such as Discussion Papers, Issues Papers and "tentative conclusions" being published for public comments. Sometimes special meetings were arranged to discuss particular issues with invited commentators such as national standard setters. As a result, the length and progression of the various projects varied greatly. The processes also differed in other respects. For example, some projects are undertaken jointly, or in co-operation with one or more national standard setter.

Although all processes appear to have been quite complex, some projects seem to have been significantly more so; drafts being discussed at several Board meetings, issues being referred back for further work, projects being split, more than one ED being published, etc. Three projects stood out in particular: A.1 *Financial Instruments*, A.2 *Intangible Assets*, and C.1 *Income Taxes*. Of these, only C.1 satisfied the criterion of completion.

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25 *IASC News* started in 1973. In July 1991, this newsletter was replaced with *IASC Insight* and *IASC Update*. (E-mail Claire Guenebeaud, Publications Administrator, IASC, May 25th 2000).

	Project	No. years	PO	DS OP	SOP	ED	IAS	+	Comments
A	***New Standards:***								
1	Fin. Instruments	[10]	1	1	1	2 [1]	1 [1]	DP	Split, joint
2	Intangible Assets	[9]		1	1	1[1]	[1]		Deferred
3	Cash Flow Stat.	3½			1	1	1		
4	Earnings p. share	7	1	1	1	1	1		def., co-op
5	Pres, of Fin.Stat.	[5]	1	1	1	1	[1]		
6	Agriculture	[5]	1	1		[1]	[1]		Sponsored
7	Interim Report.	[2½]		1	[1]	[1]	[1]	IP	co-op
8	Disc. Operations	[2½]		1	[1]	[1]	[1]		
9	Prov & Cont.	[2]		1	[1]	[1]	[1]		Joint
10	Impairment ...	[2]				[1]	[1]	TC	SC merged
B	***C / I – project:***	7						SOI	
1	R & D Costs	(5½)t				2	1		
2	Inventories	(5½)t				2	1		
3	Borrowing Costs	(5½)t				2	1		
4	Revenue Rec.	(6¼)t				2	1		
5	Constr. Contr.	(6¼)t				2	1		
6	PP & Eq	(6¼)t				2	1		26
7	Foreign Ex. Rates	(6¼)t				2	1		26
8	Bus. Combinations	(6¼)t				2	1		27
9	Eo-items etc.	(6¼)t				2	1		28
10	Retirement Ben.	(6¼)t				2	1		29
C	***Rev.other IASs:***								
1	Income Taxes	9½				2	1	BP	Deferred
2	Seg, Information	[3]		1	1	1	[1]	IP	Parallel
3	Employee Benefits	[3]	1			[1]	[1]	IP	
4	Leases	[2½]				[1]	[1]		Limited
(5	R & D Costs	[1½]							merged)
(6	Goodwill	[1½]				[1]	[1]		merged)
(7	Investments	[?]							merged)

Figure 4.5 Summary of various due processes initiated after 1987 made end 1996.

26 ED referred back before being approved

27 Board approved ED, but asked staff to carry out further research and to revise the draft as necessary before publishing an ED.

28 ED was discussed at one Board meeting prior to being approved.

29 Revision strictly limited to those required by the Statement of Intent and the change in format.

Three more projects also appeared relatively more complex in that they encompass two EDs, exposing alternative solutions to various issues for public comment: B.1 *Research and Development Costs*; B.2 *Inventories*; and B.3 *Borrowing Costs*. All of these, however, were encompassed by the Comparability / Improvements Project and therefore deemed less suitable.

Against this background it was decided that the project should start with the Income Tax project. As it turned out, the workload involved in analysing the collected material for this one case was so high that it was later ruled-out that the project should be broadened to also include other cases.

4.4 Data collection and analysis

4.4.1 Introduction

A characteristic of inductive qualitative research seems to be the use of a combination of a variety of data sources and methods. Strauss and Corbin (1990: 20) suggest that interviews and observations are generally the most common source of data for qualitative research. However, as already noted, observation seems less suited for a longitudinal case study of standard setting.[30] Instead the study relies on a combination of document analysis and in-depth interviews, where the information gathered from the study of the documents was used both as a first step in the more general endeavour and as a benchmark against which the interview data could be related. The following sub-sections describe how these data were collected and analysed.

4.4.2 The documents

The collection of various documents relating to this project began at the end of 1996 by first reviewing external (public) information relating to this project. Such information was primarily found in various IASC newsletters[31]. Following this, the collection of internal (non-public) IASC material was begun by photocopying relevant material distributed to the IASC Board. This was available through a Swedish representation on the Board. Then, end of March 1997, I spent one week at the IASC's offices

30 Nevertheless, having reviewed the documentation and undertaken the interviews, I did observe an IASC Board meeting (June 2000). Although totally unrelated to the chosen case, it was felt that this contributed to the understanding of the process. In particular, it was felt that the experience confirmed the "feelings" conveyed through the documents and interviews.

31 See footnote 25 p. 97.

photocopying other relevant documents available in the IASC archives (e.g. material distributed to Steering Committee Members). Although I had been told that these files were "not very detailed" (Letter from Sir Bryan Carsberg, March 12th 1997), I found a very extensive collection of documents; the material relating to this project fills ten Swedish binders. It consists of documents distributed to Board Representatives and Steering Committee Members prior to various meetings, minutes of Board meetings and, in some cases, informal minutes or notes from Steering Committee meetings and copies of letters/faxes with written comments from various parties prior to or between some meetings. In some cases there were notes taken by IASC Staff in relation to phone conversations. In addition there were also, in some cases, various drafts of draft documents to be submitted to the Board / Steering Committee and comments on these.

Although thus quite extensive, it must be emphasised that the material found was not complete. In a few cases this was evident from the material itself, for example documents referencing other documents that have not been found. In other cases this was made evident by some of the contributions later made by some of the interviewees (see below). In fact, one interviewee generously allowed me full access to his personal file relating to this project.

To be noted is perhaps that the amount of documentation increased significantly over the years (see next section in relation to figure 4.6, p. 102)

4.4.3 Constructing a time-axis

A first review of the documents suggested that the chosen process was very complex, encompassing numerous events and accounting issues. As a result, it was deemed hard to gain an understanding of the process without a more detailed review of the material. This review in itself took almost a year to complete, owing partly to the amount of material to cover and partly to the fact that the material was often quite hard to access.

The detailed review of the material resulted in a time-axis where different events (e.g. documents and meetings) were listed in chronological order (see figure 4.7, p. 103). In the case of the various meetings, descriptions of these in various documents were included. In the case of the numerous documents, it was decided to include the content of these word for word, rather than to summarise them. Although this entailed more work (which was later eased by finding means to scan the documents), an important argument was that it was often not apparent how to summarise the documents. Furthermore, the

inclusion of the original texts in the time-axes documents[32] was felt to aid future analysis. Although no complex databases were established as such, the search function of the word-processing program can quickly identify all references to e.g. a specific technical issue, or individual, in a given period.

Listed events (documents and meetings) were also commented (using a different format to clearly distinguish these comments). It was, e.g. noted which, if any, technical issues were referred to and attempts were made to understand who the parties involved were and how the event fitted into the process as a whole (see figure 4.7).

In total the documents including these time-axes, which may be perceived as my raw-data for the document analysis, encompasses about 2,000 pages. The general increase of documentation over the years noted above is clearly reflected in figure 4.6, setting out the number of pages encompassed by the time-axes documents for various years.

Because no attempt has been made to make these accounts anonymous, these have not been separately reported. For the same reason I have also chosen only to include a short excerpt in figure 4.7 (this has been modified in order not to reveal any identities).

To ease cross references and identification of the original documents, each document was given a unique identification consisting of the date of origin and a letter combination, e.g. a comment letter from X to Y written on January 10th 1994 was coded 940110LXY. In the case references are made to such documents in this text, the end of the code has been removed in order not to reveal the identity of those involved.

32 The time-axis was originally constructed in a word document. With time, this became so large that it was split into several documents. In the latter stages of the project, several documents were used for a single year.

Period	Number of pages		Period	Number of pages	
Chapter 5:			***Chapter 7:***		
1970s	3		1992	57	
			1993	253	
			1994	299	
Chapter 6:				609	31%
1980 – 1981	12				
1982 – 1983	16				
1984 – 1985	13		***Chapter 8:***		
1986 – 1987	10		1995	538	
1988	108		1996	576	
1989	82			1 114	56%
1990 – 1991	13				
	254	13 %			
			Total:	1 980	100 %

Figure 4.6 The time-axis – number of pages / year
For explanation of periods, see p. 104.

4.4.4 Distilling a chronological description

The time-axes thus constructed from the initial review of the documents can be seen as an attempt to give an "honest account" of the process with little or no interpretation of the data (Strauss & Corbin, 1990: 21). However, despite the inclusion of various comments from the researcher, it was more in the character of raw data than an account of the process. Because of this, in combination with its length, it remained inaccessible. In order to progress with the analysis it was thus decided that the next step would have to be to condense this material into an "accurate description" (ibid.) of the process.

Although the ambition was to keep interpretations to a minimum, reducing the material and transforming the time-axis into running text, of course, implied both selection and interpretation by the researcher. The problem of selection, however, was initially dealt with by trying to write both an accurate and complete description. This decision was partly based on a lack of ideas as to what was important and what was not. Although the ambition was to be concise, the first version of this running-text description covered

1994 **January 10th – Comment letter from X on ED931221**

Letter faxed from X (Director – Accounting Standards at …) to Y (project manager) indicating that the X will not be able to meet the deadline (21st), but that a comment will be forthcoming before January 31st. [940110LXY]

SINCE … REPLIED LATER THE SAME DAY THE LETTER WAS PROBABLY FAXED. NOTE THAT X WAS ONE OF THE COUNTRIES IDENTIFIED AS OPPOSING THE BS APPROACH AT THE NOVEMBER BOARD MEETING.

Reply to X from Y

Reply from Y to X noting that 31st January is "fine", but that that he is working on "a tight deadline":

" … ." [940110LYX]

LETTER EMPHASISES THE IMPORTANCE THAT THE SC "HAVE SOME IDEA AS TO THE CURRENT VIEWS OF THOSE COUNTRIES THAT WERE OPPOSED TO THE BALANCE SHEET APPROACH" AT THE NOVEMBER BOARD MEETING AND THAT THE VIEWS OF Z (A COUNTRY) ARE PARTICULARLY IMPORTANT TO THE EXTENT THAT Z AND IASC SHARE A SIMILAR CONCEPTUAL FRAMEWORK:

"I am particularly interested in the views of Z on the balance sheet approach. Going into the Oslo Board Meeting the Board was … as between those in favour and those opposed. A considerable amount of time was spent at the Board Meeting explaining the rationale behind the balance sheet approach and it is important that the Steering Committee have some idea as to the current views of those countries that were opposed to the balance sheet approach. The views of Z are particularly important to the extent that ….. . If it is clear from the responses to this revised exposure draft that there is not sufficient support for the balance sheet approach in order to ensure that an exposure draft can be published after the June 1994 Board meeting … ." [940110LYX]

…..

1994 **January 12th - File note on conversation with Q:**

Note by … on phone conversation with Q, inter alia re. December meeting at a national standard setter:

"Q indicated that he sensed considerable opposition to the Balance Sheet Approach at the [National Standard Setter] especially in so far as it impacts asset revaluations. We discussed how we could achieve a meaningful outcome and I also reminded Q that a revised draft of the Exposure Draft had been circulated just prior to Christmas and that I was most anxious to receive the … comments on the draft." [940112N…]

NOTE SUGGESTION OF "CONSIDERABLE OPPOSITION" TO BS APPROACH…IN PARTICULAR RELATING TO [I-10]

….

Figure 4.7 Modified excerpt from time axis for 1994

about 500 full size pages[33]. While working with this chronological description it thus appeared useful to distinguish between a number of sub-periods. With minor modifications these were retained in the following analysis and are essentially the ones presented in chapters six, seven and eight (also reflected in figure 4.6).

Although, interpretation by the researcher was unavoidable, it was not experienced as a major problem at this stage, since both gaps and uncertainty in the description were accepted (indicating suitable questions for the follow-up interviews).

4.4.5 Asking questions

Having thus begun work on mapping the process, the next step was to start analysing the material more systematically, initially with a view of gaining an understanding of the specific process, in the extension with a view to develop ideas about the standard setting process in itself. The main technique for this was to ask questions. As already noted, Strauss and Corbin (1990: 77) suggest a number of general questions that can be raised almost automatically: Who? When? Where? What? How? How much? and Why? To this list they also add a number of temporal, spatial and technological type of questions (ibid: 80). Such a long list of questions may be useful when applying a strict grounded theory approach using various coding techniques. However, this methodology was not intended here. Instead, this list of possible questions was condensed into the following *operational research questions*:

- ***What were the main issues?***

The first question was aimed at identifying the existence and nature of controversies in the standard setting process in order to provide a context for identifying principal actors and their interests.

- ***Who were the main actors? What did they do? Where? When? Why?***

The purpose of the first of these questions (Who were the main actors?) was simply to identify main actors. In contrast with previous research the focus was not only on parties submitting comment letters, but on all actors (internal and external to the IASC) participating in the process.

33 These are the Phase-documents from 1999: Phase O (3 pages), Phase I (25 pages), Phase II (58 pages), Phase III (26 pages), Phase IV (175 pages), Phase V (65) pages and Phase VI (158 pages).

In addition to identifying them, it was deemed of interest to understand how they were involved in the process, i.e. what they did, where and when and also, to the extent possible, why. The final question aimed at an understanding not only of their preferred positions, but also of the subjective logic on which that position was based. Subsumed in these questions was also a question of how the identified parties affected the process.

- ***How were the issues resolved?***

The final question asked how controversies were dealt with. Was consensus achieved, if so how? Did any one win or loose and if so how and why?

Although these questions (as it turns out) are very similar to those proposed by Hope and Gray (1982) as relevant in applying the pluralist approach / decisional method in studying power (p. 60), the intention was never to adopt such a framework. Instead, in line with the loosely formulated research objective, the intention was to allow "what is relevant to that area … to emerge" (Strauss & Corbin, 1990: 23).

Initially these questions were asked for each period independently. In answering these questions, I generally started out in the chronological description, but often had to return to information in the time-axes documents for details. It was not unusual that looking further into a detail, contributed to the understanding of the whole. As in the case of Jönsson's case studies (p. 61) this, and later parts of the analysis, was often perceived as detective work:

> Every such case study requires an extensive collection of data through studies of documents and protocols and chiefly through interviews. The method is like detective work where clues from one interview lead to another, which gives reasons to study a document, and so on. (1988: 185)

Strauss and Corbin's (1990) emphasis of the need to *conceptualise* (rather than to summarise) data also provided practical guidance in writing up the findings. In order to do this, a form of constant comparisons was automatically introduced. For example, in considering what the Project Manager did throughout a period it was necessary to compare what he did at various points in time. Parallel to this, a form of *theoretical memos* was kept (p. 85).

Inevitably, interpretations of the material by the researcher became more pronounced as the objective to build an understanding of the specific

process, as well as the standard setting process in general, became more pronounced. It is not possible for me to generally specify how these interpretations were done, e.g. how evidence in different documents were weighed against each other, other than that an over-all assessment was made. Generally, however, this was not felt to be problematic, partly because the information in the documents tended to point in the same direction, and partly because gaps and alternative interpretations were still acceptable (pointing to issues to be followed up in the interviews).

To be mentioned is perhaps that some of the issues discussed in relation methodology in historic research seemed of lesser relevance for this study. For example, I had little reason to investigate the authenticity of the documents. Furthermore, most documents were concurrent to the events studied and, in many cases, direct evidence of certain events (e.g. a copy of comments received from a delegation in the archives was evidence of such comments being made and received). However, to a certain extent reports from meetings etc. could be suspected of a certain amount of bias.

When the analytical work based on the collected documents had thus come this far, when main actors had been identified and the understanding of the process was felt to be as good as it could be based on the study of documents alone, new information was added by interviewing a number of the identified key actors (see next sub-section). Following this, the operative research questions were revisited in light of this new "data". In some cases, this gave rise to follow-up questions to some of the interviewees. In two cases, it also gave rise to specific questions being mailed (e-mailed) to two other identified (key) individuals.

To a limited extent issues of interpretation became more pronounced once the interview data were considered. However, even at this point, these were not found to be problematic, mainly because of the acceptance of the real-world phenomenon under investigation as inter-subjective and socially constructed. That is, acceptance of the view that

> … what is true depends on one's perspective, and is therefore, inherently definitional, situational, and internal… (Patton, 1990: 483).

The result of this work (discussion of operative research questions for each period) is presented in part II. However, neither the original chronological descriptions, nor the ensuing analysis of the operative questions, have been retained. Instead, in writing up the research for this thesis, the ambition has

been to identify the main story line for each period, identifying key issues and the nature of the process relating to these (chapters six, seven & eight).

Once each period had been discussed separately, a different kind of comparison and contrast was introduced through comparing and contrasting the findings for each question for the different periods with each other. This is the subject of section 4.4.7 (the thematic analysis, p. 114). First, however, some words with regard to the undertaken interviews.

4.4.6 The Interviews

Timing

The interviews with identified key players were undertaken between December 1999 and June 2000. There were several reasons for waiting with the interviews until a very late stage of the research. One obvious reason was that it was believed that it would not be possible to identity the relevant interviewees until this stage. A primary reason was also that it was believed important that the researcher should possess a thorough understanding of the "facts" of the process prior to undertaking the interviews. The reasons for this, in turn, were several. On a pragmatic level it was reasoned that the purpose of the interviews could be understood in terms of filling out the gaps left by the documents – hence it seemed appropriate to identify what those gaps were in order to make maximum use of the interviews. Similarly, it was felt that such an understanding might be a tool to counteract the effects of selective recalling and bias. More importantly, perhaps, was the suggestion that the interviewees be perceived as an elite, wanting to discuss (converse) the issues on their own terms and from their own perspectives, requiring that the interviewer has a good command of the subject area (e.g. Thorén, 1995: 37).

Who?

The document review suggested that the key individuals with regard to the income tax project consisted mainly of some of the Steering Committee Members and some of the IASC Staff, particularly the Project Managers. This judgement was essentially based on the perception of these as having participated actively in the process.

Initially, it was feared that the international aspects of the IASC's work might become a problem in terms of, for example, financing travelling to undertake the envisaged interviews. However, it was found possible to interview all of the key individuals identified initially. All of them also generously agreed to set off time to patiently answer my questions, thereby significantly contributing to the understanding of the process.

Twelve interviews have been conducted in total. More specifically I have interviewed four members of the IASC technical Staff, five Steering Committee Members (some of which were also Board Representatives) and three members of various Board delegations. See figure 4.8 for more details.

These interviews, in turn, suggested some other key players that had not been previously identified. Owing to financial and other restrictions these have not been contacted for interviews. However, in three cases such individuals have been (attempted to be) contacted through mail and/or e-mail and asked to respond to certain specific questions. Two of these, both previous IASC Staff member, have kindly responded generously via repeated e-mails (figure 4.9). In one case, no contact has been established. An overview of the involvement of the interviewees in the investigated process is provided in figure 4.10.

In order to preserve the confidentiality of the interviewees (including those contacted by mail/e-mail only), their real names are not used in the discussions in part II and III. Instead, they have been randomly ordered and assigned pseudonyms in alphabetical order: Ason[34], Bson etc.[35]

How?

Against the perceived objective of the interviews, and the suggestion that the interviewees be perceived as an elite, in-depth and fairly unstructured interviews were envisaged as the only appropriate alternative. However, in view of the objective of the interviews and to make the best usage of the limited time available in the interview situation, an interview guide was used (see below).

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34 No gender discrimination is intended by the use of ‘son’. However, to be noted is perhaps that with very few exceptions, the individuals involved in this specific standard setting process were male.

35 Hson has been avoided because of its difficult pronunciation.

Name		*Role*	
David	Cairns	Staff	Secretary General 1985-04 – 1994
Bryan	Carsberg	Staff	Secretary General 1995-05 –
Peter	Clark	Staff	Project Manager 1995-05 –
Steven	Leonard	Staff	Project Manager 1992-12 – 1994-04
Raymond	Bethoux	SC	SC Chairman 1988 – 1994
		Board	1988 – 1992
Carl-Eric	Bohlin	SC	1988 – 1995
Bernard	Jaudeau	SC	SC Chairman 1994 – 1995
		Board	1992 – 1996
Barry	Robbins	SC	1993-06 – 1995
		Board	1994 – 1997
Franz	Ulrich	SC	1992 – 1995
Gilbert	Gélard	Board TA	1987 – 1997
		Board	1997 – 2000
Sigvard	Heurlin	Board	1992 – 2000
Harry	Schmid	CG	(1991) – 1995
		Board	1995 – 2000

Figure 4.8 Interviewees (SC, Steering Committee, TA, Technical Adviser; CG, Consultative Group)

Name		*Position*	
J. A	Burggraaff	Board	Chairman 1980 – 1982
Angus	Thomson	Staff	"Project Manager" 1988

Figure 4.9 Contacts through mail/e-mail only

Problems associated with interviews (especially post facto interviews) as a means of data collection have been extensively discussed in the methodological literature. Some of the more obvious problems are that *selective recalling / forgetting* and *post-justifications / benefits from hindsight* may introduce both gaps and bias. Another problem that is perhaps less discussed is that of interviewees responding to certain questions with standard cliché-like answers (Thorén 1995: 41, 43 refers to Silverman, 1989). In this case several interviewees indirectly suggested that they were aware of existing literature on the topic of standard setting, sooner or later referring to the process being "(very) political". For others this concept

appears to have been quite problematic, almost taboo-like.[36] Whatever the case, this concept was perceived as a trigger to be avoided.

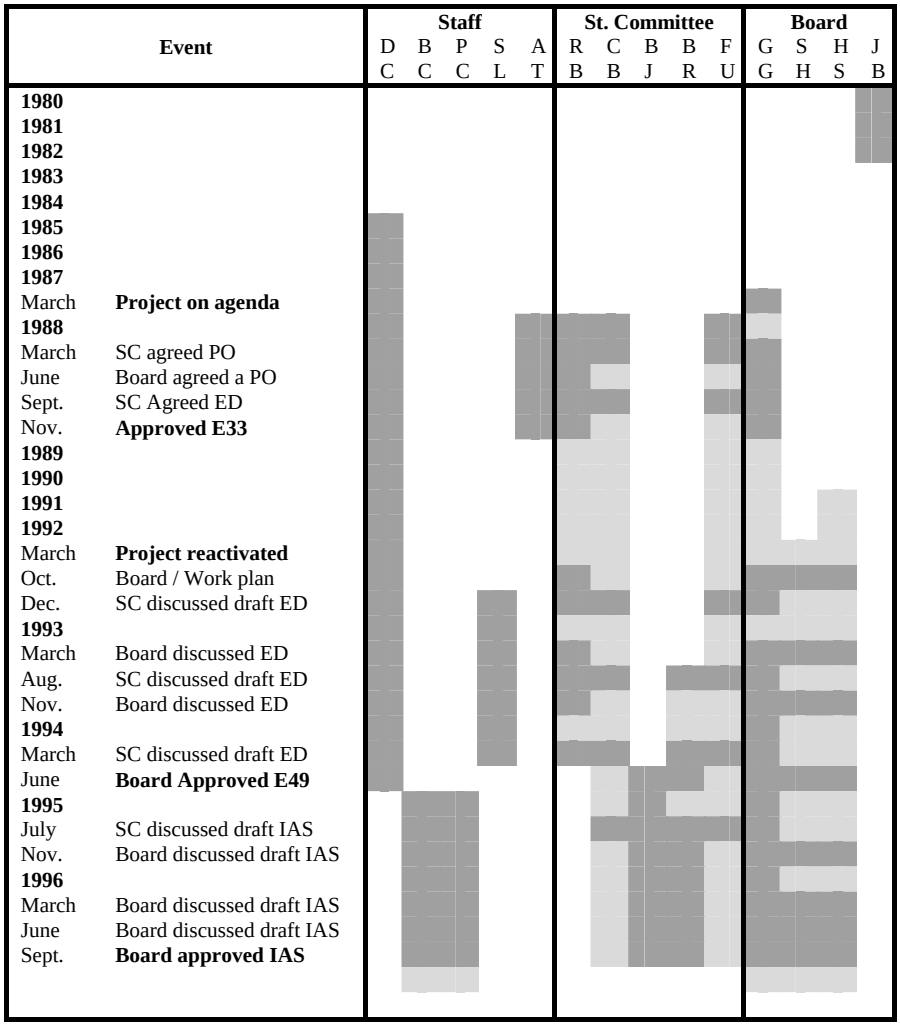

Figure 4.10 Alternative overview interviewees' engagement in the process. Initials – see figure 4.8 & 4.9 Darker shading = presence

36 Introducing the topic of power and politics in organisation theory, Shafritz and Ott quote Kanter (1979) in suggesting that "power is America's last dirty word" (2001: 298).

Based on a review of previous literature Thorén (1995: 41-2) lists a number of suggestions of how to minimise identified problems. These include asking indirect questions, focusing on actual events and avoiding concepts whose meaning might be ambiguous. In line with the two first suggestions he proposes a technique called *retrospective verbal protocol analysis*, whereby the interviewees are asked to think aloud in retrospect, i.e. describe actual events (ibid: 37-8).

In line with Thorén's reasoning it was decided to structure the interviews around the identified process and the interviewee's involvement and perception of that process[37]. In order to do this I prepared a time-axis for each interview, setting out, significant events relevant to the interviewee's participation in the process as identified through the study of the documents (e.g. meetings participated in, written comments found in the IASC files etc.) and specific questions that had arisen in the previous review of the operative questions (identified gaps). This time-axis thus also served as a general interview guide.

Whereas the *retrospective verbal protocol analysis* was seen to counter some of the identified problems with (post facto) interviews, the initial review of the documents and the fairly detailed knowledge of the identified process, was also hoped to counter some of the identified problems.

During the interview, I saw it as my job to strike a balance between allowing the interviewee to talk freely and to keep the interviewee on target, following the general chronology of the process and the focus on the interviewee's involvement and perceptions of the process (maintaining control of the interview (Patton, 1990: 330).

The interview situation

The interviewees were generally very accommodating and interested in the research project. Some have contributed further to the document studies by providing copies of documents that had not been previously collected.

In similarity with Hellman (2000: 67) it is believed that basing the interviews on actual events (rather than on diffuse, abstract and even charged concepts) as well as having gone to great lengths to gain a good understanding of these events prior to the interview contributed to the

37 A similar approach was also applied by Hellman (2000).

richness and openheartedness of the interviews. Moreover, several additional measures were also taken to establish a relaxed and conversation-like atmosphere including: explaining the purpose of the research and emphasising the confidentiality of the research, explaining the purpose of the interviews and the structure for the interview, acknowledging that the answer "I don't recall" was not only acceptable, but to a certain extent expected, beginning with simple informational, non-sensitive questions and allowing, even prompting, the interviewees to dwell on issues and events that appeared important to them.

In addition, recognising that the interviews often covered events occurring over a number of years and involving a number of events, the interviewees were generally asked if they wanted a time-axis setting out the major events pertaining to this process (e.g. Board and Steering Committee meetings, comment periods etc) to help them structure their own thoughts and the discussion. In certain cases this seemed to help significantly as interviewees, particularly those that participated in various Board meetings, would seem to remember and refer to these in terms of the Edinburgh meeting rather than the June 1994 meeting.

Some further interview details

The interviews were conducted in a sequence that was determined by opportunity. Typically they lasted for about two hours, but some were longer and a few shorter. All interviews, but those undertaken with Swedish speakers were conducted in English.

The author conducted all interviews. All interviews were taped[38]. Notes were also taken during the interviews to help formulate follow-up questions (Patton, 1990: 349). In general, notes were also made when listening to the tapes soon after the interview (same day or next day).

All interviews were transcribed, virtually without editing. In all but the two Swedish cases this was done by the researcher. However, even in the case of the two exceptions, the author listened to the tapes on more than one occasion. Following this, the author agrees with Jönsson's suggestion that:

38 The tape-recorder was only switched on following the first introduction when the purpose of the interview and the confidentiality issue was presented.

> By doing the interview, listening to it and writing it down there is a repetition effect that makes long term memory possible and allows one to return to the interviews at later stages without too much searching. (1988: 73)

The typed interviews comprise a total of 380 pages. The interviewees' answers make up 62 % of these (figure 4.11). These records were treated in essentially the same way as the previous documents in that the information in them was used to answer questions regarding what the issues were, who did what, where, when and why and how the issues were resolved.

No.	*Pages*		*Words*	
	Total	*Interviewee only*	*Total*	*Interviewee only*
1	52	35	26,451	77%
2	24	14	11,875	63%
3	32	18	14,396	57%
4	36	24	20,411	73%
5	37	22	17,612	67%
6	30	20	17,177	74%
7	49	31	26,924	70%
8	25	15	13,877	70%
9	9	6	4,390	70%
10	27	18	12,870	82%
11	35	19	14,469	57%
12	24	14	10,038	68%
	380	236	190,490	69%

Figure 4.11 Some interview data presented in the order the interviews were performed

In two cases follow-up information was volunteered during the interview and provided soon after the interview (in one case following a reminder). In two cases follow-up questions have been asked using e-mail during the process of analysis. In both cases the contacted interviewees have responded (figure 4.12). As already noted, two members of the IASC staff have also been interviewed in a more limited sense by use of mail/e-mail only and in relation to a few specific issues. Details on these contacts are also included in figure 4.12.

When quotations are used in the texts, these have been edited by the author in order to make the text anonymous, readable and understandable. The

interviewees have also been given the opportunity to look at their quotations and to give their permission to allow the quotations to be published. In some cases this has led to minor amendments that are not felt to affect the information in the quotations.

Interviewee	*Date*	*Exchange*		*Words*	
Dson	00-05-11	to	Questions	281	
	00-05-17	from	Response		711
	00-05-19	to	Questions	?	
	00-06-15	from	Response		354
Eson	00-05-09	to	Questions	104	
	00-05-24	from	Follow-up info		181
Json	00-05-02	from	Follow up info		530
		from	Documents		
	00-05-05	from	Follow up info		110
		from	Documents		
	02-09-16	to	Questions	466	
	02-12-24	from	Response		858
	02-12-24	from	Follow-up info		171
Lson	01-08-22	to	Questions	119	
	01-08-23	from	Response		58
	02-01-30	to	Questions	556	
	02-02-04	from	Response		109
	02-02-04	to	Questions	424	
	02-02-05	from	Response		358
Nson	02-09-13	to	Questions	214	
	02-09-18	from	Response		90
	02-09-18	to	Questions	195	
	02-09-20	from	Response		47

Figure 4.12 Information re. follow-up contacts information

4.4.7 The thematic analysis

The operative research questions identified in section 4.4.4 were initially asked for each period independently. Once each period had been analysed separately, a different level of comparison was introduced as the findings for question for each of the different periods were contrasted with each other.

That is, the operative research questions were asked again, but now with the whole of the process of revising IAS 12 in mind: What were the issues? Who? What? Where? When? Why? and How were the issues resolved?

Again, the ambition was to *conceptualise* rather than to *summarise*. In doing this, the theoretical memos collected previously proved especially valuable, setting out a number of themes that had transpired in the work with the operational questions. Originally separate chapters were drafted setting out these various themes. However, this work culminated in the identification of what is perceived as the main "story line" suggested by the studied case. The presentation of the findings in chapter ten is therefore structured around this story line, i.e. around the *understanding* of the process of setting international accounting standards that has been generated by the study of the process of revising IAS 12.

In line with the statement at the very beginning of the chapter (p. 80) the ideas (concepts and theories) hence arrived at were then contrasted with previous writings in this subject area.

PART II

THE SPECIFIC CASE

This second part of the thesis contains an account of the standard setting process which has been studied. Apart from a general introduction to this case (chapter 5), this account has been structured into three chronological chapters (chapters 6, 7 & 8), describing three main periods of the process of revising IAS 12. The focus of this account is on identified key issues and developments relating to these. A final chapter (chapter 9) complements this account by addressing the roles played by various participants in the process.

5 INTRODUCING THE CASE 117

6 1981 – 1990 THE FIRST ED 123

7 1992 – 1994 THE SECOND ED 165

8 1994 – 1996 THE REVISED STANDARD 218

9 THE PARTICIPANTS AND THEIR ROLES 285

CHAPTER 5

INTRODUCING THE CASE

5.1 Introduction

This thesis is based on a study of the process of developing International Accounting Standard (IAS) 12 (revised). Whereas the title of the original standard is *Accounting for Taxes on Income*, the title of the revised standard is simply *Income Taxes*.

The deliberations that make up the process of revising IAS 12 encompassed a large number of technical accounting issues. Without a basic understanding of these issues, any account of process soon becomes meaningless. For this reason this chapter includes an introduction to the key technical issues relating to the debate on accounting for income taxes. More details are provided in Appendix 2, The issues (pp. 407f) and Appendix 3, Numerical examples (pp. 431f). In addition, in an attempt to further simplify the presentation, the technical issues have been given, and are referred to with, a special code [I*ssue*-No.]. A list of identified issues (i.e. these codes) is found in Appendix 1, Identified Issues (pp. 403f). It is hoped that together these measures will make it possible for all, including non-accountants, to follow the description of the standard setting process.

In addition this chapter also introduces the case by outlining the starting point: the original standard.

5.2 Accounting for deferred tax – the issues

In most countries companies are required to pay tax based on the income earned during a period. The amount of income tax payable for a certain period is usually determined by applying a tax rate to the taxable income for the period. Taxable income for the period, in turn, is usually calculated by determining taxable revenues and deductible expenses for the period as defined by the local tax code, i.e. by applying tax accounting policies. Although the calculation of taxable income is often based on financial accounting policies, there are normally a number of significant differences between the tax and financial accounting policies, so that taxable income for

a period is seldom equal to the pre-tax financial income for that period. (See A2.2 (pp. 408-9) for more details.)

The fundamental issue in discussions relating to the accounting for income tax in the financial accounts is whether, in the presence of such differences between financial and tax accounting policies, the income tax amounts reported in the financial statements should be based on the taxes payable for the period (*the taxes payable method* or *the flow through method*) or some other amount that takes the differences in accounting policies into consideration (*accounting for deferred tax effects*, or shorter, *tax effect accounting*, or more usually, *deferred tax accounting*) [I-1].[1]

Although fundamental, more recently this issue appears to be somewhat of a non-issue, the discussions relative accounting for income tax normally assuming that deferred tax effects should be accounted for. Instead, the focus of the debate seems to have been on *how* to do this. Initially these discussions appear to have focused on what (timing/temporary) differences (A2.2.1-2 pp. 408-411) should be taken into consideration and, related to that, what tax rates should be applied to these differences. Over the years, however, these discussions have led to the distinction between various methods of accounting for deferred tax effects [I-3] primarily: the deferral method, the first unspecified, and later, income statement liability method and the balance sheet liability method (A2.3.2, pp. 412-8)[2].

Two other more fundamental issues concern the level of application of tax effect accounting [I-2] (A2.3.3, pp. 418f) and the criteria that have to be satisfied for an element (asset or liability) to be recognised in the accounting [I-5] (A2.3.5, pp. 420f). In relation to the first of these issues, the issue of whether or not the time value of money should be taken into consideration [I-4] has also continued to be discussed (A2.3.4, pp. 419f).

In addition to these more fundamental issues, certain types of differences between financial and tax accounting policies have also given rise to specific debates, including, for example, differences relating to the accounting for

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1 This issue has in part been seen to require consideration if income taxes constitute an expense or a distribution of income [I-0].

2 Appendix 3 contains some numerical examples illustrating the difference between the various methods of accounting for deferred tax effects.

investments in (foreign) subsidiaries [I-8] and to revaluations [I-10]. Section 4 of Appendix 2 (pp. 422f) presents some of these detailed issues.

All of these issues – both the fundamental issue and the issues concerning the application of tax effect accounting – are often significant in that they determine the amounts recognised in the accounting as *tax expense* and as *tax assets/liabilities*, hence affecting reported net income and equity.

Although there is often a presumption that the total tax expense reported over the life of an enterprise is not affected by the choice between the taxes payable method or some version of accounting for deferred tax effects[3], it is also often assumed that, for a going concern, tax effect accounting generally leads to the recording of higher tax expense (i.e. lower net income figures) and to higher tax liabilities (i.e. lower equity). Another common assumption has been that the reported tax expense becomes less variable and more easily reconcilable to the pre-tax financial income (and hence more predictable) under tax effect accounting. These assumptions, however, do not always hold. There are versions of tax effect accounting under which total tax expense does not match total taxes paid to the tax authorities (see figure A2.1 p. 418). Furthermore, the effect on reported net income / equity depends on the design of the tax system. More recently the discussions have come to focus on the phenomena of (deferred) tax assets rather than deferred tax liabilities.

A special sub-debate within the general tax accounting debate concerns when it is appropriate to recognise a (potential) benefit relating to a tax loss carryforward[4] [I-7] (A2.6, p. 430). Again, the impact on reported *tax expense* and *tax assets* (i.e. on net income and equity) reported in specific periods may be substantial.

Other issues in the tax accounting debate include the presentation of taxes in the financial statements (for example, whether to allow or require offsetting) and disclosure issues (what additional information to provide). These issues

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3 i.e. that under tax effect accounting the total tax payable is only allocated over different periods.

4 Tax legislation sometimes allow enterprises that report a *tax loss* – a negative taxable income (US literature uses the expression "net operating loss") – a ´refund of income tax payable relating to earlier periods and/or a deduction from taxable income in later (future) accounting periods. The first case is normally referred to as a tax loss carryback and the latter as a tax loss carryforward.

do not generally affect the reported numbers (however it may affect specific sub-totals). Instead the focus is generally on how much information should be presented and how. (For more details, see A2.5 pp. 428-9.)

5.3 The original Standard

The first IASC Steering Committee to examine the topic of accounting for taxes on income was set up three years after the IASC itself, in March 1976. At that time, the IASC Board had approved two International Accounting Standards (IASs) and six Exposure Drafts (EDs). An ED, *E13 Accounting for Taxes on Income*, was issued two years later, in April 1978. In December the same year, the Board considered comments on this ED and at its next meeting in March 1979 it approved the standard. *IAS 12 Accounting for Taxes on Income* was published in July 1979 and became effective on January 1st 1981.

The short intervals between the various developments suggest a fairly uncomplicated process, lacking fundamental controversies. Another explanation, however, is that controversies were avoided by allowing a free choices between various accounting alternatives (i.e. by introducing alternatives). Although requiring tax effect accounting, the original standard allows a free choice between two methods of tax effect accounting [I-3]. It also allows a free choice with regard to the level of application of tax effect accounting [I-2]. In addition, IAS 12 also allows a free choice relating to the treatment of subsidiaries and associates [I-8], revaluation [I-10] and tax losses [I-7]. The IAS 12 positions relating to these issues are summarised in figures 5.1 and 5.2.

It has been suggested that the Steering Committee[5] working with the development of the original standard was (unanimously) in favour of the liability method [I-3] and comprehensive application [I-2], but that the Board[6] instructed the committee to draw up a standard that would allow the deferral method [I-3] and partial application [I-2] as well, in order not to

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5 Three countries were represented on the Steering Committee: Australia, the Netherlands and the US. All of them were thus from the Anglo-American cultural sphere. All of them were also represented on the Board.

6 At the time the original IAS 12 was approved the IASC Board consisted of the nine founding members (Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK & Ireland and the US) as well as Nigeria and South Africa.

- *The method of tax effect accounting [I-3]*
  IAS 12 allowed a) **the deferral method** and b) **the (income statement) liability method**. Under both methods income tax expense calculations are based on *timing differences*, the practical difference between the two methods being related to which tax rate to be applied: the tax rate in the period the timing difference occurs (a) or the tax rate "expected" to apply as the timing difference reverses (b). In situations with unchanged tax rates, both methods give rise to the same amounts in the income statement and balance sheet. In situations where tax rates have increased (or are expected to increase) (b) gives rise to higher tax charges (lower net income) and larger liabilities (smaller equity). In situations where tax rates have decreased (or are expected to decrease) (b) gives rise to lower tax charges (higher net income) and smaller liabilities (larger equity).

- *The level of application of tax effect accounting [I-2]*
  IAS 12 allowed both (a) **comprehensive** and (b) **partial** application of tax effect accounting, i.e. that the tax effect accounting method be applied to either all (a) or only some (b) timing differences. Generally comprehensive application give rise to higher tax liabilities (and, *if applied symmetrically*, assets). Higher tax liabilities, in turn, generally lead to the recording of higher tax expense (lower net income).

Figure 5.1 IAS 12– key issues for which a free choice was allowed

contradict US and UK standards at that time. Partial application became required in the UK under SSAP 15, issued in October 1978 (after E13 but before approval of IAS 12). The deferral method, in turn, was prescribed in the US at the time:

> In the US at that time there was a strong opposition in the business-community against the prescribed deferral method because of the big workload entailed in applying this method. The Steering Committee, including its US member, endorsed these criticisms. But the Board decided to allow the deferral method since this method was prescribed in the US APB Opinion No.11, and IASC could not permit itself to prohibit what was prescribed in US. (Burggraaff)[7]

As a result, the main free choices in the original standard can be seen to reflect "differences among national standards" at the time (Cairns, 1999: 599).

7 Burggraaf has emphasised that he has responded "from memory without having the privilege of being able to consult written documentation" (e-mail 2004-11-22).

- *Undistributed earnings of subsidiaries and associates [I-8]*
  IAS 12 required recognition of taxes payable on distribution to the parent company of undistributed profits of **subsidiaries** unless it was reasonable to assume that those profits would not be distributed or that a distribution would not give rise to a tax liability. For this issue there was thus not really a choice situation. However, for undistributed profits of **associates accounted for under the equity method** IAS 12 required recognition of taxes payable on distribution to the investor, but allowed an exception when it was reasonable to assume that those profits would not be distributed or that a distribution would not give rise to a tax liability.

- *Revaluations of assets [I-10]*
  The explanation section of IAS 12 described two alternative ways of dealing with the revaluation of assets:
  (a) to recognise the tax effect related to the increase in the carrying value and transfer that amount from the revaluation account to the deferred tax balance (i.e. to record a tax liability, reducing reported equity) and
  (b) to disclose the amount of the potential tax effect related to the increase in the carrying value of the asset in the notes (to disclose the amount only). No preference was expressed, but disclosure was required of "the tax effects, if any, related to assets that have been revalued to amounts in excess of historical cost or previous revaluation".

- *Recognition of assets arising from tax losses [I-7]*
  IAS 12 stated that deferred tax assets arising on tax loss carryforwards should generally not be recognised until used. On the other hand, recognition in the period of the loss was allowed if there was *assurance beyond any reasonable doubt* that the saving would be used to reduce taxes in future periods. Moreover, recognition in the period of the loss was required to the extent of the net credits in the deferred tax balance that would reverse or could be reversed within the period during which the loss could be claimed as a tax benefit.

Figure 5.2 IAS 12 original – other issues in summary

CHAPTER 6

1981 – 1990 THE FIRST ED

6.1 Introduction

The first period to be presented stretches from 1981 – 1990, encompassing the period leading up to the adoption of a project to revise IAS 12, the development of a first Exposure Draft (ED) for public comment, the ensuing comment period and, following this, a decision to defer the project. This chapter accounts for these developments in five sections:

6.2	1981 – 1984	The IASC Working Party on Deferred Tax
6.3	1986 – 1988	Project initiation
6.4	1988	Developing the first ED (E33)
6.5	1989	Comments to E33
6.6	1989 – 1990	Following the comments

6.2 1981 – 1984 The IASC Working Party on Deferred Tax

6.2.1 Introduction

The project to revise IAS 12 was officially adopted in March 1987. However, its initiation can be traced as far back as 1981, the same year as the original standard became effective. In this year, the IASC set up a "Working Party on Deferred Tax" with the objective to consider whether recommendations could be developed leading to greater harmony between, primarily, UK and US standards on accounting for deferred tax.

The Working Party met three times: once during 1982, 1983 and 1984 respectively. In October 1984 the group reported to the IASC, recommending that "at an appropriate time" IAS 12 be amended to remove the option permitting the use of the deferral method of tax effect accounting [I-3], but that the free choice between comprehensive and partial allocation be retained [I-2] (841004RWBa&b). In other words, the publication of the original standard was immediately followed by a new attempt to work for harmonisation of accounting for deferred tax effects and three years later there was a concrete suggestion that IAS 12 be amended.

Year	Board meetings	Working Party meetings
1982		March 9th (London, UK)
1983		January 13th (Stamford, USA)
1984		September 13th (Amsterdam, Netherlands)
	October 17th – 19th (Düsseldorf)	

Figure 6.1 Summary of significant events in 1981-1984

At the time the Working Party was set up, the FASB had just decided against adopting a project on a revision of the US standard on income tax accounting. An internal IASC report from early 1981 explains that criticism of APB 11 had come "not so much from business but especially from the profession" (810513N…). The report also lists three point of criticism: (1) that the deferral method is incompatible with the conceptual framework, (2) complicated and time-consuming and (3) that the rules are conceptually weak "since a number of exceptions to the idea of comprehensive allocation had been accepted" (ibid). The topic, however, had been added to the FASB's list of potential future projects, awaiting further developments on its ongoing conceptual framework project (ibid). A US Task Force on Income Tax accounting was then set up in 1982 and a Discussion Memorandum on income tax accounting was published in 1983. In April 1984, the FASB held public hearings regarding this document and in June 1984 the FASB "tentatively decided that comprehensive application should be required" (841004R…) [I-2].

Concurrent with these efforts there was also a UK Working Party on deferred taxation, reporting to the ASC in April 1982. Based on replies to a 1981 questionnaire, this group reported that there was general satisfaction with the UK standard and suggested that no fundamental changes be made. Nevertheless, an Exposure Draft (ED33) was issued in June 1983 suggesting some (minor) amendments to SSAP 15.

6.2.2 The issues

Two types of issues gave rise to discussions during this period (1981-84): (1) issues relating to the setting up of a Working Party and its activities and (2) technical accounting issues.

The developments pertaining to the Working Party are discussed in more detail in section 6.2.3 below. During the first Working Party meeting in 1982 seven technical issues were identified (figure 6.2). Although diversity in practices and requirements between the UK, US and the Netherlands were noted on all accounts, the choice of level of application of tax effect accounting [I-2] seems to have dominated the discussions. Developments pertaining to this issue are further detailed in section 6.2.4 (p. 129).

The choice between the (unspecified, income statement) liability method and the deferral method of tax effect accounting [I-3] also seems to have been an important issue at this time. The former was required in the Netherlands and in UK and Ireland and the latter in the US. However, at the very beginning of the period it was noted that the deferral method was being challenged in the US and during the third meeting the group received information that the FASB was leaning towards the liability method. For these reasons, this issue does not seem to have been controversial during this period.

- How the issue was regulated;
- method of tax effect accounting [I-3];
- level of application [I-2];
- presentation in the income statement [I-13i];
- presentation in the balance sheet [I-13b];
- revaluations [I-10];
- tax carry-forwards [I-7]

Figure 6.2 Seven technical issues identified during the first Working Party meeting in 1982

6.2.3 The Working Party

Setting up a Working Party on Deferred Tax

The main initiative for the Working Party appears to have come from the Chairman of the IASC. Early in 1981 he contacted the (chairmen) of the

three national standard setting bodies in the UK, US and the Netherlands and discussed the idea of setting up a Working Party on deferred tax. The IASC chairman's interest in the issue of deferred tax, and the idea of setting up a Working Party on this topic, seem to have stemmed from a combination of several factors and forces.

One important force, for example, seems to have been that, at the time, various Dutch multinational companies were critical to the conflict between US and UK accounting standards. Various letters and notes (and drafts thereof) from 1981 refer to this issue, e.g.:

> In view of criticism on the existing situation expressed in the reports of some companies and in the press of some countries the Board of I.A.S.C. feels an effort should be made to overcome this conflict,…. (810930 …)

Some documents particularly refer to an annual report of the Royal Dutch Petroleum Company, in which the "(d)irectors complain about the conflict between U.S. / Dutch and U.K. rules on deferred taxation" (810513…). Following this lead it is noted that the 1980 annual report of this group reported that, as a result of the conflict between US and UK standards on deferred tax, the company had been unable to receive an unqualified audit report. The annual report also included a call for attention to this problem:

> The continuation of a divergence of view between the UK accounting authorities and those of other nations on deferred taxation accounting, which remains the subject of a qualification in the Report of the Auditors [on page 30], deserves urgent treatment. (ibid: 29)

It also seems that Dutch companies also directly encouraged the IASC to act:

> In the Netherlands the Dutch members of the IASC Board had, in or about 1981, undertaken a programme of visits to the management of prominent quoted companies, in order to urge them to apply international accounting standards and say so in the notes to their financial statements. During those visits several companies, amongst them [X and Y], stated that the best contribution IASC could make to international harmonisation would be solve the annoying incompatibility of U.S. and U.K. standards on the subject of deferred taxation. (Burggraaff)

This, in combination with the fact that the IASC chairman at this time was Dutch, appears to have been a significant factor. Another such factor may have been that he had been a member of the first Steering Committee on deferred tax and remained dissatisfied with the original standard (Burggraaff).

The Taxes Working Party idea may also be understood against the background of the developments relating to another accounting issue: foreign currencies. A concurrent internal IASC document reports that the "fact that a joint approach to the treatment of foreign-currency-translation [had] proved to be productive, [..] led the Board of I.A.S.C. to believe that a similar approach to the annoying problem of deferred taxation might contribute to international harmonisation" (810513…). One interviewee suggested that the success of the former Working Party, which had been initiated by national standard setting bodies instead of the IASC, had led to criticism within the IASC:

> …it created a bit of discomfort in the IASC because some people, particularly Continental Europeans, were saying: "Why are we putting in all this time and effort into the IASC if the US, Canada, UK go fix it all themselves outside the IASC"… (Json)

The composition of the "Working Party"

The Working Party consisted of three individuals appointed by the three standard setting bodies respectively and a French chairman appointed by IASC. The IASC Secretariat was to see to all "administrative matters" (810810DL). The Working Party members did not act as representatives, but in a "personal capacity" (ibid). Minutes from the meetings also reveal that in many cases these were attended by at least two individuals from the respective standard setters.

The inclusion of the US and UK standard setters seems obvious against the objective of the Working Party. The inclusion of the Dutch standard setter may be explained partly in terms of at least some of the impetus to the undertaking coming from Dutch companies and partly in terms of the IASC Chairman's belief that "maybe present values were the answer" [I-4] and that it would therefore "be useful to involve the Dutch with their experience in discounted values for deferred tax-charges" (Burggraaff).

The French IASC member organisation was invited to designate a suitable Chairman for the Working Party. An interesting detail is perhaps that the IASC explicitly selected a chairman representing the continental European tradition in order to avoid an impression of an "'Anglo-Saxon' exercise" (810930…) / that the group was "a get-together of certain parts of the world

only" (ibid).[1] It is therefore particularly interesting that the Chairman seems to have functioned as chairman only; French practices, regulation and experiences in these matters do not seem to have figured at all in the discussions. Hence, one could argue that despite the original intention to avoid the impression of the Working Party being an Anglos-Saxon get-together, this might be considered a fitting description.

"Working Party" activities

Although the parties originally contacted/invited to participate in the proposed Working Party seem to have been generally positive to the suggestion, there were some concerns with the conditions of participation. One of the parties in particular argued that it was important that participation neither obligated it to change its rules, nor to defer change before the Working Party had completed its task. Points of concern also included restrictions on the effort involved, for example, that the participants would not be expected to undertake a research effort. Probably as a consequence of these concerns it was made very clear from the start that participation in the Working Party did not obligate the participants to do much else than attend two or three meetings (at their own expense) and talk.

By the time the Working Party got together for the first time (1982) the national rules were being reconsidered in all three countries. With the possible exception of the Netherlands, the national developments with regard to accounting for deferred tax seem to have been perceived as just that - distinctly national affairs. In line with this, the Working Party meetings seem to have focused primarily on exchanging information on current national developments. Each member also seems to have defended the corresponding national solution. Even more important, however, the national developments were not left pending the outcome of the Working Party. Indeed, the opposite seems to have been true. Following the second meeting the future of the Working Party was left pending national developments, which delayed the final meeting almost a year.

Once the Working Party had been set up it also seems to have spent at least some time, in particular during the second meeting, debating (again) what

1 At one stage there was a suggestion that the Canadians should also be invited to join the Working Party "since they are at the beginning stages of a project on accounting for income taxes" (810826L…). This suggestion also seems to have been disregarded on grounds that it was important to avoid the impression of an Anglo-Saxon exercise (810930L…).

should be its work. While one member seems to have wanted to limit its task to an exchange of information, another seems to have pushed for something more.

6.2.4 The level of application of deferred tax

With regard to the technical accounting issues, the focus of attention was on discrepancies between UK and US standards on accounting for deferred tax. With the choice of method of tax effect accounting [I-3] becoming a non-issue, this left the choice of level of application of tax effect accounting [I-2] as a sole key issue. This issue was also especially targeted in the official letters of invitation to the Working Party:

> One area of conflict concerns the accounting treatment of deferred income tax. In the U.S., with a few minor exceptions comprehensive allocation is called for; in the U.K. and Ireland partial application is required; in the Netherlands comprehensive allocation is required in principle, however, with substantial exceptions. These different requirements may lead to substantially different figures for equity and net income in the financial statements of enterprises. (810930…)

As already mentioned (p. 127), there were some initial expectations that this issue might be resolved through the use of discounting [I-4]. There are also some indications that some participants wanted the Working Party to agree that comprehensive application is appropriate and to discuss various ways of applying it in practice, e.g. by applying discounting or partial provision as an approximation of discounting. This, however, was not to be the case. Each member reportedly defended the corresponding national solution, solutions which appear to have enjoyed strong national support. For example, during the third Working Party meeting it was reported that the FASB decision to continue with comprehensive application had been exposed in a Discussion Memorandum and had received overwhelming support (84XXXXRX, Unofficial Secretariat Notes from the meeting). It was also reported that, although there was a great deal of sympathy for discounting in the US, it was too soon for it to be permitted or required and that the AICPA would be considering discounting as a general principle (ibid).

With regard to the UK, it seems that, if anything, UK commentators (to the UK 1981 questionnaire) wanted less deferred tax liabilities to be reported. In line with this the UK Working Party in 1982 recommended to amend the wording the UK standard from *"do provide unless"* to *"do not provide unless"* (841004RWBa).

Given the entrenched positions with regard to this issue the discussions seem to have focused on the extent to which comparability could be achieved through disclosures, rather than through standardisation. An early draft of the Working Party report suggested that "international comparability would be helped considerably if those countries which require partial allocation also require footnote disclosure of unprovided deferred tax" and if "those countries which require comprehensive application also require footnote disclosure of those tax liabilities expected to crystallise" (84XXXXDrWpB). The wording in the final Working Party report, however, was significantly amended to explicitly acknowledge that requiring companies applying deferred tax accounting on a comprehensive basis to disclose tax liabilities expected to crystallise may not be possible in the short term:

> although international comparability would be further helped ~~considerably~~ if those countries which require comprehensive application were also to require footnote disclosure of those tax liabilities expected to crystallise; the Working Party recognises that this may not be possible in the short term (841004RWBa&b).

In this context it is also noted that the third Working Party meeting appears to have particularly addressed a UK proposal to only require disclosure of unprovided amounts of deferred tax for which the possibility that a liability will arise is not remote (84XXXXR). More specifically this proposal concerned whether or not to require disclosure of unprovided deferred tax relating to fixed asset revaluations and unremitted earnings of foreign subsidiaries and associates "where the crystallisation of the relevant tax liability is considered to be extremely remote and its quantification difficult to compute" (841004RWBa&b). In other words, here the discussions of the level of application [I-2] particularly touched on two other issues: revaluation [I-10] and subsidiaries and associates [I-8].

With regard to this issue it is also noted that during the third meeting it was reported that a Dutch committee had recently suggested an approach to reconcile comprehensive and partial application, recommending comprehensive application, but treating deferred tax balances as either shareholder's equity or as liabilities, depending on the probability of reversal, and, correspondingly, showing charges in the income statement as either an appropriation of profits or as a tax expense (84XXXXDRWpB).

6.2.5 Perspectives on the process

The Working Party report represents a concrete suggestion that IAS 12 be amended to remove one of the (two) critical free choices allowed by that standard – that relating to the choice of tax effect accounting method [I-3]. On the one hand it might be thus argued that one important controversy with regard to accounting for deferred tax effects was resolved during this period. On the other hand, however, it may also be argued that this controversy resolved itself as the US, through a completely national standard setting process, decided to change position with regard to this issue. Furthermore, with regard to the true key issue at the time, the level of application of tax effect accounting [I-2], the Working Party efforts can be seen to have resulted in a weak report, recommending no change to the concurrent situation. No international disagreements on technical accounting issues were thus resolved through the Working Party. Instead it functioned primarily as a discussion forum, a forum for exchanging information and explaining "the way we do it". Despite the concurrent national processes reviewing tax accounting, diversity and conflict persisted.

6.3 1986 – 1988 Project initiation

6.3.1 Onto the agenda

Having received the Working Party report in October 1984, the IASC Board agreed to take these recommendations into account when IAS 12 was revised. The project to revise IAS 12, however, was not added to the IASC's agenda until a further three years later (March 1987).

When the project thus finally got onto the standard setter's agenda, this seems to have primarily as a result of a policy to review each IAS five years after they had become effective (e.g. IASC, 1987: 3). In line with this policy, a questionnaire enquiring about accounting practices and opinions on changes to IAS 12 was sent to IASC Member Bodies in 1986. In March 1987 a French Board Representative reported to the Board on the replies to the questionnaire, recommending that IAS 12 be revised and that the deferral method no longer be allowed [I-3] (8703XXAP7). This was supported by the fact that a large majority (19 of 23[2] respondents) had replied that only one

[2] Although the questionnaire was sent to all IASC member accountancy bodies, only 23 responded. Although these representing most parts of the world and cultural areas, they constituted only roughly 20 % the IASC members at the time.

method of tax effect accounting should be allowed and that all but two of these supported the choice of the liability method (the missing two votes did not indicate a preference). Other findings included that:

- although partial application was only used in a minority of the responding countries, half of the respondents wanted to retain the free choice between comprehensive and partial application of tax effect accounting [I-2];
- most respondents supported the criteria for partial application [I-2p];
- most respondents agreed with the recognition criteria for deferred tax assets [I-5], tax loss carryforwards [I-7] and undistributed profits of subsidiaries and associates [I-8]; and
- the majority of respondents neither reported any objection to listed disclosure requirements nor suggested any additional disclosures [I-15].

The Board agreed with the proposal, apparently adding the revision of IAS 12 to its agenda during its March 1987 meeting without much discussion. The evidence strongly suggests that the review of IAS 12 was envisaged as a limited exercise, with the main objective being to amend the standard as suggested. This, in turn, appears to have been fairly uncontroversial, having been supported not only by a clear majority of the respondents to the 1986 questionnaire, but also recommended in the 1984 Working Party report. As noted in the previous section, the reason why this issue was no longer controversial was that the US standard setting body was now clearly moving away from the deferral method [I-3].

In fact, although the decision to revise IAS 12 seems to have been an outcome of an IASC policy at the time, it is striking that this came only months after the FASB had published an ED for a new standard on income tax (September 1986). An important characteristic of this ED is that it rejected the deferral method in favour of what was termed the asset-and-liability method. This is essentially what is discussed under the heading "balance sheet liability method" in section 3.2 of Appendix 2 (p. 414). In similarity with the (income statement) liability method, the objective of this method is often described in terms of identifying the *liabilities* for taxes payable in future periods and *assets* representing advance payment of future taxes. In contrast to the (income statement) liability method, however, the focus is not on what future (deferred) tax effects recognised *revenues* and *expenses* are expected to give rise to. Instead, this method focuses on future tax effects of recognised *assets* and *liabilities*. In the simple case, both methods give rise to the same accounting figures. However, as explained

further in Appendix 2, in some cases there are significant differences, the balance sheet liability method essentially giving rise to more types of deferred tax liabilities and/or assets.

The timing of the IASC's adoption of a project to revise IAS 12 is also striking in that the majority of the IASC's March 1987 Board meeting was devoted to a review of its future work. An outcome of this discussion was the decision to set up a project to consider the removal of all options in all previously issued IASs. This later became known as the *Comparability project*. Because of the decision to review IAS 12, however, this standard was kept out of the Comparability project:

> I think the reason is that we had sent out a questionnaire on IAS 12 and reviewed the responses to the questionnaire. We went to the meeting in March 87 expecting to add a project to our work programme on taxes. The comparability project was different. We had decided to spend a whole day of that meeting in March 87 discussing our strategy. One of the outcomes of that discussion was the decision to set up the project, which was to become the Comparability Project … and I think it was simply a matter of timing … (Json)

It has been suggested that the focus on the IASC's long-term plans in March 1987 was a response to the formation of the IOSCO (footnote 25 p. 24):

> The appearance of IOSCO in 1985 with a desire to harmonise differing national rules for securities offerings increased the need for an international organisation to harmonise differing national and international corporate disclosure rules and posed a threat to IASC's survival.
> (IASC, 1990a)

Other written sources also link the Comparability project to the advent of IOSCO, but somewhat differently. Purvis et al (1991: 25), for example, write that the Comparability Project was "encouraged" by the IOSCO. Also referring to the previous paper Nobes and Parker (2000: 72) argue that the fact that the IOSCO "held out the possibility that its members (e.g. the SEC) might accept IASs for the financial reporting of foreign companies listed on their stock exchanges" was one of the "spurs" to the Comparability project.

6.3.2 Setting up a Steering committee

In June 1987 the Organisation and Planning Committee of the IASC agreed to invite the member bodies in four countries to participate in the Steering Committee dealing with the review of IAS 12. These were: Brazil, France, Hong Kong and Sweden. Greece was named as a reserve, should any of the

listed non-Board countries decline the invitation. This would appear to have been the case since the actual committee consisted of members from Brazil, France, Greece and Sweden. As with the Working Party, the French Member was designated chairman (the French Member body being the only Board Member at the time):

> … somewhere along the line it was agreed that the review of IAS 12 was going to be led by the French, so when we came to appoint a Steering Committee in 87, ... there was agreement that the chairman is going to be French, …. (Json)

The choice of member bodies to be invited seems to have been influenced by a combination of factors, including responses received to the 1986 questionnaire and the desire to involve as many countries as possible in the IASC standard setting process, especially countries that had not previously been involved. This meant that participation in other (previous and concurrent) projects precluded certain countries from being discussed. A contributing factor may also have been that it was not seen to be essential to involve significant countries like the US and the UK, because it was expected that they would participate in the process anyhow, through their representation on the Board. It has also been suggested that those countries were not particularly enthusiastic about getting involved in the project (already being involved to a great extent in other IASC activities).

IASC policy at this time allowed the member bodies in each country to designate the participating member. Invitations to nominate a Steering Committee Member seem to have been sent to the selected Member Bodies at the end of July 1987. Delays in information from the invited Member Bodies as to who would be participating delayed the first Steering Committee meeting. Indeed, documents from mid January 1988 indicate that two of the Member Bodies had not yet responded at that time. One later document even suggests that it was feared that one member body would not respond at all, forcing the IASC to seek the representation of another country.

With the exception of the Chairman, all Steering Committee Members came from non-Board countries. Furthermore, all Members came from countries outside the Anglo-American cultural sphere and from countries that did not have deferred tax accounting traditions at that time. In addition, there is nothing that indicates that the selection of the individual members was guided by a desire to involve people with special interest in, or knowledge,

of deferred tax accounting. As a result, the make-up of the original Steering Committee has been described as weak, both in terms of countries represented and in competence relating to deferred tax accounting:

> Already the first time we met in Paris I felt that the Steering Committee was somewhat weak. It didn't feel right. We needed a broader competence – to include people from countries where these issues had been thoroughly discussed by the local standard setters and tested in praxis. (Nson)

6.4 1988 Developing the first Exposure Draft (E33)

6.4.1 Introduction

In the period following the decision to revise IAS 12 (March 1987), but prior to the first Steering Committee meeting (March 1988) a number of significant events relating to accounting for deferred tax effects took place outside the IASC. In December 1987, the FASB published a new standard on income tax accounting: *SFAS 96 Accounting for Income Taxes*. This standard confirmed the choice of the asset-and-liability method. In addition a number of other national standard setters also appear to have been considering accounting for deferred tax. For example, in August 1987 it was reported that the Hong Kong Society of Accountants and the Institute of Certified Public Accountants of Kenya had issued EDs proposing the liability method and that the Canadian Institute of Chartered Accountants and the French Conseil de la Comptabilité were reviewing their recommendations on income taxes (IASC, 1987c). In 1988 an ED was issued in Canada proposing a change from the deferral method to the (unspecified) liability method (891103M). Another ED was issued in South Africa indicating a preference for comprehensive application, but allowing the use of partial application (ibid).

Also in the meantime, the IASC Board met beginning of March 1988 (Düsseldorf) approving an ED of the Framework for Financial Statements and discussing the first recommendations from the Steering Committee on the Comparability of Financial Statements.

Also in March 1988 the OECD published the report “The Relationship between Taxation and Financial Reporting – Income Tax Accounting”. The second part of this report identified different methods of accounting for taxes

in OECD countries and their relative advantages and disadvantages. Although the text identifies eight main issues, it focused on a subset of these, differentiating between fundamental and other problems (figure 6.3).

When the Steering Committee met for the first time in March 1988 it considered 13 "key issues" identified in a paper prepared by the staff (880219Ra) (figure 6.4). This paper also contained staff recommendations on how to proceed with each issue.

In general the Steering Committee agreed with the staff proposals[3]. Following the Steering Committee meeting the staff thus prepared a Point Outline (PO), listing a number of points for consideration by the Board. These were the same as the issues identified by the staff prior to the meeting with the addition of one issue. Under the heading "Definition of Timing Differences", the PO stated:

> The Steering Committee proposed to place more emphasis on asset and liability orientation in accordance with the IASC Framework… (88045DRXB).

The Board considered the PO during its next meeting (June 1988). Although there was "broad agreement" with the proposals, the Board reportedly expressed "concern" over the position on revaluations [I-10], asked the Steering Committee "to reconsider" the position on discounting [I-4] and to "review" the "neutrality" of the proposed recognition criteria [I-5][I-7] (e.g. 880708DRSecSC). Nevertheless, the Board also decided that the Steering Committee should proceed to develop a draft ED. In doing this, the Board shortcut the normal process, which at the time would have entailed issuing a preliminary draft to member bodies for comment (Json) [4].

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3 In two cases, however, it went further than the Staff. See discussion relating to the recognition of the benefit related to tax loss carryforwards [I-7] and the treatment of undistributed profits of subsidiaries and associates [I-8] below.

4 This was later replaced by a Draft Statement of Principles (figure 4.3, p. 95).

1. The nature of income taxes (expense or distribution of income)
2. Overall method for allocating income tax expense to accounting periods (the taxes payable method vs. tax effect accounting)
3. Different methods of measuring deferred taxes:
   (i) the choice between the deferral method and the liability method
   (ii) whether or not to take into account all timing differences (comprehensive vs. partial allocation)
   (iii) whether to show discounted or non-discounted values
4. Recognition of the tax effects of loss carry-overs (forwards)
5. Recognition of tax credits
6. Recognition of the tax effects of restatement to reflect the effects of changing prices
7. The influence of tax regulations on financial statements
8. Comments specific to consolidated accounts, including the treatment of tax effects of intra-group profit distributions

(Dark shading = fundamental problems, Lighter shading = other difficulties)

Figure 6.3 Main issues related to the harmonisation of accounting practice identified in the 1987 OECD report

1. Deferral or liability method of tax effect accounting [I-3]
2. Comprehensive or partial allocation of tax effects [I-2]
3. Recognition criteria for tax assets and liabilities [I-5]
4. Classification of deferred tax balances [I-13b] [I-13cn]
5. Treatment of tax losses carried back [I-6]
6. Recognition of assets arising from tax losses [I-7]
7. Undistributed earnings of subsidiaries and associates [I-8]
8. Revaluations of assets and capital gains tax [I-10]
9. Offsetting tax assets and tax liabilities [I-14]
10. Adjustments due to a change in the rate of tax [I-12]
11. Disclosures [I-15]
12. Discounting tax assets and liabilities [I-4]
13. Treatment of initial investment tax credits [I-11]

Figure 6.4 Key issues identified by the staff prior to the first Steering Committee meeting

In preparation for the second Steering Committee meeting the staff drew up a draft ED based on the original standard. Amendments were made to accommodate the suggestions in the PO. In addition, a large number of drafting changes were also made, as well as a few additional substantive changes. The Steering Committee then met again in early September 1988, agreeing on several changes to the draft prepared by the staff. Two of these

were significant, the committee proposing to change the positions on revaluations [I-10] and with regard to the level of application of tax effect accounting [I-2].

The Income Tax project was then a major item on the agenda for the November 1988 Board meeting, preceded only by the Comparability of Financial Statements Project, for which *E32, Comparability of Financial Statements* was approved. At this point three Board Members objected (strongly) to the draft ED submitted to the Board, each for a different reason. One objected primarily to the proposed treatment of revaluations [I-10]. Another objected to the proposed position on tax carryforwards [I-7]. A third Member objected to the drafting in general, suggesting that the clarity of the document could be improved by rewriting it from scratch. One Consultative Group Representative also provided a written comment on the draft ED that was presented to the Board at this meeting. Although the letter expressed support for the draft, it objected to a number of the proposed disclosure requirements [I-15], arguing that they were "unlikely to be helpful to the user of financial statements", "misleading" and "not (…) very useful" (T88XXXXC…).

Before unanimously approving an ED on income taxes the Board agreed on a number of changes. In particular the Board decided to make the treatments prescribed by the Steering Committee for revaluations [I-10] and undistributed profits of subsidiaries and associates [I-8] into allowed alternatives and to designate a different treatment as preferred. Several drafting changes were also made both during and after[5] the Board meeting. These changes range from simple changes in wording to more complex re-arrangements of the text (see figure 6.6). *E33 Accounting for Taxes on Income* was published in January 1989. It proposed substantial changes to the standard in relation to six issues (figure 6.7).

5 Following the Board meeting the staff made certain "editorial amendments" to the draft "to streamline the document" (881116…). The one "major amendment" was the combination of certain headings and the combination of some of the disclosure requirements (ibid).

Year	Board meetings	Steering Committee meetings	Important papers
1988			February, Key issues paper
	February 29th - March 4th (Düsseldorf)		
		March 29th	
			March 31st , Draft PO
			April, Draft PO
	June 22nd – 24th (Toronto)		
			July 8th , Draft ED
			August 4th , Draft ED
		September 1st – 2nd	
			September 9th , Draft ED
	November 7th – 11th (Copenhagen)		
			November 16th , Draft ED
1989			E33 (January)

Figure 6.5 Summary of significant events leading up to the approval of E33

6.4.2 The issues

Although the decision to revise IAS 12 seems to have been based mainly on a belief that it was time to delete the option allowing the deferral method [I-3], the focus of attention during the development of E33 was not on this issue. Although no less than 13 issues were initially identified as key issues, E33 proposed substantial changes to IAS 12 relating to six issues. Only three of these, however, appear to have been controversial:

- the level of application of tax effect accounting [I-2];
- the treatment of revaluations [I-10]; and
- the recognition of tax loss carryforwards [I-7].

The criteria for partial application [I-2p] and a proposed disclosure requirement [I-15] also gave rise to some discussion. With the exception of the method of tax effect accounting [I-3] – which as already noted, did not give rise to much discussion – this leaves only one issue in figure 6.7. Although a significant change was proposed for the treatment of undistributed earnings of subsidiaries and associates [I-8], this issue does not appear to have given rise to much discussion in this period.

6. Another reason for a difference between taxable income and accounting income is that certain items~~, considered in determining both amounts,~~ are included in the calculation for both amounts but for different periods. For example, accounting policies usually specify that certain revenues are included in accounting income at the time goods or services are delivered but tax rules may require or allow their inclusion at the time cash is collected. The total of these revenues included in accounting income and taxable income will ultimately be the same, but the periods of inclusion may differ. Another example is when the depreciation ~~rate~~ used in determining taxable income differs from that used in determining accounting income. These items are timing differences.

The first sentence has been amended as suggested by one Board member making it consistent with the language used in §5. "items" has been inserted for the same reason. "Rate" has been deleted as suggested by another Board member.

"~~10~~12 Under t~~T~~his method of tax effect accounting, deferred tax balances are considered to be ~~recognising tax~~ assets~~,~~ and ~~tax~~ liabilities~~ and tax expense is known as the liability method and its use is required in this Statement. The tax assets and liabilities arising from timing differences are described as deferred tax balances. On the basis that they represent the amounts of economic benefits that are expected to flow to or from the enterprise, deferred tax balances~~ They are determined using the tax rates that are expected to apply when the timing differences reverse on the basis that they represent amounts of economic benefits that are expected to flow to or from the enterprise. For example, a tax asset arises when employee entitlements are recognised for accounting purposes as they accrue but are recognised for tax purposes only when paid, because economic benefits in the form of tax deductions will flow to the enterprise from the taxation authorities when the employee entitlements are paid. Therefore, ~~they~~ deferred tax balances are usually calculated using the current tax rates ~~but they~~ and are adjusted for known future changes in tax rates ~~that have been enacted or it is probable will be enacted~~ and for the imposition of new taxes."

The expression "tax rates that have been enacted or it is probable will be enacted" replaced by "for the imposition of new taxes". This expression was commented on by two Board members. "The" has been deleted from the expression "On the basis that they represent the amounts of economic benefits that are expected to flow to or from the enterprise" as suggested by one Board member.

New addition — Added in previous version
~~Deleted~~ — word order changed

Figure 6.6 Examples of drafting changes made during and after the November 1988 Board meeting

The developments pertaining to the three issues identified as contentious, as well as the criteria for partial application, are discussed in more detail in the following sub-sections. With foresight of ensuing developments the review of this period also specifically addresses the extent to which the choice of liability method [I-3] was addressed. The section closes by providing some more general perspectives on the process in this period (6.4.8, p. 150).

- ***Method of tax effect accounting [I-3]***
  E33 proposed to no longer allow the deferral method by requiring the use of the (income statement) liability method.
- ***Level of application of tax effect accounting [I-2]***
  E33 identified comprehensive application as a *preferred* treatment and partial application as an *allowed* alternative (free choice in IAS 12).
  Criteria for the application of tax effect accounting [I-2p]
  E33 proposed to replace one of the criteria for partial application – that there be no indication that the timing differences likely to reverse after a considerable period – with the requirement that there is reasonable evidence that the timing differences, when they do reverse, will be replaced by equivalent timing differences.
- ***Revaluations of assets [I-10]***
  The explanation section of IAS 12 described two alternative ways of dealing with the revaluation of assets. E33 proposed to include a standard designating the recognition of tax effects in all cases as a *preferred* treatment and recognition of tax effects only in situations when it is probable that the revalued asset will be sold as an *allowed* alternative treatment.
- ***Undistributed earnings of subsidiaries and associates [I-8]***
  E33 proposed a choice between a *preferred* treatment (recognition in all cases) and an *allowed* alternative treatment (recognition only when tax payments are probable). The original standard required recognition of taxes relating to undistributed profits of subsidiaries unless it is reasonable to assume that the profits would not be distributed. For undistributed profits of associates it required recognition of taxes payable on distribution to the investor of its share of undistributed profits recognised by the investor, but allowed an exception if it is reasonable to assume that those profits will not be distributed.
- ***Recognition of assets arising from tax losses [I-7]***
  E33 proposed to delete the free choice in IAS 12 by require recognition of the saving in the period of the loss when there is assurance beyond any reasonable doubt that the saving will be realised.
- ***Disclosures [I-15]***
  E33 proposed various new requirements. In particular it proposed to require the disclosure of:
  - the major components of tax expense (§50),
  - the amount of assets and liabilities that arise from timing differences expected to reverse in each of the three years following the balance sheet date and in the period more than three years after the balance sheet date (§51,a); and
  - the amount of saving arising from a tax loss in a previous period that is used to reduce the provision for income tax in the period (§51, b).

Figure 6.7 Summary of significant changes proposed in E33 compared to the original standard

6.4.3 Level of application [I-2]

Whereas the original IAS 12 allowed a free choice between comprehensive and partial application of deferred tax accounting, E33 identified the former as a *preferred* treatment and the latter as an *allowed* alternative. From a practical perspective the change imposed by the ED was thus very limited (the choice in the original Standard remained, although one of the methods had been designated as "preferred").

The key issues paper initially prepared by the Staff in this period noted that the report based on the 1986 questionnaire advised that the respondents were evenly divided about whether one basis of allocation should be required. It also reported, however, that the Steering Committee on the Comparability of Financial Statements had "tentatively recommended that comprehensive allocation be the benchmark treatment" and partial allocation be permitted, provided there is disclosure of the amount, both current and cumulative, of timing differences not accounted for (880219Ra: 14). Although with some hesitation, the paper suggests that the staff agreed with these proposals:

> …if the Steering Committee is prepared to recommend the removal of the option to use either comprehensive or partial allocation, it would seem appropriate to prescribe the use of comprehensive allocation. However, there are good arguments for both types of allocation, and partial allocation has the support of the accounting bodies in a number of countries.
>
> An approach which may be more suitable than eliminating the option entirely is …. That is, establish comprehensive allocation as the benchmark treatment and permit the use of partial allocation when the nature of some timing differences within the tax system is such that they are akin to permanent differences. … (ibid)

This is also the position proposed by the Steering Committee in the PO and the position proposed by the Board in E33. A peculiarity of this issue is that the proposed position remained more or less untouched throughout the period and does not appear to have been extensively discussed. Although this might suggest that the issue was non-controversial, it seems to have been a case of the issue being too controversial. In line with this interpretation one interviewee suggested that it had been understood that a Standard that did not allow partial application would not be accepted by the Board:

> I don't recall details of contentious issues -- in broad terms there was the issue of whether we keep partial tax effect accounting, but it was apparent that sufficient Board votes were unlikely to be available to issue a

> Standard without the partial option. … A simple majority would probably have favoured eliminating the option -- but not enough to pass a Standard. (Eson)

To be noted, however, is that this issue was not completely untouched. First, in June 1988 the Board asked the Steering Committee to reconsider the position on discounting suggesting that "it may be possible to entirely remove the option to partially allocate the tax effects of timing differences if it were required to discount tax assets and tax liabilities" (880804P). The reasoning was reportedly that "a major concern of supporters of partial allocation is the size of tax balances created when tax effects are comprehensively allocated" and that "(d)iscounting those balances would reduce their size" (ibid). Following this, the staff prepared a paper on discounting for the Steering Committee, recommending that the draft ED should not include reference to this issue on the basis that (a) no member countries required tax assets and tax liabilities to be discounted and (b) there was no consensus on the merits of discounting (880804P). The Steering Committee appears to have agreed with this conclusion and the issue does not appear to have been raised after this.

Second, in drafting the draft ED to be presented to the Board, the description of comprehensive application was altered so that it allowed for the non-recognition of the tax effects of some timing differences. The draft ED submitted to the Board referred to "all timing differences *for which it is probable* that future economic benefits will flow to or from the enterprise" (emphasis added). However, following criticism in one of the written Board comments and in Board discussions, that there remained no difference between comprehensive and partial application as described, this addition was deleted.

Although the proposed change could be interpreted as an attempt to make comprehensive application more appealing to its opponents (and hence as a means of resolving the controversy), it may also have been (simply) an effect of the influence of the draft IASC Framework. In fact, already the February 1988 staff key issues paper stated that "(i)t should be noted that, even under comprehensive allocation, the recognition criteria may still result in some timing differences not being recognised as tax assets and liabilities" (880219Ra). The example given referred to deferred tax assets not meeting the recognition criteria: "For example, where there are timing differences that could potentially give rise to tax assets but future taxable profits are not

probable" (ibid). This influence of the Framework is even more apparent in a staff file note from the very first start of the project:

> It can be argued that the issue of comprehensive versus partial allocation should be settled substantially by reference to the definitions of assets and liabilities. If all timing differences give rise to assets and liabilities comprehensive allocation is appropriate. If only some timing differences give rise to assets and liabilities partial allocation is appropriate. …
>
> It is also worth noting that it may be possible to choose comprehensive allocation while only recognising some as assets and liabilities in the financial statements because, in particular circumstances, only some may meet the recognition criteria. For example, where future taxable profits are not probable but there are timing differences giving rise to assets and liabilities, the tax assets could be recognised t the extent of the offsetting liabilities. (871214N)

6.4.4 The criteria for partial application [I-2p]

The original IAS 12 stated that tax effect accounting should "normally" be applied to all timing differences, but allowed exclusion of the tax effects (i.e. partial application) of those timing differences for which:

(1) there is reasonable evidence that they will not reverse for some considerable period (at least three years); and

(2) there is no indication that they are likely to reverse after this period.

E33 proposed to replace the latter criterion with a requirement that there is reasonable evidence that the timing differences, when they do reverse, will be replaced by equivalent timing differences. The idea that what is important is whether or not the timing differences are replaced (rather than whether or not they reverse) is found already in the initial key issues paper:

> (p)artial allocation normally involves the recognition of tax assets and liabilities only in relation to timing differences that it is expected will reverse and will not be replaced by new timing differences of the same type. (880219Ra)

The draft PO submitted to the Board in June 1988 did not contain any details of the proposed criteria for partial application. Nevertheless, changes were made in respect of this issue in the draft ED prepared by the staff for the second Steering Committee meeting. To be noted is that in the first version the focus of the relevant guidance was shifted from whether or not the timing differences are expected to *reverse* to whether they are expected to be *replaced* by equivalent timing differences:

> ~~20~~19. Under the partial application, tax expense for a period excludes the tax effects of certain timing differences when ~~there is reasonable evidence that those timing differences will not reverse for some considerable period (at least three years) ahead. It is also necessary for there to be no indication that after this period these timing differences are likely to revere.~~ they are expected to be replaced by equivalent timing differences. … (880708ED)

In the following version (the one submitted to the Steering Committee), however, these changes had been taken out:

> ~~19~~21. ~~Under the p~~Partial application, where the tax expense for a period excludes the tax effects of certain timing differences**,** is permitted as an allowed alternative treatment when ~~they are expected to be replaced by equivalent timing differences~~ there is reasonable evidence that those timing differences will not reverse for some considerable period (at least three years) ahead. (880803ED, draft submitted to Steering Committee)

The draft ED drafted following the Steering Committee (and submitted to the November 1988 Board meeting), however, reflected a combination of both approaches:

> ~~21~~19. Partial application~~, where the tax expense for a period excludes the tax effects of certain timing differences,~~ is permitted as an allowed alternative treatment ~~when~~ in respect of those timing differences for which there is reasonable evidence that ~~those timing differences~~ they will not reverse for some considerable period (at least three years) ahead and will be replaced by equivalent timing differences. (880909ED).

This position can be perceived as somewhat strange. If the key is whether or not the timing differences are replaced as they reverse, why also include a time frame? A similar concern was also raised by a Board delegation prior to the November 1988 meeting:

> Timing differences do reverse. The point to be made is that, when timing differences reverse that they are replaced by equivalent timing differences. (881104…)

Although other Board delegations also raised concerns in relation to this proposals prior to the November meeting[6], it was retained in E33. It was, however, further redrafted in the draft ED following the Board meeting:

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6 At least three of the written comments suggested amendments with the implication that the standard should clarify that a tax liability should be recognised if a timing difference is expected to reverse beyond the cut-off period. In other words, these

> 19. Comprehensive allocation is the preferred treatment in this Statement. Partial application is permitted as an allowed alternative treatment in respect of those timing differences:
> (a) for which there is reasonable evidence that they will not reverse for some considerable period (at least three years) ahead; and
> (b) that, when they reverse, will be replaced by equivalent timing differences. … . (881116ED, draft after Board meeting and E33)

6.4.5 Revaluations [I-10]

The original IAS 12 did not include a prescribed treatment for revaluations. However, the explanation section of the standard described two alternative ways of dealing with this issue: (1) to recognise deferred tax (§29) and (2) not to recognise deferred tax, but "disclose in the notes …the amount of the potential tax effect related to the increase in the carrying value of the asset at the date of the revaluation" (§30).

The initial staff key issues paper argued, on the one hand, for the second of these alternatives and, on the other hand, that no *standard* should be introduced relating to this issue. However, it suggested that all references to the non-preferred alternative (i.e. the first alternative noted above) should be deleted from the explanation section of the standard.

Initially the Steering Committee seems to have agreed with these suggestions. However, following an expression of "concern" over this proposal at the June 1988 Board meeting (e.g. 880804RSecSC: 2), the Steering Committee proposed to *require* recognition of deferred tax liabilities on revaluations *if it is probable* that the revalued asset will be sold. The note to the following Board meeting explained that the proposed treatment was "consistent with the recognition criteria in the proposed Framework and the requirements of IAS 16, Accounting for Property, Plant and Equipment" (8811AP4). It was also the same position as proposed for undistributed profits for subsidiaries and associates [I-8].

Two Board members supported this proposal in their written comments prior to the November 1988 meeting. One of these, however, warned that others might not. In addition, a third commentator strongly opposed the position, arguing that:

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focused on the deletion of the deleted criterion and the 'old' notion of they key being whether or not the timing differences are expected to reverse.

> In our view the leading and only relevant argument is - in all situations, not only in the case of revaluations - whether the measurement of assets and liabilities in the Fst. leads to values different from those for tax purposes. In all such cases tax-effects should be provided for to be credited to income in later years. Such treatment complies with the matching concept, which is not true for the treatment required by revised IAS 12. (8810XX…)

During the Board meeting one Board Representative is also reported to have "advised that he had very strong feelings about this issue and believed that all differences between book and tax valued assets must be recognised and that a tax liability must be recorded for these items" (8811BMM).

Before approving E33, the Board agreed to change the proposals relating revalued assets. The treatment previously prescribed (recognition only if tax payment probable) was made into an allowed alternative treatment and a new treatment (recognition in all cases) into a preferred alternative. It would thus appear that the strong sentiments of one Board Representative (Delegation) were decisive for the position in E33 with regard to this issue. In respect of later developments, it is particularly striking that this delegation appears to have been thinking in terms of a temporary differences approach to deferred tax accounting already at this time and that the appropriate treatment under this approach was designated as a preferred treatment. Nevertheless, controversy with regard to this issue was resolved by, in fact, allowing more than one alternative. Hence, E33 was stricter than the original IAS 12 in that it contained a standard on this issue, yet the flexibility in choice of treatments remained.

February staff	a tax liability should not be recognised on the revaluation of an asset + no standard relating to this issue
March SC	agreed
June Board	concern over proposal expressed
August staff	similar to original standard: both approaches (recognition and disclosure) described in the explanation section
September SC	require recognition of deferred tax liabilities on revaluations if it is probable that the revalued asset will be sold (standard introduced)
November Board	preferred alternative: recognition of deferred tax liability on revaluation allowed alternative: recognition if tax payment is probable

Figure 6.8 Various positions on the treatment of revaluations

6.4.6 Tax loss carryforwards [I-7]

The original IAS 12 allowed a free choice between two recognition criteria for (presumptive) tax assets relating tax loss carryforwards; either on *realisation* or at the time there is *assurance beyond reasonable doubt that the asset will be realised* (§§ 46-48). E33 proposed to eliminate this free choice incorporating only the latter criterion. On the one hand it appears that this position was reached despite strong protests from at least one Board delegation. On the other hand, the adopted position clearly was not as progressive as some other delegations would have wanted it to be.

The initial key issues paper reported that the Steering Committee on the Comparability of Financial Statements had identified the free choice in the original standard with regard to this issue and recommended that it should be removed, but without recommending how (880219Ra: 22). It also discussed whether special recognition criteria should apply to tax assets relating to tax losses, noting that a key difference exists "in that special limitation often apply to the use of tax losses which may make the realisation of the benefits associated with them less likely than for ordinary timing differences" (ibid: 24). In contrast with some other issues, the position in the staff paper was not clear-cut:

> Based on the above analysis, if the Steering Committee is prepared to recommend the removal of the option to use either realisation or assurance beyond any reasonable doubt that the asset will be realised, it would seem appropriate to prescribe that the use of the latter criterion (ibid: 25).

The Income Steering Committee appears to have agreed with its counterpart on the Comparability of Financial Statements (that the free choice with respect of this issue should be deleted) and with the staff with regard to how. The draft PO submitted to the Board in June 1988 thus proposed to require recognition in cases with "assurance beyond reasonable doubt". As already noted, the June Board suggested that the Steering Committee "review the neutrality of its proposals in respect of the recognition of tax assets and tax liabilities" (e.g. 880708DRSecSC). The draft ED submitted to the November Board, however, continued to require "assurance beyond reasonable doubt" (890909ED, §§ 23, 41).

Five of the ten written Board comments prior to the November Board meeting addressed this issue. However there was no consensus in the comments. For example, while one respondent argued that the criterion was too strict (suggesting recognition if realisation is probable) (88XXXXC…), another argued strongly for recognition on realisation (881103C…). A third simply argued that the proposal would "create conflicts with a number of national standards" (88XXXXC…) and a fourth respondent proposed to include a second condition (that the enterprise will earn profits in an amount necessary to recover the loss) (881102C…). The position was not changed by the Board before approving the ED.

6.4.7 Choice of liability method [I-3]

Although the FASB had published SFAS 96 requiring the asset-and-liability method of deferred tax accounting in December 1987, the list of key issues initially drafted by the staff does not include the choice of liability method [I-3]. Nor did the PO submitted to the Board in June 1988 explicitly raise this issue.

Several of the interviewees explained this in terms of there not being a general understanding of there being a significant difference between the liability method in IAS 12 and asset-and-liability method in SFAS 96. One interviewee, however, suggested that, in fact, the issue did surface at the first Steering Committee meeting, but that the Steering Committee had been persuaded that the IASC "should not pursue the FASB approach" (Eson). The same person explained this in terms of proponents of this strategy being output oriented, wanting "a more limited exercise" fearing that "that we would never get a product if we made the project too complicated":

> I think that the reason we did not seriously consider this path [to harmonise with SFAS 96] was that the balance sheet method was seen as

> too theoretical by many people and not suitable for many jurisdictions that are less sophisticated than the USA. The investment of time that would have been required to get the Board up to speed on the balance sheet method would have been immense and it was thought that the staff and Board's time could be spent more productively on other projects. (Eson)

Another interviewee also confirmed that the issue had in fact been discussed during the first Steering Committee meeting:

> … but I can confirm that we were affected by FAS 96. … It was a long time ago, but the FASB's approach was naturally discussed at the meeting. (Nson)

In view of these interviews, the suggestion in the draft PO submitted to the Board in June 1988 that the Steering Committee "proposed to place more emphasis on asset and liability orientation in accordance with the IASC Framework" (880405DRXB) becomes ambivalent.

With regard to this issue it is also particularly interesting to note that the evidence suggest that some Board representatives may have been thinking in terms of the temporary difference approach (the balance sheet liability method) not only in November 1988 (p. 147) but also in June 1988. In reporting the concern expressed over the position on revaluations, the minutes from this meeting also state that:

> …it was suggested that this point could be resolved as part of the definition of the liability method. (880708…)

6.4.8 Perspectives on the process

Once a Steering Committee had been set up, the process of developing an Exposure Draft was accomplished in less than one year. During this time the Board discussed this project twice. In June 1988 it discussed a draft PO. In November the same year it then discussed and approved (unanimously) an ED. Although a number of technical accounting issues were raised, only a few of these appear to have been controversial. In fact, the process appears to have been short, fairly non-controversial and low-profiled.

Although it can be argued that E33 proposed substantial changes to IAS 12 in relation to six issues (figure 6.7, p. 141), it can also be argued that the proposed changes only had significant implications in two[7] cases:

(1) the recognition of assets arising from tax losses [I-7]; and

E33 proposed to delete a free choice in IAS 12 by requiring recognition of a tax saving relating to a tax loss carryforward in the period when there is "assurance beyond any reasonable doubt" that the saving will be realised. This position, which was proposed by the Steering Committee in the draft PO and then retained, has been characterised as a compromise between those who argued for a more stringent solution (realisation) and those who argued for a less stringent recognition criterion (probable).

(2) disclosures [I-15].

The proposed new disclosures have not been identified as contentious and hence not discussed in detail in the previous account. In short it can be noted that they appeared in the draft ED drawn up after the second Steering Committee meeting (880909ED) despite initial suggestions that the disclosure requirements in IAS 12 not be revised (880219Ra) (880405DRXB). They were then retained more or less unchanged in E33 despite receiving some criticism[8].

In the other three cases the position in E33 may be different from that in the original standard, but not significantly so. In particular it is noted that controversy relating to these issues was "resolved" through compromise solutions (too). In these cases the compromise consisted of *retaining* flexibility in the proposed rules:

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7 The option of the deferral method [I-3] was also removed. As already noted, however, the project to revise IAS 12 seems to have been based on the notion that this issue was no longer controversial.

8 Prior to the November Board meeting one Board Member wrote: "The disclosure requirements are onerous. Par. 45 requires disclosures of components of tax expense which, to the best of our understanding, does not serve any need of user-groups. Also the paragraphs on expected periods of reversal of timing differences (46a) should be reconsidered." (8810XXC…). A Consultative Group Member also submitted a comment relating to these proposals: "The disclosure proposed in these paragraphs of tax assets and liabilities that are expected to reverse in each of the following three years would be extremely misleading and would unnecessarily complicate the already complex tax disclosure notes. Tax reversals do not represent cash flows and their projection for three years would be no more appropriate than projection of any other elements of the income statement." (88XXXXC…)

(1) the level of application of tax effect accounting [I-2];
It has been suggested that this issue was too controversial to address. The proposed solution was the same throughout the period.

(2) revaluations of assets [I-10]; and
This case appears to have been much discussed. Different solutions were also proposed (tried) at different points in time.

(3) undistributed earnings of subsidiaries and associates [I-8].
This issue does not appear to have received the same attention as the others. The compromise solution proposed in November seems to have originated in concerns of consistency (wanting to treat this issue in the same manner as that of revaluations).

In summary then it would thus appear that few, if any, international disagreements with regard to accounting for deferred tax effects were resolved during this period either. In fact, with two exceptions the ED did not propose any significant changes to the concurrent situation. Instead inter-national diversity, and hence controversy, were allowed to persist in the ED.

E33 was unanimously agreed by the IASC Board in November 1988. Before approving it, the Board agreed (amongst other things) to change the proposed position relating to revaluations [I-10] (and, as a consequence, for undistributed profits of subsidiaries [I-8]). The imposed change was in line with the suggestions of one Board Member, a Board Member that had expressed "strong feelings" on this issue (p. 147). This suggests that a deal may have been made in order to win the support of this Board Member.

Although none of the interviews provided further insight into this issue, they suggested that one reason for why E33 continued to allow diversity on three key issues could be that this project was dealt with after the concurrent Comparability project:

> …what had happened during the E32 debate is that where the Board couldn't reach agreement on keeping only one treatment, it designated one treatment as preferred and another as allowed alternative ...and …my recollection of that meeting is that, **by the time the Board got to consider taxes, it was probably tired** … and ready to compromise … it was sort of "preferred allowed alternative happy" and … it's possible that on a different occasion we might well have been more rigorous in our decision making, but as luck would have it we weren't. (Json, emphasis added)

The above quotation suggests that executive aspects of the standard setting process affected the political aspects of the process: the income tax project

was neither the only nor the primary issue on the agenda and by the time the Board got to this agenda item, it was weary and hence ready to compromise.

The concurrent effort to reduce flexibility in existing IAS (an external event to the IAS 12 project) may also have influenced the process relating to the income taxes project in other ways. In particular it is suggested that this seemingly non-controversial and limited (pp. 132, 149-150) project had to compete for attention and resources with this other project, which was perceived as a "turning point" for the IASC (IASC, 1987a: 2) and "a key step towards the use of International Accounting Standards in multinational securities offerings" (IASC, 1988a: 2). Hence it may not only have been a case of the Board being "tired", it may have been a case of this project not being the most important agenda item, neither for the IASC nor for individual Board Members / Representatives. This too, may have affected the willingness to compromise and hence the political dimension of the process.

There is also another potential implication of the suggestion that this project was seen as a limited exercise (possibly in combination that there was another much more important project). Although there are several indications of concurrent changes in the understanding of some of the key issues at the time, the review suggests that these did not really surface in this standard setting process. This somewhat bounded learning process may explain why some of the proposals in E33 can be perceived as strange and/or inconsistent. One such instance has already been noted: the adopted criteria for partial application [I-2p] (p. 145). Another example is that, even though the ED retained an income statement approach to the liability method, the preferred position on revaluations was motivated in terms of a balance sheet liability method (p. 147). On a higher level, it might be argued that as a result, the ED was outdated even before it was published (because it did not address the asset-and-liability method adopted in SFAS 96 which had been approved one year earlier). Moreover, it seems that, as a result, there was not a general understanding of there being a significant difference between the method of accounting for deferred tax in E33 and that in SFAS 96.

In light of this it is perhaps particularly interesting to note the suggestion that efforts were made to restrict the process in this dimension. For example, this appears to have been the case during the first Steering Committee meeting (p. 149). It may also have a factor behind the decision to shortcut the normal due process and move straight to an ED (p. 137). As already noted, these

efforts, which were explained in terms of executive concerns (wanting to make progress on this project as well as others), appear to have been successful.

6.5 1989 The comment period

6.5.1 Concurrent developments

Just after E33 was approved in November 1988, the IOSCO held its annual conference. Following this, it announced that it encouraged the IASC to pursue the Comparability project and that it wanted the IASC "to ensure that its Standards are sufficiently detailed and complete, contain adequate disclosure requirement, and are prepared with a visible commitment to the needs of users of financial statements" (e.g. IASC, 1989a). It was also reported that a panel discussion had concluded that the IASC's goals could only be achieved with the IOSCO's support and that the panel had "strongly urged IOSCO to support and endorse IASC as the appropriate body to set international accounting standards and to support their acceptance by IOSCO members" (ibid).

During the next IASC Board meeting (April 1989), the Board agreed to set up a new project – *the Improvements Project* - with the objective to make further improvements to IASs "to ensure that they are sufficiently detailed and complete and contain adequate disclosure requirements" (890411M). It was also agreed that the Steering Committee for this project would liaise closely with the Comparability Steering Committee and the Technical Committee of IOSCO (ibid). Later the Comparability and Improvements projects became known as one: *the Comparability / Improvements* (C/I) *project*.

The adoption of the Improvements project followed an IASC staff proposal which argued that the IOSCO communiqué referred to above, as well as other comments from regulators and international business, made it clear that the Comparability project was not sufficient to meet the "urgent" need "for truly international standards of accounting and disclosure", that the "IASC must make other improvements to its Standards in order that they gain greater acceptance" and that not making these improvements at the same time as implementing the Comparability proposals would be a "missed opportunity" (8904AP22):

> If International Accounting Standards are revised only for the proposals in E32 they will not be sufficient for the needs of IOSCO, individual securities regulators and the international business community. The Board will have failed to meet, on a timely basis, one of its key objectives. (ibid)

An article in the July 1989 edition of *IASC News* similarly explained:

> The message is clear. Although the IASC has achieved a great deal in its first sixteen years, it has not done enough. It must do more, much more, to meet its key objective of the development of truly international standards of accounting and reporting that can be used by international capital markets and the international business community.
>
> IASC must improve existing International Accounting Standards through the elimination of free choices in accounting treatment in its Standards, through additional guidance and through better disclosure requirements; IASC must also fill the gaps in its set of Standards. (IASC, 1989b: 1)

6.5.2 The comments to E33

E33 and *E32 Comparability of Financial Statements* were both released in January 1989, with comment deadlines of September 30th 1989. All in all 45 comments were received in response to E33, 32 of these in time for the October 1989 Board meeting (figure 6.9). Noting also that "many of the comments are the result of considerable consultation within individual countries, accountancy bodies, international accounting firms and other organisations", a staff summary of comments received for this meeting argued that "(t)he level of responses is good for IASC", suggesting that "it is likely that E33 benefited from the publicity obtained for E32" (8910AP6). In this context it may be noted that over 100 responses were received on E32.

Although the comments on E33 originated in a number of countries from all parts of the world, there was a distinct North American dominance (19 letters). There was also a distinct dominance of IASC Member Bodies (17 letters)[9]. The second largest category of respondents was individual companies (10 letters). Notably, most (6) of these came from the US. (See figure 6.10.)

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9 In contrast to the total number of IASC Member Bodies, however, this figure is perhaps not so impressive.

Member bodies:

1. Instituut der Bedrijfrevisoren (Belgium) [890213CBelg]
2. Institute of Chartered Accountants of Zimbabwe [890410CZim]
3. Institute of Certified Public Accountants of Kenya [890807Icpak]
4. Institute of Certified Public Accountants of Singapore [890808CSing]
5. Institute of Chartered Accountants of Trinidad & Tobago [890918CT&t]
6. South African Institute of Chartered Accountants [890919CSaica]
7. New Zealand Society of Accountants [890925CNz]
8. National Association of Accountants (USA) [890925CNaa]
9. Schweizerische Treuhand- und Revisionskammer (Switzerland) [890926CSwiss]
10. Institut der Wirtschaftsprüfer (Germany) [890928CIdw]
11. Certified General Accountants' Association of Canada [890930CCga]
12. Compagnie Nationale des Commissaires aux Comptes ; and
    Ordre des Experts Comptables et des Comptables Agrees (France)
    [89XXXXCFrench]
13. Japanese Institute of Certified Public Accountants [89XXXXJicpa]

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14. *Hong Kong Society of Accountants [891018CHksa]*
15. *American Institute of Certified Public Accountants [891031CAicpa]*
16. *Foreningen af Statsautoriserede Revisorer (Denmark) [891208CDen]*
17. *Institute of Chartered Accountants of Nigeria [900124/890929CNig]*
18. *Institute of Chartered Accountants of Pakistan-[890225/900803CPak]*

Standard setters:

1. Raad voor de Jaarverslaggeving (Netherlands) [89XXXXCRj]

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2. *Australian Accounting Research Foundation [891221CAarf]*
3. *Accounting Standards Committee (UK & Ireland) [89XXXXCAsc]*

Securities Regulators:

1. *Securities and Exchange Commission (US) [891023CSec]*

Bankers:

1. British Bankers' Association [890713CBba]
2. Citicorp Citibank (US) [891011CCiti]

Financial Executives:

1. Financial Executives Institute (US) [890622CFei]

Figure 6.9a *List of commentators to E33 (comments in italics not received in time for October 1989 summary)*

Companies:

1. Royal Dutch Shell Group (UK(/Netherlands) [890803CShell]
2. Household International Inc. (US) [890921CHi]
3. I. du Pont de Nemours & Company (US) [890922CDup]
4. Broken Hill Proprietary BHP (Australia) [890925CBhp]
5. Unilever PLC (UK) [890925CUni]
6. The South African Breweries Limited (South Africa) [890926CSab]
7. Texaco Inc. (US) [890928CTex]

8. Pacific Telesis (US) [891006CPt]
9. Salomon Inc. (US) [891009CSal]
10. Philip Morris (US) [891127CPM]

Financial Analysts:

1. Financial Analysts Federation (US) [890929CFaf]

2. Society of Investment Analyst (UK) [8910XXCInv]

Accounting firms:

1. Hodgson Impey (UK) [890510CHica]
2. Arthur Andersen & Co (US) [890721CAa]
3. Coopers & Lybrand (US) [890929CC&l]
4. Price Waterhouse (US) [891003CPw]

Individuals:

1. Professor of Accounting K Most (Florida International University) (US) [890327CKsm]
2. W A Smith (US) [890707CWas]
3. S MacFarlane, South African Breweries (South Africa) [890712CSm]

4. M P Carscallen (Coopers & Lybrand, Canada) [890829CMpc]

Figure 6.9b List of commentators to E33 (comments in italics not received in time for October 1989 summary)

No respondent disagreed with the proposal to require tax effect accounting using the liability method [I-3]. Nevertheless, disagreement was voiced relating to a number of issues relating to how to apply this approach. Two proposals in particular gave rise to a number of adverse comments: the treatment of undistributed profits of subsidiaries and associates [I-8] and one of the proposed disclosures (timing differences expected to reverse in next three years) [I-15]. In relation to two other issues the comment letters suggested that opinions were very much divided: the level of application of tax effect accounting [I-2] and revaluations of assets [I-10]. (See figure 6.11.)

Origin / Category	Tot.	North America US	North America Can.	Carib-bean	Europe UK & Ireland	Europe Other Europe	Africa	Asia	Austral-asia
Member bodies	18	2	1	1		5	4	4	1
Standard setting bodies	3				1	1			1
Security regulators	1	1							
Bankers	2	1			1				
Financial Executives	1	1							
Individual Companies	10	6			2		1		1
Financial Analysts	2	1			1				
Accounting Firms	4	3			1				
Individuals	4	2	1				1		
Total	45	17	2	1	6	6	6	4	3

Figure 6.10 Summary of comments received on E33

Given developments in the next period it is interesting to note that there is no mention in any of the (staff) reports on comments received of comments indicating that there is a difference between the liability method proposed in E33 and the "asset-and-liability method" required in SFAS 96 [I-3]. Nevertheless, five comment letters do indicate both an awareness of, and concern with, this issue. Admittedly, all but one of these did not state this clearly, commenting instead e.g. on the definition of timing differences:

> Since ED 33 adopted the liability method, "timing differences" should be defined as the differences between the tax basis of an asset or liability and its reported amount in the financial statements that will reverse in future as taxable or deductible amounts. If the definition changes in this way, the word "timing differences" may not be appropriate. Other word, for example "temporary difference" in FASB NO. 96, would be better.
> (Comment from an Asian member body)

The above quotation seems to argue that the IASC should switch to the balance sheet liability method. Whereas another commentator suggested that the latter approach also be permitted (a US company), a third commended the IASC for sticking to the income statement liability method (a European company:

- ***Undistributed profits of subsidiaries and associates [I-8]***
  Twenty (24) commentators are reported as having disagreed with the proposals relating to undistributed profits of subsidiaries and associates, most of them proposing that the allowed alternative treatment be the preferred treatment. Only one (2) commentator(s) is (are) reported as having explicitly supported the proposals, with an additional two implying support

- ***Disclosure of timing differences expected to reverse in next three years*** *[I-15]*
  Twelve (16) commentators are reported to object to this proposed proposal.

- ***Level of application of tax effect accounting [I-2]***
  Ten (15) commentators are reported to support preference for comprehensive application, six (11) of these preferring that partial application not be permitted. Four (5) commentators are reported to have argued that partial application be the preferred treatment and three (4) that both levels of application be allowed without distinction.

- ***Revaluations of assets [I-10]***
  Seven (9) commentators are reported as disagreeing with the proposals, all of them arguing that the allowed alternative be the preferred. Six (7) commentators are said to support the proposals, but only two (3) explicitly. [I-10]

- ***Criteria for partial application [I-2p]***
  Two commentators are listed as having proposed a slackening of the criteria and one as having argued for tighter criteria.

- ***Criteria for recognition of tax assets relating to tax loss carryforwards [I-7]***
  Two (3) commentators are reported to disagree with the proposal.

- ***Discounting [I-4]***
  (Two commentators are said to have suggested that the standard address the issue of discounting.)

Figure 6.11 Summary of comments received[10]

10 This table is based on the summaries of comments received prepared by the staff. The numbers in the running text refer to numbers quoted in the report to the October 1989 Board meeting (8910AP6). The numbers in parenthesis refer to numbers quoted in an updated version sent to the Steering Committee in early 1990 (900205LSecSc).

> *THE COMPANY* supports the proposal's choice of a required liability approach whereby income taxes would be calculated based on current tax rates and law. The proposal employs an income statement approach in the determination of deferred income taxes, whereby permanent differences in pre-tax income are excluded. *THE COMPANY* believes that a balance sheet approach for the calculation should also be permitted under the required method. Essentially, under a balance sheet methodology, no permanent differences would exist for asset or liability balances; book/tax differences associated with nontax balance sheet accounts would be subject to deferred income taxes. (890928C…)

> By contrast with the US statement FAS 96, ... , this exposure draft continues to distinguish "permanent" and "timing" differences. We support this important distinction, … We urge IASC to retain this important distinction between permanent and timing differences. (890803C…)

6.6 1989 – 1990 After the comments to E33

6.6.1 Introduction

According to normal procedure at the time, the Steering Committee would have discussed the responses received on the ED before reporting to the Board. However, following the deadline of E32 and E33 it was decided that the Board would receive reports on the responses received prior to the respective Steering Committees.

The first Board meeting following the deadline was held in New York at the end of October 1989. Prior to this meeting the Board received a report of the (34) comments received on E33 by that time and the agenda allotted 30 minutes to a discussion of this. Informal notes from the meeting (891103M) suggest that there was not so much a discussion as a voicing of opinions. The focus seems to have been on one technical accounting issue: the level of application of tax effect accounting [I-2]. In respect of this issue the notes suggest that: two delegations expressed strong support for partial application, another delegation expressed concerns over allowing partial application and another two delegations advised that the level of application were not controversial in their respective countries. In addition, the notes suggest that the issue of appropriate criteria for recognition of tax assets relating to tax loss carryforwards [I-7] was also raised.

Although no decisions are reported relating to this project, a staff suggestion that the Steering Committee would not meet until mid 1990 seems to have been accepted. A Steering Committee meeting was accordingly scheduled for July 2nd - 3rd 1990 (900205L…), signalling a slow process on this project. Following the March 1990 Board meeting (Amsterdam), the project was deferred. A letter to the Steering Committee explains that this decision was made by the Secretary-General and the Steering Committee Chairman "(a)fter consultation with the Chairman of the Board (…) and the Chairman-Designate ()" (900327L…). The IASC Board was informed of this decision at its meeting in June 1990 (Paris), the related agenda paper explaining that:

> … the July 1990 meeting has been postponed pending further study and consultation. It is unclear at this stage when the Board will be asked to consider the revised International Accounting Standard (or whether a revised Exposure Draft will be necessary). It is, however, intended that the project should be completed by the end of 1992, the same deadline that has been set for the approval of the revised and improved set of International Accounting Standards. (9006AP11)

The issue of how to proceed with this project does not appear to have given rise to much controversy. Instead, the focus of attention at this time seems to have been the C/I-project. In relation to this project the October 1989 Board agreed that it should aim to approve an IAS based on E32 at its meeting in June 1990 and that the agreed changes would then be incorporated into revised individual standards over a period of years.

6.6.2 How to proceed with the project

The main issue relating to this project following the comment deadline thus appears to have been how (particularly with what speed) to proceed with the project. This issue did not arise out of the comments received to the ED. In fact, two of three factors relating to this decision refer to factors more or less outside the project itself:

(1) Other IASC projects

Other IASC standard setting projects, particular the Comparability project, affected this project in that it took up a lot of the (limited) IASC staff resources, leaving little or no room for pursuing with this project:

> …we had to pull in three extra people to help us review the comment letters on E32 … we had just started intangibles and had some trouble with that, we were trying to get IAS 30 on banks finished, and there were a few other things going, … (Json)

In fact, the C/I-project had made it clear that the small IASC secretariat needed to be expanded. In early 1990, the Board recognised that its work programme required a doubling of its budget and funding in order to, amongst other things, recruit additional staff (IASC, 1990b: 1).[11]

However, a shortage of staff resources – which relate to the executive aspects of the standard setting process – was not the only impact of concurrent projects. Uncertainty regarding how to proceed with E32 also seems to have given rise to caution. A letter from February 1990 argues that it "would be unwise to proceed with E33 while we are unsure how we will proceed with E32" (900205L…). In relation to this one interviewee explained:

> …there was a lot of discussion around that time as to just how we should take forward E32, about whether we should issue one composite document and change ten standards at the same time or whether we should deal with them all through the improvements process. We were also having quite a lot of discussion about whether to refer to benchmark or preferred and we eventually settled on benchmark. We also had a lot of discussion about the reconciliation proposal in E32 that if you adopted the allowed alternative you had to reconcile to the preferred treatment. (Json)

This impact is of a different kind, relating on the one hand more to the overall IASC strategy and, on the other hand, specifically to what types of compromise solutions were to be considered acceptable.

(2) The IOSCO position

A second factor identified as important for the deferral of the project was the IOSCO position. The evidence suggests that the IOSCO had, through informal discussions, suggested that IAS 12 required further improvements, but had not identified what improvements were desired. In view of this, it was argued (in February 1990) that "it would be pointless proceeding with the project until IOSCO can give us some further help" (900205…). This factor thus seems to be related to the political aspects of the standard setting

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11 The 1990 October edition of *IASC News* included an advertisement for a Technical Director. The April 1991 edition of *IASC News* then reported on three new appointments, increasing the IASC's technical staff from two to five: a "technical director", a "visiting technical director" on a 1½ year secondment from the Australian Accounting Research Foundation; and a "research manager" on a two year secondment from a Dutch accounting firm. Around this time, the IASC also relocated its offices in London in order to have adequate space for the new staff.

process. To the extent it was suggested that this major player had not made its mind up regarding which improvements were desired, however, this factor may also suggest that further learning was required.

(3) Developments of parallel national projects

Just prior to the release of E33, in December 1988, and then again in December 1989, the effective date of the US standard on deferred tax (SFAS 96) was postponed, first to December 15th 1989 and then to December 15th 1991. These developments seem to have been significant in that the IASC adopted a 'wait and see' strategy. In fact, one interviewee suggested that the US problems was the main reason for the IASC slowing down/delaying its project on deferred tax, also relating this to IASC strategy at the time:

> …the Americans at that time had difficulties with their own standard, and the reason was that until the Americans had settled their problems, it was thought advisable not to finalise an IAS standard and this is very significant of the way IASC has been working for the last 10 years … while the Americans have problems... it is no use for us trying to reinvent the wheel, to do something very different, otherwise we'll have a problem… (Fson)

Another interviewee (Pson) suggested that the decision to defer the project awaiting the developments in the US, rather than to attempt to adopt a leadership role, was the most important political decision in the process of revising IAS 12.

This said, however, it should be noted that there are some indications that at least one Board delegation (or representative) argued that the IASC should not defer the project, but instead seize the opportunity. Informal notes of discussions at the October 1989 meeting include the following notation in relation to one delegation:

> IASC should adopt a leadership role. Many countries are grappling with this topic and somehow IASC should involve itself. This is an ideal opportunity for IASC. (891103M)

One document suggests that a (cautious) attempt to sound out the prospects of adopting a leadership role was made: a fax dated May 29th 1990 refers to the forthcoming June 1990 Board meeting, indicating that a decision has to be taken on what “whether to slow down” the taxes project, and continues:

> Clearly an IASC led initiative may be helpful to Canada and would be supported by [a Canadian]. It would fit in well with [the IASC’s] current strategy.

> The real problem, however, is the US – would the FASB be willing to participate in some sort of effort to resolve some of the tax accounting issues and get some greater international harmonisation. … Do you think we could set something up which involves the US and Canada (and others) under an IASC Chairman? (900529L…)

However, no other references to such an effort have been found, suggesting that if such an effort was made, it was limited and had few if any consequences. Although one would think a situation where the accounting in several important countries is under revision to be an ideal situation for work on harmonisation, the opposite thus happened. This suggests that the national standard setting processes were still seen to be more important than the international process.

The US developments also appear to have been significant from another perspective. The letter informing the Steering Committee of the decision to defer the project refers to "(s)ome major differences (perhaps unintended) between FAS 96 and E33 and SFAS 96 which should be researched further" (900327L….). Another letter suggests that the differences referred to were in relation to the recognition of deferred tax assets [I-7]:

> One of the major problems in the USA is that, after the recent tax reforms, many deferred tax balances would be assets rather than liabilities. The FASB does not want these assets recognised as assets - but E33 would probably require their recognition. I think it is true to say that E33 was developed on the assumption that virtually all timing differences give rise to liabilities rather than assets. We should not proceed without further research on this issue. (900205L...)

Although this factor also seems related to the political process (the acceptability of the proposals by the US), the above quotation is also indicative of something more: that learning has taken place. This learning, in turn, seems to have shed new light on the project and the proposals in E33.

The importance attached to the developments in the US in this period also seem significant from another perspective; it contrasts sharply with the previous period, when little attention seems to have been paid to US developments.

CHAPTER 7

1992 – 1994 THE SECOND ED

7.1 Introduction

Having been deferred in the spring of 1990 the IASC project on Income Taxes was reactivated in 1992. Two years later, in June 1994, a second ED was released for public comment. This chapter accounts for the events leading up to this document in two main sections:

7.2 1990 – 1992 Reactivating the project
7.3 1992 – 1994 Developing E49

These sections, however, are of unequal weight, the majority of the chapter focusing on the development of E49.

7.2 1990 - 1992 Reactivating the project

In the period during which the project on income taxes was on hold (1990-1992) the IASC's focus was primarily on the C/I-project. In March 1990 the Board rejected the original plans of approving an IAS based on E32, agreeing instead to implement the changes directly into revised IASs over a period of two to three years.[1] At its next meeting (June 1990), the Board approved a "Statement of Intent on the Comparability of Financial Statements", setting out its position on each of the technical issues identified in E32. Then, following the November Board meeting later that year, it was reported that the IASC intended, under the Improvements Project (p. 154), to revise all existing Standards, including those not affected by the Comparability Project, into a new format and style. Initially it was envisaged that this would be completed by the beginning of 1993. In June 1991, however, the Board decided to accelerate the C/I-project with an intention that all the changes in the Statement of Intent should be in-corporated in revised IASs by October 1992. Following the next Board meeting (November 1991), however, the IASC revised its work programme to achieve "a proper balance … between the need for quality and due process

1 It also agreed to remove the reconciliation requirement in E32 and to use the term "benchmark" instead of "preferred" treatment (9003M). (See quotation p. 162.)

and the need for speed" (IASC, 1991). In practical terms the finishing line was moved to the end of 1993 (ibid).

Other major topics on the Board's agenda during this period included financial reporting of interests in joint ventures (IAS 31, November 1990), cash flow statements (E36, February 1991) and financial instruments (E40, July 1991).

In March 1992, the Board once again reconsidered its work programme, agreeing on a number of changes, including to limit the Improvements Project to those IASs affected by the Statement of Intent (IASC, 1992a). During this discussion it also decided to reactivate the project on Income Taxes "once staff and other resources become available" (ibid). Notably this decision followed the release of a new US standard on tax accounting by one month only, SFAS No. 109, Accounting for Income Taxes having been issued in February 1992.

Work on the project, however, did not resume until about six months later when the staff drafted a work plan. This plan was presented[2] to the IASC Board in October 1992, apparently without much discussion. Discussions of how to extend the involvement of the preparer community in the work of the IASC, however, resulted in an invitation to the International Chamber of Commerce (ICC) - a Consultative Group Member - to appoint a (fifth) Member to the Steering Committee on Income Taxes. The member thus appointed has been described as having "considerable experience with respect of tax accounting problems in multi-national groups of companies" (9303AP10). A relevant detail in this context is that he worked for the same multinational company as an ICC Consultative Group Representative[3] and that the two of them collaborated very closely in preparations for their various meetings.

In the meantime the Board also met in June 1992 when it discussed its "longer term plans and priorities" (IASC, 1992b). As part of these discussions the Board agreed to set up "a working party to consider the establish-

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2 The work plan appears to have been drafted by the Secretary-General, the Technical Director and a Research Manager. It was presented to the Board by the Secretary-General, the Technical Director being absent from the meeting and the Research Manager having left the IASC that month.

3 In fact, the appointed Steering Committee Member had represented the ICC at the Chicago Consultative Group Meeting.

ment of an International Accounting Standards Foundation and the future structure and organisation of IASC" (ibid). The Secretary-General also reported that he had agreed with the Secretary-General of the IOSCO on a timetable "which could lead to the endorsement of" IASs by IOSCO in October 1993 (921214…). Both the June and the October 1992 Board meetings were otherwise devoted mainly to the C/I-project as well as the project on Cash Flow Statements, a revised IAS 7 being approved in October 1992.

Year	Board meetings	
1992	March 4th – 6th (Madrid, Spain)	Decision to reactivate project
	(June 16th – 18th (Amman, Jordan))	
	October 7th – 9th (Chicago, USA)	Work plan presented to Board

Figure 7.1 Summary of Board meetings in 1992

7.3 1992 – 1994 Developing a second ED (E49)

7.3.1 Introduction

When work on the project on deferred tax resumed in the autumn of 1992 there seems to have been general agreement that a revised ED should be published. Although many seem to have expected another fairly straightforward process, this was not to be the case. Major concerns with the proposals prevented the Board from agreeing on an ED until two years later. During this time the Steering Committee and the Board each discussed draft EDs at three meetings respectively. Furthermore, all in all at least 22 draft versions of the ED were produced (see figure 7.2).

The ED that was finally approved in June 1994 (published in October 1994), *E49, Income Taxes*, was very different from its predecessor. In particular, it proposed to require comprehensive application [I-2] of a new method of deferred tax accounting: the balance sheet liability method [I-3]. The recognition criteria for deferred tax assets in E49 were also significantly different from those in E33 [I-7]. See figure 7.3 for further details.

Year	Board meetings	Steering Committee meetings	Draft EDs
1992			November 2nd
			November 23rd
		December 9th -11th	December 9th
			December 11th December 11th
1993			January 8th
			January 19th
	March 23rd – 26th (Tokyo, Japan)		
	(June/July 1993 (London, England))		
			July 29th
		August 24th -25th	August 24th
			September 2nd
			September 9th
	November 2nd – 5th (Oslo, Norway)		November 4th
			December 21st
1994			February 2nd
	~~March 1994~~[4]	March 15th -16th	March Xth
			March 23rd
			April 19th
	June 13th-17th (Edinburgh, Scotland)		June 14th
			July 6th
			July 18th
			July 20th
			September 2nd
			October 13th (E49)

Figure 7.2 Summary of significant events leading up to the approval of E49

4 The 1994 March meeting was cancelled in November 1993 with the argument that "(c)onsiderable resources have been committed to the Comparability / Improvements project in recent years with the result that no current projects will require Board time in March" (IASC, 1993d).

- ***The level of application of tax effect accounting [I-2]***
  E49 proposed to require comprehensive application of tax effect accounting (i.e. to no longer allow partial application).

- ***Method of tax effect accounting [I-3]***
  E49 proposed to require the balance sheet liability method. Under this method deferred tax is recognised on all *temporary differences*. Since not all temporary differences are timing differences, this change had important potential implications on reported numbers. However, E49 proposed to make exceptions for a number of cases, thus limiting these effects:
  - investments in ***subsidiaries, associates and joint ventures*** (in certain cases) [I-8];
  - ***goodwill*** for which amortisation is not deductible for tax purposes (and negative goodwill accounted for as deferred income) [I-16b,c];
  - ***long-term assets*** (when the temporary difference arises on initial recognition of the asset other than in a business combination) [I-21] [I-16a]; and
  - ***non taxable government grants*** [I-22].

  However, E49 did not contain any exception for temporary differences arising on ***inter-company transactions*** [I-9] or ***revaluations*** [I-10].

- ***Recognition of assets [I-5][I-7]***
  E49 proposed that deferred tax assets (liabilities) should be recognised when it is *probable* that an associated future economic benefit will flow to (from) the enterprise and the amount can be measured reliably. These proposals were significantly different from those in E33, at least for deferred tax assets arising on tax loss carryforwards.

Figure 7.3 Summary of significant changes proposed in E49 compared to E33

Before discussing the developments leading up to E49 in more detail, it is noted that again the project to revise IAS 12 was far from the only, or even major, project on the IASC's agenda. Most notably it still had to share resources with the high profiled C/I-project[5] and also with the Financial Instruments project[6]. Besides the approval of E49 in June 1994, the main event at this Board meeting was probably a special arrangement consisting of two days of discussion of the Financial Instruments project with national standard setting bodies.

The project to revise IAS 12 also had to share resources with continued discussions relating to two important strategic issues for the IASC: its

5 Drafts of the three revised IASs were considered in March 1993 and approved in June/July. A set of ten revised IASs were then finally approved in November 1993.

6 In November 1993 the approval of a second ED (E48) was an important milestone.

relationship with the IOSCO and its future structure and organisation (p. 167).
With regard to the first of these issues, it is noted that at the end of October 1993 the IOSCO endorsed *IAS 7, Cash Flow Statements* and "agreed a list of the core standards that should be included in the necessary components of a reasonably complete set of accounting standards" (IASC, 1993e: 4). Moreover, in September 1994 (i.e. after the IASC had approved, but before it had published E49) the IOSCO wrote to the IASC about the acceptability of 24 of its standards. Although accepting 14 IASs, the IOSCO informed the IASC that it would not endorse any further IASs "until IASC has completed all the core standards to IOSCO's satisfaction" (IASC, 1994b). At the IOSCO's annual conference in October 1994, the IASC chairman criticised this approach, arguing that it should endorse the process of setting IASs rather than review each standard in detail (IASC, 1994b & c).

7.3.2 The issues

When work on the income tax project resumed attention first focused on five issues that the staff identified as needing to be revisited based on the comments received on E33. These were five of the six issues for which E33 proposed significant changes to IAS 12 (see figure 6.7, p. 141), the exception being the method of tax effect accounting [I-3].

Prior to the first Steering Committee meeting (December 1992) the staff prepared two draft EDs. The first of these encompassed revisions of format and terminology in line with the Improvements Project[7]. The title of the Standard was also changed from *Accounting for Taxes on Income* to (*Accounting for) Income Taxes*[8]. The second version incorporated proposed changes to the proposed rules with regard to the five issues referred to above. In all cases the staff suggested changes in line with the comments received (see figure 7.4 for further details). Although this implied elimina-

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7 Changes in format basically amounted to the explanation and standard sections being merged. Changes in terminology included a change from *preferred* to *benchmark* treatment and from *accounting income* to *accounting profit and loss.* The latter term was later amended to *accounting profit* only.

8 A note to the March 1993 Board meeting explained that the reason for this change was that income was now a defined term in the IASC Framework and that since "the purpose of IAS 12 and E33 was not to prescribe guidance on accounting for all taxes on items qualifying as income under the Framework the title has been changed" (9303AP10 §19). Later the title changed to simply Income Taxes (draft ED date 930909).

ting the free choices allowed in E33 in relation to three issues, the proposed changes tended to make the proposed standard less demanding. The exception was that the staff proposed to require comprehensive application [I-2].

(1) ***Level of application of tax effect accounting [I-2]***
Whereas E33 identified comprehensive application as a preferred treatment and partial application as an allowed alternative, the staff proposed to require comprehensive application. This proposal, for what has been identified as a previously very contentious issue, may be understood in view of many commentators to E33 stating preference for comprehensive application, most of these preferring that partial application not be permitted.

(2) ***Undistributed profits of subsidiaries and associates [I-8]***
In line with the suggestion of many commentators to E33 the staff proposed that the allowed alternative treatment in E33 be the required treatment. In doing this the staff proposed to return to the proposal submitted by the Steering Committee to the November 1988 Board meeting.

(3) ***Revaluations of assets [I-10]***
Also in line with the suggestion of several commentators (but fewer than in the previous case) the staff proposed that:
- taxes that become payable on the revaluation of an asset should be recognised and charged to revaluation surplus as a liability when the asset is revalued; and
- taxes that become payable on the sale of an asset should be recognised as a liability and charged to revaluation surplus when the sale is recognised.

This proposal was similar, but not identical, to the allowed alternative in E33 and to the position in the draft ED submitted by the Steering Committee to the November 1988 Board.

(4) ***Disclosures [I-15]***
The staff also proposed to *encourage*, rather than *require*, the much opposed disclosure in E33.

(5) ***Recognition of tax loss carryforwards [I-7].***
The staff proposed to replace the (stricter) recognition criteria in E33 with the general recognition criterion in the framework.

Figure 7.4 Proposed changes to the content of the proposals by the staff prior to the December 1992 Steering Committee meeting[9]

Both the Steering Committee, in December 1992, and then the Board in March 1993, agreed with most of these proposals. To a certain extent it thus seems fair to argue that initially this period was about listening to (even

9 Comments received on E33 are summarised in figure 6.11 on p. 159.

bending to) the opinions expressed in the comment letters. However, from here on the story becomes more complicated. First, for one issue – revaluation [I-10] – the Board, somewhat contrary to the opinions expressed in the comments received, decided to require recognition of deferred tax in relation to revaluations (this was the preferred treatment in E49). Second, and more importantly, in December 1992 the Steering Committee also agreed to propose to the Board to amend the definition of timing differences, a key concept in the application of deferred tax accounting under E33. With time, this proposed change, which does not appear to have been a response to comments received on E33, led to the reframing of the whole discussion and, in the end, the adoption of what has become known as the balance sheet liability method [I-3].

A number of things are striking about the developments during this period. First, it is intriguing how this fundamental shift in the proposals appear to have happened without being (at least initially) explicitly recognised for what it was and, related to this, how the choice of liability method [I-3] thus only slowly emerged as a key issue.

Second, it is striking how, even after the choice of liability method had surfaced as a key issue, most of the concerns were not expressed in terms of opposition to the fundamental ideas on which the balance sheet liability method rests, but in terms of (concern for) the implications of this choice for the treatment of specific items/ transaction. Those items/transactions that were in focus were primarily those where a change was implicated by the proposed change[10]. As a result, it is hard to distinguish what was the key issue during this period: the choice of method of tax effect accounting [I-3] or how to deal with certain specific items and transactions (particularly revaluation [I-10]). As a result it is also hard to account for the various issues separately. In this respect, the process during this period was quite different from the period during which E33 was developed (when the issues appear to have been discussed more or less separately).

A third characteristic of this period is that some issues that had been discussed in previous periods were re-framed as they started being discussed in terms making exceptions, or not, from the general principle of recognising

10 In general the new rules would potentially give rise to (primarily) larger deferred tax liabilities (higher deferred tax expense/lower equity).

deferred tax on all temporary differences. These included two of the choice situations in E33: revaluations [I-10] and the treatment of undistributed profits of subsidiaries and associates [I-8]. Furthermore, with time, new issues emerged. These include the issue of how to deal with intra-group profits [I-9], government grants [I-22] and non-deductible assets [I-19][I-16a]. In this respect too, this period is thus different from the period during which E33 was developed (in that period both issues and alternatives were stable and well defined).

Parallel to discussions of how to implement deferred tax accounting the criteria for recognising deferred tax assets [I-5][I-7] also continued to give rise to concern and discussions. In addition, the standard setting process *per se* also seems to have given rise to some controversy.

The rest of this chapter first provides further details of the developments pertaining to what has been identified as key issues during this period:

7.3.3 The choice of liability method [I-3];
7.3.4 Revaluations [I-10] (pp. 185f);
7.3.5 Investments in subsidiaries etc [I-8] (pp. 187f);
7.3.6 Intra-group profits [I-9] (pp. 193f);
7.3.7 Government grants [I-22] (pp. 197f);
7.3.8 Non-deductible assets [I-19][I-16a] (pp. 199);
7.3.9 Recognition issues [I-5][I-7] (pp. 205f); and
7.3.10 Issues of procedure (pp. 209f).

The final section of this chapter (7.3.11, pp. 209f) then discusses what has been identified as the logic of the developments pertaining to this project during this period.

7.3.3 The choice of liability method [I-3]

This period is characterised above all by the emergence of the choice of liability method as a key issue. This section provides a more detailed account of these developments, focusing first on the chronology of the developments and closing with a review of arguments presented for and against adopting the balance sheet liability method.

A change in the wording and focus is proposed and agreed

The first Steering Committee meeting after the release of E33 and the reactivation of this project was held in December 1992. As noted above, this

meeting focused on a revised draft ED prepared by the staff incorporating a number of changes to issues identified as controversial based on the comments received to E33. Also as noted above, the Steering Committee agreed with most of these proposals and to propose to the Board a change the definition of timing difference "to be a balance sheet rather than an income statement oriented definition" (9303AP10, §20)[11]. More specifically the Steering Committee proposed the following amendments:

> Timing differences are the differences between ~~the~~ tax~~able income~~ base of an asset or liability and ~~accounting profit for a period that originate in one period and are expected to reverse in one or more subsequent periods~~ its carrying amount for financial reporting purposes that result from non-permanent differences between taxable income and accounting profit and from business combinations which results in taxable or deductible amounts when the asset is recovered or the liability settled. (2nd draft dated December 11th 1992, i.e. final day of Steering Committee meeting, changes marked in comparison with draft dated November 23rd 1992)

In the report to the following Board meeting this was described as a change in focus and wording (9303AP10, §20). As a contrast an earlier part of the report set out some "substantive changes" (ibid, §16).[12] Indeed, it seems that, at the time, the Steering Committee also perceived this as a (mere) change in wording and not as the fundamental change that it, in fact, implied:

> ... at the end of *[the Steering Committee meeting] [Y]* said to me, I still remember *[Y's]* words: I don't think they realise what they've done. (Json)

Although the staff note to the March 1993 Board meeting framed the proposed change as a response to comments received[13], the review of the process does not support this suggestion. In particular, neither staff summaries of comments received, nor staff papers for the December 1992 Steering Committee meeting raise this issue. Instead it seems that the shift in

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11 In a staff work plan from June 1993 (six months later) this decision was described in terms of "a change in emphasis from an income statement approach to a liability approach similar to (but not the same in all respects) as FAS 109" (930615WP).

12 These included the suggestion to delete the free choice in E33 with regard to the level of application [I-2], undistributed profits of subsidiaries and associates [I-8] and revalued assets [I-10].

13 "A number of commentators remarked that the focus of E33 was very much on the income statement and the determination of tax expense with little discussion of current and deferred tax liabilities. This seemed anomalous to the commentators in light of the proposed requirement for the liabilities method." (9303AP10, §16)

terminology can be attributed to the presence of the FASB's project manager on income taxes at this meeting, commenting and questioning the Steering Committee's reasoning:

> ... all through the meeting [X] would be saying, very politely: Well, this is very interesting, what you are saying, but have you considered x, y, z? Have you considered how this fits in with your framework? (Kson)
>
> …then discussions started and there was [X], who started to make proposals: Could we not improve the wording here? Could we not improve the wording there? …When I came back and got a new version of it, and I read it through I realised that we had changed the whole standard..., but without me noticing it, … When I was there I did not realise it, no, I realised it when it was on my desk … (Cson)

The interviews suggested that FASB project manager persuaded the Steering Committee by the logic of his arguments rather than anything else:

> I think he was just, such an articulate and knowledgeable individual and very difficult to argue with. (Json)

One Steering Committee member reacted strongly against the revised draft ED circulated to the committee after this meeting, arguing forcefully against the new definition and against the consequences for certain transactions and events, particularly revaluations [I-10] and fair value adjustments on consolidation [I-16a]. Another Steering Committee member, on the other hand, distinguished himself by addressing issues for which the IASC proposals were different from the US standard. His comments to the draft ED circulated after the meeting included that the draft did not deal with timing (actually temporary) differences arising on intra-group profits [I-9] or the translation of foreign subsidiaries using the temporal method [I-17a].

The original plans were to approve a revised ED based on the Steering Committee's suggestions at the following Board meeting in March 1993. One day prior to this meeting, however, it was decided that the Board should discuss the proposed draft without the ambition of approving it. This was on the recommendation of the Steering Committee Chairman, reporting disagreement within the Steering Committee and major concerns in written Board comments (9303OPC).

The minutes from the ensuing Board meeting, however, suggest that the Board only explicitly disagreed with one of the presented proposals: that relating to revaluations [I-10]. A staff work plan dated June 1993 describes the discussions in March 1993 as "very brief", adding that the decisions taken should therefore "be regarded as being tentative" (930615WP). On the one hand it would thus appear that the Steering Committee's proposals to amend the definition of timing differences were approved by the Board in March 1993 without much discussion. On the other hand, however, the Board's decisions vis-à-vis this project have been described as tentative. In addition, it is also noted that the Board also requested the Steering Committee to consider "whether timing differences arising from goodwill acquired through a business combination should be tax effected or not" [I-16b] (9303M) and "whether a comprehensive worked example would enhance the proposed standard" (930406…) / "assist potential users of the standard" (930811…). This latter decision seems in line with the suggestion in one of the written comments received from Board Members prior to the meeting arguing that:

> (c)onsiderably more guidance material and examples need to be added before the standard is ready for comment, **since the full meaning and basis for applying the proposed requirements are not clear from the draft presented** (9303C…emphasis added).

At this meeting it was also decided that an additional member should be appointed to the Steering Committee. Later the US was invited to appoint a sixth and final member. The addition of this member seems to have been made with the explicit purpose of strengthening the Steering Committee.[14] In sum it would thus appear that the Board did not really consider the Steering Committee's proposals in March 1993, but returned the issue to the (strengthened) Steering Committee for reconsideration.

Implications of proposed changes begin to be noted

Following this the next step in the process was for the Steering Committee to meet again to address the issues requested by the Board and, for the Staff to prepare material for this meeting. The staff note to the following Steering Committee meeting, which was held in August 1993, focused on the implications of the proposed change in definition of timing differences, noting that it meant that "(s)ome items that were permanent differences

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14 In similarity with previous members, this newcomer could not be characterised as an expert in tax accounting. However, he was a technical partner of a US firm and was generally perceived to raise to the technical competence to the group.

under the income statement approach are now timing differences" (9308…). It also included an illustrative list of five such differences (figure 7.5), noting also that expenditures on non-deductible assets [I-19] give rise to timing differences under the new definition, but not the old. The staff note and draft ED also included proposed positions relating to each of these issues.

(1) revaluations of assets [I-10];
(2) restatement of the financial statements of an enterprise that reports in the currency of a hyperinflationary economy [I-17b];
(3) the restatement of identifiable assets and liabilities to fair values in a business combination accounted for as an acquisition [I-16a];
(4) government grants and ITCs that are accounted for by reducing the carrying amount of the related assets (to the extent that such a reduction is not required from the tax basis as is sometimes the case with investment tax credits) [I-22]; and
(5) profits on intra-group transfers of assets [I-9].

Figure 7.5 List of "new" timing differences in papers for August 1993 Steering Committee meeting

Following this information, the August 1993 Steering Committee meeting, explicitly focused on the proposed change in *approach to the liability method* as it was now framed. In the end the Steering Committee agreed[15] with most of the staff's detailed proposals, but also to highlight to the Board "the considerable impact" (930826L…) of this change. In line with this, the report to the next IASC Board meeting no longer referred to the proposals in terms of a change in focus and wording. Instead, it emphasised that the proposed approach was "profoundly different" (930909Ap5) from the previously recommended approach.[16]

15 All but one of the Steering Committee members seem to have agreed with the proposed change in approach to the liability method.

16 In line with the Board's suggestion to consider whether a comprehensive worked example should be included, an appendix to the draft ED submitted to the November 1993 Board meeting included two numerical examples.

The approach is discussed and approved

November 1993 Board meeting

Written Board comments on the draft circulated prior to the November 1993 Board meeting suggested that the Board was roughly split in half with regard to the proposed ED. Following this the subject was extensively discussed during the meeting. Board Representatives from five Members are reported to have expressed "serious reservations about the approach" (931122…). The documents suggest, however, that the proposed approach gained more support during the meeting, e.g.:

> it appeared that a number of Board members became more comfortable with the approach. (ibid)

Even so, a vote was not taken on a re-drafted ED, a number of Board representatives having "indicated that they wished to have further discussions with their advisers in their countries" (ibid).

A letter dated December 21st 1993 explains that the concerns expressed "were addressed by the Steering Committee Chairman and staff". Other sources refer to this meeting as *the* meeting when a FASB observer explained the balance sheet (approach to the) liability method in detail to the Board using various examples (e.g. 940210…). As was the case with the FASB project manager, it was suggested that the FASB Board observer was persuasive because

> he'd spent a lot of time on these issues, was very articulate, very knowledgeable, difficult to argue against (Json).

In addition to discussing the proposed approach to deferred tax accounting the Board also "completed a paragraph by paragraph review of the proposed draft", during which "a number of changes were proposed by Board Representatives" (931122…) and a number of changes to detailed issues were agreed. It was, for example, at this meeting that the Board agreed to replace the expression "timing difference" with "temporary difference". The Board also agreed that

> the Steering Committee should prepare background material on the reasons for the change to the balance sheet method and the advantages of that method over the income statement liability method currently required by IAS 12 and proposed in E33 (940511Ap5).

Although the Board was reported to have (again) "tentatively agreed" to require a liability method that "is substantially different from the liability method in both IAS 12 and E33" (IASC, 1993b), two documents from December 1993 indicate that the IASC Staff was not convinced that sufficient consensus existed on the Board with regard to this issue. First, on December 21st a revised draft ED was circulated to Board Members with a request for comments, in particular on the acceptability of the balance sheet (approach to the) liability method. Second, a December 1993 work plan concluded that the Board would appear to be evenly split on this issue and considered what to do if sufficient consensus for this method did not exist on the Board by the time of the next Steering Committee meeting:

> Most importantly if, by the time of the Steering Committee Meeting, a significant number of Board members do not support the approach the Steering Committee will need to consider what further, or even alternative, recommendations it wishes to make to the Board. For example if there is still considerable opposition to the balance sheet approach it may be appropriate for the Board to defer consideration of draft Exposure Draft and instead publish a Draft Statement of Principles. (931230WP)

The deadline for Board comments was set to January 21st 1994. Comments were received from eleven Board members. While eight of these were favourable to the balance sheet approach, three suggested the opposite. No comments were received from another three members. These are all reported to have been negative to the balance sheet approach in November. Noting that "at least two" of these seemed "likely to be opposed to the balance sheet approach", the staff concluded that "the chances of the proposal being, approved in its present form do not seem encouraging" (940215Ap1).

The staff note to the next Steering Committee meeting thus considered two alternative strategies to gain sufficient Board acceptance of a draft ED in June 1994: (1) introducing the income statement liability method as an allowed alternative and (2) re-introducing an allowed alternative treatment for revaluations.

When the Steering Committee met again in March 1994 it considered a revised draft ED effecting the Board's decisions in November and a draft Background Information paper prepared by the staff as requested by the Board. The most significant change in the proposals following this meeting was that the allowed alternative treatment for revaluations [I-10] was again re-introduced.

Spring 1994

Parallel to these developments in the Spring of 1994 the IASC staff requested input on the experience of the balance sheet liability method (i.e. of applying SFAS 109) particularly in non-US tax environments by contacting various companies (mostly contributors to the IASC) as well as a number of knowledgeable individuals in various countries. The IASC files contained evidence of 29 such responses. Most of these were from companies (19) and most came from the Anglo-American cultural sphere (24 of which 18 were companies).

The most striking finding from these efforts is perhaps the extent to which they were frustrated by a lack of experience with the balance sheet liability method. For example, a file note of a conversation with one of the contacted individuals reported that:

> [Y] informed me: (a) that [country Z] would be providing comments on the proposed draft Exposure Draft circulated prior to Christmas. They had undertaken a mini research project in order to provide comments. This is because [Y] is not aware of anyone in [country Z] who has knowledge or experience of the balance sheet approach. Apparently [country Z] has no SEC registrants of which [Y] is aware. [Y] also indicated that many senior practitioners such as former IASC Board Member [W] were not in the least familiar with the approach and therefore found it difficult to comment on; (940118N…)

Moreover, another respondent indicated that most multinationals were at this point in time in the process of implementing FAS 109 for the first time, noting that they therefore did not (yet) have enough experience, hindsight and/or time "to articulate clearly their views on FAS 109" (940304L…). On a similar theme another respondent indicated that he was not aware of any pervasive problems for foreign SEC registrants in applying SFAS 109, arguing however that this may be because the potential problems (with the approach) do not appear in this context (as these companies also were applying US GAAP in all other respects).

A lack of experience with, and understanding of, the balance sheet liability method is also reflected in the responses received. These strongly suggest widespread confusion as to what was meant by "the balance sheet approach", making the classification between those for and against difficult. In addition, some responses were unclear with regard to this issue, stating no overall preference but listing a number of concerns, e.g. that "the imple-mentation of

the new proposals may well require substantial time and effort" (940310L..., a UK company). Nevertheless, it is noted that the respondents tended to object to, or express concern for, issues where the proposals implied change. In particular, several preparers of accounts expressed concern in relation to the treatment of revaluations [I-10].

June 1994 Board meeting

The next Board meeting was held in June 1994. A staff note circulated to the Board Members prior to this meeting emphasised that the Board should address the fundamental issue of the choice of liability method before considering the draft in detail. Three types of transactions/events were listed as giving rise to different results under the two liability methods:

(1) revalued assets [I-10];
(2) assets which are not tax deductible [I-19][I-16a]; and
(3) liabilities which do not represent future taxable income (e.g. in some jurisdictions the receipt of government grants) [I-22].

Written comments were received from nine Board members prior to the meeting, eight of these were favourable to the balance sheet (approach to the) liability method, but expressed concern on detailed issues. In other words, even as this meeting started, it remained uncertain whether sufficient consensus existed on the Board for approving the ED.

After considerable deliberations, relating both to the choice of the balance sheet liability method and to detailed proposals, and after a number of changes to the draft submitted by the Steering Committee (including a number of exceptions to the main principle of recognising deferred tax in respect of temporary differences) the Board finally approved *E49 Income Taxes*. Although E49 was thus approved in June 1994, it was not published until October. During this time a number of further drafting amendments were made to the ED and the Background Paper.

Arguments for and against the approach

It would seem that, although the proposed switch gave rise to much discussion, many Steering Committee and Board members supported this change. One interviewee argued that it was a logical next step, having deferred the project pending developments in the USA (Pson). Another interviewee suggested that many were attracted and persuaded by the conceptual foundations of the proposals:

> And although I think people had a lot of sympathy with what *[Z]* was saying, they just thought that the arguments to do with the framework and this whole idea of looking at things like property, plant and equipment as being cash flows and … taxing the cash flows, people could understand that. (Kson)

Such conceptual arguments were also used when the staff drafted the Background Paper requested by the Board in November 1993. A first version of this paper explained that:

> The Board has identified two reasons why the balance sheet liability method is preferable to the income statement liability method. These reasons are:
>
> (a) to the extent that an enterprise has temporary differences that have not arisen as a result of timing differences, the income statement liability method does not recognise all its deferred tax assets and liabilities. As a result the financial statements may be incomplete and therefore unreliable.
>
> (b) the balance sheet liability method recognises deferred tax assets and liabilities for certain permanent differences for which deferred tax assets and liabilities are not recognised under the income statement liability method. As a result the tax effect of such permanent differences is recognised in the period in which they arise rather than in the period in which they are recognised in determining accounting profit. (940302BI, §32)[17]

In the following version (written after the March 1994 Steering Committee meeting) this section had been substantially expanded, including also some pragmatic reasons:

> The Board has identified ~~two~~ a number of reasons why the balance sheet liability method is preferable to the income statement liability method. These reasons are:
>
> (a) ~~to the extent that…unreliable.~~ The balance sheet liability method recognises all deferred tax assets and deferred tax liabilities whereas, the income statement liability method does not recognise all deferred tax assets and liabilities;
>
> (b) ~~the balance … accounting profit~~ an approach focusing on the balance sheet is more consistent with the Framework which defines equity in balance sheet terms rather than income statement terms (the residual interest in the assets of the enterprise after deducting all its liabilities).

17 A numerical example was included to illustrate this point. This is referred to in section 7.3.8 (p. 202) .

> (c) the balance sheet liability method is a relatively straightforward methodology to apply in practice once the tax base of assets and liabilities has been determined;
> (d) the scheduling requirements of E-- (see paragraphs 79 to 82 of this Background Paper) are not expected to be onerous for most enterprises, and to be a less onerous task than keeping records of originating and reversing timing differences as is required under the income statement liability method; and
> (e) the importance to the management of enterprises to be aware of the tax base of assets and liabilities and the tax consequences of recovering the assets and liabilities at their carrying amounts. (§31, 940414BI)

Such pragmatic arguments were also sometimes raised in written Board comments:

> I am basically in favour of the Balance sheet approach as it is probably the best way to keep track of deferred tax balances, to adapt them to actual rates and conditions. (940131C… ,comments on December 21st 1993 draft from Steering Committee Member)

The key argument, however, remained that the balance sheet liability method (is conceptually sound because it) leads to the recognition of *all* deferred tax assets and liabilities. In the final versions of the background paper this was also the only argument that was retained:

> The Board believes that the balance sheet liability method is preferable to the income statement liability method because the balance sheet liability method recognises all deferred tax assets and deferred tax liabilities. The income statement liability method recognises only those deferred tax asset and liabilities that arise through timing differences.
> (§17, 949898BP)(940819BP) (941013BP)

Although the proposed choice of the balance sheet liability method was much discussed, it would appear that, in fact, only one Steering Committee Member and three Board Members were opposed to this choice per se. Arguments against the proposed new approach included on the one hand, objections to the implications for the reporting of specific items/transactions (particularly revaluations [I-10] and fair value restatements on consolidation [I-16a]). More fundamentally such arguments were primarily framed in terms of the proposed approach/method not producing *meaningful* numbers. Linked to this argument already from the beginning was the conceptually based argument that accounting for deferred tax effects should be about allocating taxes actually paid to correct periods, e.g.:

> The purpose of deferred tax accounting is to spread the real tax charge meaningful over the periods of the financial accounts in order to take timing differences into consideration. At the end of a cycle, when the timing differences reverse, the total of the items debited or credited to the financial income statement must equal the total of items recognised by the tax authorities. The sum of the tax expense charged to the financial income statement must equal the sum of the taxes actually paid (taking into account the amounts charged to equity, para. 15). The purpose of deferred tax accounting can not be the calculation of a theoretical, artificial tax expense as if the tax authorities had recognised an item they have actually not. By doing so, the after tax profit in the income statement would be misleading and not reflect economic reality.
> (Comment letter on draft circulated after December 1992 meeting)

> Major conceptual difficulties arise with the adoption of the balance sheet approach as set out in the document and in [Board Member] believe that misleading figures would result from its application. We strongly believe that the object of tax accounting should be to allocate the tax actually paid and to be paid to appropriate periods, not to create pure "book entry" tax charges. In short, the ED appears to advocate a tax equalisation approach, which is not what would intuitively be expected from what is described as a balance sheet approach.
> (931027C... written comment prior to November 1993 Board meeting)

A more pragmatic argument against the proposal was that the approach is difficult to understand and to explain:

> How can I explain to […] senior executives, who are not accountants, why I have to show a tax charge in the income statement, even if we don't pay taxes? Should we not stay with a standard that is understandable even to non-specialists? (Letter dated February 7th 1994)

Other, similarly pragmatic arguments raised against the method include that:

- it would not be accepted;
- it would require a complete re-education (involving considerable time and effort) which would not be justified since the income statement approach is not "conceptually unsound" (940606C…);
- it relies on exceptions to make it workable in practice; and
- as proposed, it would not result in significantly different amounts being recognised in financial statements.

To be noted is perhaps that similar concerns were also raised by Board Members not identified as opposed to the proposals per se.

7.3.4 Revaluations [I-10]

As in the period during which E33 was developed, the treatment of revaluations appears to have been a frequently discussed topic. In fact, it may have been the most controversial of all (sub-) issues during this period. Following the proposed switch to the balance sheet liability method this issue was reframed, the debate focusing on whether or not an exception should be made for temporary differences arising on revaluations. Some of the developments pertaining to this issue have been referred to in the previous section relating to the choice of liability method. This section, however, summarises and adds some further detail (see also figure 7.6, p. 188).

As already noted (figure 7.4, p. 171) the position in draft ED prepared by the staff for the first Steering Committee meeting was similar to the allowed alternative in E33, i.e. that deferred tax should not be recognised on revaluations. The position in the draft ED submitted by the Steering Committee to the March 1993 Board meeting, however, was identical to that in E33, with a preferred alternative of always recognising deferred tax and an allowed alternative of recognising deferred tax (only) if a sale of the item is probable. The documents suggest that the Steering Committee first considered proposing to require the preferred treatment in E33, but that the allowed alternative from E33 was added as a means of achieving consensus on the proposed draft.

Also as already noted, contrary to the staff suggestions and the Steering Committee proposals, when the Board considered this project in March 1993 it agreed to require recognition of deferred tax on revaluations (i.e. to designate the preferred treatment in E33 as the only acceptable alternative). Following this, however, the Steering Committee once again agreed to revert to the E33 position at their third meeting in March 1994. In similarity with the first time, this decision seems to have been controversial. Two documents indicate that again this change was made (only) to gain unanimous support for the draft from the Steering Committee. In fact, one document suggests that the committee had, in fact, not agreed to reinstate the allowed alternative:

> Paragraph 14 states that the Steering Committee recommends to the Board that the allowed alternative on asset revaluations be included in the

> Expo-sure draft. My recollection of our decision at the meeting, which may have suffered from the passage of time, is different. I believe we decided, with the exception of [X], to recommend that the Board not include the allowed alternative. We would provide the Board with the allowed alternative to use in the event that its inclusion proved necessary to win approval of the Exposure Draft. The Steering Committee unanimously recommends that including the allowed alternative is better than not going forward with the entire project. (940414L a fax from a Steering Committee Member)

The reason for the Steering Committee repeatedly suggesting that an allowed alternative be introduced relating to this issue seems to be attribut-able to one Steering Committee Member in particular. Because of his position, the Steering Committee could not gain unanimous support for the proposals without an allowed alternative treatment allowing non-recognition of deferred tax on revaluations.

It should be noted, however, that he was far from the only supporter for an allowed alternative (or an exception) for revaluations. For example, in March 1993 three IASC Board Members voted in favour of the allowed alternative. At the time it was noted that they all represented countries that had "experience with revaluations" (930406…). Staff papers from this period also report that most countries where periodic revaluations were permitted at this time took the position that deferred taxes should not be provided until the realisation of the revaluation surplus is probable (the suggested allowed alternative).

The staff report to the March 1994 Steering Committee meeting also reported that many of the companies contacted in the spring of 1994 objected to the requirement to recognise tax on revaluations. This report also mentioned that making an exception relating to this issue was similar to the Norwegian approach. At the time Norway was probably the only country, beside the US, that had implemented a balance sheet liability method to accounting for deferred tax effect:

> Since the last meeting of the Steering Committee the staff has learnt that Norway has adopted an accounting standard on income taxes that is based on SFAS 109. … One of the significant differences between SFAS 109 and the Norwegian standard is that the Norwegian standard does not require tax effecting of temporary differences arising on the revaluation of nondepreciable assets which there is no intention to sell e.g. land, and investments. (Footnote: It should be noted that asset revaluations are expected to be phased out in Norway in the foreseeable future.) The

> reason for this is that the recovery of the carrying amount would not enter into the determination of taxable profits unless it is intended to sell the asset. The way that Norway has implemented SFAS 109 has similarities with the proposal of [objecting Steering Committee Member]. Steering Committee members will also recall that the draft they approved in December 1992 proposed that:
> (a) the benchmark treatment require tax effecting of temporary differences arising from asset revaluations; and
> (b) the allowed alternative treatment requires tax effecting when the revalued asset is sold. (940215Ap1)

Despite the fact that the IASC Board was swayed with regard to a number of other issues in June 1994, it agreed again to neither include an allowed alternative, nor to make an exception, relating to revaluations.

In this context it is noted that, one country allowing periodic revaluations at that time reportedly required recognition of deferred tax in relation to revaluations. It is also noted that the Board delegation from this country, along side some other delegations, argued strongly against an allowed alternative/an exception, e.g.:

> The allowed alternative standard in paragraph 27 of the proposed ED is inappropriate. There is not logic to recognizing an increase in value of an asset without also giving recognition to the additional taxes that will result from realization of the asset. (9303…)

7.3.5 Investments in subsidiaries, associates & joint ventures [I-8]

Prior to the December 1992 Steering Committee meeting the staff suggested that the allowed alternative treatment in E33 with regard to undistributed profits in subsidiaries and associates should be the required treatment. That is, in view of comments received on E33, the staff suggested that the revised standard should require deferred tax to be recognised (only) if tax payment of undistributed profits of subsidiaries and associates is probable. As already noted, E49 also proposed to make an exception relating to this issue. The route there, however, was far from straightforward. This section provides some detail of the developments relating to this issue in this period (see also figure 7.7 p. 194).

Revaluations [I-10]	
E33	Preferred treatment: deferred tax always recognised on revaluation Allowed alternative treatment: recognition of tax effects when it is probable that the revalued asset will be sold
Staff proposal	Identified as contentious. Deferred tax liability not to be recognised.
December 1992 Steering Committee	To revert to the E33 position.
February 1993	One Consultative Group member wrote a three page letter to the Secretary-General expressing concerns for the balance sheet approach in general, and in relation to revaluations in particular, requesting that his views should reach the Steering Committee and Board members.
March 1993 Board Meeting	Deferred tax liability always recognised. (Three Board Members voted in favour of the allowed alternative.)
Staff proposal	
August 1993 Steering Committee	
Papers prior to November meeting	Two Board members disagreed with the proposal to require recognition of deferred tax; one member suggested that the proposal may be inconsistent with various measurement models (in particular current cost accounting model).
November 1993 Board Meeting	
Spring 1994	Many of the companies contacted as a means of investigating the experience of the balance sheet method objected to the requirement to recognise tax on revaluations.
Staff proposal	Staff report mentions possibility of exception, noting that it was similar to the Norwegian approach.
March 1994 Steering Committee	To revert to E33 position, i.e. to include an allowed alternative.
Papers prior to June meeting	Identified as one of three “problem areas”.
June 1994 Board Meeting	Deferred tax always recognised.

Figure 7.6 Summary of developments pertaining to revaluations [I-10] during 1992 – 1994

Both the Steering Committee and the Board appear to have agreed with the Staff suggestion in the autumn of 1992, which, after the adoption of the balance sheet (approach to the) liability method, implied that an exception be made from the general rule of providing deferred tax on all temporary differences. Various comments, however, suggest some lingering differences in opinion during 1993 and 1994 on this issue, differences which continued to give rise to discussions throughout the period. A number of adjustments were also made to the proposals before E49 was approved.

For example, some of the written board comments received prior to the November 1993 Board meeting suggested that the ED should also (i) deal with joint ventures and (ii) include a requirement of an agreement that profits will not be distributed in the case of joint ventures and associates. The Board apparently agreed with both these proposals, the draft ED circulated following this meeting stating that:

> **23. Income taxes related to temporary differences arising from undistributed profits of subsidiaries should be recognised as a tax expense and as a liability except when it is probable that those profits will not be distributed.**
>
> **24. Income taxes related to temporary differences arising from undistributed profits of joint ventures and associates should be recognised as a tax expense and as a liability except when there is an agreement between the parties that such profits will not be distributed.**
>
> 25. Undistributed profits of subsidiaries, associates and joint ventures are often subject to tax upon distribution. This creates a temporary difference on the presumption that a parent or investor will recover its investments in a subsidiary, investee or joint venture.
>
> 26. With respect to subsidiaries many groups do not intend to remit all profits from subsidiaries to the parent, for example, when the parent considers the reinvestment of a subsidiary's profits as part of its permanent investment in the subsidiary. Temporary differences for undistributed profits may, therefore, be treated as an exception to the general rule that deferred tax assets and liabilities should be recognised for all temporary differences. (931221ED)

However, all suggestions did not lead to changes in the proposals. A particular example of this is that, although certain comments raised concerns regarding the conceptual logic of the proposed rules, no changes were proposed with regard to these comments in this period. For example, comments to the December 1993 draft (see quotation above) included that:

> Those requirements to qualify for nonrecognition of the deferred tax liability would seem to almost require an assertion that the undistributed profits will never, ever be distributed. If those profits will never, ever be distributed, however, there might be a question of whether those profits should be recognized in the parent's, investor's, or venturer's financial statements. (940204L…)

In fact, a similar comment had already been made prior to the November 1993 meeting:

> In providing the exception, the Draft requires recognition of a tax expense and liability … only when it is probable that those profits will be distributed. However, in our view the probability criterion does not seem to fit the peculiar nature of undistributed profits of subsidiaries and associates. It is unlikely that subsidiaries or associates are held without a view to ultimately benefiting from their profits. Furthermore, it is likely that at some point in time, maybe indefinitely, profits of subsidiaries or associates will be distributed. Accordingly, the probability test will always be met as there is no time period control placed on the test. Therefore, we do not believe that the nature of undistributed profits warrants treatment as an exception. (931027…)[18]

Other written responses to the December 1993 draft referred to above argued that:

(i) agreements between parties of associates and joint ventures to the effect that profits will not be distributed are unlikely and that the requirement is both too strong and too vague;

(ii) there is a difference between joint ventures and associates in that a venturer can control that profits are not distributed (one Board Member was therefore "not entirely comfortable" with "lumping "joint ventures with associates (940119C…));

(iii) the discussion be expanded to include translation adjustments / that the exception was restricted to temporary differences arising from undistributed profits; and that

(iv) the recognition of deferred tax liabilities for undistributed profits was one of the three most controversial issues during the development of the US standard, that there were significant differences between the IASC proposals and SFAS 109 and that this might mean that some US companies might have to recognize a deferred tax liability when none

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18 The comments did not come from the same Board delegations. However, both originated in the Anglo-American sphere.

is required under Statement 109, something which might not be favorably received by US companies:

> Statement 109, in certain circumstances, permits nonrecognition of a deferred tax liability for undistributed profits of foreign subsidiaries and foreign corporate joint ventures. The Statement 109 requirements to qualify for nonrecognition of the deferred tax liability, however, are quite different from the proposed requirements of the IASC draft. Under Statement 109, the deferred tax liability is not recognized unless it becomes apparent that the temporary difference will reverse in the foreseeable future.
>
> Significant differences between the draft and Statement 109 are:
>
> a. Under the draft, the presumption is that a deferred tax liability is recognized except.... Under Statement 109, the presumption is that a deferred tax liability is not recognized unless …
> b. Under the draft, the criterion is "probable," and under Statement 109, the criterion is "apparent."
> c. Under the draft, the future time period seems to be almost forever, and under Statement 109, the future time period is the foreseeable future. (940204…)

Although a number of concerns were thus raised in response to the December 1993 draft, the staff papers for the March 1994 Steering Committee meeting only addressed one of these: (iii) that the exception was restrictted to temporary differences arising on undistributed profits. Although noting that Steering Committee might "wish to consider whether the exception should be wider than as drafted", the Staff position at this point was clearly that it should not:

> The view of the staff is that this exception should not be wider for three reasons:
>
> (a) with respect to losses to the extent that they are undistributed the asset recognition criteria should be the same as the deferred tax asset recognition criteria in the present draft; and
> (b) although an exception could be phrased in terms of temporary differences as the concept of undistributed profits is well understood to change it to a more general exception related to temporary differences may cloud the meaning for many users; and
> (c) although a parent, for example, can control the payment of dividends it is not so apparent how they could control other aspects of a temporary difference between the carrying amount of the subsidiary and its tax base. (940215Ap1, §39)

The Steering Committee, however, did not agree; in the draft ED submitted to the Board in June 1994 the exception was no longer limited to temporary differences arising on undistributed profits:

> A deferred tax liability should be recognised for all taxable temporary differences arising from investments in subsidiaries and associates and interests in joint ventures except when:
> (a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
> (b) it is probable that the temporary difference will not reverse.
> (949419ED, § 44)

Although the Steering Committee thus proposed that the same criteria should apply for subsidiaries, joint ventures and associates, the specific guidance differed for the three cases. With regard to temporary differences arising on subsidiaries it is noted that both the above standard paragraph, and the guidance, still suggested a requirement that the temporary differences will never reverse:

> Many groups do not intend to remit all profits from a subsidiary to the parent, for example, when the parent considers the reinvestment of a subsidiary's profits as part of its permanent investment in the subsidiary. As the parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of the temporary difference. Therefore, when the parent has determined that those profits will not be distributed a deferred tax liability is not recognised. (ibid, §46)

Again, this issue was also raised in the written comments received prior to the (June 1994) Board meeting:

> …, it is difficult to envisage a situation where a parent will determine that the profits of a subsidiary will never be distributed to or at least obtained by the parent (whether through dividends or sale of shares for a capital gain). Therefore it is always probable that the temporary difference referred to in paragraph 44 will reverse. Hence the exemption allowed in paragraph 44 would never be invoked and should be removed.
> (940608…same commentator as prior to November 1993 meeting)

The guidance for associates (but not joint ventures) also still referred to the existence of an agreement:

> A venturer is a party to a joint venture and has joint control over that joint venture. Joint control is the contractually agreed sharing of control over an economic activity. The contractual arrangement between the venturers usually deals with the sharing of the profits and identifies whether decisions on such matters require the consent of all the venturers or a

> specified majority of the venturers. Therefore, when the venturer can control the sharing of profits and it is probable that the profits will not be distributed, a deferred tax liability is not recognised. (§48)
>
> An investor in an associate does not control that enterprise and is usually not in a position to determine its dividend policy. Therefore, in the absence of an agreement requiring that the profits will not be distributed, a deferred tax liability is recognised in respect of taxable temporary differences arising from undistributed profits of an associate. (§49)

In June 1994, the Board appears to have agreed with the Steering Committee's proposals, the paragraphs pertaining to this issue in E49 remaining more or less unchanged from the draft submitted by the Steering Committee.

7.3.6 Intra-group profits [I-9]

As already noted, the treatment of intra-group profits (temporary differences arising on intra-group transactions) emerged as controversial issue during this period. In similarity with the developments pertaining to revaluations [I-10], the developments relating to this issue involve the Staff/Steering Committee twice proposing that an exception be made and the Board twice agreeing not to include such an exception in the ED. The developments, which are accounted for in more detail in this section are also summarised in figure 7.8 below (p. 198).

Also as already noted, this issue appears to have been first raised by a Steering Committee Member after the December 1992 meeting, noting that the draft did not deal with timing (temporary) differences arising on intra-group transactions and asking if this meant "that these items are to be dealt with in accordance with FAS 96"[19] (921218L...). His comments also referred to the fact that "FAS 109 disposed of the proposed FAS 96 treatment and exclude both of these items from the deferred tax calculation" (ibid).

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19 I.e. that deferred tax should be recognised relating to these timing/temporary differences.

Investments in subsidiaries, associates & joint ventures [I-8]	
E33	Preferred treatment: recognition of deferred tax liability Allowed alternative: recognition (only) if tax payments are probable
Staff proposal	Recognition of deferred tax liability on undistributed profits if distribution and tax payments are probable (Allowed alternative in E33).
December 1992 Steering Committee	Agreed.
March 1993 Board Meeting	Agreed.
Staff proposal	
August 1993 Steering Committee	
	One Board member suggested that the text also refer to joint ventures. Two members argued that it is inappropriate to extend the exception to associates: • because the exception "rests on the ability of the parent to control the future distribution of profits and thus determine whether any taxes will become payable"; • because i) distribution of profits by associates affects group cash flow and ii) the group does not control the decisions to distribute the profits of the associate. One Board Member argued that the exception be deleted.
November 1993 Board Meeting	• also deal with joint ventures • requirement of an agreement that profits will not be distributed in the case of joint ventures and associates.
	Several comments received on December 21st 1993 draft in relation to this issue raising a number of concerns.
Staff proposal	Staff papers noted that the exception was restricted to temporary differences arising on undistributed profits suggesting, however, that the exception should not be wider.
March 1994 Steering Committee	Broader exception – all temporary differences when the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and it is probable that the temporary difference will not reverse.
	Three written Board comments referred to this issue, one Board member still arguing that the exception be deleted.
June 1994 Board Meeting	Agreed with the Steering Committee's proposals.

Figure 7.7 Summary of developments pertaining to investments in subsidiaries etc. [I-8] during 1992 – 1994

Despite this, the issue does not appear to have been raised (in the papers) prior to or during the March 1993 Board meeting. However, the staff work plan following this meeting (dated June 1993) states that the staff should consider whether the ED should deal with deferred taxes on inter company inventory profits. Following this the draft ED submitted to the August 1993 Steering Committee meeting included an exception for intra-group profits on asset transfers:

> A deferred tax asset or liability should be recognised for each timing difference other than: …
>
> (d) unrealised profits and other differences between the tax base of assets in a buyer's tax jurisdiction and their cost as reported in the consolidated financial statements on intragroup transactions. (930729ED, §11 draft submitted to Steering Committee meeting)

The Steering Committee retained both the exception and the accompanying guidance in the draft ED submitted to the November 1993 Board meeting:

> If an enterprise transfers assets to another enterprise in the same group, a new tax base (including any unrealised profit on the transfer) for those assets is established in the purchaser's tax jurisdiction. The new tax base of those assets will be deducted in computing the buyer's taxable income which is usually when the asset is disposed of. A deferred tax asset is not recognised for the excess of the purchaser's tax base over the carrying amount of the asset as reported in the consolidated financial statements. In the consolidated financial statements the tax expense recognised by the seller on the sale is deferred until the asset is sold outside the group or used in operations. The deferred asset is recognised only to the extent that it is probable that an associated future economic benefit will flow to the enterprise. (930909ED, §25 draft submitted to November 1993 Board meeting)

Moreover, an executive summary accompanying this draft included profits on intra-group transfers of assets as an example where the balance sheet liability method leads to different accounting from the income statement liability method. In November 1993, however, the Board's decisions included that that an exception should not be made relating to this issue.

Following this some responses to a draft ED circulated in December 1993 referred to this issue, one Board Member requesting that the Steering

Committee reconsider this issue (940124C…) and one Steering Committee member (the same as had raised this issue originally) objecting to the deletion of the exception. Another comment noted that the draft ED was silent on this issue and, while on the one hand acknowledging that that the proposed rules thus require a treatment that is "prohibited" by the US counterpart, it also argued that

> …the silence approach gives rise to certain risks. One risk is that it simply may not occur to some people that intercompany asset transfers give rise to temporary differences. Obviously, people who do not know about these temporary differences will not account for them. Another risk is that other people might misinterpret silence as permitting free choice – account or do not account for the temporary differences based on whichever accounting results are preferred. (940204L…)

The same commentator also noted that SFAS 96, as well as the ED preceding SFAS 109, had required recognition but that "(m)any of the [FASB's] constituents" had not agreed with that requirement, thus suggesting that the proposed requirement might reduce the acceptability of the proposals.

Following these comments the Staff proposals to the March 1994 Steering Committee meeting included that the committee should reconsider this issue. An interesting detail is perhaps that the staff note to the Steering Committee suggested that the Board's decision to delete the proposed exception in November 1993 had not been informed:

> At the Oslo Board Meeting the Board decided that temporary differences arising on intra-group assets transfers should be tax-effected. … . [The staff] do not believe that the Board decision was based on a sufficient understanding of the potential problems that may arise from tax effecting these temporary differences and therefore [the staff] believe that the Steering Committee should re-examine the issue. It is interesting to note that the present IASC Board position is that preferred by the FASB staff but not the Board of FASB. (940114…)

Somewhat unsurprisingly then, the Steering Committee reintroduced the exception in March 1994. The note to the June 1994 Board meeting explained the reintroduction of an exception in terms of the Steering Committee not finding it "appropriate" that deferred tax assets should be recognised on intra-group asset transfers. In the related Background Paper, this was explained in more detail using conceptual arguments nested within the concepts of group-accounting:

> The reason for this exception is that if assets are transferred between enterprises in the same group but in different tax jurisdictions a deferred tax asset may be recognised as a consequence of an intragroup asset transfer. As the asset has not been sold outside the group it is inappropriate to recognise a deferred tax asset relating to an unrealised profit on an intragroup transaction. (940414 and 940426, excerpt §74).

Prior to the June 1994 Board meeting one Board Member objected to the exception arguing that although it is "theoretically correct" it is "unnecessarily complicating" (940608C…). The exception was also deleted before the Board approved E49. As a consequence, the proposed rules in E49 differ significantly from the US standard (SFAS 109) with regard to this issue.

7.3.7 Government grants [I-22]

Before approving E49 in June 1994 the Board similarly introduced an exception for temporary differences arising on government grants. Interestingly such an exception does not appear to have been discussed in any of the documents prior to this meeting. The issue of whether or not to account for deferred tax in relation to government grants, however, had been discussed since the summer of 1993. Prior to the June 1994 Board meeting, government grants was also identified as one of the three cases where the balance sheet liability method fundamentally gives rise to different numbers compared to the income statement liability method. Developments pertaining to this issue are accounted for in more detail in this section and summarised in figure 7.9 (p. 200).

The origin of the issue of government grants has been traced to a suggestion prior to, and during, the March 1993 Board meeting by one Board Member that the revised standard should include guidance on the methods for accounting for ITCs. At this meeting the Board also decided to request the Steering Committee see to this. In August 1994 the Steering Committee agreed with a staff proposal that it would not be appropriate to include such guidance, but that it would be appropriate to clarify that, where the accountting for *government grants* and ITCs result in temporary differences[20], these

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20 According to *IAS 20* government grants and ITCs may be deducted from the carrying amount of the related asset or recognised as deferred income. Initially it was argued that items only give rise to temporary difference when they are deducted from the carrying amount of the related asset (e.g. 940215Ap1).

Intra-group profits [I-9]	
E33	
Staff proposal	
December 1992 Steering Committee	
	One Steering Committee member noted that the draft did not deal with this issue noting that SFAS 96 had not included an exception, but SFAS 109 did.
March 1993 Board Meeting	
Staff proposal	That an exception be made.
August 1993 Steering Committee	Agreed.
	Executive summary to Board notes that without an exception, this is an issue for which the balance sheet liability method leads to different accounting from the income statement liability method.
November 1993 Board Meeting	Deleted exception.
Comments to December 21st 1993 draft ED	One request that the Steering Committee reconsider this issue. One objection to the deletion of the exception and a suggestion that there is a risk involved in being silent on this issue. Also noted that not having an exception may not only introduce differences vis-à-vis the US standard, but also reduce the acceptability of the proposals.
Staff proposal	That the Steering Committee reconsiders this issue.
March 1994 Steering Committee	Reinstated exception.
	One Board Member objected to the exception.
June 1994 Board Meeting	Exception deleted

Figure 7.8 Summary of developments pertaining to intra-group profits [I-9] during 1992 – 1994

should be accounted for as set out in the standard. A list of examples of timing differences in the draft ED was also amended to include that of government grants and ITCs when these are deducted from the carrying amount of the related asset but not from the tax base of those assets (see figure 7.5, p. 177).

At the following Board meeting (November 1993), the Board is reported to have decided that "in view of the anomaly … it would be best to delete references to investment tax credits and government grants" (940215Ap1).

The Board is also reported to have argued that the deferred tax effects of government grants should not depend on the way the grant is accounted for (footnote 20, p. 197), but without giving further instructions of how to deal with this issue.

Following this, the staff note to the March 1994 Steering Committee meeting maintained that the case where a government grant is deducted from the carrying amount of a related asset "is a good example to include in the proposed exposure draft as it is a significant item that is a temporary difference but not a timing difference" (940215Ap19. Furthermore, the accompanying version of the Background Information (940302BI) drafted for this meeting not only addressed this issue, but included two illustrative examples of this. In addition it also stated that the difference between the amount of a government grant accounted for as deferred income and its tax base is a temporary difference on which deferred taxes should be recognised when the grant relates to depreciable assets (ibid §75).[21]

The Steering Committee in turn, seems to have agreed with the Staff's proposals. The papers for the June 1994 Board meeting accordingly identify government grants as one of three cases where the proposed new method (the balance sheet liability method) gives rise to different numbers compared to the old method (the income statement liability method). Before approving E49, however, the Board decided to make an exception for temporary differences arising on government grants. The minutes from this meeting simply explain that the Board decided that

> for practical reasons, temporary differences arising on initial recognition of government grants should be treated as if they were not temporary differences, and that deferred tax assets and liabilities should not, therefore, be recognised for such differences (9406M).

7.3.8 Non-deductible assets [I-19][I-16a]

Before approving E49 in June 1994 the Board also decided to introduce an exception for temporary differences arising on recognition of what was called "*non-deductible assets*". As in the case with government grants, such an exception had not been discussed in any of the identified documents prior to this meeting. Developments pertaining to this issue are accounted for in more detail in this section and summarised in figure 7.10 (p. 206).

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21 As noted above, previously it had been argued that in fact this was not a temporary difference, thus giving rise to the anomaly referred to above.

Government grants [I-22]	
E33	
Staff proposal	
December 1992 Steering Committee	
	Board Member raised issue of accounting for ITCs.
March 1993 Board Meeting	Requested Steering Committee to consider whether the standard should include guidance on methods for accounting for ITCs.
Staff proposal	Suggested to clarify that where the accounting for government grants and ITCs result in timing (temporary) differences, these should be accounted for as set out in the standard.
August 1993 Steering Committee	Agreed.
November 1993 Board Meeting	Deleted references to this issue in draft ED. Argued that deferred tax effects of government grants should not depend on the way the grant is accounted for.
Staff proposal	Noted that the example of a government grant deducted from the carrying amount of the related asset "is a good example to include in the proposed exposure draft". Suggested that the difference between the amount of a government grant accounted for as deferred income and its tax base should be considered a temporary difference.
March 1994 Steering Committee	Suggested draft should address government grants, stating that a temporary difference arises even if it is accounted for as deferred income.
Staff papers to Board meeting	Identified as one of three cases where the proposed new method gives rise to different numbers compared to the old method.
June 1994 Board Meeting	Exception for temporary differences arising on government grants.

Figure 7.9 Summary of developments pertaining to government grants [I-22] during 1992 – 1994

The origin of this issue has been traced to a section of the staff papers for the August 1993 Steering Committee meeting explaining the implications of the proposed change in definition of timing differences. The paper identifies expenditures on non-deductible assets (e.g. certain intangible assets in some jurisdictions) as an example of a transaction now giving rise to a timing difference:

> Some items that were permanent differences under the income statement approach are now timing differences. This is best illustrated by way of example. In many countries expenditures on certain intangible assets are not deductible expenses for tax purposes. Under the income statement

> approach the amortisation of such intangible assets is regarded as a permanent difference between accounting income and taxable income because the amortisation does not enter into the determination of taxable income. Under the balance sheet approach what is considered is not the deductibility of the expense but the recovery of the difference between the accounting carrying value and the tax base of the asset itself. In other words there is a presumption (which is entirely consistent with the Framework) that the carrying amount of the intangible asset represents a future income stream, regardless of other future events, which will be taxed when it is received. The taxation authorities may permit a deduction for amortisation of the asset and this amount will reduce the taxes payable on the income stream. In the case of an intangible that is not tax deductible the tax base is nil and therefore the accounting carrying value of the intangible has the same numerical value as the timing difference. (9308Ap1, §15)

Prior to the Steering Committee meeting, one of its members, in commenting this example, argued that accounting for a deferred tax on recognition of an intangible asset which is not tax deductible is "completely irrational and has no logical explanation" (930819L…). To be noted is that this comment appears to have been based on the assumption that the recognition of deferred tax liability would give rise to a deferred tax expense in the period when the asset is acquired.

It is not clear how the Steering Committee reasoned with regard to this issue in August 1993. In the papers for the November 1993 Board meeting the issue was referred to in similar terms as prior to the Steering Committee meeting. Furthermore, the issue does not appear to have surfaced during the November 1993 Board meeting. Instead this issue next re-appears in the notes from a December 1993 meeting between the staff of the IASC and a national setting body on the issue of deferred tax. During this meeting a staff member of the national standard setting body is reported to have raised the example of a situation where recognition of deferred tax on a temporary difference does not seem sensible:

> If an enterprise operating in a tax jurisdiction where entertaining expenses are not tax deductible pays a number of years of entertaining expenses in advance there is a temporary difference between the carrying amount of the prepaid expenses and the tax base of nil. If the temporary difference is tax effected a liability is established for deferred income taxes payable of the temporary difference times the tax rate. (931213…)

Following this meeting the same example was included in draft Background Information paper submitted to the March 1994 Steering Committee meeting. The example followed the stated reasons for "why the balance sheet liability method is preferable to the income statement liability method" (940302BI, §32) and was used to illustrate "(t)he reason for recognising deferred tax assets and liabilities for certain permanent differences" (ibid, §33). Again, it was assumed that the related tax expense should be recognised in the income statement in the same period as the related asset is recognised in the balance sheet:

> At the end of 19X4, there is a temporary difference between the carrying amount of the prepaid expense of 1,000 and the tax base of nil. The recovery of the asset will give rise to a taxable amount therefore the temporary difference is a taxable temporary difference. The enterprise recognises a deferred tax liability of 500 at the end of 19X4 and deferred tax expense of 500 in 19X4. In 19X5 the expenses are recognised as an expense in determining accounting profit. At the end of 19X5, the carrying amount and the tax base are both nil because the temporary difference has reversed resulting in a deferred income tax recovery in 19X5 of 500. (Numerical example following §33, 940302BI).

The next document to refer to this issue is then a letter from the same national standard setting body dated March 11th 1994 (i.e. just days prior to the March 1994 Steering Committee meeting) arguing that the "main practical difference" between the income statement and balance sheet liability method is the accounting for non-deductible assets. Again, it was assumed that the deferred tax would be charged to the income statement:

> Under the traditional approach, the non-deductibility of the asset is reflected by increased[22] tax charges as the asset is depreciated. Under the 'balance sheet' approach, these increased tax charges are recognised in full in advance by providing deferred tax on purchase of the asset. (940311...)

This letter also raised the issue of assets being non-deductible *in substance* (owing to the construction of the tax rules, so called roll-over relief [I-11c]). Perhaps in response to this comment, the Steering Committee in March 1994 agreed to include a new guidance paragraph in the draft ED stating that:

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22 i.e. Tax charges greater than the "expected' charge of accounting profit multiplied by the tax rate.

> An asset will have a tax base of nil only in those circumstances where the taxation authorities will **never** permit a deduction, with respect to the cost of that asset, in determining taxable profit of the enterprise.
> (940323ED §6 emphasis added).

Furthermore, in the version of the Background Paper following the March 1994 meeting the example on entertainment expenses was deleted. Instead, this version refers to the case where the cost of a building is never deductible. Again, it is assumed that the related tax expense should be charged to the income statement in the same period as the asset is recognised:

> The adoption of the balance sheet method in certain circumstances may give rise to deferred tax assets, liabilities and expense that appear to be anomalous, especially to those who are used to the income statement liability method. The main circumstance which produces an anomalous result is the acquisition of an asset the cost of which will never be deductible in determining taxable profit. In some jurisdictions, for example, the cost of a building is never deductible in determining taxable profit and gains on the subsequent sale of the building are not taxable. The difference between the carrying amount of the building and its tax base of nil is a taxable temporary difference for which a deferred tax liability should be recognised. In these circumstances if a building is purchased for 1,000,000 and recognised as an asset there is a taxable temporary difference of 1,000,000 which at a tax rate of 50% would result in a deferred tax liability and deferred tax expense of 500,000 being recognised when the building is acquired. (940414BI, §32)

No significant changes were made to the text in relation to these issues before submitting the proposals to the Board in June 1994. However, the issue of non-deductible assets was identified as one of three "problem areas" in the papers prior to the meeting (940511Ap5). As noted initially, before approving E49, the Board introduced an exception for non-deductible assets. As in the previous case the minutes from the meeting report that this exception for *temporary differences arising on initial recognition* was made "for practical reasons" (9406M),

Following the June meeting the text of the ED was redrafted several times. As part of these developments this exception was amended to refer to *long-term assets, other than long-term assets acquired in a business combination, when the tax base on initial recognition is less than cost* (E49, §26). No explanation for these modifications has been found. The Background Paper issued with the ED only explains that:

> …the Board decided not to permit the recognition of the deferred tax liability because the consideration paid for the long-term asset implicitly takes account of the non-deductibility of the asset for tax purposes. In these circumstances, it is inappropriate to recognise a deferred tax liability **for which the related deferred tax expense would have to be either recognised as an expense immediately, added to the cost of the asset, or shown as a separate asset.** Therefore, E49 does not permit the recognition of a deferred tax liability in respect of either the origination or reversal of such temporary differences.
> (941013BP, from § 38, emphasis added)

A significant development in this document is thus that, for the first time there is a suggestion of some other treatment of the deferred tax than recognising it directly an expense. Various indications in the documents also suggest that the IASC Board in June 1994 discussed these alternatives, including to require that the carrying value of the related asset to be grossed-up (i.e. that the deferred tax be added to the cost of the asset).

With foreknowledge of ensuing developments it seems of interest that the grossing-up treatment envisaged at this point was fairly simple and did not take circular references into consideration. In respect of a long-term asset purchased for 1,000, the paper thus suggested the following grossing-up treatment (as one of four alternative treatments[23]):

Account	Debit	Credit
Cash (or equivalent)		1,000
Long-term asset	1,500	
Deferred Tax Liability		500

Also in view of the developments in the following period it is noted that prior to the June 1994 meeting one Board Member raised the issue of tax base for assets which are not deductible and which are not subject to capital gains tax on realisation. In particular the comment noted that the draft suggested that the tax base would be nil and that deferred tax should be recognised, but that under FAS 109 no deferred tax would be recognised since the tax base would equal cost. After the meeting, the same Board

23 The other three alternatives were: recognise immediately as an expense, recognise as a separate asset and E49 requirement (941013BP, Example 10 following § 38).

Member argued that the need for an exception "is created by the definition of tax base" and suggested that tax base should equal cost:

> If tax basis equals cost, there is no temporary difference and no deferred tax liability on the acquisition date of the asset. Thus, the desired answer (no deferred tax liability) is achieved using the basic concepts and without the need for an exception to the basic concepts. (940826C...)

7.3.9 Recognition issues [I-5][I-7]

Parallel to these discussions of issues relating to the application of the balance sheet liability method, the criteria for recognising deferred tax assets also continued to give rise to concern and discussions. In fact, a staff note for the March 1994 Steering Committee meeting identified this as the second most important issue.

Prior to the December 1992 Steering Committee meeting the Staff suggested that the recognition criteria in E33 relating to tax loss carryforwards [I-7] (assurance beyond any reasonable doubt) be replaced with the general recognition criterion in the framework ("probable").[24] Following this, the debate had two focal points. On the one hand there was a discussion of the meaning of the adopted threshold, particularly in comparison with the "more likely than not" threshold in SFAS 109. A key argument in this debate was that "probable" needed to be defined, lest different inter-pretations (and applications) would result:

> … . Also, the term "probable" may be interpreted quite differently without clarification, since some construe it as requiring no more than 50% mathematical probability and others as requiring a much higher level. (931027C…, Board comment prior to November 1993 Board meeting)

> In the U.S., many people believe that probable represents a level of likelihood that is much higher than 50.1 percent. Obviously, the amount of information available about the future is very limited. For that reason, use of probable (a level of likelihood that is much higher than 50.1 percent) as the criterion often would create a problem. The problem is that recognition of a deferred tax asset that is expected to be realized would be prohibited when the likelihood of realizing that asset is considered to be less than probable. (940204L…, comment on 931221ED)

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24 This general recognition criterion was proposed in E33 for deferred tax assets arising on timing differences [I-5].

Non-deductible assets [I-19][I-16a]	
E33	
Staff proposal	
December 1992 Steering Committee	
March 1993 Board Meeting	
Staff proposal	Noted that expenditures on non-deductible assets give rise to timing differences under the new definition, but not the old. Assumption that deferred tax recognised immediately as an expense.
	One Steering Committee member strongly critical of suggestion to account for a deferred tax on recognition of an asset which is not tax deductible.
August 1993 Steering Committee	
November 1993 Board Meeting	
	Example raised in discussions between IASC staff and a national standard setter. Assumed that the deferred tax should be recognised immediately as an expense.
	Example of pre-payment of non-deductible expenditure included in draft version of Background Information.
March 1994 Steering Committee	Agreed to include new guidance stating that an asset will have a tax base of nil only when the related expenditures are never tax deductible.
Staff proposal	Identified as one of three "problem areas".
June 1994 Board Meeting	Exception for temporary differences arising on initial recognition of assets, other than assets acquired in a business acquisition.
E49	Exception for l*ong-term* assets, other than long-term assets acquired in a business combination, when the tax base on initial recognition is *less than cost*

Figure 7.10 Summary of developments pertaining to non-deductible assets [I-19][I-16a] during 1992 – 1994

With respect of this issue and the March 1993 Board meeting (the first Board discussion in this period) one interviewee remarked:

> And I well remember, …at the Tokyo meeting, we must have spent a whole day almost, talking about this temporary differences, timing differences … and I can remember, for example, spending almost an hour on, talking about what's the difference between probable and more likely than not, for example … (Kson)

On the other hand, there was also a discussion of the recognition criteria per se, some arguing that these had been lowered too far (i.e. that it should be more stringent, as in E33), others arguing that they should be lowered further (e.g. as set out in SFAS 109, see above). In either case, comparisons seem to have been made with existing national thresholds, the comments depending on whether the proposed threshold was lower or higher than the national norm.

Over time the guidance relating to recognition of deferred tax assets was significantly reworded and restructured, gradually becoming more specific. This, in turn, gave rise to new controversies. For example two commentators to the December 21st 1993 draft objected to the use of "projections" in one paragraph, noting that the concept of "projections" might have a specific accounting meaning in certain jurisdictions.

A sub-issue to the recognition of deferred tax assets was that of the subsequent recognition of a tax asset (relating to loss carryforwards) existing, but not recognised, at the time of a business combination [I-5pu/I-16pu]. The origin of this issue in this context has been traced to the March 1993 Board meeting, when the Board reportedly agreed to require that the tax benefits should be recognised by:

- first reducing any goodwill related to the acquisition to zero;
- secondly, reducing other unamortised intangible assets related to the acquisition to zero; and
- thirdly reducing income tax expense for the period in which the benefits are recognised. (IASC, 1993: 27)

With respect of this issue the agenda papers for the following Board meeting dealing with this project (November 1993) reported that the accompanying draft incorporated this decision, but that this was at variance with the requirements in another standard approved by the Board in June 1993:

> The Steering Committee has implemented the March 1993 Board decision with respect to subsequent recognition of tax losses in paragraph 32 of the draft. It requires that when such tax losses are subsequently recognised that they should be applied against **all** goodwill and all non-current intangible assets related to the acquisition, before reducing income tax expense. The business combinations standard IAS 22 (revised) only requires the portion of goodwill attributable to the tax benefits to be written off when the tax assets are realised. [See paragraph 69 of IAS 22 (Revised)]. The Steering Committee are of the view that the Income Taxes and Business Combinations Standards should be consistent. (930909Ap5)

In addition, it was reported that the Steering Committee had "some concerns about the theoretical underpinning of the proposal to write off non-current intangible assets before income tax expense is reduced" (ibid).

In November 1993 the Board agreed to conform the guidance on the recognition of deferred tax assets not recognised as a separate asset at the time of a business combination to the guidance in IAS 22 (e.g. 940215Ap1). The draft circulated in December 1993 accordingly stated:

> When deferred tax assets not recognised as a separate asset at the date of a business combination are subsequently recognised by the acquirer in accordance with paragraph 37, the benefit should be recognised as a reduction in tax expense. In addition, the acquirer recognises as an expense that part of the unamortised balance of goodwill arising on the acquisition that is attributable to those previously unrecognised deferred tax assets. (931221ED, §38)

Even so, one commentator to this draft later argued that the draft ED on income taxes remained inconsistent with the revised IAS 22 (but with another aspect of this standard):

> Paragraph 38: The requirement that a deferred tax asset recognized after the date of a business combination reduces tax expense is inconsistent with paragraph 58 of revised IAS 22. Paragraph 58 provides that adjustments to acquired assets and liabilities during the first accounting period after an acquisition are charged or credited to goodwill or negative goodwill. (940121C…)

Another commentator on the December 1993 draft also noted that there was a significant difference between the proposed treatment and that in SFAS 109 and suggested that the IASC proposals may provide an opportunity for abuse:

> …. But why couldn't companies argue that none of the unamortized balance of goodwill is attributable to unrecognized deferred tax assets? On that basis, all of the tax benefits would be recognized in income and there would be no simultaneous write-off of goodwill. That problem would not arise under the Statement 109 approach that requires allocation of acquired tax benefits directly to reduce goodwill. (940204L…)

The guidance, however, remained; drawing the same comments prior to the June 1994 Board meeting from the same commentator (940609C…). Nevertheless, it remained in E49.

7.3.10 Issues of procedure

Parallel to these technical issues, the process itself seems to have given rise to some controversy. As already noted, initially many seem to have expected another fairly straightforward process. One interviewee suggested, however, that after the December 1992 Steering Committee meeting, it was realised that it was not going to be "a simple fix to IAS 12" (Kson) and that the staff had "had a lot of discussions" about the appropriate strategy, whether to "keep on producing EDs" or "to stop everything and start talking about this from first principles" (ibid). As should be apparent from the above, the first alternative won; although in a sense the process began all over again, it didn't. Instead of reverting to earlier stages in the due process (or indeed to stages of the process that had initially been skipped, pp. 136-7), the focus was entirely on producing a revised ED.

Nevertheless the documents indicate that the issue of how to proceed with this project continued to give rise to discussions. For example, a December 1993 work plan stated that if, by the time of the March 1994 Steering Committee meeting "a significant number of Board members do not support the approach" it might be appropriate to publish a DSOP instead of an ED (931230WP). Similarly, prior to the June 1994 Board meeting it was suggested that the Board might issue the Background paper as a Discussion Paper prior to issuing a new ED (9406AP1).

7.3.11 Perspectives on the process

The process leading up to the approval of a second ED relating to income taxes took almost two years. During this time the IASC Board discussed draft EDs three times. The discussions during the first meeting (March 1993) have been characterised as brief and the Board's position at this point as tentative, awaiting further material from the Steering Committee. Although

discussions during the second meeting (November 1993) are described as extensive, and although the intention appears to have been to approve a revised draft at this meeting, a vote was not taken at this point. The reason was ostensibly that a number of Board Representatives had indicated that they were not ready for this. After considerable deliberations, relating both to the choice of the balance sheet liability method and to detailed proposals, and after a number of changes to the draft submitted by the Steering Committee, the Board finally approved *E49 Income Taxes* at the third Board meeting (June 1994).

Two explanations have been offered on how the Board finally achieved a sufficient majority to approve E49 in June 1994. On the one hand it has been suggested that difficulties in understanding what the proposed new approach/method implicated created a need for more than one meeting to discuss the proposals thoroughly, but that in June 1994, this *learning process* had matured:

> …many Board members at this stage said that there was something fundamentally strange about this approach, because taxes are related to profits and shouldn't taxes be related to profits before tax. That ought to be the approach. This is a completely different approach and why is this so, what are the implications and how meaningful are the numbers that it produces. (Ison)
>
> I think it was the normal maturation process because really, that means there was ... (1) the Board meeting in Tokyo, the Board was not prepared, (2) in Oslo, the Board went into more in detail and the understanding was better and (3) in Edinburgh, it was around to be mature (Pson)

On the other hand, it has also been suggested that it was *deal-making* (in combination with *weariness*) that swung the vote in June 1994:

> … [] made two slides the last day .. because there were many changes… saying well you can say yes or no … if you say no it's finished ...and .. then it was a yes vote… (Bson)
>
> … at the end of the day, whether it was Thursday evening or Friday afternoon, the view was: we've discussed this long enough, let's issue the exposure draft …there certainly was a change in vote ...by [X] which swung it … but that change was driven by the desire to end the discussion and issue the draft …(Json)

Learning

The suggestion that the developments leading up to the approval of E49 can be understood in terms of learning makes a lot of sense. The previous account of the developments in relation to various key issues (7.3.3 – 3.3.10) includes numerous examples of such learning processes. It should be emphasised, however, that the developments are characterised by more than individual learning processes (i.e. individuals learning more about the issues being discussed). There were also significant collective learning pro-cessses in the sense of new insights/understanding and, with this, new (sub-) issues and new alternatives. (This, in turn, had implications for the over-all process.)

Learning in relation to the choice of liability method [I-3]

The most striking example of learning in this period occurred in relation to the discussions vis-à-vis the definition of timing differences and the choice of liability method (7.3.3, pp. 173-85). The evidence strongly suggests that initially there was no general understanding of the liability method in E33 being fundamentally different from the asset-and-liability approach advocated in the US. For example, a staff note from the very start of this period (September 1992) suggested that the asset-and-liability approach was required by E33:

> Initially, it should be assumed that there will be no comprehensive review of tax accounting and therefore issue no. 1 *[tax effect accounting **and the liability method]*** **is assumed to be agreed upon in the way it is incorporated in E33. This means that tax assets and liabilities will be recognised (asset/liability approach).** (920925… emphasis added)

As a consequence there was also no general understanding that the changes proposed to the definition of timing differences in December 1992 were more than changes in wording and focus. A note to the November 1993 Board meeting (i.e. almost a year later) suggests that by this time the understanding of this issue was changing:

> It was clear from discussions at the Steering Committee [in August 1993] that the expression "liability method" means different things in different countries. In the United States the expression has the connotation of the Balance Sheet Approach. In the other countries represented on the Steering Committee the liability method connotes essentially same approach as the Income Statement Approach as described in IAS 12 but with the deferred tax liability adjusted to reflect currently enacted tax rates. (930909…)

A document from early 1994, however, suggests that there was still some confusion, at least at the individual level:

> [X] expressed the view that he did not understand how an income statement approach could be described as a liability method as the amount on the balance sheet would not meet the Framework definition of a liability. I explained the rationale behind the liability method in IAS 12 and again [X] repeated that this methodology by restricting itself to the income statement timing differences and ignoring other deferred tax liabilities arising from temporary differences (such as business combinations and asset revaluations) did not reflect the complete liability and that therefore the use of the expression liability method was misleading. In [X]'s view the result is not a liability but a "thingamajig" and it would be more accurately described as the "thingamajig method. (940121…)

Further evidence of continuing confusion is found in various comments from one Steering Committee Member that opposed the proposals. In fact his continued opposition to the proposals seems to have been based at least partly on the belief that the Board had not understood the implications of its decision to adopt the balance sheet (approach to the) liability method. Even as late as April 1994 he argued that there was "still a lot of confusion about the different methods", and suggested that the papers for the June 1994 Board meeting be re-written, clearly distinguishing between the deferral, income statement liability and balance sheet liability method (940411L…).

In relation to these developments some interviewees acknowledged that their understanding of the alternatives had developed over time, e.g.:

> I have to put my hands up and admit that I didn't understand the implications of the change in liability method for at least six to nine months and it was only in the middle of 93 that I began to understand the implications of the change. (Json)

Similarly, one interviewee stated that

> I had a feeling that ... the Americans mixed up the income statement approach with the deferral method. (Cson)

The gradual development of the understanding of the implications of the proposed changes was also reflected in the language used to describe these: from a change in *wording* and *focus* (March 1993), to a change in *approach* (November 1993) to a change of *method* of tax effect accounting (Spring 1994). The draft background paper submitted to the Steering Committee in March 1994 is one of the first documents using the concepts "income

statement liability method" and "balance sheet liability method". However, it (still) also refers to these as two approaches to *the* liability method:

> There are two approaches to the liability method:
> (a) the income statement liability method which focuses on timing difference and which was required by IAS 12 and proposed by E33; and
> (b) the balance sheet liability method which focuses on temporary differences and which is proposed by E--. (940302BI, §16)

Learning in relation to other issues

As a result of the changes in the understanding vis-à-vis the choice of liability method [I-3] the issues relating to the treatment of revaluations [I-10] and undistributed profits of subsidiaries and associated [I-8] were re-framed. Both issues were now discussed (understood) in terms of whether an *exception* should be made to a fundamental principle. The latter issue was also expanded to encompass all forms of temporary differences arising from these types of investments.

Furthermore, as the understanding of the implications of the balance sheet (approach to the) liability method developed, new issues (relating to its application) emerged. Three such key issues have been discussed in more detail: intra-group profits [I-9], government grants [I-22] and non-deductible assets [I-19][I-16a]. In each case the previous accounts suggest changes in the understanding of the issues (see figure 7.11, p. 214).

Individual, and collective, learning also seem to have played a certain part in respect of the second main issue, recognition. In particular it is noted that the meaning of, and difference between, the key expressions "probable" and "more likely than not" were not initially well defined.

Deal-making

When the vote was first called in June 1994 a sufficient majority was not achieved for the proposals. It therefore seems unlikely that it was simply a case of a learning process that had matured. Instead, the process also seems to have been marked by explicit deal-making, i.e. effort to construct the proposals to achieve sufficient majority for approval of the ED.

- ***Intra-group profits [I-9]***
  While the staff note to the March 1994 Steering Committee meeting referred to "potential problems" associated with tax effecting these temporary differences, the Background Paper submitted to the June 1994 meeting relied on conceptual arguments relating to the nature of group accounting.

- ***Government grants [I-22]***
  Initially it was argued that while one way of accounting for government grants gave rise to temporary differences another did not. This was perceived as problematic. With time it was then argued that a temporary difference arises no matter how the grant is accounted for.

- ***Non-deductible assets*** *[I-19]*
  For a long time the documents suggest an understanding that the deferred tax liability associated with the acquisition of a non-deductible asset should be recognised by a deferred tax expense in the period of acquisition. The above review, however, suggests that some time in the summer of 1994, it was recognised that there were at least two other potential solutions.

Figure 7.11 Learning in relation to issues related to the application of the balance sheet liability method in 1992 - 1994

In more detail it is noted that the Board was scheduled to discuss this project with a first "run through" in the morning of the first day of the meeting (Monday). A second run-through was then scheduled as the last item on the third day (Wednesday). At the end of this session, however, only nine[25] votes were counted in favour of the draft (three against and two abstentions). It was thus agreed to come back to this project later in the week. Following three further changes to the draft, twelve votes were then finally counted in favour of the revised draft (one abstention and one against).

Several of the changes to the proposals agreed in June 1994 can be seen to make these more appealing to various Board Members. The first time round the Board agreed to delete the proposed exceptions for revaluations [I-10][26] and for intra-group asset transfers [I-9][27]. Although there were definitely some Board Members who wanted an exception for revaluations [I-10], these were generally opposed to the balance sheet liability method. However, at least two of those perceived to be generally in favour of this method argued strongly against such an exception (p. 187). The situation

25 Ten votes were needed, representing a 2/3 majority.

26 This was suggested in one of the comment letters and implied in another.

27 This was suggested by another Board delegation.

was similar for the exception relating to intra-group asset transfers [I-9]: one Board Member in favour of the proposals argued against such an exception. Moreover, two of the final changes made were to introduce of exceptions for temporary differences arising on the initial recognition of non-deductible assets [I-19] and government grants [I-22]. This effectively cancelled out most of the impact of the proposed switch to the balance sheet liability method (the only remaining situation was revaluations [I-10]). The third change, finally, was to strengthen the guidance on recognition of income tax losses "to emphasise the need for convincing evidence in support of the probability criterion for recognition" [I-5][I-7] (9406M). This, in turn, might be understood as an attempt to appease those who believed that the recognition criteria had been lowered too far.

An important condition for the Board finally agreeing on an ED in June 1994 seems to have been that it was possible to construct solutions that made the proposals acceptable to some without making them unacceptable to others. In this period the main tool for constructing such deals (compromises) appears to have been to introduce exceptions. This was used by the Board in June 1994 as well as by the Steering Committee (e.g. p. 186).

The interaction of learning, deal-making and executive concerns

Just as in the period during which E33 was developed, the review suggests that initially this project was again perceived as limited. For example, the Staff's proposals for the first Steering Committee meeting can be understood in terms of making certain adjustments to the proposals in E33 in view of strong opinions expressed in the comment letters received (p. 171). It has been reported that, after the December 1992 Steering Committee meeting, the IASC Staff discussed whether to continue with an ED or "start talking about this from first principles" (Kson, p. 209). As already noted the first alternative won. This may be an indication of the staff not understanding the implications of the proposed changes either. However, it may also be an indication of executive concerns (making progress):

> this is a long time ago … I think what we were trying to do with all this was really to try and not forget the big picture, which was that the IASC was trying to eliminate its allowed alternatives and so … I think that the plan was that we didn't want the Board to go too far off the rails worrying about this temporary differences approach … I suspect that … we didn't really want to make a big issue of this temporary differences because at the time ... .we were not really sure how big an issue it was … (Kson)

However, in contrast to the earlier period the learning process was not restricted. In March 1993 the Board essentially sent the project back to the Steering Committee for further consideration and clarification. The unfolding of the learning process following this reveals the importance of how the standard setting process within the IASC was organised. In particular it is noted that the IASC's standard setting process can be characterised as a non-continuous process consisting of meetings of various groups, linked together by documents drafted by the staff. Following the March 1993 meeting, the Steering Committee did not meet again until August 1993 (five months later). The next Board meeting then took place in November 1993 (two months later). Furthermore, the above review suggests that, in the case of the Board, the significant learning took place during and perhaps after, rather than in preparation for, this meeting. As a result, final deliberations were postponed to June 1994 (another seven months later).

In general terms it might thus be argued that the political aspects of the process triggered a learning process which then held-back the standard setting process. The length of this delay, in turn, may be seen to be related to how the process was organised. Still, the fact that a learning process had been triggered did not stop the process. The focus continued to be on producing and getting an ED approved. This involved the Staff driving (facilitating) the above learning. At the same time, however, it also involved attempting to restrict the learning process. For example, in the case of undistributed profits of subsidiaries etc. [I-8] the staff papers appear to have ignored certain concerns, suggesting also that the exception not be widened to include all temporary differences (p. 191). Whereas the former attempts appear to have been at least partially successful, the latter was not.

In addition, concerns for progress also seems to have involved attempting to manage (facilitate) the political dimensions of the process. A particular aspect of this is that, for the November 1993 Board meeting the proposed switch was framed as a response to comments received on E33 (p. 174). A more striking aspect of this is perhaps that the Staff, following the November 1993 Board meeting, attempted to ascertain the degree of support for the balance sheet liability method on the Board and, having done this and concluded that "the chances "of the proposal being approved in their present form did "not seem encouraging", proposed alternative strategies to gain Board acceptance in June 1994 to the March 1994 Steering Committee meeting (p. 179).

These kind of executive concerns, however, were not restricted to the Staff. In fact, an important condition for the Board finally agreeing on an ED in June 1994 appears to have been the fact that at least some Board Representatives believed that an ED based on the draft was better than no progress at all:

> we […] resisted very much this … like many delegations, and finally we were convinced that the right thing …to do was … to vote [for] a standard, we had to have a standard …we couldn't stay in a vacuum … ….
> My personal view has always been that we had to have a standard and that we could find advantages and disadvantages with both approaches. So the right thing was to go ahead with what most people thought... the better being the enemy of the good … (Fson)

A result of this (interaction between learning, deal-making and executive concerns) was, in the words of one interviewee:

> Coming out of that meeting I was saying: Well we've approved the ED, but I'm not sure the Board is that convinced of its proposals. (Json)

Another result was that, despite proposing to require application of the balance sheet liability method [I-3], the ED also proposed to make exceptions for most of the cases where this proposed switch in method was perceived to implicate change. Moreover, as will be seen in the next chapter, further consideration of the issues involved would reveal that the ED did not clearly specify how to determine one of the key concepts on which it relied: that of tax base.

CHAPTER 8

1994 – 1996 THE REVISED STANDARD

8.1 Introduction

This chapter analyses developments after the release of E49 up until the approval of the final standard, distinguishing between two periods:

8.2 October 1994 – May 1995 The comments received on E49
8.3 June 1995 – October 1996 After the comments on E49.

8.2 October 1994 – May 1995 Comments to E49

8.2.1 Concurrent developments

E49 was released in October 1994 with a comment deadline of May 31st 1995. During this period the IASC Board met three times. For the IASC as a whole, key issues during 1994 – 1995 were about the relationship with the IOSCO and the projects on Financial Instruments[1] and Intangible Assets[2]. With regard to the relationship with IOSCO it is noted that in November 1994 the Board approved a revised work programme taking into account, amongst other things, the correspondence from IOSCO on the acceptability of IASs mentioned on page 170. The Board also agreed to invite the IOSCO to send a representative to its Steering Committee meetings, a right offered no other organisation or country (Cairns, 1998: 62). On its agenda were also other projects including Earnings Per Share and Segments.

Also in the meantime, the standard setters in Australia, Canada and the UK took various steps in relation to national projects on accounting for deferred tax. For example, concurrent with the IASC's publication of E49 the Canadian standard setter issued an invitation to comment on the issues raised

1 Important events relating to this project included a November 1994 decision to complete the project in two stages and the approval of *IAS 32, Financial Instruments: Disclosure and Presentations* in March 1995 (completing the first stage).

2 Important events relating to this project include a discussion of a SOP with representatives of national standard setting bodies in March 1995 and the approval of *E50, Intangible Assets*, in May 1995.

in E49. In February 1995 IASC received information that a "fair number of comments" had been received and that "a number of respon-dents" would be unhappy for the Canadian standard to depart too far from FAS 109, being less concerned about differences with a future IAS (950205L….). However, this communication also stated that the Canadian body found compatibility with the forthcoming IAS "desirable" (ibid). Following this, the IASC staff suggested that the Canadian body should receive copies of comment letters received by the IASC and that their project manager could attend the forthcoming Steering Committee meeting (950207L…).

Moreover in March 1995 two Discussion Papers were published, one in Australia and one in the UK. Whereas the Australian paper suggested that comprehensive allocation [I-2] using the balance sheet liability method [I-3] should be required, the UK paper rejected this method. On the other hand, perhaps somewhat surprisingly, it did propose to require comprehensive allocation. Commenting this the chairman of the ASB is reported to have stated that the ASB Board "were swayed by the fact that full provisioning is used internationally, but if someone comes up with very good reasons why we shouldn't use it, we will listen" (Anonymous, 1995). The same source suggested that a switch to comprehensive application of deferred tax "would lead to a drop in EPSs of up to 35% in some of the UK's largest companies".

8.2.2 The comments

A press release announced the publication of the ED. The December 1994 edition of IASC Insight then carried an article on the ED, highlighting that in most cases the "new liability method" gives rise to the same accounting as under E33/IAS 12 (IASC, 1994d: 14). The most significant change was said to be for long-term assets acquired in business combinations [I-16a] (ibid: 15).

All in all 73[3] comments to E49 have been identified. Just over half of these were dated prior to the deadline of May 31st 1995, a third in June 1995 and the rest later (figure 8.1).

3 An IASC collection of comments received lists 74 comments. However, one of these only states that the respondent has discussed the draft with other parties and that their comments will be submitted through one of these.

Companies represented the largest category of respondents, contributing with roughly a third of the comments. Most of these, in turn, came from Europe. The second largest group of respondents was member bodies. However, despite the large number of IASC members, only 14 comments were received from these[4].

Although just over half the responses originated in Europe, more responses originated in the Anglo-American cultural sphere[5], compared to the Continental European sphere. See figure 8.2 for further details.

Roughly 40% of the respondents were seen to support E49, although most with "reservations on certain specific aspects" (950706Ap2). About half as many were seen to oppose a standard based on E49. The remaining respondents did not state whether they supported E49 or not, commenting specific issues only. See figure 8.3 for further details.

Most of those objecting to E49 did so because they disagreed with the balance sheet liability approach [I-3] and/or believed that partial application should be permitted or required [I-2]. About half of these responses came from companies. Two thirds of these came from the UK (6) and South Africa (2). See figures 8.3 and 8.4 for further details.

Together the comment letters received on E49 covered a large number of issues. In most cases, however, each issue was addressed by a smaller number of respondents only. Two exceptions were the choice of the balance sheet liability method [I-3] and the proposal to require comprehensive allocation [I-2]. Six other issues were commented by at least 10% of the respondents: initial recognition of long-term assets [I-21], revaluations [I-10], discounting [I-4], presentation [I-13], deferred tax asset not recognised in a business combination [I-5pu] and disclosure of a numerical reconciliation of the relationship between tax expense and accounting profit [I-15].

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4 One could argue that the actual number was somewhat higher, some of the responses from member bodies being included in the category of joint responses.

5 35 if this is defined as including responses from North America, the UK, the Netherlands as well as Zimbabwe and South Africa. 40 if responses from international organisations, mainly accounting firms, are also included.

Two UK respondents commented the IASC's timing vis-à-vis the UK, characterising it as "inopportune" (950609C…) and suggesting to "delay the development of the final IASC accounting standard until the ASB's proposals are further refined and developed and responses to the Discussion Paper, Accounting for Taxes, are evaluated" (950707C…). On the other hand, at least two other respondents argued that the issues have been debated for a long time and "no useful purpose is served by prolonging the debate" (950523C…).

Member bodies:

1. Institute of Management Accountants (US) [T950329CIma]
2. New Zealand Society of Accountants [950501CNz]
3. SchweizerisheTreuhand - und Revisionskammer [950504CSchw]
4. Institute of Chartered Accountants of Zimbabwe [950519CZim]
5. Föreningen Auktoriserade Revisorer (Sweden) [T940524CFar]
6. Japanese Institute of Certified Public Accountants [950525CJicpa]
7. Institut des Reviseurs d'Entreprises (Belgium) [950530CBel]
8. Canadian Institute of Chartered Accountants [950530CCica]
9. Certified General Accountants' Association of Canada [940530CCga]
10. Institut der Wirtshaftsprüfer (Germany) [950531CIdw]
11. Consultative Committee of Accountancy Bodies (UK) [950531CCcab]

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12. *American Institute of Certified Public Accountants [950619CAicpa]*
13. *Institute of Chartered Accountants in Ireland [950707CIre]*
14. *Instituto Mexicano de Contadores Publicos AC [950710CMex]*

Other accountancy bodies:

1. *New Jersey Society of Certified Public Accountants (US) [950621CNjscpa]*
2. *Fédération des Experts Comptables Européens FEE (Europe) [950627CFee]*

Standard setters:

1. FASB (US) [950531CFasb]
2. Raad voor de Jaarverslaggeving (Netherlands) [9505XXCCar]

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3. *Norsk Regnskaps Stiftelse (Norway) [950612CNrs]*
4. *Australian Accounting Research Foundation (Australia) [950616CAarf]*
5. *European Commission [950627CEc]*
6. *Foreningen af Statsautoriserede Revisorer (Denmark) [950713CFsr]*
7. *Accounting Standards Committee of the Institute of Chartered Accountants and Auditors of Thailand [950627CThai]*
8. *Consiglio Nazionale dei Dottori Commercialisti (Italy) [950731CItaly]*

Security regulators:

1. *Australian Securities Commission [950627CAsc]*
2. *SEC (US) [950628CSec]*
3. *Commission Nazionale per la Società e la Borsa (Italy) [950720CConsob]*

Figure 8.1a List of commentators to E49

Joint:
1. Arbeitsgemeinschaft für Wirtschaftliche Verwaltung (Germany) [950523CAwv]
2. South African Institute of Chartered Accountants [950531CSaica]

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3. *L'ordre des Experts Comptables et des Comptables Agrées, Compagnie Nationale des Commissaires aux Comptes and Conseil National de la Comptabilité [950616CFrench]*
4. *Foreningen af Statsautoriserede Revisorer (Denmark) [950713CDan]*

Industry Representative Groups:
1. Group of 100 (Australia) [950412C100]
2. International Federation of Financial Executives Institutes (IAFEI) [950530CIafei]

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3. *Federation of Swiss Industrial Holding Companies & European Round Table [950606CSwiss]*
4. *Association Française des Entreprisses Privées (France) [950620CAfep]*

Insurers:
1. Verbond van Verzekeraars (Netherlands) [950529CVvv]

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2. *Association of British Insurers (UK) [950626CAbi]*

Companies:
1. Alcan Aliminium (Canada) [950523CAlcan]
2. CG Smith (South Africa) [950413CSmith]
3. Broken Hill Proprietary (Australia) [950420CBhp]
4. Philips International BV (Netherlands) [950524CPhil]
5. Texaco Inc. (US) [950526CTex]
6. South African Breweries Limited (South Africa) [950529CSab]
7. Nestlé SA (Switzerland) [940526CNest]
8. BP (UK) [T950530CBP]
9. Lafarge Coppée (France) [950530CCoppee]
10. Oerlikon-Bührle (Switzerland) [950530CO-B]
11. Telefónica (Spain) [950530CTele]
12. BAT Industries (UK) [950531CBat]
13. Carlsberg (Denmark) [950531CCarl]
14. Unilever (UK) [950531CUni]

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15. *Ascom AG (Switzerland) [950602CAscom]*
16. *Keramik Holding AG Laufen (Switzerland) [950613CLauf]*
17. *Allied Domecq (UK) [950615CAllied]*
18. *Coles Myer Ltd. (Australia) [950621CColes]*
19. *Shell (Netherlands/UK) [950621CShell]*
20. *Merck (US) [950622CMer]*
21. *Solvay S.A. (Belgium) [950629CSolvay]*
22. *Sandoz International (Switzerland) [950630CSand]*

Financial Analysts:
1. Association for Investment Management and Research AIMR (US) [950523CAimr]
2. Security Analysts Association of Japan [950529CSaaj]

Figure 8.1b List of commentators to E49

Accounting firms:
1. Deloitte Touche Tohmatsu (New Zealand) [950524CDttnz]
2. Arthur Andersen (international) [950526CAnd]
3. Price Waterhouse [950531CPw]
4. KPMG Denmark [950531CKpmgD]

5. *Ernst & Young International [950608CE&Y]*
6. *KPMG (UK) [950609CKpmgU]*
7. *Coopers & Lybrand (UK) [950614CC&L]*
8. *Deloitte Touche Tohmatsu International [950726CDtti]*

Academics:
1. *American Accounting Association [950627CAAA]*

Individuals:
1. Y Dotan (Israel) [950110CDotan]
2. R Cotting (Switzerland) [950529CCott]

Legal Profession
1. The Law Society (UK) [950517CLaw]

Figure 8.1c List of commentators to E49

	Total	North America	Europe (UK & Neth.ands)	Europe (other or joint)	Africa	Asia	Australasia	International	Other
Member bodies	14	4	2	4	1	1	1		1
Other acc. Bodies	2	1		1					
Standard setters	8	1		5		1	1		
Securities regulators	3	1		1			1		
Joint comments	4			3	1				
Ind. Representatives	4			2			1	1	
Insurers	2		2						
Companies	22	3	5	10	2		2		
Financial analysts	2	1				1			
Accounting firms	8		2	1			1	4	
Legal profession	1		1						
Academia	1	1							
Individuals	2	1		1					1
	73	12	12	28	4	3	7	5	2

Figure 8.2 Comments received on E49: type of respondent and origin

	Total	Support E49 without reservation	General support reservations on certain aspects	Reservations on certain aspects, no general opinion	Oppose E49
Member bodies	14	1	7	4	2
Other acc. Bodies	2		1	1	
Standard setters	8		4	4	
Securities regulators	3			3	
Joint comments	4		1	1	2
Ind. Representatives	4		2	2	
Insurers	2			1	1
Companies	22	1	6	9	6
Financial analysts	2	1	1		
Accounting firms	8		4	2	2
Legal profession	1	1			
Academics	2			2	
Individual	1			1	
	73	4	26	30	13

Figure 8.3 Comments received on E49: type of respondent and general position[6]

	Total	North America	Europe (UK & Neth.lands)	Europe (other or joint)	Africa	Asia	Australasia	International	Other
Support E49 without reservation	4		1	2		1			
General support reservations on certain aspects	26	7	3	4	1	1	6	4	
Reservations on certain aspects, no general opinion	30	4	1	19	1	1	1	1	2
Oppose E49	13	1	7	3	2				
	73	12	12	28	4	3	7	5	2

Figure 8.4 Comments received on E49: general position and origin

6 These categories have been adopted from staff papers.

Comments on the balance sheet liability method [I-3]

Roughly two thirds of the comments were seen to support the choice of the balance sheet liability method [I-3]. However, only half of these did so explicitly. A third of the comments were seen to oppose the method, two thirds of these explicitly.

Although most responses were fairly short (median 2, mean 3 pages)[7], a number of reasons were provided for objecting to the balance sheet liability method. Stated objections included that E49 proposes to achieve harmonisation by imposing "a new standard which will require virtually every country in the world to change its method of accounting for income taxes" (940530C…) and that it places "an unfair burden on underdeveloped countries" (ibid). More theoretically oriented objections argued that the approach is "based on an implied premise that the carrying amount of an item represents its recoverable amount" (950609C…). Comments objecting to the balance sheet liability method are summarised in figure 8.5.

In relation to this issue it is also noted that three commentators addressed the (large) number of exceptions to the balance sheet method in E49:

> In general, implementation problems grow with the number of exceptions made to an underlying concept. (950329C…)
>
> While the balance sheet approach might be conceptually sound, and in line with the Conceptual Framework, we believe that it loses its credibility as a result of the many exclusions contained in the exposure draft. (950531C…)
>
> In our view this method is conceptually flawed. E49 does seem to recognise some of the flaws and puts into place a number of exemptions in an attempt to deal with them. However, this granting of exemptions does nothing to restore credibility to the method. (950609C…)

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7 This measure – number of pages of comments – is used as a rough measure of the length/amount of comments received. Due to differences in layout between the various letters it is, however, not strictly comparable. The longest letter was 13 pages. The shortest was one sentence long: "We reviewed Exposure draft E49 and are in agreement with the proposals" (950630C…)

(a) the balance sheet liability method introduces needless complexity and the end result of the method may not be relevant. The business community is best served by a coherent method of accounting for taxes that produces a realistic figure for the amount of tax that actually be payable;

(b) E49 adopts an over-theoretical approach focusing on the taxation of future transactions that have not themselves been recognised in the financial statements and the exemptions do not remedy the problem but highlight its existence;

(c) many users do not understand what deferred taxes represent and use of the balance sheet liability method would leave them just as confused as before;

(d) many countries would need to change their domestic standards to bring them into line with a standard based on E49. This may lead to a low level of support for the final Standard and harmonisation will be further from reality if many countries do not change. The UK Accounting Standards Board has rejected the balance sheet liability method and the balance sheet liability approach could not be applied in France at present. Moreover, many developing countries do not have accountants trained well enough to implement a standard based on E49 or users sophisticated enough to understand such a standard;

(e) the exceptions in E49 cover most of the items which constitute temporary differences but not timing differences and the number of those exceptions undermine the credibility of the balance sheet liability approach. It is awkward to deny recognition to temporary differences that are essentially permanent;

(f) temporary differences include impairment of the value of assets in that the future amortisation of such assets will not be tax effected on the basis of the carrying value. This impairment does not meet the IASC Framework's definition of a liability. Moreover, the balance sheet liability approach creates a smoothing of the effective tax rate over time which is not particularly useful to investors as it tells little about the actual tax rates being incurred currently and in the foreseeable future. Investors need to know about actual tax bills, current and future, and are not helped by amalgating these tax bills with this form of asset impairment;

(g) recognition of deferred tax liabilities arising from the future disposal of an asset takes account of the tax consequences of a future potential management decision (the disposal). This contradicts IAS 10 which does not allow the recognition of contingent liabilities and expenses that are not probable;

(h) temporary differences do not generate a present liability, because the liability only exists if and when the future economic benefits are recognised as income to be earned in the future. It is not appropriate to base deferred tax on expected future benefits;

(i) the balance sheet liability approach leads to an overvaluation of goodwill, creating an increased amortisation expense;

Figure 8.5a Objections raised to the balance sheet liability method in comment letters to E49, excerpt from staff paper

(j) the only rationale for this approach is a decision to follow SFAS 109. If IASC generalises this approach to US GAAP, this would take away much of the incentive for non US companies to adopt International Accounting Standards;

(k) the approach provides for only one of many liabilities implicit in the future recovery of an asset and the approach is based on a false premise that the carrying amount of an item represents its recoverable amount;

(l) the effect of the approach is tantamount to capital maintenance adjustment to ensure that sufficient equity would be retained to cover the tax that would arise on a realisation and settlement of the entire balance sheet at its carrying amounts. It is worthwhile considering the merits of this on distributable reserves. However, it cannot be correct to achieve it by booking a liability where the enterprise is a going concern;

(m) if no exemption were granted, it would be necessary to gross up non-taxable items, such as property or assets purchased on which no tax relief is available. This involves increases in both tax relief and depreciation. This treatment is artificial in that, for instance, it does not reflect the buyer's perspective at the time a property is purchased. Moreover, it is not necessarily true that the price paid varies in direct proportion to the availability (or non-availability) of tax relief. Tax is just one of the factors involved in pricing and is perceived differently by each buyer and seller. The market sets prices without taking note of the peculiarities of each individual participant's tax position; and

(n) it could give rise to a provision significantly greater than that required on a going concern basis.

Figure 8.5b Objections raised to the balance sheet liability method in comment letters to E49, excerpt from staff paper (cont.)

Level of application of deferred tax effect accounting [I-2]

Just over a third of the respondents commented the proposal to require comprehensive allocation. The majority of these (17[8]) argued that partial allocation should be permitted or required. Objections included that under comprehensive application large deferred tax liabilities, that are unlikely to lead to tax payments, are reported and that partial application (with disclosure) provides the more relevant information.

8 The staff summary for the November Board has 20 respondents in this category. However, according to my interpretations, only 17 of these were arguing in favour of partial application.

8.3 June 1995 – October 1996 Developing IAS 12 (revised)

8.3.1 Introduction

Following the end of the comment period on E49 the process to a revised standard took another 15 months. During this period the Steering Committee met once. The Board, however, discussed this project – i.e. draft revised standards – at four consecutive meetings, before approving IAS 12 revised in September 1996. All in all 16 versions of the draft standard have been identified from this period.

The Board's discussions of this project in this period are reported to have been lengthy and sometimes heated. The discussions during the first meeting in November 1995 appear to have been almost traumatic. However, following extensive and detailed discussions the Board confirmed its "support for the broad principles embodied in the proposed Standard" with 11 votes for (three against and one abstention) (9511M…). In fact, at this point the Board only appears to have agreed on one significant change to the proposed draft standard: to add a third criterion for the exception relating to investments in subsidiaries, associates and interests in joint ventures [I-8]. To be noted, however, is that a number of issues were deferred.[9]

Following this, the intentions with the meeting in March 1996 were (only) to discuss the project with an objective of resolving outstanding issues (rather than approving a revised standard). The documents suggest two reasons for this. First, in December 1995 it was argued that in order to ensure sufficient time for Board representatives to study a revised draft Standard, such a draft would need to be circulated by the end of January. This, in turn, was not deemed to be possible. (In other words, almost two months for revision of the draft was not deemed sufficient.) Second, it was also argued that the Board may not have "resolved all the issues in principle yet" (951122L..) and that it may therefore need more than one day to discuss the final Standard at the next meeting.

9 The minutes from the meeting list 12 Steering Committee recommendations not considered by the Board. Another document lists an additional five such points.

Two important decisions were made in relation to this project in March 1996: (1) the Board decided not to require grossing-up with respect of temporary differences arising on initial recognition [I-19] and (2) the Board agreed to amend the disclosure requirements [I-15] as suggested by one delegation.

Although the intention was to approve a revised Standard in June 1996, again this did not happen. During the meeting the opinion swung on one critical issue: the treatment of situations with dual tax bases [I-25b]. This, in turn, had implications for the position on several other issues and for the drafting of the standard. Beginning of July 1996 a revised draft incorporating the Board's decisions was circulated to the various Board members. Comments were asked for by the end of July with the remark that the "aim is to resolve any remaining issues now so that the Board can vote on the standard in Barcelona without further discussion at the Board meeting" (960708L…). In line with an explicit decision in June, the comments received on the July draft, together with a summary of these and the staff's proposed response, were circulated to all Board delegations in August. A revised IAS 12 was then approved at the following meeting in September. At this meeting the discussions are reported to have been comparatively short. Nevertheless, a few changes were made to the draft presented to the Board before the standard was approved.

In contrast to earlier periods the Steering Committee only met once in this stage of the process. This is because it was disbanded during the Board meeting in November 1995. Nevertheless much work remained on this project and, following this Board decision, an informal, ad-hoc, working group seems to have replaced the Steering Committee. The core of this group consisted of the Project Manager, the (former) Steering Committee Chairman and the (former) US Steering Committee member. In addition, a number of other individuals also contributed greatly to the work on this project.

Important concurrent events during this period include developments in the relationship between the IASC and the IOSCO. A press release dated just days before the July 1995 Steering Committee meeting announced an agreement between the IASC and the IOSCO in the form of a work plan designed to lead to IASs "comprising a comprehensive core set of standards" by June 1999 (PR95July11). The achievement of such a core set of standards, it was argued, would enable the IOSCO to "recommend

endorsement of IAS for cross-border capital raising and listing purposes in all global markets" (ibid). The Income Tax standard was the first item on the agenda of what later became know as *the Core Standard Project*. According to the first time plan this project was scheduled to be completed at the following Board meeting in November 1995.

Even though this was not the case, the Board "agreed unanimously in March 1996" to accelerate its work-programme by moving the target date of the Core Standards Project forward by fifteen months to March 1998 (1996b). This was to be achieved by lengthening Board meetings, increasing the number of such meetings to four per year, restricting the number of published documents [10] and shortening the comment periods for these documents to three months (ibid). The decision was reportedly made in response to "many requests from international companies and from members of IOSCO" (IASC, 1996c: 9).

With regard to concurrent national standard setting efforts it is noted that the Canadian Accounting Standards Board approved an Exposure Draft on Income Tax accounting in December 1995. The Canadian proposals were different from the IASC proposals on number of issues, but consistent with the SFAS 109, and different from both on some issues. Also in 1995, the Swiss Foundation for Accounting and Reporting Recommendations approved FER 11, Taxes in the Consolidated Financial Statements. This requires comprehensive application of tax effect accounting using the balance sheet liability method. However, under this standard, a tax rate of nil is applied to temporary differences that do not lead to a taxable or deductible amount; examples are revaluations of assets without a tax effect [I-10] and intangible assets (goodwill [I-16b]) if amortisation is not deductible for tax purposes. An exception is also made for temporary differences relating to investments in subsidiaries and associates; deferred tax is only recognised when distribution is planned [I-8].

10 To an ED only for revision projects and one preliminary discussion document and an ED for major projects.

Year	Board meetings	Steering Committee meetings	Draft Standards
1995			July 6th
			July 17th partial
		July 27th - 28th	
			August 11th
			August 15th partial
			August 16th
			September 20th
	November 1st – 4th [11] (Sydney, Australia)		
1996			January 12th partial
			February 2nd
			February 26th
	March 27th – 30th (Brussels, Belgium)		
			April 16th
			May 15th
	June 11th – 14th (Stockholm, Sweden)		June 13th
			July 8th
			August 6th partial
			September 9th partial
			September 10th
	September 23rd – 28th (Barcelona, Spain)		

Figure 8.6 Summary of significant events leading up to the approval of IAS 12 (revised)

8.3.2 The issues

Although not longer than previous periods, the level of activity appears to have been significantly higher in this final period. Not only were many[12] issues discussed, many of these were extensively discussed, both during and in-between meetings. This increase in the level of activity is particularly

11 There was an unusually a long delay of six months between this and the previous meeting, in Amsterdam in early May. The reason was partly that the meeting in May was held earlier than usual and partly because this meeting was sometimes held in October rather than in November.

12 For example, the minutes from the July 1995 Steering Committee meeting lists 19 decision where the committee reconfirmed previous decisions, 29 decisions where they agreed with the Staff's recommendations, 11 decisions where they rejected the Staff proposals and at least 11 other decision, most of which related to various technical issues.

reflected in the amount of written material available in the IASC's archives. A rough estimate suggests that just under half of the collected documents relate to this period.[13]

Another characteristic of this period is that most of the key issues were generally minor in the sense that it probably was not of great practical concern to a lot of people what was actually decided. A third characteristic of this period is that the issues tended to be both related and intertwined, decisions pertaining to one issue having implications for other issues.

Although many technical issues were discussed, six issues appear to have been particularly in focus. These issues – which are listed and briefly explained in figure 8.7 – can be seen to consist of three groups of issues:

(1) issues relating to the definition/nature of the concept of tax base and, related to that, the drafting of the standard;
(2) issues relating to the use of exceptions and, related to that, to grossing up; and
(3) disclosure issues.

While the number of key issues during this period may thus seem to be limited, it should be emphasised that a number of sub-issues were raised in relation to each main category, thus significantly increasing the total number of issues. For example, in relation to the issue of grossing up certain assets and liabilities on initial recognition [I-19] the staff paper prior to the November 1995 Board meeting asked the Board to confirm that:

(a) an enterprise should not recognise deferred tax assets and liabilities associated with goodwill for which amortisation is not deductible and with negative goodwill that is treated as deferred income;
(b) an enterprise should gross up the initial carrying amount of an asset or liability by the amount of any deferred tax arising from the initial recognition of the asset or liability in a transaction which:
    (i) is not a business combination; and
    (ii) does not, at the time of the transaction, affect the determination of either accounting profit or taxable profit (tax loss);´

13 The information in figure 4.6 supports this estimate, with 1114 pages of 1980 being attributed to 1995 and 1996.

(c) an enterprise should gross up the initial carrying amount of a non-taxable government grant to reflect the additional benefit of the tax exemption;
(d) an enterprise should use the grossing up treatment for 'super-deductions' whereby some tax authorities permit an enterprise, over the useful life of an asset, to deduct depreciation that exceeds the cost of the asset; and
(e) on initial recognition of a compound financial instrument, the issuer should charge or credit the deferred tax to the equity component only, without grossing up. (950920Ap4)

i. The definition (nature) of tax base [I-25a]
The definition of tax base was repeatedly amended during this phase; 19 versions have been noted in various drafts and comment letters. On the one hand the proposed definitions were said to be "wrong". On the other hand it was also said to be correct, but "ignored" or "inconsistently applied".

ii. Dual tax bases/tax rates [I-25b]
E49 did not include guidance on how to deal with situations with dual tax bases. The discussion focused partly on whether to include such guidance, partly on the choice between the "most tax efficient" and the "expected manner" approach. The issue was explicitly discussed by the Board in March and June 1996, the Board first agreeing on the first approach and then on the latter.

iii. Non-taxable grants [I-22] and
iv. Temporary differences arising on initial recognition [I-19]
E49 proposed to make exceptions for temporary differences arising on initial recognition of non-taxable government grants [I-22] and long-term assets [I-21]. The discussion focused on whether these exceptions should be deleted, requiring instead that the tax effects be grossed-up [I-19]. The Board first decided in favour this, but later reversed this decision, the revised IAS 12 including one general exception for temporary differences arising on initial recognition of assets and liabilities [I-21].

v. Investments in subsidiaries, associates and joint ventures [I-8]
E49 proposed to make an exception for deferred tax arising on investments in subsidiaries, associates and joint ventures under certain conditions. The discussion focused first on these criteria (the Board decided to add a third criterion in November 1995) and then on whether a separate exception was necessary. When the Board switched to the "expected manner" approach (ii), it also decided to re-instate an exception very similar to that in E49 (also reversing the decision to add a third criterion).

vi. Disclosure of the relationship between accounting profit and tax expense [I-15]
The discussions focused particularly on an E49 requirement to disclose a numerical reconciliation of the relationship between tax expense and accounting profit.

Figure 8.7 Technical issues extensively discussed during 1995-1996

To be noted is also that a significant number of other technical issues were also discussed, but to a lesser extent. These are listed in figure 8.8:

1.	Revaluations [I-10]
2.	Fair value adjustments in business combinations [I-16a]
3.	Rollover relief [I-29]
4.	Translation of the cost of non-monetary assets and liabilities of an integrated foreign operation [I-17a]
5.	Restatements of non-monetary assets and liabilities in a hyperinflationary economy [I-17b]
6.	Subsequent recognition of deferred tax assets not recognised at the time of a business acquisition [I-5pu]
7.	Compound financial instrument [I-23]
8.	Super-deductions [I-24]
9.	Situations when an enterprise has unrecognised tax benefits and acquires an entity with taxable temporary differences [I-16d]
10.	Presentation of income taxes in the balance sheet and income statement [I-13]
11.	Goodwill (and negative goodwill) [I-16b,c]
12.	Inter-company transactions [I-9]

Figure 8.8 Other technical issues discussed during this period

The rest of this chapter provides further details of the developments pertaining to each of the six key issues, distinguishing between the three categories suggested above:

8.3.4 Issues relating to the definition/nature of tax base and, related to that, the drafting of the standard (pp. 237-56);

8.3.5 Exceptions (pp. 256-70); and

8.3.6 Disclosures (pp. 270-73).

First, however, a separate section accounts for the developments relating to the choice of the balance sheet liability method [I-3]. Another section explains that the process itself gave rise to a certain amount of controversy during this period:

8.3.3 The choice of the balance sheet liability method - A non-issue? [I-3] (pp. 235-7);

8.3.7 Due process considerations [I-41] (pp. 273-4).

The final section of this chapter (8.3.8, pp. 275-84) discusses what has been identified as the logic of the developments pertaining to this project during this period.

8.3.3 The choice of the balance sheet liability method - A non-issue? [I-3]

The staff report to the July 1995 Steering Committee meeting acknowledged that a "substantial minority" of the comments to E49 opposed the balance sheet liability method. It also noted that although some of the comments received stated support for the balance sheet liability method, "other comments in their responses suggest that … they may really support an income statement liability approach" (950706AP1). Nevertheless the Staff recommended that the balance sheet liability method should be retained, arguing that "(t)here is insufficient evidence of support for any alternative approach to justify reverting to an income statement liability approach" (ibid).

In fact, whereas a number of issues relating to the implementation of the balance sheet liability method were discussed throughout this period, it seems almost characterised by a refusal to re-open the debate regarding the appropriateness of the choice of this method. For example, the Board repeatedly emphasised its to support for this choice. In November 1995 it confirmed "its continuing support for the broad principles embodied in the proposed Standard" (with eleven votes in favour) (9511M…). In March 1996 the "Board instructed the Staff to present a revised draft of the final Standard to the Board in June 1996" (with 13 votes for) (9603BMM). In June 1996 it "confirmed that it supported the revised draft of the Standard in principle" (with 11 votes in favour) (9606BMM).

Nevertheless, the choice of this method came under direct attack during this period too. Some of the interviewees suggested that this could be attributed to the influence of one Board Representative in particular. Some interviews suggested that he had spoken up during the first Board meeting in November 1995:

> …. he ….sat quiet for a long time … did not interrupt process, but then essentially said: I think you've got it all wrong, inventing things that don't exist. (Mson)
>
> One of the persons who were opposed to passing the standard [X] said: "Well in fact the best thing to do is to go back to the tax payable approach … this is not a liability… " . He is very eloquent and very brilliant and he represented a large country with a lot of power. …. So this, of course, resuscitated the discontent of those who were only half

> convinced of the standard. When you have a person like this pushing, saying he doesn't agree at all and when you are yourself a very mild supporter of the text, it wakens the idea that after all you are not alone … It might well topple the whole thing … (Fson)

For the next Board meeting (March 1996) the same Board Representative submitted a 21-page written comment setting out the reasons for opposing the balance sheet liability method and describing an alternative approach to deferred taxation being considered by the corresponding national standard setter (960301LT+). The letter also explicitly states that the Board Delegation intended to "vote against any standard based on mechanistic application of the temporary difference rule" (ibid).

For the same meeting the Secretary-General of the IASC also submitted a paper in which he expressed scepticism that deferred tax balances can "properly be regarded as an asset or a liability in its own right" (96XXXXAP10A: 9). The paper suggested, however, that deferred tax accounting is "a necessary valuation adjustment" (ibid).

News reports of IASC Board meetings are rare. However, *Accountancy* reported from the March 1996 Board meeting suggesting that

> … the UK lost what was described as 'the biggest argument ever seen at these meetings'. (Anonymous, 1996)

Although this characterisation of the Board meeting elicited some cautionary reactions in the interviews, the following information is confirmed by the documents:

> Despite heated discussions in Brussels, the UK delegation was unable to sway opinion in its favour. Only two other delegations supported its view. (ibid)

In fact, in this period three/four Board Members seem to have been fundamentally opposed to the proposed standard because of the adopted method of deferred tax accounting. Again, the basis for rejection of the balance sheet liability method (as stated in their written comments) included references to the proposals being too complex and conceptually flawed, failing to produce relevant and useful information, even distorting "the true tax position of an enterprise" (960313…). To be noted is perhaps that the argument of complexity subsumed concerns as to whether the standard would be widely understood and consistently applied. Another stated reason

for opposing the proposals related to the acceptability of IASs and the IASC's reputation:

> I recognise that at this late stage, and in the light of the time pressures imposed by the agreement with IOSCO, such a move *[voting against the proposed standard]* might appear unhelpful. However, I remain convinced that our overriding objective must be to develop accounting standards that make sense to preparers and users of financial statements, both accountants and, with explanation, non-accountants. In my view, the current proposals fail to meet this objective.
>
> I am concerned that companies that have previously adopted all International Accounting Standards without question may cease to do so after publication of a standard based on the present draft and that, in the long run, the IASC's reputation will suffer.
> (960301… written comment prior to March 1996 Board meeting)

Similarly, another Board delegation argued both in May and September 1996 that

> if a standard is issued as drafted, it will harm the credibility of the IASC and back-fire on the Board in many areas where it has recently gained support. (960917…).

As suggested previously, these allegations may have "resuscitated the discontent of those who were only half convinced of the standard" (Fson, pp. 235-6). However, as will be seen in the next section, the potent threat to the choice of the balance sheet liability method came not from these direct attacks, but from discussions concerning what was, in fact, proposed. As a result of these discussions it was suggested that what the IASC proposed to require was indeed something different from the US asset-and-liabilities method.

8.3.4 Issues relating to the definition/nature of tax base and, related to that, the drafting of the standard

The first group of identified key issues includes three issues:

(i) the definition of tax base [I-25a],
(ii) the treatment of situations with dual tax bases[14] [I-25b]; and
(iii) the drafting of the standard.

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14 This situation may arise if, for example, the tax regulations specify that the cost of a fixed depreciable asset is only deductible if the asset is sold.

These issues appear to have originated in concerns that many commentators to the ED appeared not to have understood the proposals. For example, an article in the June 1995 edition of *IASC Insight* with the title "Temporary Confusion" argued that "(s)ome commentators may not appreciate the radical departure from existing practice that is implicit in Exposure Draft" (IASC, 1995: 11). In the staff note to the July 1995 Steering Committee meeting these concerns were phrased in terms of the ED being "too long, complex and difficult to interpret" (950706AP1, §106). In response to these concerns the staff initially proposed to considerably restructure and redraft the standard, including to delete the definition of tax base, replacing it with additional implementation guidance on the identification of temporary differences.

On the one hand these issues can be seen to be concerned with how to implement the balance sheet liability method (in very specific situations not generally expected to arise). On the other hand these issues can also be seen to be fundamental and related to the understanding of what constitutes the balance sheet liability method.

The definition/nature of "tax base" [I-25a]

The staff proposals to the July 1995 Steering Committee meeting included to delete both the definition and concept of tax base from the standard[15]. Supporting arguments included that "several commentators" had "difficultties with the concept of the tax base, because they considered that it is artificial and difficult to apply in those countries that do not require a tax balance sheet" (950706AP1). It was also argued that E49 gave "insufficient guidance to allow enterprises to determine the tax base in many common situations" (ibid).

With foresight of ensuing developments it is also noted that the staff papers for this Steering Committee meeting noted and rejected a FASB staff proposal concerning the definition of tax base:

> FASB staff believe that the tax base of an asset at initial recognition is cost, whether or not that cost can ever be deducted in subsequent determinations of taxable profit. This proposal would have the advantage that no temporary difference would arise on initial recognition of a long-term asset which is not depreciable for tax purposes. Thus E49's exception for such assets would no longer be required. Nevertheless, the staff recommends that the Steering Committee should reject this proposal

15 The definition of tax base in E49 is found in figure 8.8a p. 240.

> because it relies on a definition of tax base that is specific to the US tax system and because it is inconsistent with the balance sheet liability approach. The philosophy underlying the balance sheet liability approach is to recognise the future tax that would be payable or recoverable when an asset or liability is recovered or settled at its carrying amount. (950706AP1, § 20)

Instead of deleting the concept of tax base (as suggested by the Staff) the Steering Committee agreed that the definition should be amended "along the lines of the current draft Canadian proposal" (950808M). Or, in other words:

> …to recognize that there is always a substantive, if not legal, concept of tax base in that there is some value that is attributed to an item in calculating the profits upon which taxes are paid… (960129…).

The precise wording, however, was not determined. The Steering Committee meeting was thus followed by an exchange by fax between a handful of individuals on how to implement this decision. In other words, a number or alternative definitions were suggested (Nos. 2- 8 in figure 8.8).

The definition of tax base does not seem to have been an issue during the November 1995 Board meeting. Nevertheless, in proposing how to proceed after this meeting, the staff suggested that the definition of tax base should be revised, arguing that it was "wrong" and "the source of unnecessary complexity and confusion" (951122L…). In January 1996 the staff then sought comments on a proposed amended definition of tax base (No. 11). Although the focus of attention now seems to have been on the issue of how to deal with dual tax bases (see next sub-section, pp. 249f), a number of further suggestions were proposed (Nos. 12-17) in the period leading up to the March 1996 Board meeting. The staff papers for this meeting consequently identified the definition of tax base as one of five "technical issues on which additional guidance from the Board would be helpful" (960228Ap10). In particular, the staff asked the Board to confirm a new definition of tax base (No. 17).

No. 0 E49 The tax base is the amount attributable (explicitly or implicitly) to an asset or liability by the taxation authorities in determining taxable profit.
No. 1 Staff recommendation prior to July 95 Steering Committee meeting No definition of tax base. Definition of temporary difference amended: The ~~T~~temporary differences associated with an asset or liability is ~~are differences between the tax base of an asset or liability and its carrying amount in the balance sheet that will result in~~ the taxable or deductible amounts that will increase or decrease the ~~in determining~~ taxable profit (or tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled. (Draft dated July 6th 1995) CHANGES MARKED IN COMPARISON WITH E49 .
No. 2 "Definition along the Canadian lines" [16] The tax base is the amount attributable ~~(explicitly or implicitly)~~ to an asset or liability that would be used in the determination of future taxable income if the asset were realised or liability settled for its carrying amount ~~by the taxation authorities in determining taxable profit.~~ CHANGES MARKED IN COMPARISON WITH E49.
No. 3 First suggestion dated August 4th 1995 The tax base of an asset (or liability) is the amount that will be attributed~~able (explicitly or implicitly)~~ to ~~an~~that asset (or liability) ~~by the taxation authorities~~ in determining taxable profit of future periods if the asset (or liability) is realised (or settled) in those periods for its carrying amount at the balance sheet date. CHANGES MARKED IN COMPARISON WITH E49.
No. 4 Second suggestion dated August 4th 1995 The tax base of an asset or liability in a particular tax jurisdiction is the amount ~~attributable~~ recognized (explicitly or implicitly) ~~to an~~ for that asset or liability by the ~~taxation authorities~~ taxing authority ~~in determining taxable profit~~ for purposes of applying tax law. The initial tax base of an asset (that is, prior to any amortisation or depreciation) ordinarily is the amount paid to acquire that asset or the amount of income accrued and reported on the tax return for the current or prior periods. .... initial tax base for an asset is provided if the... is any ... can be recovered without imposition of tax. ..... ordinarily is the amount borrowed or the amount of .... as a tax deduction of the current or prior periods. There is .... will result in an equivalent tax deduction. CHANGES MARKED IN COMPARISON WITH E49.
No. 5 Third suggestion dated August 4th 1995 The tax base of an asset (or liability) is the amount that ~~will~~ would be attributed to that asset (or liability) in determining taxable profit ~~of future periods~~ if the carrying amount of the asset (or liability) ~~is~~ were to be recovered ~~realised~~ (or settled) ~~in those periods for its carrying amount~~ at the balance sheet date. CHANGES MARKED IN COMPARISON WITH NO. 3.

Figure 8.8a List of various definitions of tax base in 1995-1996

16 The documents do not specify exactly what was understood by this expression. However, a fax dated August 8th suggests that the Canadian definition at the time was as follows. (950808L…)

No. 6 Forth suggestion dated August 4th 1995
The tax base of an asset (or liability) is the amount that ~~will~~ would be attributed to that asset (or liability) in determining taxable profit of future periods if the asset (or liability) ~~is~~ were realised (or settled) in those periods for its carrying amount at the balance sheet date.
CHANGES MARKED IN COMPARISON WITH NO. 3

No. 7 Suggestion in response to No. 5 dated September 10th 1995
The tax base ~~of an asset (or liability)~~ is the amount ~~that would be~~ attribute~~d~~able to ~~that~~ an asset ~~(~~or liability~~)~~, based on tax legislation, that will be used in determining taxable profit (tax loss) of future periods when ~~if the carrying amount of~~ the asset ~~(~~or liability~~)~~ is ~~were to be~~ recovered ~~(~~or settled~~) at the balance sheet date~~.
CHANGES MARKED IN COMPARISON WITH NO. 5.

No. 8 Version in draft IAS submitted to November 1995 Board (September 20th)
The tax base of an asset (or liability)is the amount that would be attributed to that asset (or liability) in determining taxable profit (tax loss) if the carrying amount of the asset (or liability) were to be recovered (or settled) at the balance sheet date.
CHANGES MARKED IN COMPARISON WITH NO. 5.

No. 9 Suggestion in comment dated October 25th 1995
The tax base of an asset (or liability) is the amount that would be attributed to that asset (or liability) in determining taxable profit (tax loss) if the carrying amount of the asset (or liability) were to be recovered (or settled) in the most tax effective manner at the balance sheet date. CHANGES MARKED IN COMPARISON WITH NO. 8.

No. 10 Proposal in note dated November 22nd 1995
The tax base of an asset ~~(or liability)~~ is the amount that ~~would~~ will be ~~attributed to that asset (or liability)~~deductible in determining taxable profit ~~(tax loss)~~ of future periods when ~~if~~ the carrying amount of ~~the~~ that asset ~~(or liability) were to be~~ is recovered ~~(or settled) at the balance sheet date~~.
The tax base of ~~an asset (or~~ liability~~)~~ is the amount of that liability less the amount that that ~~would~~ will be ~~attributed to that asset (or liability)~~deductible in determining taxable profit ~~(tax loss)~~ of future periods when ~~if~~ the carrying amount of ~~the~~ that ~~asset (or~~ liability~~) were to be~~ is ~~recovered (or~~ settled~~) at the balance sheet date~~
CHANGES MARKED IN COMPARISON WITH NO. 8.

No. 11 Proposal in note dated January 12th 1996
The tax base of an asset or liability is the amount that is implicitly attributable to that asset or liability for tax purposes. The tax base of an asset~~)~~ is the amount that will be deductible in respect of that asset against the ~~in determining~~ taxable profit (tax loss) of future periods when the carrying amount of that asset is recovered. The tax base of a liability is the carrying amount of that liability less the amount that that will be deductible in respect of that liability against the ~~in determining~~ taxable profit (tax loss) of future periods when the carrying amount of that liability ~~-~~is settled.
CHANGES MARKED IN COMPARISON WITH NO.10.

Figure 8.8b List of various definitions of tax base in 1995-1996

No. 12 Proposal in letter dated January 25th 1996 The tax base of an asset or liability is the amount that is ~~implicitly~~ will be attribut~~able~~ed to that asset or liability for tax purposes. The tax base of an asset is the amount that will be deductible in respect of that asset against the taxable profit (tax loss) of future periods when the carrying amount of the asset is recovered. The tax base of a liability is the carrying amount of that liability less the amount that will be deductible in respect of that liability against the taxable profit (tax loss) of future periods when the carrying amount of that liability is settled. CHANGES MARKED IN COMPARISON WITH NO. 11.
No. 13 Proposal in letter dated January 29th 1996 The tax base of an asset or liability is the amount that is implicitly attributable to that asset or liability for tax purposes. The tax base of an asset is the amount that will be deductible in respect of that asset against the taxable profit (tax loss) of future periods when the carrying amount of the asset is recovered. The tax base of a liability is the ~~carrying~~ amount ~~of~~ that ~~liability less the amount that~~ will be ~~deductible~~ taxable in respect of that liability and included in ~~against the~~ taxable profit (tax loss) of future periods when the ~~carrying amount of that~~ liability is settled. CHANGES MARKED IN COMPARISON WITH NO. 11.
No. 14 Proposal in another letter dated January 29th 1996 The tax base of an asset or liability is the amount that is implicitly attributable to that asset or liability for tax purposes. ~~The tax base of an asset is the amount that will be deductible in respect of that asset against the taxable profit (tax loss) of future periods when the carrying amount of the asset is recovered. The tax base of a liability is the carrying amount of that liability less the amount that will be deductible in respect of that liability against the taxable profit (tax loss) of future periods when the carrying amount of that liability is settled.~~ CHANGES MARKED IN COMPARISON WITH NO. 11.
No. 15 Draft IAS dated February 2nd 1996 The tax base of an asset or liability is the amount ~~that is implicitly~~ attributable to that asset or liability for tax purposes. ~~The tax base of an asset is the amount that will be deductible in respect of that asset against the taxable profit (tax loss) of future periods when the carrying amount of the asset is recovered. The tax base of a liability is the carrying amount of that liability less the amount that will be deductible in respect of that liability against the taxable profit (tax loss) of future periods when the carrying amount of that liability is settled..~~ CHANGES MARKED IN COMPARISON WITH NO. 11.
No. 16 Proposal in comment dated February 20th 1996 The tax base of an asset or liability is the amount attributable to that asset or liability for tax purposes on the basis that the asset or liability is recovered or settled in the most tax-efficient manner. CHANGES MARKED IN COMPARISON WITH NO. 15
No. 17 Version in draft IAS submitted to March 1996 Board meeting (February 26th 1996) The tax base of an asset or liability is the amount that is expected to be attributed~~able~~ to that asset or liability for future tax purposes. CHANGES MARKED IN COMPARISON WITH NO. 15.

Figure 8.8c List of various definitions of tax base in 1995-1996 (cont.)

No. 18 Version suggested in comment dated March 14th 1996 The tax base of an asset or liability is the amount that is ~~expected to be~~ attributed~~able~~ to that asset or liability for ~~future~~ tax purposes. CHANGES MARKED IN COMPARISON WITH NO.17.
No. 19 Version agreed by Board in March 1996 (= version in revised IAS 12) The tax base of an asset or liability is the amount that is attributed~~able~~ to that asset or liability for tax purposes. CHANGES MARKED IN COMPARISON WITH NO.18.

Figure 8.8d List of various definitions of tax base in 1995-1996 (cont.)

The minutes from this Board meeting in March 1996 state that the Board agreed on a definition of tax base (No. 19) without a formal vote. This version then survived the following months and is found in the final standard. In both March and June 1996, however, the focus of attention seems to have been on the issue of dual tax bases.

Just days after the March meeting, however, the Project Manager received a memo from the Secretary-General arguing that the tax base/temporary difference approach does not always identify the correct deferred tax liability. The accompanying example outlined a situation where tax will be payable when the carrying amount of an asset is recovered, even if there is no temporary difference (because of a difference between the income tax rate and capital gains tax).[17] The memo thus proposed that the revised standard should "explain that the fundamental principle is assessing actual tax consequences" (960619L…). Following this a paragraph was added to the July 8th 1996 version of the draft standard:

> Where the tax base of an asset or liability is not immediately apparent, it is helpful to consider the fundamental principle upon which this Standard is based: that an enterprise should, with certain limited exceptions, recognise a deferred tax liability (asset) if recovery or settlement of the carrying amount of an asset or liability would increase (decrease) future tax payments. (§11 of July 8th 1996 draft) [18]

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17 Assume purchase of an asset for 1,000, with a ten year life (expected scrapped / sold for zero, after ten years), straight line (non-deductible) depreciation and an income tax at 40% and capital gains tax at 25%. As it recovers the carrying amount of the asset, the company will earn taxable income of 1,000 and pay tax of 400. On disposal of the asset, the capital loss of 1,000 will generate a potential tax benefit of 250. There is thus a net deferred tax liability of 150 (400-250).

18 This principle was also expressed in the staff papers for the July 1995 Steering Committee meeting. Compare, for example, with final sentence of the quotation on p. 239.

The draft revised standard circulated to the Board for comment in July 1996 also contained a new numerical example, based on the example provided in the memo (footnote 17 on the previous page).

This, in turn seems to have triggered renewed FASB criticism of the draft standard. The FASB comments on this draft (received in August 1996) argued that the document was not ready to be issued stating that it "perpetuates the flawed application of tax base from earlier drafts" (960802…). This comment letter was sent to all IASC Board members and became the first of a letter-exchange between the FASB's IASC Board observer and the IASC Secretary-General, letters which were sent to all IASC Board members. It is in this renewed[19] discussion of the definition (nature) of tax base that we find the suggestion that what the IASC (perhaps primarily its staff) had in mind, was something quite different from the approach adopted by the FASB, i.e. that the IASC had (perhaps unwittingly) developed a new method to deferred tax accounting: *a differential tax receipts and payments approach to deferred tax effect accounting.*

In a response to the FASB comment on the July 8th 1996 draft the IASC Secretary-General argued that the basic approach in the draft standard (and FAS 109) in relying on the notion of tax base[20] "works well enough in many practical cases" but not in all (960828L…). Three difficulties with relying on the concept of tax base were identified:

(1) when the tax base differs according to the mode of realisation;
This is the situation of dual tax bases [I-25b] discussed in the following sub-section.

(2) when there may be a tax effect from realisation of an asset, even though the "tax base indicates a temporary difference of zero"; and
This is the case suggested above.

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19 The ideas vis-à-vis tax base presented in the letter dated August 2nd 1996 were not new, but had been discussed in, e.g. the FASB comment letter on E49 (this was the background to the quotation on pp. 238-9) and in a note to the project manager dated February 16th 1996.

20 "a unique number which can be compared with the numbers for assets and liabilities to identify a temporary difference which can then be multiplied by some tax rate to give the differential receipt or payment" (960828L…)

(3) when the tax base is indeterminate.
(For example for accrued non-tax-deductible expenses).

The letter further acknowledges that the IASC "may have made a mistake in following FASB in using the concepts of tax base and temporary difference" arguing that "(i)t would have been more elegant to express the standard in terms of *differential tax receipts and payments* directly " (ibid, emphasis added). The letter continues, however, by stating the view that the IASC should not change direction now because of the confusion it would cause and because it will have "no practical importance because the cases where the difficulty arises are initial recognition cases where we say that the deferred tax effect should not be recognised anyway" (ibid).

The staff note to the following Board meeting in September 1996 similarly argued that it was not justified to rewrite the Standard "at this stage to cater for such rare circumstances" (960912Ap5). The numerical example in the draft standard referred to above was deleted, but the guidance paragraph was retained[21]. In addition, footnotes were added to some of the examples in the final standard stating e.g.:

> Under this analysis, there is no taxable temporary difference. **An alternative analysis** is that the accrued dividends receivable have a tax base of nil and that a tax rate of nil is applied to the resulting taxable temporary difference of 100. Under both analyses, there is no deferred tax liability. (Footnote following example 4 following § 7, IAS 12 revised, emphasis added)

An internal staff note dated August 15th 1996 summarises the situation as follows:

> 3. Even without a definition everybody understands what the tax base is in simple cases (…). However, not defining the tax base at all would be unacceptable because there are many cases when the tax base is either not clear or indeterminate. …
>
> 4. A simple definition, as in E49, with little or no further guidance, would also not be acceptable, because it would lead to uncertainty, confusion and inconsistent application.
>
> 5. An exhaustive formal definition would have to deal with many of the following circumstances. …

21 This is the origins of §10 in the final standard.

> 6. Such a definition would be exceptionally complex and would impede understanding even of those relatively common cases when it should be quite clear what the tax base is.
>
> 7. We decided therefore, to keep a simple definition (which is readily understandable in straightforward cases), backed up with guidance on the more difficult circumstances.

Perhaps for the first time, this IASC staff note also clearly specifies the reason(s) for the encountered difficulties:

> The reason why the tax base is indeterminate in certain cases is **because income taxes are based on income, not on the balance sheet.** To compute income taxes, it is not necessary to prepare a full balance sheet for tax purposes. [Footnote: In fact, this statement is true even in those countries that compute income taxes as the difference between the opening and closing balance sheets.] Thus, it simply does not matter what tax base is ascribed to certain assets or liabilities.
> (960815L…emphasis added)

Given the significance of the proposed switch to the balance sheet liability method in 1992/3 it is perhaps surprising that this fundamental issue does not appear to have been explicitly discussed previously. It is, however, raised in the written Board comment letter submitted prior to the March 1996 meeting (p. 236):

> The temporary difference approach is argued entirely from the perspective of the balance sheet. However, **taxes are charged not on assets or liabilities but on profits. In order to make the connection between the income statement and balance sheet,** the temporary difference approach argues that where there is a taxable profit inherent in the carrying value of an asset, that profit gives rise to a tax liability. …
>
> This rationale contains the implicit assumption that the carrying value of an asset is stated at the amount that is expected to be recovered from using or selling it. Hence, although there is no present obligation to pay tax arising from past events, the tax provision represents the valuation adjustment that is necessary to reduce the asset's value to its post-tax recoverable amount, or in other words, to recognise an impairment. (960301LT+, §§ 8-9)

The August 1996 staff note also attempts an exhaustive list of possible assets/liabilities and the related tax base, noting several cases where tax base can be considered to be indeterminate (figure 8.9, p. 248). The note

emphasises that in these situations it can be considered to be "completely arbitrary" whether the item is regarded as having a tax base of zero, or the same as the carrying value (ibid, § 10), but that there are some advantages with the adopted position (tax base equals carrying value).

The staff note to the following Board meeting similarly emphasised that the discussions on the application of tax base in certain situations "are matters of drafting and not of substance" arguing that since it is not suggested that the adopted approach leads to recognition of the wrong amounts, the "only point at issue is to explain the standard as simply as possible" (960912Ap5).

A further peculiarity of developments pertaining to this issue is that, in September 1996, the former IASC Secretary-General added to the discussion by writing to the FASB's IASC Board observer revealing his recent understanding of there being a significant difference between the IASC and FASB approaches:

> In your comment letter on E49, you assert that tax base is cost regardless of whether the cost can be deducted in the subsequent determination of taxable profits. [The FASB project manager] confirms this in his fax to me. I agree that your interpretation is different from the approach adopted by the IASC in E49. It is also different from what I understood from early in 1993 when the IASC first adopted the FAS 109 approach, from what the then IASC project manager assured me, and (I believe) from what most other IASC people were thinking in 1993 and 1994. ……
> I don't know which interpretation of tax base is right and it is not important that you convince me of your interpretation. What is important is that the revised IAS should be clear and unambiguous on what it means.. … … …
> … … It also troubles me that the IASC can get into this position particularly after all the effort I made to obtain clarification on this point from May 1993. Perhaps the point has now been clarified but your correspondence with [...] suggests otherwise. It must be resolved; it cannot be fudged. (960919…)

This letter followed an exchange between the writer and the FASB project manager on this issue (August 21 and September 5), which in turn followed discussions during a visit to the FASB. Copies of the above letter, however, were sent to two IASC Board representatives with whom he had "discussed income taxes with () on several occasions" and to the IASC Secretary-General "as a matter of courtesy". The response letter was similarly distributed.

Circumstances	Tax base
A. Depreciable asset, depreciation Deductible for tax purposes.	The amount that will deductible for tax purposes in future periods.
B. Asset representing income which has already been taxed.	Carrying amount
C. Asset representing income which has not yet been taxed, but will be taxed in the future.	Nil
D. Asset representing income which will never be taxed	**Indeterminate** - see below
E. Expenditure already written off in the financial statements but that will be deductible for tax purposes only in future periods.	The amount that will be deductible for tax purposes only in future periods.
F. Cash	Carrying amount (**or indeterminate**)
G. Loans receivable	Carrying amount (**or indeterminate**)
H. Liability representing an expense which has already been deducted for tax purposes.	Carrying amount
I. Liability representing an expense which has not yet been deducted for tax purposes, but will be deducted in the future.	Nil
J. Liability representing an expense which has already been partially deducted for tax purposes.	Carrying amount, less any amounts that will be deducted for tax purposes in the future.
K. Liability that will never be deductible for tax purposes.	**Indeterminate** - see below.
L. Loan payable	Carrying amount (provided that repayment of the loan will have no tax consequences).
M. Revenue received in advance that has already been taxed.	Nil.
N. Revenue received in advance that will be taxed in the future.	The amount that will be taxed in the future (in most cases, probably the carrying amount).
O. Revenue received in advance that will never be taxed.	**Indeterminate** - see below.
P. Liability component of compound financial instrument.	**Indeterminate**

Figure 8.9 *List of circumstances needing to be dealt with by an exhaustive definition of tax base, as suggested in internal staff note dated August 15th 1996 (emphasis added).*

The treatment of dual tax bases [I-25b]

As already noted, prior to the July 1995 Steering Committee meeting the staff proposed to delete the definition of tax base and to include, instead, additional implementation guidance on the identification of temporary differences. Although the issue of dual tax bases was not addressed in E49, the suggested implementation guidance included a statement that temporary differences are determined "in a way that reflects the expected manner of recovery of the asset" (950706AP1). This was the same approach as suggested in E49 for situations with different tax rates [I-12d].[22]

One interviewee suggested that this staff proposal had not been controversial at the July 1995 Steering Committee meeting until one participant had "surprised" everyone by arguing against this solution and for an alternative position:

> …in the US you only get a deduction for 50% of say certain travel and entertainment expenses, so we said, let's say a company wants to have big corporate retreat in January and it's going to cost a million dollars and they pre-pay most of that to the conference centre, the rooms and food and the drinks in December, so at the balance sheet of December 31 you have an asset, a pre-paid asset of a million dollars. Now when you actually hold the retreat, you are going to charge to expense that million dollars, but for tax purposes …you'd only deduct five hundred thousands, ….Is the tax base 500.000? That's what most of us thought. But then [X] said, I remember [X]:" No the tax base is a million." And we looked at him and said: "What? You are only going to get a deduction for 500.000!" He said: "No, …, if you're able to get a million dollars back by cancelling the meeting, then your tax basis is a million." (Mson)

To be noted is perhaps that this is basically the same example as was used in 1993/1994 to illustrate "why the balance sheet liability method is preferable to the income statement liability method" (940302BI, §32). Whereas the corresponding tax base does not appear to have been questioned at that point (pp201-2), it certainly was at this point:

> …, so then we got into a maybe the tax basis is maximum asset or the minimum liability … cause if you have control over having the meeting and deducting 500.000 or cancelling the meeting and getting essentially a deduction for a million, … , then how can you have a liability if it is

22 Paragraph 53 of E49 states that when the tax rate that applies to capital gains or losses differs from that which applies to other taxable income or expense, the rate used to measure deferred tax assets and liabilities reflects the expected manner of recovery of the asset. (950706AP1)

> voluntary?....but then people said: "Well, but that doesn't make any sense, …if you …intend to have the meeting, shouldn't you base the tax base on how you intend to recover the asset?" It seemed to make a lot of sense to a lot of people, but then … shouldn't be based on intention, so we went back and forth …on that… general question about intention versus control, … we realised that we really didn't understand tax base …. (Mson)

In the end, however, the Steering Committee was apparently swayed, agreeing that no deferred tax liability should be recognised when an enterprise can dispose of an asset without incurring a liability. A letter dated in January 1996 explains that the Steering Committee did recognise the inconsistency in assuming *the most tax-effective manner of recovery* in determining tax base, but assuming the *expected-manner of recovery* in determining tax rate, but

> …thought that this is logical on the grounds that the determination of tax base (and hence, of whether a deferred liability or asset exists) is separate from the measurement of that liability or asset. (960112L..)

The issue was apparently not raised or discussed by the Board in November 1995. This, however, may be related to its subdued presentation in the papers circulated prior to this meeting. The draft standard submitted to this Board meeting merely stated that:

> The tax base of an asset or liability is determined by reference to the rules established by the taxation authorities. For example: ….
>
> (d) when the cost of an asset cannot be deducted in determining taxable profit, but any proceeds of a disposal of the asset would not be included in the determination of taxable profit, the tax base is equal to the carrying amount; (950920DIAS, §18)

In addition, however, the accompanying note stated that:

> New guidance in paragraph 18(d) of the proposed Standard reflects the Steering Committee's decision that when the cost of an asset cannot be deducted in determining taxable profit, but any proceeds of a disposal of the asset would not be included in the determination of taxable profit, the tax base of the asset is equal to the carrying amount. **Therefore, no temporary difference arises where an enterprise can dispose of an asset without incurring a tax liability, even if the enterprise expects to recover the carrying amount of the asset through consumption, rather than on disposal**. (950920Ap4a, emphasis added)

In view of this it is interesting to note that an internal staff note from just after the November 1995 Board meeting suggests that the Steering Committee had wanted not to include guidance on situations where an asset may have two tax bases:

> on the grounds that they arise only in a limited number of jurisdictions and that International Accounting Standards do not, and should not, deal with problems that are not of general applicability. (951122L...)

The staff note, however, argued that it was wrong to ignore this issue

> despite its limited applicability, because the proposed Standard does not make it possible to determine the temporary difference in such cases in a way that is unambiguously consistent with the principles underlying the proposed standard. (ibid)

It also argued that the position in the November 1995 draft – that the determination of tax base should be based on assumption of *the most tax-effective manner* of recovery, but that the determination of tax rate should reflect *the expected manner* of recovery of the asset [I-12d] – could be considered to be illogical:

> it cannot be right to determine the tax base assuming one particular method of recovering the carrying, amount of an asset and to then apply a tax rate that could apply only if the carrying amount were recovered in a different way. (ibid)

Instead, the staff proposed that "both the tax base and the tax rate should be determined jointly in the way that leads to the smallest deferred tax liability or asset[23], rather than the smallest temporary difference" (ibid). This approach was motivated in terms of reflecting "the view (which is already in the proposed standard) that an enterprise has discretion to avoid anything other than the smallest liability".

In mid January 1996 the project manager submitted a number of proposed changes to the draft IAS, first to the Secretary-General and the Technical Director, and then to the previous Steering Committee. These proposals reflected the previous position, proposing to include a new standard paragraph explicitly addressing this issue:

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23 It is not explained why the smallest (rather than the largest) deferred tax asset should be assumed.

> The amount of a deferred tax liability or deferred tax asset may depend on the manner in which an enterprise recovers (settles) the carrying amount of an asset (liability). In such cases;
> (a) deferred tax liabilities should be measured at the lowest amount that the enterprise will be obliged to pay when the carrying amount of the asset (liability) is recovered (settled):
> (b) deferred tax assets should be measured at the lowest amount that the enterprise will be able to recover when the carrying amount of the asset (liability) is recovered (settled); and
> (c) if one manner of recovery (settlement) leads to a deferred tax liability and another to a deferred tax asset, no deferred tax asset or liability should be recognised.

The reactions to this proposal were mixed. While three commentators reportedly preferred the most tax-efficient manner of recovery, one suggested the expected manner of recovery. While three of the comments received did not comment this issue, another argued that

> The problem with how to deal with dual tax bases is not an easy one. Fortunately, the issue arises relatively infrequently; unfortunately, it seems to get a disproportionate amount of attention. (960129L…)

Noting also that the US standard "hardly acknowledges" the problem, it was suggested to

> try to make our approach clear and as simple as possible, without overemphasizing the matter or requiring complex calculations. (ibid)

The approach taken in the draft standard submitted to the November 1995 Board meeting was said to have been "understandable and relatively simple", if not "conceptually pure and consistent" (ibid). If a change was to be made, however, the respondent suggested adopting the approach considered by the Canadians, i.e. to assume the manner of recovery that maximises the deferred tax asset/ minimises the deferred tax liability:

> This is based on the concept that an obligation does not exist unless an enterprise has no means of avoiding it and that an asset exists provided an enterprise has the ability to realize it. (ibid)

Early February 1996, the project manager distributed a revised draft IAS to the former Steering Committee and some Board Representatives for comments. In this version the previously suggested standard paragraph had been replaced with a shorter paragraph clearly referring to the most-tax-efficient approach (as suggested in the previous quotation):

> In measuring deferred tax liabilities and deferred tax assets, an enterprise should assume that it will recover or settle the carrying amount of its assets and liabilities in the most tax-efficient manner. (960202DIAS, § 48)

A new guidance paragraph also clearly stated that the choice of tax rate should be "consistent with the method of recovery or settlement that is assumed in determining the tax base" (ibid, §50).

The IASC files contained twelve written comments to this draft standard. Several of these addressed this issue. Based on these comments the staff suggested that the proposals should be retained, but that this issue should be considered by the Board in March 1996. In fact, the staff note for this meeting identified this issue as the only issue for which a "substantive change" (960228AP10) had been made from the previous draft.

A staff summary of written Board comments received prior to this meeting noted that while two commentators agreed with the proposed most tax-efficient basis, one preferred the expected manner, another argued that there is no need for consistency and two that it is impracticable to compute most tax-efficient manner. One commentator also suggested a third alternative, arguing that in reality companies will use assets in *the most economically efficient manner* which is not necessarily the most tax-efficient manner.

Not surprisingly, this issue appears to have been much discussed in March 1996. One interviewee suggested that it was *the* big issue with regard to this project at this meeting. First the Board rejected the proposed most tax efficient approach with seven votes against, five for and four abstentions. Later, however, it agreed (though without a formal vote) that

> …deferred tax liabilities should be measured using the tax rate, and tax base, that will apply if the reporting enterprise chooses to recover or settle the carrying amount of its assets and liabilities in the manner that gives rise to the lowest tax liability (9603BMM).

A staff work-plan following this meeting notes that this decision is ambiguous in that it does not specify how deferred tax *assets* should be measured. It states, however, that the "discussion implied that the highest deferred tax asset should be recognised" (96XXXXNC). Hence, the staff concluded that the "Board's decision does not appear to require a substantive change to the 'most tax-efficient' proposal discussed in Brussels" (ibid). In preparing a revised draft Standard for the June 1996 Board meeting,

however, the staff replaced the expression "the most efficient manner" with the expression "the manner that minimises the amount of income taxes payable or maximises the amount of income taxes recoverable" (e.g. 960416DIAS).

In April the Staff mailed a number of questions to the various Board delegations. One of these asked if the Board delegations agreed with the enclosed revised material pertaining to this issue. Fifteen replies were found in the IASC's files; several of these objected to *the most tax efficient basis*, preferring instead the *expected manner of recovery* approach.

Four Board Members also commented this issue prior to the June 1996 meeting, two of which suggested the use of the alternative *expected manner of recovery* approach. It is perhaps especially noteworthy that one delegation can be seen to have turned somewhat on this issue:

> While we responded positively to the provisions of paragraphs 42 to 44 in our April 29, 1996 letter, we have subsequently learned that several of those in [the country] with whom we consult have reservations with regard to using the optimal tax rate rather than the rate expected to be applicable. We look forward to hearing the views of the other Board members on this matter. (960606C…)

Following this, the June Board voted for a revised position, more in line with the original staff suggestion (expected manner of recovery). Thirteen votes in favour, two against and one abstention suggest a broad, but not unanimous, consensus on this issue.

Drafting of the standard

As already noted, prior to the July 1995 Steering Committee meeting the staff argued that comments received on E49 suggested that many commentators did not understand the proposals in the draft. The staff thus proposed extensive structural and drafting changes to the text, the draft IAS circulated prior to the July meeting looking quite different from E49.

The Steering Committee, however, rejected the suggestion to restructure the standard.[24] Subsequent versions of the draft IAS thus resembled E49 much

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24 This gave rise to a certain amount of friction between the Steering Committee and the Staff. Explanations provided for the irritation focus on the staff having (1) taken liberties, (2) made unnecessary changes and (3) caused the Steering Committee

more. The "need for clear and concise drafting" was, however, one of three issues that reportedly led to "much debate" in November 1995 (IASC, 1995b). It was particularly emphasised that the rules had to be clear. This reasoning is also reflected in a concurrent article in *IASC Insight* explaining that "clear and concise drafting is essential" because "(t)he proposed Standard could lead to radical changes for some enterprises" (IASC, 1995b). One interviewee suggested that the emphasis on drafting came after, and perhaps as a consequence of, the renewed discussion of the choice of the balance sheet liability method:

> …what happened… … a number of the people … not native English speakers, started then to say: Well this is, really is awfully difficult to understand …then other people said: it's kind of confusing and it is difficult. And I remember [Y] saying: … this is a new concept for a lot of the people in the world and … we at the Board have been immersed in this for the last couple of years, so we understand it but to communicate, we've got to a document that is very, very clearly written… No one had any specifics, …. …. but they couldn't tell us what in the document wasn't clear (Mson)

With regard to this topic a staff note from just after the Board meeting states that "the Board discussion indicated that the draft is currently too difficult to understand" (951122LCC). While this may seem well in line with the above suggestions, one of the interviews suggested a somewhat different interpretation:

> …not so much that there was discussion of the drafting really, but I think it was still clear at that meeting that people didn't understand the concepts well enough at that stage to even be able to discuss some of the issues that well and so I think it was partly a demand from them to have a document that expressed the things more clearly and I think it was partly a concern that [] felt that people weren't reading the document and understanding it well enough to be able to discuss some of the issues… (Gson)

General suggestions for improving the structure and/or drafting of the proposed Standard were requested from Board Members in December 1995. Although a number of comments were received, they did not provide significant guidance. In fact, although many argued that the draft text was unsatisfactory, few or no-one, specified what was not clear or offered suggestions of how to improve the drafting.

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members more work when what they really wanted was to (finally) finish this project.

As noted above, the Staff's suggestions for improving the understandability of the standard in early 1996 included to look again at the definition of tax base. Amendments prior to the March 1996 Board meeting also included introducing (numerical) examples in the text[25]. Following this, the issue seems to have faded.

8.3.5 Exceptions

E49 proposed four exceptions to be made to the general rule to recognise deferred tax on all temporary differences, namely for temporary differences arising on:

- investments in subsidiaries, associates and joint ventures [I-8];
- goodwill (and negative goodwill) [I-16b];
- long-term assets (other than an asset acquired in a business combination) [I-21]; and
- (non-taxable) government grants [I-22].

After the comment period on E49 these exceptions were in focus, following comments that

> the balance sheet liability method loses credibility in E49 by the large umber of exceptions to the general principle, which cover most of the items which constitute temporary differences but not timing differences (950706AP).

With time two main themes developed in the discussions vis-à-vis these issues. First, the discussions relating to the exceptions for non-taxable grants [I-22] and certain long-term assets [I-21] were re-framed, focusing instead collectively on temporary differences arising on initial recognition and whether or not "grossing-up" should be required for the related deferred tax [I-19]. A new sub-issue also emerged from these discussions: the treatment of temporary differences arising when split accounting is used in the accounting for compound financial instruments [I-23]. Second, the exception relating to investments in subsidiaries, associates and joint ventures [I-8] was also extensively discussed.

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25 A note accompanying the February 2nd version of the draft standard states that these examples had been included "in manner similar to the examples in E52, Earnings per Share". Some of these examples were new, but some were also based on previous examples used in the background paper distributed alongside E49.

Exceptions for temporary differences arising on initial recognition and the issue of grossing up [I-16b][I-21][I-22][I-19]

Three of the four exceptions in E49 related to temporary differences arising on *initial recognition* of specific items:

- goodwill (and negative goodwill) [I-16b];
- long-term assets (other than an asset acquired in a business combination) [I-21]; and
- government grants [I-22].

Prior to the July 1995 Steering Committee the Staff proposed to delete the third exception (that relating to government grants), replacing it with an explicit requirement to add the resulting deferred tax benefit to the carrying amount of the grant, i.e. with a grossing-up requirement [I-19]. The staff also considered deleting the second exception (that relating to certain long-term assets), arguing however, that although this might be "the appropriate conceptual treatment" (950706AP1), the exception be retained based on cost-benefit considerations:

> The staff consider, conceptually, that an enterprise should recognise a deferred tax liability with a corresponding increase in the carrying amount of the long-term asset acquired. Nevertheless, the staff believes that the costs of such an approach would exceed the benefits because the necessary computations may be complex and because users may find the resulting information confusing and difficult to interpret…. (950706AP1)

Instead the staff proposed to extend the second exception to also include long-term assets acquired in a business combination [I-16a][26]. As a result, the first exception (goodwill) was deemed unnecessary; the draft standard submitted to the Steering Committee in July 1995 thus contained one exception only – relating to the initial recognition of long term assets.

The Steering Committee agreed with the first of these proposals (deleting the exception relating to government grants). In addition it also agreed to delete the second exceptions in E49, i.e. that for *certain* long-term assets. In the period between the July Steering Committee meeting and the ensuing November 1995 Board meeting there followed a brief discussion whether a separate exception was needed for goodwill (as in E49). It was suggested

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26 As noted on page 219, when E49 was released, this was identified as the one situation for which the balance sheet liability method gives rise to significantly different accounting.

that such an exception was not needed "because the tax base of goodwill on initial recognition will almost invariable be equal to its carrying amount" (950808…). Another participant, however, argued that - although there had been a lot of confusion over the tax base of goodwill – its tax base is nil:

> If the group will dispose of the goodwill (and not of the investment) there will be no (explicit or implicit) deduction in determining the taxable gain or loss. I agree with you that it is not probable that the group can dispose of its goodwill without disposing of its investment, but that is not the question. The question is: what tax deduction would there be if the goodwill was totally or partially disposed of. The answer is, in most tax jurisdiction: nil. (950809L…)

A separate exception relating to such goodwill was thus retained in the draft standard submitted to the November 1995 Board meeting.

These proposals were criticised by at least five Board members prior to this meeting. While two comments received prior to the Board Meeting only stated objection to the proposed grossing-up requirement, one commentator argued that "too great a prominence is given to" this requirement (951025C…). Another response argued that it is "too artificial" leading "to accounting as if an item were taxed or tax deductible while in fact it is not" (951019C…). A similar perspective on why the grossing-up requirement was resisted was offered by one interviewee:

> [X] from [Y] was … adamant that we couldn't gross up. He says: You cannot record in the balance sheet a cost of an asset in excess of its cost. And I said: But [X], this is part of the cost, you're assuming a liability. But he just would have none of that … intellectual construct. He said: No, you paid a hundred for it, it cannot go on your balance sheet for a hundred forty. I said: But you paid a hundred to that guy and, and you also owe forty to the government. No, come on, he said, that's a … that's a bunch of intellectual bullshit, you paid a hundred, you cannot put in on the balance sheet for more than a hundred. So he wouldn't accept the gross-up and he was very influential Board Representative … well he was actually a technical advisor ... (Mson)

Arguments against the proposed changes also included that it was inappropriate to make such fundamental changes to the proposals in the ED without re-exposure:

> We must, therefore, put on record that we do not agree with the fundamental new orientation of the proposed new draft. It almost does not deserve anymore the title "Income Taxes" and would rather have to be called, e.g. "Tax effect valuation of the balance sheet". We think that,

> if this revised standard would meet Board approval, a new Exposure Draft should be published for comments. The changes introduced, in addition to those commented upon by commentators of E49, are far too important and fundamental that the Board could approve this standard for implementation. (951024C…)

This issue appears to have been much discussed in November 1995. In the end, however, the Board concurred with the Steering Committee's proposals. However, this was only with "a fairly narrow majority" of nine votes in favour, five against and one abstention (e.g. 951213LCM).

At this point the Staff intervened. A staff note following the Board meeting expressed surprise that the Board had agreed to the proposed grossing-up treatment, arguing that although it should apply rarely, it made the standard more difficult to sell to preparers and that any benefits of grossing-up may not be justified by the cost (951122L…). The note also suggested to contact one Board Member that had expressed support for grossing-up during the meeting, suggesting to find out whether this change was something that this delegation "would want, or merely ….. be prepared to accept" (ibid). If the specific delegation was indifferent, the note suggested that the Board should be asked "to reassess whether the additional complexity is justified" (ibid).

In line with these suggestions a letter was sent to this Board Member in January 1996. The response letter indicated a change of mind:

> In this letter, I would like to address the issue of grossing up since I defended the practice at the Board meeting in Sydney. At that meeting I expressed the view that grossing up is logical because it would put all assets and liabilities on a pre-tax basis. After a great deal of thought, a discussion with [X] at the FASB, and an exchange of views with [Y], I have changed that view. I have concluded that the economic situation of a company is probably more transparent … if deferred taxes are not recorded at the date of acquisition in any situation (purchase business combination, purchase of a single asset, government grant, revaluation, etc.) (960322…)

The staff note to the March 1996 meeting did not especially focus on the issue of grossing-up[27]. In relation to the issue of dual-tax bases (see above), however, it noted that

> If the Standard requires measurement assuming the most tax-efficient manner of recovery, such initial temporary differences are likely to be extremely rare. However, if the Standard requires measurement assuming the expected manner of recovery, an initial temporary difference is likely to rise whenever an enterprise acquires a depreciable asset for which depreciation is not deductible for tax purposes. (960228Ap10, §27)

Following this three of ten written comments received prior to the March Board meeting addressed this issue. In fact one delegation explicitly stated that its final vote on the Standard would "very much depend on a satisfactory solution for this problem" (960215…). The Board then unanimously agreed to delete the grossing-up requirement. No explicit exception was re-instated with the argument that temporary differences arising on initial recognition (other than in cases with non-taxable government grants) would be extremely rare (because of the position on dual tax bases). With regard to the one situation where such temporary differences were not expected to be rare – the situation of non-taxable government grants [I-22] – the staff was requested to "give further consideration" to this issue (9603BMM).

In preparation for the ensuing June 1996 Board meeting the staff reasoned that there were, in principle, only three possible approaches with regard of the issue of government grants:

(1) to require grossing-up;
(2) to insert an exception, or
(3) to provide "guidance which indicates either that there is no temporary difference or that any temporary difference would be nil" (960412..).

The "simplest way" to provide such guidance was suggested to be by adding an example to the standard:

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27 It did, however, specifically ask for guidance on five other issues: (a) the definitions of the tax base and of temporary differences [I-25a][I-26][I-25b]; (b) problems caused by dual tax bases and dual tax rates [I-25b]; (c) investments in subsidiaries and associates and interests in joint ventures [I-8]; (d) fair value adjustments and revaluations [I-10][I-16a]; and (e)presentation of income taxes in the balance sheet and income statement [I-13]. (960228Ap10)

> A machine has a carrying amount of 900, after deducting a government grant (net of amortisation) of 100. For tax purposes, the depreciable amount of the machine is its cost before deducting the grant and depreciation rates are the same as those used for financial reporting purposes. The government grant is not taxable. The tax base of the asset is 900. If the enterprise chooses instead to present the grant as deferred income (see IAS 20, Accounting for Government Grants and Disclosure of Government Assistance), the carrying amount and tax base of the machine are both 1,000 and the carrying amount and tax base of the deferred income are both 100. (ibid)

The first approach was suggested not to be acceptable to the Board and the conceptual validity of the third was questioned. The Staff thus suggested the second alternative – i.e. making an exception.

Written Board comments on this issue prior to the June meeting were diverse, one respondent arguing that the grossing-up requirement for non-taxable government grants should be reinstated and two respondents expressed support for the proposed exception.

Following the decision to adopt the *expected manner approach* to dual tax bases, however, the Board agreed in June 1996 that the revised standard should include a general exception for temporary differences arising on initial recognition of assets and liabilities (except those relating to business combinations). This exception was thus not limited to *long-term* assets and liabilities as in E49.

Compound financial instruments [I-23]

Parallel with these discussions a new sub-issue emerged: how to deal with temporary differences arising on initial recognition of compound financial instruments when split accounting is used [I-23].

The draft standard submitted to the Board November 1995 Board included for the first time guidance on the treatment of compound financial instruments. A new paragraph stated that accounting for compound financial instruments in accordance with IAS 32 may give rise to a temporary difference on initial recognition and that (a) a deferred tax liability should be recognised in such cases and (b) that a corresponding adjustment should be made to the carrying amount of the equity component, without grossing-up. This addition appears to be a response to two comments received on a draft

revised standard circulated after the Steering Committee meeting to the Steering Committee members.

Although some issues were deferred at the November 1995 Board meeting, the Board agreed (with eleven votes in favour, one against and two abstentions) with the proposed treatment relating to this issue (9511MBMa).

Following this, this issue appears not to have been significantly discussed until the period following the June 1996 Board meeting, reappearing in the wake of the (new) general exception relating to temporary differences arising on initial recognition (see previous sub-section). The Staff appears to have concluded that the new exception required a change in position on compound financial instruments. In the July 8th version of the draft revised standard the paragraph relating to this issue was accordingly deleted and the guidance in Appendix 1 to the standard was amended, stating explicitly that "paragraph 16(b) of the Standard prohibits recognition of the resulting deferred tax liability".

Three respondents commented this issue. One delegation argued that the draft did not reflect the Board's intention:

> The exception in paragraph 16(b) was designed to avoid the need to record assets or liabilities at grossed-up or grossed-down amounts. Recognizing the deferred tax liability associated with convertible debt does not involve grossing-up or grossing-down any asset or liability; the deferred tax adjusts the carrying amount of the warrant recorded in equity. We believe it is important to the integrity of the income tax accounting model to keep exceptions to a minimum and to have clear, consistent reasons for those exceptions that are made. Therefore, the position taken in the current draft with respect to the temporary difference associated with convertible debt should be changed back to the position in the Stockholm draft. (960801C…)

Another written Board comment suggested that the wording relating to the exception for temporary differences arising on initial recognition "is too general", noting a "fear that the exceptions might be construed to include … (l)iabilities arisen from issuing compound financial" (960730C…). A third comment simply suggested that the wording in the Appendix 1 be reverted to that in the previous draft.

Staff comments to these comments, in turn, included that the exception for initial temporary differences would become very complex if compound financial instruments were excluded. They also argued that it is not clear if compound financial instruments give rise to temporary difference and, if so, "whether that temporary difference is attributable to the liability component or to the equity component" (960813…). In light of this, the staff proposed no change.

This, in turn, led to further comments by two respondents, one stating that the delegation continued "to take exception with the staff proposal", arguing that:

> The rationale given by the staff - doubt about the existence of a temporary difference, doubt about which element the temporary difference relates to, and complexity in drafting - are not persuasive. The former Steering Committee considered this issue, after consultation with experts on FAS 109, and concluded that a temporary difference does, indeed, exist and that it is attributable to the equity component. There should, therefore be little remaining doubt. As to complexity of drafting, … , the Board should not allow such difficulties to cause it to compromise sound principles. (960903C…)

The other Board delegation wrote that it did not "understand how the introduction of the exception for initial temporary difference could induce that the treatment of compound financial instruments should change compared with the one that was in the draft presented to the Board in Stockholm" (960830C…).

In view of these comments the staff papers for the September 1996 meeting noted that "some" Board members had argued that deferred tax should be recognised in relation to compound financial instruments and that this implied that "there should be an exception to the exception" (960912Ap5). While on the one hand arguing that the insertion of a requirement to recognise deferred tax for these cases "would make the Standard excessively complex ", the staff note also noted that the objecting Board Members "note that US specialists on the balance sheet liability approach generally consider this treatment to be correct" (ibid).

Before approving IAS 12 revised, the Board decided, contrary to the staff proposals, but in line with the position in earlier drafts, that an enterprise should recognises deferred tax assets or liabilities resulting from the issuance

of compound financial instruments and charge the resulting deferred tax to the carrying amount of the equity component of that instrument. The minutes from the meeting indicate 12 votes in favour of this decision, two against and two abstentions.

Investments in subsidiaries etc. [I-8]

E49 proposed to make an exception for deferred tax arising on investments in subsidiaries, associates and joint ventures when

> (a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
> (b) it is probable that the temporary difference will not reverse. (§41)

This exception was retained in the draft IAS submitted by the staff to the July 1995 Steering Committee meeting. However, the accompanying staff note explained that this was only "reluctantly" because "the Board has consistently supported this exception" and "comment letters from preparers strongly support the exception, which is consistent with current practice in many countries" (950706AP1). In addition, the Staff note reported that "some" commentators to E49 believed this exception to be inconsistent with the IASC's conceptual framework, arguing that "if it is not probable the temporary difference will reverse, then the investment does not qualify for recognition as an asset" (ibid). In fact, two commentators appear to have raised this concern:

> By definition, all temporary differences eventually reverse. Accordingly, as written in the proposed statement, the criteria in paragraphs 41(b) and 46(b) could not be met. (950526C…Accounting firm)
>
> Paragraphs 41 and 46 permit nonrecognition of deferred taxes for temporary differences attributable to investments in subsidiaries, associates, and joint ventures if "it is probable that the temporary difference will not reverse." That condition is impossible to meet. (950531C…National standard setter)

This is fundamentally the same concern that was raised to the December 1993 draft ED and prior to the November 1993 Board meeting (see pp. 189-190.) Now, however, the staff argued that this is a "valid concern" and recommended the Steering Committee to

> ask the Board to consider what implications arise for consolidation accounting and for the equity method from the conceptual inconsistency between the two assertions that:
> (a) an enterprise will recover the carrying amount of investments in subsidiaries and associates and interests and joint ventures and
> (b) the resulting taxable temporary differences will not reverse. (950706AP1)

With regard to this issue it is also noted that the staff memo also recommended the Steering Committee to consider deleting the first of the proposed criteria in E49, i.e. that of control. This suggestion followed some commentators to E49 arguing, on the one hand, that "calculation is purely hypothetical and is often extremely complex, at no benefit to users" and, on the other hand, that "the condition requiring control is superfluous because it is already covered by the requirement that it is probable that the temporary difference will not reverse" (ibid).

When the Steering Committee met in July 1995 it agreed with the proposal to retain the exception in E49. It also agreed to add the expression "in the foreseeable future" to the criterion that it is probable that the temporary difference will not reverse, thus dealing with the conceptual criticism noted above. It did not, however, delete the requirement of control.

Following extensive and detailed discussions in November 1995 the Board reportedly agreed with most of the Steering Committee's proposals. In fact, the only significant change from these proposals was to add a third criterion to this exception (twelve votes in favour, two against and one abstention). The Board also agreed to insert a reference to the "manner" of timing in the first criterion and the expression "in the foreseeable future" in the second criterion[28]. As a result this exception thus read:

> **An enterprise should recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries and associates and interests in joint ventures except when:**
> **(a) the parent, investor or venturer is able to control <u>the manner or</u> timing of the reversal of the temporary difference; ~~and~~**
> **(b) it is probable that the temporary difference will not reverse in the foreseeable future; <u>and</u>**

28 The documents suggests that the Board considered whether this criterion should be retained; the minutes from this meeting list eight votes in favour and five against keeping this criterion.

> **(c) it is impracticable to estimate whether a tax cost other than nil will apply when the temporary difference does ultimately reverse.**
> (960112IAS, §34 compared with 950920IAS, §41)

Following this the Staff intervened. A staff note from January 1996 suggests that the Board may not have "really understood the impact" of the added restriction to the exception (c), suggesting also that this criterion would be "strongly opposed by preparers" (960112L…). Because of this it also suggested that this issue should be "one of the major changes on the agenda in March" and that the staff should write an article about it in the IASC's newsletter (ibid). Said and done under the title – Subsidiaries – A Taxing Problem – the staff explained that as a result of the new addition many parent companies will have to recognise a deferred tax liability (unless it is clear that no income tax will be payable regardless of the manner or recovery) (IASC, 1996a).

Following this, developments took another twist, the Staff note for the March 1996 Board meeting suggested that the separate exception for investments in subsidiaries and associates and interests in joint ventures be deleted, arguing that was unnecessary given the proposed position on how to deal with situations with dual tax bases and dual tax rates (see above).

Comments received prior to this meeting suggests differences in opinion vis-à-vis this issue. One respondent argued for an exception. Another argued for an exception for investments in associates and joint ventures (but not subsidiaries). A third opposed the proposed change and two suggested that the proposed change may need re-exposure. Another respondent, finally, suggested that the new criterion be deleted, because it will never be fulfilled[29], or amended along the lines of it being "impracticable to estimate the tax cost that will apply" (960314L…).

During the March 1996 meeting the Board is reported to first have rejected a proposal that the third criterion should be deleted with nine votes against, four for and one abstention. Following this, the Board is reported to have decided (with ten votes in favour and two against) that a separate exception

29 "As nobody could ever pretend that the tax cost will be other than nil, we can as will drop paragraph 35 a and b." (960314L…)

is not needed (as suggested by the staff) and should therefore be deleted, but that

> …further guidance is needed for cases where an enterprise has no means of avoiding the payment of income taxes when it recovers the carrying amount of its investment, but it is impracticable to estimate the amount that will be payable. (e.g. 960412L…)

The Board did not discuss the content of that guidance, leaving it to the staff to come up with a suggestion for the next (June) Board meeting. Such a suggestion appears to have been circulated to the Chairman and the US Member of the former Steering Committee in early April 1996. In a partial redraft of the standard new guidance had been introduced stating that, in some cases, it may be difficult to determine the tax consequences of recovering the carrying amount of an asset and that, when it is not possible to determine precisely where the lower end of the range falls, the deferred tax liability should be measured "at a reasonable estimate of the lower range" (960403L…). It is also stated that in "extremely rare circumstances … it may be impracticable to estimate with reasonable reliability where the lower end of the range falls" and that in such cases, an enterprise should recognise no deferred tax liability (ibid).

Both respondents replied within a week. A fairly innocuous comment was that, in relevant cases, it should be disclosed that it is impracticable to estimate with reasonable reliability where the lower end of the range falls. Another more substantial comment was that the real problem is not that it may be *impracticable*, but that the calculations can be *extremely complex*. Asking if progress is made if "a very subjective judgement (impracticability)" replaces a "much less subjective one (probable of reversal in the foreseeable future)", it was suggested to follow the example FASB and make a wider exception (960411L…).

In response, the Staff reasoned that the Board had not really discussed what it wanted, noting particularly that it was not clear "whether Board members intended this guidance to apply only in exceptional cases … or more frequently …." (960412L…). The Staff further reasoned that "the choice is between saying that 'impracticability' will be highly exceptional and going back to a separate exception" (ibid). Following this it was suggested to keep the reference to "exceptional" in a proposal to be circulated to the Board for comment, but to discuss the objections in a covering letter.

Said and done, further guidance on this issue (amongst others) was sought from the Board in a letter dated April 16th 1996. The enclosed material on investments in subsidiaries and associates and interests in joint ventures was very similar to that previously circulated. However, in response to the first comment, the text now proposed that, in cases where it is "impracticable to estimate with reasonable reliability where the lower end of the range falls", the enterprise should disclose "both the fact that it is impracticable to estimate with reasonable reliability where the lower end of the range falls and the aggregate amount of the temporary differences concerned" (§49 of draft dated April 16th 1996).

Most responses to this request for comment stated agreement with the proposed material. However, two objected to the proposals relating to this issue and one suggested "take a fresh look at this issue" noting that the proposals not only had "come a very long way from E49", but had moved "in the opposite direction from what the comment letters requested" (960429C…). Again two respondents argued that the new position on this issue called for re-exposure.

To be noted is perhaps also that the request for comments included a number of specific questions. One of these was if it will be impracticable to estimate the lower end of a range with reliability only in extremely rare cases. Responses to this question varied, some respondents stating that they did not know. The answers to a question if, and if so how, guidance should be given were similarly diverse. While at least three respondents argued that no guidance was needed, at least two argued that guidance was preferable. The most memorable comment received in relation to this issue, however, argued that the proposed accounting rules would lead to a very "unsatisfactory scenario":

> Thus not only do we drive a further wedge between management and financial reporting, but also provide the following unsatisfactory scenario:-
>
> - management produce their numbers for managing the business, which ignore the intended standard.
> - they then incur the cost and potential confusion of changing these numbers to the published requirements.
> - they are then told users need supplementary information to enable them to adjust the numbers back to a result more like the management accounts, so as to predict cash flow. (960525L…)

In view of the diverse comments received, the Staff did not make any significant changes to the material submitted to the June 1996 Board meeting in respect of this issue. The staff note to this meeting stated that various views had been received and suggested that the Board should either:

(a) retain the approach in the current draft, with guidance stating that it will be impracticable to determine where the lower end of the range lies only in extremely rare circumstances; or
(b) revert to the exception proposed in E49. (960515Ap6)

The Board Papers for this meeting also included a letter from a Board Representative stating "serious reservations on the direction the IASC is taking in respect of deferred tax" (960525LP+). The "rigid application" of the balance sheet method, particularly in respect of retained profits of subsidiaries and associates, were particularly said to cause great concern.

Written comments prior to the June meeting pertaining to this issue were again diverse. However, four commentators suggested that an exception be made for temporary differences arising on investments in certain subsidiaries etc (i.e. alternative b above). When the Board met in June 1996, this is also what it decided, i.e. to reinstate a separate exception (similar to that in E49) for certain investments in subsidiaries, associates and joint ventures. Two conditions were agreed on:

(a) that the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and
(b) that it is probable that the temporary difference will not reverse in the foreseeable future.

These are the same two criteria agreed on before introducing the third criterion in November 1995. Fifteen votes in favour and one abstention are listed for this decision, indicating a very large majority in favour of this decision.

Undoubtedly, the Board spent a considerable amount of time discussing this issue during this period. However it is nevertheless surrounded by a sense of confusion. Although this issue was reportedly much discussed in November 1995 and March 1996, it seems as if a broad understanding of this issue was not achieved. In line with this one interviewee suggested that "(n)o-one ever really cared" or understood this issue (Mson). Yet this was one of the issues that probably (potentially) had the most practical importance.

8.3.6 Disclosures

Of the key issues listed initially now remains one disclosure issue: the suggested requirement in E49 to disclose a numerical reconciliation of the relationship between tax expense and accounting profit:

> 70. The following should also be disclosed separately: …
>
> (d) an explanation of the relationship, including a numerical reconciliation, between tax expense included in the determination of the net profit or loss for the period and accounting profit when there is a material difference between tax expense included in the determination of the net profit or loss for the period and the amount that would arise by applying applicable tax rates to accounting profit. When an enterprise is unable to determine an applicable tax rate, a numerical reconciliation need not be disclosed but the reason why an applicable tax rate cannot be determined should be disclosed; and (941013ED)

A staff summary of comments received note that 23 (of 74) comment letters on E49 commented this proposal (960912Ap5), a number of these objecting to the proposals (see figure 8.10). A note to the July 1995 Steering Committee meeting listed the following arguments:

> (a) the reconciliation would be misleading in the case of multi-national groups, because it would convey the impression that some relationship exists between the various tax rates; and
>
> (b) the information would be costly to develop and would provide little benefit;
>
> (c) the tax reconciliation could require disclosure of commercially sensitive information or reveal sensitive tax issues agreed, or under negotiation with, the tax authorities.
>
> (d) the reconciliation should be required of publicly held companies only; and
>
> (e) taxation rules are particularly complex for insurance companies and that a reconciliation would be confusing and unhelpful to users, particularly for long term business for which the tax must be allocated between shareholders' and policyholders' profits.
>
> (950706AP1)

The staff was not swayed by these arguments, proposing to the July 1995 Steering Committee meeting to retain the requirement:

> The staff agrees with commentators who believe that a numerical reconciliation is essential. It also recommends that the Steering Committee should consider adding requirements for cases, which the staff

> believe will be rare, when an enterprise is not able to determine an applicable tax rate. Appropriate requirements might be for:
> (a) reconciliations between year-to-year effective rates or between a weighted average effective rate and the current effective rate of total tax, with a brief description of how such a rate was determined; and
> (b) disclosure of the rate used if it is not the domestic tax rate."
> (950706AP1)

To be noted is perhaps that an adjoining summary of comments on E49 specifies that "FASB staff have been informed by financial analysts that a numerical reconciliation is essential. SEC would require it in all cases" (950706Ap2).

No. of commentators	**Comment**
2	Require neither numerical reconciliation nor narrative information
13	Require narrative information, but not a numerical reconciliation
4	Require narrative reconciliation, except for certain enterprises (multi-nationals; non- listed; insurance enterprises)
3	Require numerical reconciliation
1	Require, not encourage, explanation of changes in relationship between tax expense and accounting profit compared to previous accounting period.

Figure 8.10 Summary of comments received on E49 pertaining to the proposed requirement for a numerical reconciliation between tax expense and accounting profit. Based on information in (960912Ap5)

The Steering Committee, however, was swayed by the comments, proposing to the November 1995 Board to require only an explanation of the relationship between tax expense (income) and accounting profit. In November 1995 the Board agreed with this proposal. In March 1996, however, it agreed - without prior discussion and without a formal vote - to incorporate a number of changes to the disclosure requirements (including to require a numerical reconciliation) suggested by one Board delegation.

In relation to this issue the staff note to the following Board meeting noted both the way these changes had been agreed and that some of the suggestions contradicted earlier Board decisions (960515Ap6). Although at least one Board delegation objected, no change seems to have been agreed vis-à-vis this issue in June 1996. Voting records, however, reveal that this was with a narrow majority with only ten votes in favour, five against and one abstention (960912Ap5).

Following this comments received on the draft standard circulated after the June meeting initiated a renewed discussion of the requirement to disclose a numerical reconciliation. An internal staff note from mid August reports that one of the objecting Board Members had been contacted to discuss this issue and that this had led to the realisation that they did not object to the reconciliation requirement per se, but to the requirement to reconcile to a single tax rate. The note also states that an example (of a disclosure in the annual report of a multinational company) provided by this Board Member in a comment letter to the July draft "reconciles the actual tax charge to the expected tax charge", that the "expected tax charge is based on the actual tax charge in each jurisdiction, rather than the domestic rate (or some weighted average)" and that this disclosure complies with FASB requirements (960816L…).

Shortly following this another internal staff note encloses "a suggestion for amending the required numerical reconciliation to take account of the concerns of the [identified Board] delegation" (960905L…). The main change is the addition of the following guidance concerning how to identify the applicable tax rate:

> However, for an enterprise operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction. (960905L…)

A few days later a copy of the proposed change was faxed to a number of people[30]. An opportunity to comment was given, but the timing was very tight since the final draft standard was scheduled to be sent to Board members during the same week. No evidence of any responses has been

30 Three different, but similar versions of the fax have been found addressed to: four Board Representative (representing 3 Board Members), several financial analysts, the Chairman and US member of the former Steering Committee. One of these explicitly asked the Board delegation if the proposed change would enable it to support the requirement for a numerical reconciliation.

found. The material submitted to the September Board meeting incorporated these proposals, the accompanying staff note highlighting this fact and asking the Board to confirm the replacement of the requirement to reconcile to a single tax rate with a requirement to reconcile to an expected tax charge based on the actual tax charge in each jurisdiction. The minutes from the meeting indicate that 15 votes were counted in favour of this proposal (and one abstention).

8.3.7 Due process considerations [I-41]

Just as in the previous period, the process itself also gave rise to controversy during this final period. On the one hand, there was a discussion of what changes could be made to the proposals in E49 without requiring re-exposure. For example, following the July 1995 Steering Committee meeting, one committee member responded that he could not recommend to the Board to accept the draft standard without re-exposure because too many changes have been made to points which were not criticised by the majority of commentators (950829L…). In fact, this very issue seems to have been raised at all three Board meetings in 1996, being specifically addressed in the staff papers for both the June and September meetings. In September 1996 the Board also specifically agreed that the changes made since E49 were not sufficient to require re-exposure, counting thirteen votes in favour and three against (9609M).

On the other hand, a number of other concerns relating to the process were also raised. For example, one Board delegation particularly objected to the way in which the Board in March 1996 agreed to include amendments to the disclosure-section suggested by one Board delegation (see previous sub-section). Another example is that, prior to the November 1995 meeting, one Board Member argued that the Board should not aim to approve a final standard "considering the big number of changes since the exposure draft and considering the short notice the Board members were given to study the material before the meeting" (951018…). A similar concern was raised by another Board Member prior to the June 1996 meeting:

> The …delegation is pleased to submit its comments on certain of the technical items on the Board's agenda for the June 1996 meeting in Stockholm. We are not able to submit written comments on all of the technical items because of the timing of our receipt of the materials and our process by which we consult with others in [country] on the agenda items. ….

> On a more general note, we believe it would be most useful if the staff would discuss with the Board, at an appropriate time at the Stockholm meeting, the entire process by which materials are sent to Board members in advance of the meeting to ensure that such procedures meet Board members' needs. We are concerned that there seems to be an increasing amount of material and a decreasing amount of time given to Board members to prepare. (960606C…)

In this context it is also noted that a characteristic of this final period is the extent to which the Staff (the Project Manager) requested further guidance from Steering Committee Members, Board Representatives and others (particularly individuals associated with various national standard setters) between the various meetings. Several such instances have been referred to in the previous text. For example, following the July 1995 Steering Committee meeting the Project Manager sought input on how to amend the definition of tax base [I-25a] from a select circle of such individuals (see p. 239). Three other such references are found in the account of developments relating to the treatment of dual tax bases (pp. 251, 252, 254). Other instance include when drafting comments were requested in December 1995 (p. 255) as well as when the staff contacted one Board Representative regarding the issue of grossing-up (p. 259) and another with regard to the disclosure issue (p. 272).

A major reason for seeking further guidance between meetings seems to have been to speed up the process. Although the adopted approach seems to have lead to a more continuous work process, it also gave rise a new sub-issue of due-process considerations. For example, prior to the September 1996 Board meeting one delegation wrote:

> We have read all of the letters received from Board delegations with respect to the draft Income Taxes standard and the Staff's response to those comments, included in your mailing of August 13, 1996. Although we agree, for the most part, with the proposed Staff responses, there remains several issues that need to be considered further. It may very well be the case that some or all of these issues will need to be discussed at the Board meeting in Barcelona. **The credibility of the Board's process and procedures is crucial. A final standard should not be issued unless all issues have been discussed and resolved by the Board at a meeting, not simply through a letter-writing process**.
> (960903… emphasis added)

8.3.8 Perspectives on the process

The process leading up to the approval of the revised standard took just over a year. During this time the IASC Board discussed draft standards at four meetings. The Board's discussions of this project in this period are reported to have been both lengthy and heated; the existence of sufficient support for the approval of a revised standard based on the ED being far from certain. A letter written prior to the November 1995 meeting speculated that, at that point, as many as seven Board Members had "major concerns" about the proposals (950911L). The position of another two was said to be "uncertain", leaving only six members believed to be without "major concerns" (ibid).

Following extensive and detailed discussions in November 1995 the Board "confirmed its continuing support for the broad principles embodied in the proposed Standard" with the required minimum number of votes[31] and "expressed the intention of moving to a final vote on the proposed Standard in the first six months of 1996" (9511M…). As already noted a similar vote was called in March 1996, where 13 votes were counted in favour of the fundamental concepts in the draft and going forward with a standard (3 against)[32]. In June 1996 the Board similarly "confirmed that it supported the revised draft of the Standard in principle" (with 11 votes in favour) (9606BMM). Nevertheless, comments received in the summer of 1996 indicated that at least four Board members were likely to vote against a standard based on the July draft, leaving the approval of a standard in September somewhat uncertain. In September 1996, however, a revised IAS 12 was approved with 13 votes for and 3 against.

In similarity with the period during which E49 was developed it is suggested that the developments described in the previous sections can be understood in terms of the developments of, and interplay between learning, deal-making and executive concerns.

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31 11 votes for, three against and one abstention. In July 1995 the composition of the IASC Board had changed. The number of Board members also increased to fifteen. (See figure 4.2 p. 92.)

32 In 1996 the number of Board Members increased to sixteen as the International Association of Financial Executives Institutes (IAFEI) took up the third seat available of other organisations.

Learning

The developments during this period can, to a large extent, be explained in terms of both individual and collective learning processes. Although this may seem somewhat surprising, given that this period was preceded by two EDs, it is perhaps not so surprising in view of the description of how consensus was reached in June 1994 (e.g. pp. 210f).

Individual learning

The suggestion that there were (still) significant individual learning processes is perhaps best supported by the recognition that there was significant collective learning in this period (see below). However, indications of Board delegations (Representatives) changing their mind with regard to certain issues may be indicative of individual learning processes. Such examples have been mentioned in relation to the issue of dual-tax bases [I-25b] (p. 254), and grossing-up (p. 259). The most striking example of this, however, is perhaps when just prior to the September 1996 Board meeting one of the Board Members previously opposed to the balance sheet liability method reported a shift in position:

> Your letter to us … opened up a new line of thought and this together with a thorough debate and examination with members of our constituency has led us to conclude that we should support the conceptual basis for raising deferred tax on revaluations. We should point out however that this view is based on a rigid application of the framework. We still have misgivings about the practical difficulty of converting the existing body of revaluation prepares to this highly conceptual application. But this has removed one of the fundamental obstacles obstruction our support for the standard. (960919C…)

Although direct references to/indications of individual learning processes are rare, the documents include numerous references to various players not *understanding* the proposals and/or the related discussions, e.g.:

> Someone (X, I think) made the point that (most of) the Board have been discussing the temporary difference approach since March 1993 and still have trouble understanding it, …(960112…, staff note)

> … the standard is still extremely complex and if some of the better accounting minds in [a country] are having difficulty in understanding the document, we will have immense difficulty in getting the average preparer and user of financial statements to understand it.
> (9603..., Board written comment.)

> Finally, I have to confess that I never fully understood the discussion we had on grossing-up. (960410…, Board written comment)

Another such example is found in the review of developments pertaining to investments in subsidiaries, associates and interests in joint ventures [I-8]; two respondents to the Staff request for further guidance in April 1996 (p. 268) answered that they did not know the answer to a question[33]:

> We do not know whether such cases will be extremely rare or not, but suspect that in normal circumstances, it will be possible to at least identify a range of possible outcomes. … (960508C…)
>
> With respect to question 3 (a) … I must admit I cannot comment. A tax expert would probably be better suited to give a response. As a consequence of the difficulty for me to respond I recommend that the expression of *extremely rare* be replaced by something to the effect of the following: … (960503C…)

All of these examples suggest incomplete individual learning processes. Related to this it is further noted that, even as late as June and September 1996, concerns were raised over continuing confusion over what was intended with the revised standard:

> The drafts since E49, with the numerous changes and the obvious continuing confusion and disagreement over what is actually intended, do little to reassure one that clarity and lack of confusion is being achieved. (960525L…)
>
> I urge you to test your theory with the IASC, and if that is the approach they want to adopt, to do so. Draft the document on a basis consistent with that notion rather than the inconsistent basis now used. I do find this document unacceptable as you assume because it fails to consistently apply any single approach. I also believe standard setters have an obligation to discuss substantive issues raised in their processes whether internal or external, and reach a common understanding of the results of applying the standard they are considering. In my opinion that has yet not taken place. That is why I believe additional substantive discussion is necessary. Comment letters on the draft have raised substantive points, and the internal inconsistencies in the document preclude a common understanding of how the document would be applied, and that is evident from the discussions and the correspondence. (960905L…)

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33 If it will be impracticable to estimate the lower end of a range … with reliability only in extremely rare cases.

At the same time the former IASC Secretary-General similarly argued that the meaning of the concept of tax base still had to be resolved (p. 247).

Collective learning

If direct references to individual learning processes are rare, indications of collective learning processes, i.e. of new understanding emerging, and with that, new issues, are more frequent.

This aspect of the process is perhaps most evident in relation to the discussions relating to definition of tax base in general [I-25a], and how to deal with situations with dual-tax bases in particular [I-25b]. See, for example, the suggestion (p. 250) that the discussion of an example during the July 1995 Steering Committee meeting led to the realisation that "…we really didn't understand tax base" (Mson). This, in turn, appears to have prompted a discussion which a year later led to the suggestion that the IASC had developed a new method to deferred tax accounting (p. 244).

However, learning also seems to have played a part in the process relating to the various exceptions in E49 (8.3.5) as well as in the developments relating to the proposed disclosure requirements (8.3.6):

- *Exceptions for temporary differences arising on initial recognition*
  Examples of issue-expansion relating to these issues include the suggestion that grossing-up is the conceptually correct treatment [I-19], as well as discussions relating to the tax-base of goodwill [I-16b] (pp. 257-8) and the emergence of the treatment of compound financial instruments [I-23] as a separate issue (pp. 261f).

- *Investments in subsidiaries [I-8]*
  In this period (in contrast to the previous) concerns regarding inconsistencies between the proposed exception and the IASC's conceptual framework were specifically addressed. Initially these discussions seem to have led to the addition of a third criterion, something which then gave rise to significant discussions and individual as well as collective learning (pp. 254f).

- *Disclosures [I-15]*
  Discussions late in the process (August 1996) led to new understanding of the opposition to a much criticised proposed disclosure. This, in turn, seems to have opened up for an agreement on this issue (pp. 272-3).

Consequences of learning

An important implication of the learning aspects of the standard setting process appears to be a tendency to introduce twists and turns to the process. Commenting particularly on this one interviewee suggesting that, as a result, the standard-setting process might be *perceived* as a random process:

> … It was a funny feeling watching some of those discussions because sometimes you get a sort of 15-1 vote for something like [an issue], let's say, and then at the next meeting you get a 15-1 vote the other way and … there was no obvious factor other than just more time to understand what the issue was or what the implications were … …
>
> My favourite example is [another issue]…where we had four board meetings and at four successive board meetings there were four different decisions …and it always seemed to me that.. we ended up with.. … that was just where the [lucky] wheel was moving when we pressed the button to stop it … and it seemed to be just a, you know, random decision every meeting. (Gson)

On further consideration it was suggested that, as a result, of learning, the process might also be compared to electrical oscillations or, depending on the issue, a pendulum between extremes:

> …I think it is more like … if you've got an electrical oscillation that sort of starts off with a big fluctuation and then gradually settles down to a steady state and I think that's what you'd say about the grossing up decision for example, that they started with quite a wild decision really and then .. it gradually settled down to a kind of constant view, whereas on something like negative goodwill, where there isn't really a right answer, it probably is more like a pendulum swinging between different alternatives which were all equally reasonable. (ibid)

Deal-making

In addition to learning, the developments during this period can also be explained in terms active deal-making (searching for a position that would be supported by a sufficient majority for Board approval). Support for this suggestion is, for example, found in the letter from September 1995 setting out views about how different Board members were likely to vote in the forthcoming Board meeting (p. 275). The letter, which was written by a member of the IASC Staff suggested that, in view of the perceived situation, might be productive to address the concerns of various Board Members in the letter accompanying the draft standard. Another indication a pervasive deal-making mentality is found in a written comment following the November 1995 Board meeting:

> I suppose my view is that the objections of those who voted against the document (or who expressed reservations about it) are so fundamental that they cannot be resolved simply by changing the structure or drafting, and that the best hope for getting the standard approved is to get it done in a spirit of cooperation on the basis that 'we are so nearly there'. (951214…)

Elements of explicitly searching for sufficient consensus are also evident in the previous descriptions of developments pertaining to the key technical issues. In particular it is noted that, because the number of Board members fundamentally opposed to the proposals (particularly the balance sheet liability method) was very close to the maximum no votes (four), those disagreeing strongly with certain aspects of the proposals had a lot of leverage. For example, by severely objecting to grossing-up, a minority managed (in the end) to retain an exception relating to temporary differences arising on initial recognition. As noted on page 260, one Board Member explicitly made its support of the standard contingent on a "satisfactory solution" for this issue (960215…). Similarly, by attaching great importance to certain disclosures, another Board delegation was able to introduce these in the Standard in March 1996 almost without discussion (p. 271). However, although attempts were again made to make the issue of revaluations [I-10] (and fair value adjustments [I-16b]) into a deal-breaking issue[34], these failed in this period too.

A consequence of this explicit search for sufficient consensus seems to have been the introduction of numerous turns and twist in the proposed positions. In other words, it is suggested that part of the "lucky-wheel" syndrome referred to above, might be attributed to this aspect of the standard setting process.

In similarity with the period during which E49 was developed a key factor making it possible for the Board to reach agreement was the fact that there was room for deals that made the proposals acceptable to some without

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34 In response to the July 8th 1996 draft IAS, one Board Member stated that it: "… would be willing to put its conceptual concerns aside and vote for the proposed standard if the exceptions given in the standard were sufficient to remove the most unacceptable consequences of the temporary difference approach". The response further explained that the Board member approved "of the exceptions incorporated in the latest draft of the IAS but, … , would wish to see these extended to avoid the automatic requirement for deferred tax to be provided for whenever a fixed asset is revalued or fair valued on acquisition" (960731…).

making them unacceptable to others. In this respect it is noted that most Board Members were not simply for or against the proposals. Although there was a (small) number of Members that were fundamentally opposed to the balance sheet liability method (but not sufficient to stop the proposals), there were also Members who were essentially in favour of the proposals, but concerned with specific details. A further facilitating factor seems to have been that many of the contentious issues were perceived as minor in some sense. For example, the position relating to dual tax rates [I-25b] and temporary differences arising on initial recognition [I-19] was only of perceived to be of relevance in a hand-full of situations. Moreover, prior to the September 1996 Board meeting the staff argued that the discussions on the application of tax base in certain situations "are matters of drafting and not of substance" (960912Ap5).

As in the previous period exceptions remained a main tool for reaching consensus. Although the process first moved away from the positions in E49 for a number of issues[35], the process thus tended to revert to the E49 solution before IAS 12 (revised) was approved.

The impact of executive concerns

In similarity with the period during which E49 was developed, the Board's approval of IAS 12 (revised) in September 1996 seems at least in part to have been dependent upon the fact that a majority preferred *a standard with*, for example, certain disclosure requirements and exceptions to *no standard* at all.

In this period such executive concerns (and hence the impact of what might be perceived as an executive force) appear to have been stronger than in any of the previous periods. For example, it has already been suggested that one characteristic of this final period is the extent to which the Staff *requested further guidance* from various participants between the various Board meetings (some examples are listed on p. 274). A major reason for seeking such guidance seems to have been to speed up the process by making possible a more *continuous* process, both with regard to learning (seeking and providing further explanations) and deal-making (eliciting reactions to various proposals). This perceived need, however, may also have been instigated by the Board's decision in November 1995 not to convene a new

35 Due to concerns that the balance sheet liability method/the standard "loses credibility" by the large number of exceptions (p. 256).

Steering Committee meeting. Owing to the organisation of the IASC, this essentially left the Project Manager without other means of assistance. An interesting detail in this context is perhaps that some interviewees described this Board decision as surprising and attributable to one Board Representative in particular, e.g.:

> .. I remember that it came a bit as a surprise ... as a suggestion from [X] who meant that in principle the Steering Committee had completed its mission … had produced something that was ready to become a standard, it only needed a bit of fixing and that the secretariat could do … (Ison)

Essentially the interviewees suggested that this suggestion/decision had been based on a belief that this might speed up the process.

A related characteristics of the standard setting process in this period is that the staff can be seen to have *intervened* in the process relating to several issues. Examples of this can be found in all of the detailed accounts of developments with regard to key issues and include that the staff:

- repeatedly suggested to amend the definition of tax base [I-25a];
- repeatedly raised the issue of dual tax bases [I-25b];
- repeatedly raised concerns about the position on grossing-up, even contacting one Board delegation directly [I-19];
- resisted the suggestion that an exception be made to the exception with regard to compound financial instruments [I-23]; and
- argued that the Board may not have understood the impact of the restriction added to the exception for investments in subsidiaries etc. in November 1995, raising this issue not only in the papers for the March 1996 meeting, but in an article in IASC Insight [I-8].

In some cases the actions of the staff can be understood in terms of *facilitating closure* of the process. In the case of the choice of the liability method [I-3] / the nature of tax base [I-25a], the staff appears to have toned down differences emphasising that they concerned matters of drafting (pp. 246-7). In this particular case, it would thus appear that closure was facilitated by preventing the learning vis-à-vis tax base / the balance sheet liability method from leading to a renewed debate of the appropriate choice of method for tax effect accounting.

In other cases, the staff's actions can be seen to have facilitating the learning processes. In the case of the debated disclosure, for example, it has been noted that the staff contacted a Board delegation to enquire about its

concerns, thus leading to new insights, which introduced a new alternative on which consensus could be achieved [I-15] (pp. 272, 278). A more striking, but also more isolated, example of such staff intervention is when the Secretary-General wrote to a dissenting Board member explaining why "it is impossible to sustain the position that provisions should be made for such items as accelerated depreciation and not for revaluations" (revaluations [I-10] having been identified as key issue for this Board Member):

> The basis is to ask whether incremental taxes would arise if assets are realised at their balance sheet amounts and in the case of revaluations the answer is quite clear: additional taxes would arise. …
>
> I do not think that it is true, as you claim, that recognising the tax on a revaluation would result in recognising a significant liability which would in most circumstances not be paid. The taxes will be paid. They will normally be paid as taxes on income because the revaluation will be realised through use which generates income. … (960822L…)

This is an excerpt from the letter referred to in the quotation noted on page 276, a quotation which suggests that the above explanation was instrumental for that Board Member's change in position with regard to the standard.

To be noted, however, is also that in some cases when the staff intervened, they can be seen to have re-raised issues and thus to have (at least in the short term) delayed, rather than speeded-up the process. This was, for example the case relation to the issues of grossing-up [I-19] (where the staff contacted a Board delegation to enquire about their position, p. 259) and the third criterion for the exception relating to investments in subsidiaries [I-8] (where the staff questioned the solution agreed by the Board, p. 266). In both these cases, the staff actions were argued in terms of concern for the *acceptability* of the future standard, not on the Board, but by its constituents. A related concern – *complexity* – was expressed in relation to the issues of the definition of tax base [I-25a] (the staff argued that the definition was the source of unnecessary complexity and confusion, p. 239), dual tax bases [I-25b] (the staff argued that it was wrong to ignore this issue because lacking specificity it would not be possible to determine temporary difference in such cases , p. 251) and compound financial instruments [I-23] (with a view to consistency the staff inferred a change in position, p. 262).

Two factors have been suggested to have contributed to the role played by executive concerns, and hence deal-making, in this phase of the project. First, the deferred tax project was the first project on the list to be completed

within the Core Standards Project (p. 230). As a result it was felt/understood that the IASC could not fail with this project. Second, people involved in the project were weary of it and did not want to go through this process all over again, e.g.:

> This was in the time where the imperative was to complete the core standards as fast as we can, we had a lot of standards still to go, this was going to be one of the first to be completed …. and if we had argued: Let's get rid of this whole balance sheet liability method….we would have been back to square one, …, we would have been five years away from completing a standard on income taxes, after all this work! And in the final analysis I think that nobody wanted to go back that far, nobody wanted to go back and do this all over again. And people decided well, yea maybe this is a little weird, maybe this isn't quite …, but it's not terrible, it's not bad, it has logic to it. OK, in some odd cases it is a little strange …, but it's not bad, the Americans have it and the world hasn't come to an end. And the alternative would be we wouldn't get the core standards done. (Mson)

This impact of this second factor is perhaps most evident in relation to the issue of the definition and nature of tax base [I-25a]. As noted above, in August 1996 these discussions ended up with the IASC staff acknowledging that it would have been more elegant to express the standard in terms of differential tax receipts and payments rather than to rely on the concept of tax base, but also arguing that it was not justified to rewrite the Standard to exclude the concept of tax base and temporary difference *at this stage* of the process (p. 245).

On a final note it is noted that the above quotation again suggests that as result of the interaction between learning, deal-making and executive concerns, the resulting product (in this case the revised standard) can be perceived as “a little weird” (compare with the suggestions on page 153).

CHAPTER 9

THE PARTICIPANTS AND THEIR ROLES

9.1 Introduction

Previous chapters in this part have provided a chronological account of the process of revising IAS 12 focusing on the developments pertaining to the technical issues at the heart of this process. To a large extent this description has disregarded *who* it was that did *what*. This chapter sets out to rectify this by addressing the roles played by various types of participants in the process.

Whereas much of the previous literature on participation in the accounting rule-making process appears to be based on the notion of interest groups (normally based on affiliation to constituent groups, p. 38), this chapter distinguishes between:

- *the decision-makers* (9.2);
  the members of the body making the decisions to publish various documents for public comment and, in the end, for approving a final standard, i.e. the IASC Board Members/Representatives;
- *the task force members* (9.3);
  the members of the task force set up to assist the decision-makers with this project, i.e. the Steering Committee Members;
- *the staff members (*9.4);
  the member of the IASC Secretariat;
- *the observers* (9.5);
  other individuals directly involved in the process without being Board Members/Representatives, Steering Committee Members or members of staff;
- *the formal consultants* (9.6)
  representatives of other organisations formally consulted with, i.e. members of the IASC Consultative Group; and
- *the commentators* (9.7);
  outsiders, members of "the public", using the option to provide comments on documents published for public exposure.

On the one hand these groupings may be seen to follow from the adopted research methodology (focusing on the whole process – including developments internal to the standard setter - rather than just the comments received). On the other, they may be seen to follow from the empirical data: this did not suggest that a distinction between constituent groups was useful.

Since much of the previous (empirical) accounting standard setting literature addresses issues concerning the role and significance of various actors in the standard setting process, the empirical observations in relation to the IASC and IAS 12 summarised in this chapter are continuously contrasted against relevant prior literature.

9.2 The decision-makers

9.2.1 Introducing the IASC Board

At the start of the studied period the IASC Board consisted of 14 *Board Members*, each having one seat on the Board. Thirteen of these were so called country-seats, the outstanding seat being held by the International Co-ordinating Committee of Financial Analysts. During the studied period the Board was expanded. Two new seats were taken on by two preparer organisations: the Federation of Swiss Holding Companies joined in July 1995 and the International Association of Financial Executives (IAFEI) in January 1996.[1] Over time there was also some rotation of the country seats on the Board, India replacing Korea in 1993, Italy and Jordan being replaced by Malaysia and Mexico in 1995. At this point, the delegations from India and South Africa were also joined by Representatives from Sri Lanka and Zimbabwe respectively.

Although each Board Member had only one vote, even non-sharing members would normally be represented by a *delegation* of *Board Representatives* and, in some cases, so called *Technical Advisors* (pp. 90-1*)*.These individuals were part-time volunteers. Part time in the sense that they only meet three/four times each year and generally only for three/four days at a time. Volunteers in the sense that they did not receive any remuneration from the IASC for their efforts on, or in relation to, these meetings.

1 For details of the Board composition see figure 4.2 on p. 92.

9.2.2 Board activities

Introducing the Board activities

The review of the process of revising IAS 12 strongly suggests that, in line with official descriptions of the IASC, the ultimate decisions pertaining to the standard setting process were generally made by the IASC Board. In practical terms this translated to the Board Representatives *approving* various documents (a PO, an ED or an IAS, depending on the stage of development, see figure 4.3 p. 95)[2]. This, in turn, translated to the Board Representatives, during various Board meetings, *discussing* and *taking votes* on draft versions of the relevant document generally submitted by the Steering Committee (but prepared by the staff). A significant aspect of the process was that the draft document(s) to be discussed and approved were not only circulated among Board Members prior to the meetings[3] (providing these with an opportunity to prepare for the meeting), generally the Board Members were also requested to provide written comments on these drafts prior to the meetings.

In summary Board activities relative this standard setting project thus can be seen to have consisted of three main types of activities:

- providing *written comments* on draft documents;
- *oral discussions* during the various Board meetings; and
- making decisions with respect to the project *by means of voting*.

Before considering the significance of the Board, each of these activities is discussed in more detail in the following sub-sections.

The written Board comments

Board Members were asked to provide written comments on draft documents relating to the income tax project on 14 occasions. Normally these comments were not circulated among the Board Members/ Representatives, but reviewed by the Staff (and the Steering Committee Chairman) as a means of

2 On two occasions the Board explicitly discussed a document without this intention: in March 1993 and in March 1996. Moreover, in October 1989 the Board received a report on comments on ED E33 only.

3 In some cases draft documents were also circulated after/between meetings. For example, a draft ED was circulated after the November 1993 meeting to ascertain "the acceptability of the balance sheet approach" following the meeting (931221LL) and a draft IAS was circulated between the June and September 1996 meetings.

preparing for the upcoming Board meeting. In the final period, however, some Board Members/Representatives explicitly asked to have their comments circulated to the Board. Notably these were all opposed to the proposals and new on the Board. Following this the Board agreed in June 1996 that all comments on a draft to be circulated after the meeting would be circulated to all Members prior to the next meeting.

Varying response rates, as well as the length and details of the comments received, suggest large differences in the degree of involvement. In general, written comments were received from many, but far from all Board Members[4]. In 1988 ten of fourteen Board delegations provided written comments on the draft ED submitted to the November meeting. Response rates for the following two periods are similar (see figures 9.1 and 9.2).

While some comments covered several pages, some responses were very short, e.g.:

> Theoretically the tax effect accounting is good. This exposure draft appears good to me. (88….C…)

In general, those who commented frequently tended to provide lengthy and detailed comments relating to a number of issues, suggesting that a lot of effort was invested in reviewing and commenting the documents. Those who did not comment often, on the other hand, tended to provide much shorter comments.

Generally, the written comments focused on specific aspects of the proposals with which the authors disagreed, or found unclear. Supportive comments were rare. Even those generally in favour of the proposals often listed a number of specific detailed concerns. In fact, many of the comments did not address the substance of the proposals, but focused on, for example, the choice of words or argued for further guidance. Moreover, those comments that did address the substance of various proposals generally focused on sub-issues rather than on the core issues. Often, the reasoning behind the comments was not explained, e.g.:

> Paragraph 43. Consider adding a time frame for the "probable" distribution of profits. (881102…)

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4 In some cases, the comments received were from committees or consultative groups advising the Board Representatives and hence might not directly have reflected the opinions of the Board Members/Representatives.

Occasion:	**March 1993**	**Nov. 1993**		**June 1994**		No. of resp.
Board Member:	*Jan. 19 draft*	*Sep.9 draft*	*Dec.21 draft*	*Apr. 19 draft*	*July 20 draft*	
1	√	√	√	√	√	5
2	√	√	√	√	√	5
3	√	√	√	√	√	5
4	√	√	√	√	√	5
5	√	√	√	√*	√	5
6	√	√	√	√	√	5
7	√	√	√		√[5]	4
8	√	√	√	√		4
9	√		√	√	√	4
10	√		√	√*		3
11		√	√*			2
12						0
13						0
14						0
	10	9	11	9	8	

* Have not found comment, referred to in a file note

Figure 9.1 Summary of written Board comments during 1992- 1994[6]

This was not the case, however, in the case where core proposals were addressed. The most striking example of this is perhaps when one Board Representative submitted a 21-page written comment setting out the reasons for opposing the balance sheet liability method (p. 236).

The comments received were often diverse in the sense that they did not suggest a consensus opinion on specific issues. One exception to this was perhaps when as many as five comments received prior to the November 1995 Board meeting addressed the issue of grossing-up [I-19].

5 These comments, however, were received very late, after the following version of the ED had been prepared.

6 With a few noted exceptions this table has been constructed based on copies of written comments found in the IASC files.

Occasion: Board Member:	**Nov. 1995** ***20/9*** Draft	***29/11*** request	**March 1996** ***26/2*** Draft	16/4 questions	**June 1996** 15/5 Draft	8/7 Draft	***13/8*** proposals	**Sept. 1996**	**Σ**
1	√	√	√√	√	√	√		√	*7*
2	√	√	√	√	√	√	√		*7*
3	√	√	√	√√	√	√√			*6*
4	√	√	√	√	√	√			*6*
5	√	√	√	√	√	√			*6*
6	√	√	√	√	√	√			*6*
7	√		√	√	√√	√	√		*6*
8	√		√	√	√	√	√		*6*
9	√[7]		√			√	√		*4*
10	√	√		√	√				*4*
11	√	√		√		√			*4*
12				√	√	√	√		*4*
13		√√				√√	√		*3*
14			√	√		√			*3*
15				√		√			*2*
16				√					*1*
11	*9*	*10*	*14*	*10*	*14*	*6*	*1*		

Figure 9.2 *Summary of written Board comments during 1995-1996 (Not in the same order as in figure 9.1)*

7 Comment from the Association Francaise des Entreprises Privee, dated October 29th 1995. May be as a Board representative.

The Board discussions

All in all the IASC Board discussed the taxes project at 11 meetings, often with considerable time passing between each occasion (figure 9.3, p. 292). To be noted is also that a number of other agenda items (including other standard setting projects) were also dealt with during each meeting.

During the Board meetings normal procedure was to discuss the draft document circulated prior to the meeting in stages, with a first, second and, sometimes, third "run-through" on the various days of the meeting. In between these discussions the Staff and Steering Committee Chairman could re-draft the relevant document(s) to reflect the Board's discussions and decisions. The purpose of this was to provide a clean draft document to be voted on at the following run-through:

> I spent probably 75% of the meeting in the corridors with [X] and [Y], … redrafting… we had a long discussion early in the meeting, .., and we got some decisions … that had a lot of consequential changes … the three of us together, partly with [Z] and [W] as well, spent probably about two days … working out the implications and wondering how to take the drafting forward … so I spent very little time actually in the meeting I spent most of it out, either discussing how we were going to do the redrafting or doing the redrafting (Gson).

Informal discussions also appear to have continued in between the formal discussions, in the various breaks (coffee/tee, lunch, dinner etc.) as well as during the evenings:

> .... you discuss things in the coffee break and in the bar in the evening and so on and …. we always find some way of reaching agreement … (Ason)

The general rule seems to have been that the Steering Committee Chairman (who was normally also a Board Representative, see below) presented the Steering Committee proposals (or project update etc.) to the Board and led the discussion pertaining to this agenda item. However, it has been suggested that on occasion, the Project Manager may have taken at least part of that role. It has also been pointed out that in June 1994 an exception was made as this role was played by the US Steering Committee Member, rather than the incoming Steering Committee Chairman. Another interviewee also suggested that things had worked somewhat differently under different IASC Chairmen:

	Meeting	Developments relating to income tax project
1987	March (Sydney)	Project added to agenda
	~~July (Edinburgh)~~	
1988	~~February/March (Düsseldorf)~~	
	June (Toronto)	Agreed a PO
	November (Copenhagen)	Approved ED (E33)
1989	~~April (Brussels)~~	
	October (New York)	Report of comments received on E33
1990	~~March (Amsterdam)~~	
	~~June (Paris)~~	
	~~November (Singapore)~~	
		Project deferred
1991	~~February (London)~~	
	~~June (Milan)~~	
	~~November (Seoul)~~	
1992	March (Madrid)	Decision to reactivate project
	~~June (Jordan)~~	
	October (Chicago)	Work plan presented
1993	March (Tokyo)	Discussed ED
	~~June/July (London)~~	
	November (Oslo)	Discussed ED
1994	June (Edinburgh)	Approved ED (E49)
	~~November (Budapest)~~	
1995	~~March (Düsseldorf)~~	
	~~May (Amsterdam)~~	
	November (Sydney)	Discussed draft IAS
1996	March (Brussels)	Discussed draft IAS
	June (Stockholm)	Discussed draft IAS
	September (Barcelona)	Approved IAS

Figure 9.3 Board meetings during which the project on Income Taxes was discussed 1988 - 1996

> …. the way it worked is that [X], sat at the head at the table and whoever the Steering Committee chairman was for that project sat next to him up there, …during [the discussion of the project] … you see before [X] became chairman, the chairman of the IASC didn't conduct the [Board] meetings, each Steering Committee chairman conducted his part of the meeting …so [X] was very much more, was fairly active in this … (Mson)

Generally the Board's discussions seem to have been lengthy and detailed, encompassing both general discussions and paragraph-by-paragraph or section-by section reviews of the draft document to be considered. In contrast, the discussions in March 1993 have been described as "very brief" (930615WP). As already noted, however, the recollections of one interviewee suggested that the discussions were not all that brief (see quotation on p. 207). The apparent contradiction is explained by the fact that the Board did not review the proposals paragraph by paragraph and did not address the draft itself during this meting.

Some of the interviewees suggested that there was something special about the Board's discussions of its accounting standard setting projects: that they could be perceived as quite heated, even intimidating. At the same time it has also been suggested that fun/jokes played an important part:

> …. there was quite a heated debate between [Z] and [Y]….on the balance sheet liability method … … … I remember [Z] at one point saying: It's only a liability if you can describe it to your mother and she agrees it is a liability and then [Y] said that … he went out of the room for some reason and when he came back in he said: By the way,…, that was your mother on the phone and she says you've got to book the liability…. But that's what it was, it was just two of them having a debate and the way they debate is by, they insult each a lot when they are debating and they have lots of jokes in … (Gson)

> …. I think it is probably also a question of being familiar with debating this kind of issue, I think it's ... and again that is partly cultural, that it can be quite intimidating, if you are not used to discussing issue in this kind of technical way. (Gson)

> …we had [U] on the Board … he certainly spoke up strongly in Board meetings …, I remember that very clearly …. because it developed into a joke … he would speak up very aggressively …, not in serious aggression but partly in fun, he would say [things like] how silly the [Vs] were and, you know, nobody with any intelligence could think a thing like that, he

> would make remarks like that as part of his jocular way of speaking .. (Ason)

One interviewee suggested that the discussion were also coloured by the fact that accountants like to debate "detailed issues for the intellectual fun of it" (Mson).

Board decision-making / Voting

Board decisions were normally framed in terms of agreeing or disagreeing with, or making amendments to the proposals (draft documents) presented to it. Although the Board often agreed with the proposals, there are also numerous instances where it disagreed. In some cases the Board discussion introduced new issues. On occasions issues were also reconsidered by the Board, following which previous decisions were either confirmed or reversed. In some cases the Board also asked the Steering Committee to reconsider specific issues.

Votes were normally first taken on individual issues (simple majority) and then for the whole document (qualified majority).[8] To be noted is that when the Board increased from 14 to 15 Members in July 1995 this increased the required number of yes votes for approving a revised Standard from 11 to 12.[9]

In some cases official votes were not taken. Instead, straw votes were taken "to check that Board [representatives] were … supporting the general approach" (Ason), or as expressed by another interviewee:

> When a wise chairman sees that we have an insufficient straw vote, a vote that does not provide sufficient support, he obviously abstains from calling a real vote. (Ison)

There are no indications of bloc-voting or voting pacts.

9.2.3 Significance of the Board

The extent to which the Board Representatives disagreed with, and made amendments to proposals presented to them strongly suggests that the Board Representatives were the ultimate decision-makers. It was here consensus

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8 The constitution of the IASC set out that a ⅔ majority was required for the Board to approve an ED and a ¾ majority to approve a standard.

9 The second addition did not impact the number of yes votes needed for approving a Standard, 75 % of 16 being exactly 12.

(sufficient majority) had to be achieved. The fact that the Steering Committee had agreed on a proposal (a draft document) did not mean that this would automatically be accepted by the Board. The chronological review includes many instances where the Board rejected proposals presented to it and where the Board, at various points, voted on alternative solutions in search of a sufficient majority. Failure to find sufficient majority here inevitably delayed the process, often for several months, awaiting the next Board meeting.

To be noted, however, is that the Board activities were not only about finding solutions supported by sufficient majority. In addition, the review of the process of revising IAS 12 strongly suggests that the Board's detailed review of proposals presented to it sometimes also allowed, prompted, or even forced, the Board Representatives/Technical Advisors to undertake a personal learning process. At times these learning processes, in turn, would prompt a collective learning process, leading to the introduction of new alternatives and/or (sub-)issues. The chronological review in the previous chapters clearly suggests that, although the objective of the various Board meetings (in relation to the specific technical project) was almost always stated in terms of approving a document, it was sometimes recognised that this was not realistic as the Board was not "ready" yet.

Just as failure to approve a document would hinder/delay progress in the sense of completion, other Board decisions - e.g. directing the Steering Committee to prepare a draft ED and directing the Staff not to reconvene the Steering Committee - directly affected executive aspects of the process.

9.2.4 Discussion of observations

In summary it has been suggested that the ultimate decisions were indeed made by the Board. In practical terms this translated to the Board Representatives discussing and voting on draft documents during Board Meetings, which were held three or four times per year. The Board's discussions were generally both lengthy and detailed. Some suggested that they could be perceived as intimidating. There are no indications of bloc-voting. In this section these empirical observations are contrasted to previous accounting standard setting literature under three sub-sections: (1) the significance of the Board, (2) the nature of Board discussions, and (3) voting behaviour.

(1) The significance of the Board

Perhaps somewhat surprisingly the role played by the Board (the standard setting body itself) vis-à-vis other bodies/participants in the standard setting process has not been extensively discussed in the previous literature. Instead the focus seems to be, for example, on the role played by the Staff and Commentators. However, in similarity with this research, Flower's review of the process leading up to IAS 37 also concluded that the IASC Board was "clearly the ultimate authority" (1998: 17) arguing that it did not "simply rubber stamp texts" (ibid) proposed by the Staff and the Steering Committee.

(2) The nature of Board discussions

The nature of the deliberations of various standard setting bodies is also a topic that has not been extensively addressed in previous literature. This may be related to, but cannot be completely explained by the fact that not all standard setters operate in the 'sunshine' as the FASB and, more recently, the IASC. Nevertheless some, almost anecdotal, references to this issue can be found in the previous literature. In general they seem to suggest great similarities with the observed process. For example, Flower's account of the process leading to IAS 37 emphasises that the IASC Board discussions were lengthy and detailed:

> In the case of IAS 37, it spent two full days discussing the draft text and voted on some forty different specific points, apart from the final vote on whether to issue IAS 37. In addition the Board gave almost equal attention to the DSOP and the exposure draft, discussing each document at two meetings. (1998: 17)

In his account of the deliberations of the Swedish standard in the case of consolidated accounting Zetterlund (1998) similarly notes that it, despite other intentions, would focus on the detailed wording of the text. Also in similarity with the observed IASC process he notes that the discussions would tend to follow a chronological order, with the result that in some cases issues dealt with in the latter part of the text became less thoroughly discussed (ibid: 147).

Finally, in his account of FASB deliberations, Beresford has characterised these as *vigorous*:

> FASB Board members are intelligent, independent, strong-willed individuals. They truly enjoy a vigorous debate and believe it is their responsibility to do so. It is a real strength of our system that each Board member

> considers the issues so carefully and argues for what he truly believes in. (1997: 85)

Reflecting further on this Beresford suggested that "the FASB's scales are weighted too much to seeking a perfect answer and not enough to resolving issues in a timely manner" (ibid), a suggestion which seems well in line with the suggestion noted above (p. 294) that accountants like to debate "detailed issues for the intellectual fun of it".

(3) Voting behaviour

In 1997 Flower suggested that that the Anglo-Americans "should be capable of dominating the IASC's agenda and output, by acting as a united bloc" (1997: 293). In response to this, a former IASC Secretary-General argued that things did not work this way within the IASC (Cairns, 1997: 311). The observations vis-à-vis the revision of IAS 12 would seem to support this. To be noted, however, is that this stands in sharp contrast to Rahman's (1998) description of the situation within the UN (p. 62).

9.3 The task force

9.3.1 Introducing the IAS 12 Steering Committee

Normal due process for an IASC standard setting project included the appointment of a Steering Committee (p. 93). The original Income Tax Steering Committee consisted of four individuals, one each from Brazil, France, Greece and Sweden. The French member was designated chairman (the French member body being the only Board member).

As noted in section 6.3.3 (p. 135), the make-up of the original Steering Committee has been described as weak, both in political and technical terms. First, it was noted that, with one exception, all members came from non-Board countries. Second, it was noted that all members came from countries that did not generally have deferred tax accounting and that there is nothing that indicates that the selection of its members was guided by a desire to involve people with special interest in, or knowledge of, deferred tax accounting.

In the period during which E49 was developed the Steering Committee was expanded twice. A fifth member was added in October 1992 and a sixth in March 1993. While the first addition was a consequence of the Board trying

to extend the involvement of the business community in the work of the IASC, the sixth member was explicitly added to strengthen the committee.

Although only the Chairman was required to also be a Board Representative, and although initially this was also the case (see below), it is noted that in the final period the distinction between Steering Committee Members and Board Representatives became fuzzy. First, the US Steering Committee Member became a US Board Representative. Second, the Swiss Federation of Holding Companies became a Board Member. One of its Board Representatives was the (previous) representative for the International Chamber of Commerce on the Consultative Group. This person was employed by the same company as that group's Steering Committee Member. As there was a close co-operation between the two, the distinction between Steering Committee and Board comments thus became confused in this period in relation to this group.

In similarity with the Board Representatives, the Steering Committee Members were part time volunteers that met for a few days at a time. In contrast with Board meetings, however, Steering Committee meetings were not held at regular intervals, but were called when some kind of action was required. The Income Tax Steering Committee met in total six times (figure 9.4). The shortest interval between meetings was five months, the longest over four years. This, however, was exceptionally long owing to the project being deferred for a number of years. The second longest interval was one year and four months. The meetings normally lasted two days and, with the exception of the first meeting, they were held in London in the IASC's administrative offices.

9.3.2 Steering Committee activities

The activities of the Steering Committee echoed those of the Board, with the exception that the objective with these meetings was for the Steering Committee Members to agree on a (draft) document to be submitted to the Board and that the Steering Committee Members discussed and made decisions relative to (voted on) various proposals (i.e. draft versions) submitted and prepared by the Staff. A further difference was that, in general, Steering Committee Members were requested to provide comments following (not before) a meeting, the objective being to determine that the draft to be submitted to the Board reflected the committee's decisions/discussions. In the final period, after the committee had been disbanded, the committee members were nevertheless asked to provide

written comments on draft IAS twice. In addition, they were also asked for input in relation to four questions asked by the Staff in April 1996.

1988	March 29 - 30th (Paris)	Agreed PO
	September 1st -2nd (London)	Agreed ED
1992	December 9 - 11th (London)	Discussed draft ED
1993	August 24 - 25th (London)	Discussed draft ED
1994	March 15 - 16th (London)	Discussed draft ED
1995	July 27 - 28th (London)	Discussed draft IAS
1996		

Figure 9.4 Steering Committee meetings during which the project on Income Taxes was discussed 1988 - 1996

As in the case with the Board, the Steering Committee seems to have agreed with most of the proposals presented to it, but not with all and not without discussion. There were also instances where the Steering Committee re-raised issues already discussed by the Board and instances where the Steering Committee introduced issues not previously discussed in, for example, the documents prepared by the Staff.

A peculiarity of the process at the level of the Steering Committee is that it, in contrast with the Board, aimed for unanimous support of the proposals to be presented to the Board. In similarity with the situation on the Board, however, there were certainly differences of opinion. Owing to the set-up of the committee, however, these did not directly reflect those on the Board.

In March 1993 the Steering Committee chairman reported that, as a result of "major differences of opinion between the members of the Steering Committee" (9303OPC), it had had "difficulties in reaching agreement" in December 1992. On the same theme one interviewee suggested that difference in opinion caused friction in the workings of the committee (Kson).

Besides causing friction in the Steering Committee's deliberations, the requirement of unanimous support also affected the proposals being presented to the Board. In particular it seems to have led to the repeated introduction of an allowed alternative/exception for revaluations [I-10] in the

final period. In other words, the adopted decision-rule created a situation where each (disagreeing) member had a lot of leverage on the proposals.

Although a Steering Committee meeting was generally almost as long as a Board meeting, and although the income tax project was the only agenda item, there were times when there was not enough time to discuss all of the issues raised or to finalise the discussions.

As was the case with the Board Representatives, there appears to have been large differences in activity of various Steering Committee Members, both during and between the meetings. Several sources indicate that in the period during which E33 was developed discussions primarily took place between two Steering Committee Members and a member of Staff. Nevertheless, even one of the more active members described himself as relatively complaisant during this early period:

> …in the beginning I just went along and thought that what the Secretariat produced was relatively OK … (Nson)

In the following periods it seems that two of the original Members remained fairly inactive. (In fact, owing to non-attendance at the December 1992 meeting, there was even some uncertainty regarding one of these members at the beginning of this period.) On the other hand, both of the two newcomers appear to have been very active, even more so than the original members.

The interviews suggested that a combination of interests and language difficulties contributed to the relatively low activity of some of the Steering Committee members.

9.3.3 The Steering Committee Chairman

The Steering Committee was headed by a Chairman, whose task it was to *chair* (lead) the Steering Committee meetings. It was also the Steering Committee chairman that presented the committee's proposals to the Board and chaired the Board's discussions pertaining to this project (see above). In addition, or perhaps as a consequence of these roles, the Steering Committee Chairman seems to have had a significant say in how to proceed with the project, particularly vis-à-vis the Staff (see below). For example, the Chairman was generally allowed to comment on draft versions of the papers to be distributed to the Steering Committee and the Board and seems to have had the final say in how to incorporate Steering Committee decisions and in how to present the proposals to the Board.

The Steering Committee chairman was the only member of the Steering Committee required to also be a Board Representative. Although this was the case as the Income Tax Steering Committee set out in 1988, this individual ceased to be a Board Representative in 1992. At first, the original chairman nevertheless continued to act in this capacity. He thus travelled to the Board meetings in Tokyo in March 1993 and in Oslo in November 1993 for no other purpose than to lead the Board's discussions relating to this project. Shortly before the June 1994 Board meeting (Edinburgh), however, he handed over the chairmanship to a concurrent French Board Representative.

When the decision finally was made to step down as Chairman, the triggering factor seems to have been developments within his main employer. However, at the same time the main reason seems to have been that the fact that he was no longer a Board Representative had made his tasks as Steering Committee Chairman increasingly difficult, particularly the "personal lobbying" that it involved:

> It is very important, when you are a [Steering Committee] chairman, to also be a Board Representative because you have a lot of personal lobbying to do… It is not just to chair the Steering Committee and to present information to the Board. You have to identify where the difficulties are and to speak personally with various people, to understand their concerns or to explain … If you know the Board representative personally it is fine, but I had a second period, after I left the Board (I left the board in 92 and I was the chairman of the Steering Committee from 92 to 94) and that was the most difficult part of the task … (Bethoux)

A consequence of stepping down just prior to the June 1994 meeting, however, was that the incoming chairman did not have any experience from the preparatory process. As a result the US Steering Committee Member, having recently been named as a future US Board Representative, led the Board discussions related to income taxes project during this meeting.

9.3.4 Significance of the task force

While the Board stands out as the ultimate decision-maker, the role and significance of the Steering Committee is less clear. On the one hand, there are factors suggesting that the influence and importance of the task force was limited. These include, for example, that the Board disagreed with Steering Committee's proposals on several occasions. Moreover, in the final period, it even decided not to reconvene the committee. On the other hand, there are also factors suggesting a perceived need of some kind of (smaller) support

group (i.e. a task force). These include that the Steering Committee Members were repeatedly consulted even following its demise. Moreover, in its wake developed another (ad-hoc) group of people relatively closely involved in the work of producing a final standard[10]. The key to this puzzle might be in the suggestions that the (composition of the) Income Tax Steering Committee was (perceived to be) weak both technically and politically. In other words, that this specific task force did not always function as intended (or required).

The chronological review in the previous chapters suggests two potential functions of the Steering Committee: (1) injecting additional resources into the specific standard-setting process and (2) providing a means of letting "different countries participate in the process and feel good about it" (Mson). While the first function is related to the specific standard setting project, the latter is not, suggesting that the role of the Steering Committee might be sought in a broader context. It therefore seems important that the chronological review suggests that this factor did matter at the time the Income Tax Steering Committee was originally put together (p. 134).

The suggestion that the Income Tax Steering Committee did not function as intended (or required) refers to the first suggested function, i.e. injecting additional resources into the standard setting process. The idea of setting up such work groups might thus be related to the fact that the Board Representatives were part-time volunteers meeting only for a short time with long intervals in-between and that the IASC operated with a relatively small Secretariat. The development of an ad-hoc working group in the final stage of the process might, in fact be seen to confirm the need for: (a) a smaller entity developing proposals for the decision-makers to consider (rather than the decision-making body working from scratch) and (b) collected resources exceeding those that one (part-time) person can supply[11].

Some of the interviewees expressed the idea that Steering Committees were intended to provide additional time and expertise for consideration of the technical issues, i.e. to inject additional resources into the standard setter's learning process. It can be argued, however, that the use of a Steering

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10 These included primarily the (previous) Steering Committee Chairman and another of its (former) members, as well as some of its (former) observers.

11 As will be noted below, the IASC Staff were generally involved in more than one standard setting project (p. 305).

Committee also potentially injected additional resources into the political process (the deal-making). This is perhaps most obvious in consideration of the role (potentially) played by the Steering Committee Chairman (see above reference to "personal lobbying" during Board meetings p. 301). However, it might also be argued that, subsumed in the task of submitting draft documents to the Board, lies also the task of identifying proposals ("deals") believed to be likely to win Board approval.

The activities of the Steering Committee thus potentially affected both the learning and political process at Board level. Presumably the fruits of these additional resources would be transferred to the Board through the various documents submitted by the Steering Committee. This, however, required that the Steering Committee Members met certain requirements regarding, for example, dedication (time) and expertise (subject proficiency) and that the documents submitted to the Board successfully conveyed the understanding and suggestions accomplished by the Steering Committee. The previous review, however, suggests that all of these requirements may not always have been satisfied. For example, it has been noted that the Steering Committee Members were also part-time volunteers. They can therefore be assumed to have had other agendas and limited time available for these activities. Moreover, as noted above, it has been suggested that the Income Tax Steering Committee was perceived to be weak both technically and politically.

To be noted is also that the use of a task force not only (potentially) injects additional resources into the standard setting process; it also adds an additional level to this process. Not only did the Steering Committee's deliberations affect the learning and the deal-making at the Board level. At the same time, there was also learning and deal-making going on at the Steering Committee level. In addition, there were also executive aspects of organising activities at this level, the task force meeting only a few times on a non-continuous basis.

9.3.5 Discussion of observations

In summary it has been suggested that the activities of the Steering Committee echoed those of the Board, with the main exception that the committee was smaller and addressed this project only. Two functions of the Steering Committee vis-à-vis the particular standard setting project are suggested: a technical (injecting resources into the learning process) and political (injecting resources into the political process). It is noted, however, that the Income Tax Steering Committee was perceived to have been week in both dimensions. A third function of the Steering Committee was also suggested: providing a means of letting different groups participate in the IASC's activities.

The role and significance of task forces is not an issue that seems to have been particularly explored in the accounting standard setting literature. It is noted, however, that, also in a specific IASC context, Flower and Ebbers (2002: 278) briefly refer to two potential functions of a Steering Committee: a *technical* (preparing the text) and a *political* (ensuring that the provisions are appropriate and acceptable to the principal actors). Arguing that the Steering Committee met infrequently and were all part-timers in relation to the IASC, they suggest that the function of the Steering Committee was mainly political (ibid). In an earlier text, Flower (1998) also noted that, in the case of IAS 37, few major amendments to the text were made following committee meetings and that the committee played only a minor role in the finalisation of the standard:

> The Steering Committee met rather infrequently during the project and its members were all very much part-timers from the IASC's viewpoint. Hence its function was not so much the technical one of preparing the text of the standard but rather the political one of ensuring that its provisions were appropriate and acceptable to the principal actors in the financial community. (ibid: 17)

Flower's description of the process of developing IAS 37 also includes a suggestion that a small of ad-hoc working group was formed in this project too:

> The process of putting the text into its final form over the next six months was achieved almost exclusively by the IASC Secretariat working closely with the Steering Committee Chairman and with occasional inputs from individual members of the Steering Committee and the Board. (ibid: 13)

This seems to support the suggestion that there is a (perceived) need for a smaller working group. The perceived need for such smaller working groups is also reflected in Zetterlund's account of how the newly established Swedish standard setter "fairly soon recognised that that it was impossible for so many persons to sit together to redraft text and therefore designated a working group" (1998: 147 translation).

9.4 The Staff

9.4.1 Introducing the IASC staff

During the period encompassed by this research there was a marked increase in the size of the IASC Secretariat. In the beginning (1988) it operated with two technical and two administrative personnel. At the very end (1998) the technical staff consisted of a Technical Director and "four to six other full-time (or almost full-time) technical staff and one part-time project manager" (IASC, 1998b: 67). The other support staff counted about ten, including a "Commercial Director" (ibid).

This third category of participants – the Staff of the standard setter– stand out in one respect. These were the only participants for whom participation in the IASC's standard setting activities was the main job, i.e. who received their salaries directly in return for the work undertaken as part of the standard setting process and who were involved in these activities on a more or less continuous basis. This suggestion, however, requires three modifications:

- Some (even many) of the technical staff were not employees of the IASC as such, but on secondments from other organisations.

- The technical members of the Staff were generally involved in more than one standard setting project at a time.

- Owing partly, but not exclusively to the use of seconded technical personnel, there was also a non-negligible staff turn-over, at least in relation to this project. The most turbulent period in respect of staff turn-over seems to have been the period during which the second ED was developed (see figure 9.5, p. 306).

Work on the project resumed when the Secretary-General, the Technical Director and a Research Manager drafted a work plan. This was presented to the IASC Board in October 1992 by the Secretary-General, presumably owing to the absence of the Technical Director at this meeting and to the fact that the Research Manager had just left the IASC at that point.

The preparatory work for the December 1992 Steering Committee meeting seems to have been handled primarily by the Technical Director. Since the Technical Director's secondment with the IASC ended only days after this meeting, a new member of staff then took over, acting as Project Manager until April 1994. Although this member was not on secondment, he left the IASC after 18 months.

Following this, the Secretary-General re-drafted the staff note to the June 1994 Board meeting. The Secretary-General also worked with the redrafting of the ED and background material after the approval of E49. Moreover, in this period a newly appointed Technical Director also seems to have been involved, but mainly in dealing with practicalities such as circulating various drafts as required.

Figure 9.5 Staff involvement in the Taxes project in 1992 – 1994.

Concurrent with this staff turn-over, the first Steering-Committee Chairman stepped down just prior to the June 1994 Board meeting. In this period (as before), it was the Secretary General of the IASC that provided continuity. End of December 1994, however, he retired, a new Secretary-General taking up his position in May 1995. In other words, following the comment deadline for E49 there was essentially no continuity on the staff side for this project. At this point both the Secretary General and the appointed Project Manager were new, both to the IASC and to the project.

Most of the Staff activities were handled by one member of the technical Staff who was assigned the role of Project Manager. This role is the subject of the next sub-section (9.4.2). Other staff positions discussed in this section include the Secretary General (9.4.3) and the Technical Director (9.4.4).

9.4.2 The Project Managers

Introducing the Project Managers

In 1987, when an IASC policy called for a review of IAS 12, a Board Representative, and not a member of the IASC Staff, was asked to review and report to the IASC Board on the replies to a questionnaire sent out to various Member Bodies for this purpose. A year later, in the period when the

first ED was developed, however, most of the work on the project seems to have been handled by what was then termed a *Research Accountant.* The "title" *Project Manager* appears for the first time in December 1992.[12] Owing to the passage of time, combined with a staff turnover, three individuals were specifically assigned to this project, one as a Research Accountant and two as Project Managers. Sometimes there was no assigned Project Manager[13]. At these times the current Secretary General and/or the Technical Director would temporarily play the role of Project Manager.

Project Manager activities

On the one hand the Project Managers handled a number of administrative tasks such as setting up Steering Committee meetings and distributing various documents[14] to the Steering Committee, Board and sometimes also to the public[15]. On the other hand, and more importantly, the Project Managers also prepared most of those documents. Preparing these documents, in turn, seems to have consisted of two main activities:

- revising previous drafts to reflect decisions made by the Steering Committee/Board; and
- reporting on the changes made and not made.

In some cases these tasks were fairly straightforward, e.g. when the Steering Committee decided to add the expression "in the foreseeable future" to the draft standard (p. 265). In most cases, however, this involved identifying implications of decisions made, i.e. considering which changes and consequential changes would need to be made to the text (see, for example, quotation on p. 291). In some cases it also involved interpreting what the Steering Committee/Board had actually decided and/or wanted, identifying alternatives as well as making decisions/suggestions of how to proceed. For example:

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12 With one exception, the title "Project Manager" was also used in a letter dated in January 1988 (880113…).

13 From here on the term Project Manager should also be taken to include the prior position of Research Accountant.

14 Primarily (revised) draft EDs/Standards and accompanying notes. From time to time, however, the Staff also prepared other documents, e.g. a special paper on the scope exclusion paragraphs of E33 and the Background Information distributed alongside E49.

15 From time to time the Project Managers also wrote project summaries and articles related to the project in the IASC's newsletters: *IASC Update* and *IASC Insight*.

- In July 1995 the Steering Committee decided to amend the definition of tax base [I-25a] without determining the precise wording (pp. 239f).
- In March 1996 the Board decided how to deal with deferred tax liabilities, but not assets, in the case of dual tax bases [I-25b] [I-12d] (p. 253).
- Also in March 1996 the Board decided that further guidance should be included relating to the investments in subsidiaries [I-8], without discuss the content of that guidance (p. 267).

While identifying alternatives and implications can be seen to imply some form of research, making recommendations can be seen to encompass strategic considerations with the aim of making progress on the project.

As noted in chapter 8 (p. 274), a characteristic of the final period was the extent to which the Project Manager sought further input from the Steering Committee/Board in between meetings. To the extent such input was received, this too had to be interpreted, alternatives and implications identified etc. Although ostensibly leading to a more continuous work process, it also gave rise a new sub-issue of due-process considerations. Furthermore, although the Project Manager did receive a number of comments on most occasions, it is questionable how much guidance these actually provided, the comments received from Board Representatives and Steering Committee Members often being diverse and pointing in opposite directions. In the case of dual tax bases [I-25b], however, the request for comments on relating to a staff proposal in April 1996 appears to have affected the discussions during the following Board meeting (p. 254).

In addition to handling various administrative matters and collecting, preparing and distributing information in the form of various documents, the Project Managers also actively participated in Steering Committee and Board meetings. This was certainly so in the final period when the Steering Committee had been disbanded. However, in varying degrees it also appears to have been the case prior to this, e.g.:

> Usually it is the Chairman of the Steering Committee who does the talking and the staff member really does note taking and may, if there is a particularly, sort of technical point that they understand better than the chairman, they might explain it, but usually what happened is that [the project manager] ended up being the spokesman … (Kson)

A final point to be raised in the context of the work done by the Project Managers is that they would, in varying degrees and with varying responses, also consult with other members of the Staff, as well as the Steering Committee Chairman[16]. As noted above and below these would generally have a significant say in how to proceed with the project.

Significance of the Project Mangers

The Project Managers can be seen to have functioned as a primary driving force, pushing the process forward between the various Board and Steering Committee meetings. This is perhaps most evident in cases where a lack of Project Manager activity slowed down the process.

The Project Managers had this effect, acting not merely in the capacity of *Administrators* (arranging various meetings) and/or *Note-takers* (documentting the process), but also in the capacity of *Authors* of most of the various documents that linked the discrete Board and Steering Committee meetings into a process. The documents produced by the Project Managers were not (mere) minutes of various meetings. By authoring these documents, by - for example - focusing on (or avoiding) specific issues, explaining these and suggesting how to proceed, the Project Managers contributed to setting the agenda and hence, in addition to providing momentum to the standard setting process, also potentially affected its direction, both with regard to learning and deal-making.

More obvious examples of how the presentation in the key documents affected the process of revising IAS 12 include:

- that the summaries of comments received on E33 did not mention concerns raised with regard to the difference between the liability method proposed in E33 and the "asset-and-liability method" required in SFAS 96 [I-3] (pp. 158f, 174);
- the presentation of the proposed change in liability method in the papers to the March 1993 meeting as a (mere) change in focus and wording (in contrast to some other substantive changes) (pp. 174f);

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16 What is perhaps peculiar in relation to the final period is that prior to the July 1995 Steering Committee meeting the Project Manager does not appear to have consulted with the Steering Committee Chairman. In combination with the drastic redrafting of the text proposed by the staff, this gave rise to some conflict during and after this meeting. In the period immediately following the meeting, however, the opposite became true. For example, it was the chairman who decided on the definition of tax base [I-25a] to include in the draft revised Standard to be submitted to the Board.

- the subdued presentation of the proposals regarding the issue of dual tax bases in the papers for the November 1995 Board Meeting (p. 250); and
- the staff papers for the September 1996 Board Meeting presenting disagreements regarding the definition of tax base in terms of being matters of drafting rather than bringing forth the suggestion that the liability method reflected in the draft standards was fundamentally different from the asset-and-liability method adopted by the FASB (pp. 247f).

These examples have in common that they can be seen as attempts to restrict the process. These examples also illustrate that the power of the Authors in this respect is far from absolute; in all but the last case the related issues did emerge and significantly affect the process, albeit with delay.

Another example of how the author(s) of a document can attempt to restrict the process is found in the Staff papers for the November 1995 Board meeting (i.e. first meeting after E49). For this meeting two notes from the staff were presented: agenda paper 4 and 4a:

> Agenda Paper 4 sets out contentious issues that the Board will discuss in Sydney. This note (Agenda Paper 4(a)) summarises:
> (a) current national developments in accounting for income taxes; and
> (b) other changes made to E49, ... , in drafting the proposed International Accounting Standard and other issues considered by the Steering Committee during its meeting on 27 and 28 July 1995. It is not intended that the Board will discuss these other changes and other issues in Sydney unless Board Representatives submit a written request in advance to discuss such issues. (950920Ap4a)

More generally, the documents appear to have played a facilitatory role: specifying the issues, providing explanations, arguments and alternatives. For example, as already noted, the staff papers for the very first Steering Committee meeting (March 1988) outlined no less than 13 key issues, containing also recommendations on how to proceed with each issue (p. 136). Similarly, the agenda paper 4 (see previous quotation) for the November 1995 Board meeting, outlined nine identified contentious issues, closing each section with a specification of “Decisions for the Board”. An example of such a list is provided on pages 232-3. Another example of how staff documents would seem to attempt to facilitate the political process is when the staff note to the March 1994 Steering Committee meeting presented two alternative strategies to gain sufficient Board acceptance of a draft ED in June 1994 (p. 179).

In view of this potential to affect the process two key factors have emerged in considering the significance of the staff/Project Managers: (1) their control over the documents and (2) their responsiveness to the comments of other participants (thus opening up for others to influence the agenda and the process). With regard to the first issue it is noted above (p. 300) and below (p. 312) that both the Steering Committee Chairman and the Secretary General would have a significant say in these matters. With regard to the second issue it is noted that while, in some cases the Project Managers appear to have taken care to be responsive to comments and suggestions received[17], there were cases where at least some participants who felt that their perspectives did not receive sufficient attention:

> I had the feeling that the personal remarks on drafts of the standard which I sent to the IASC ended up in the drawer of the staff member and were not communicated … (Cson)

Two further comments need to be made with regard to the role of the Project Managers. First, in similarity with Board Representatives and Steering Committee Members, the Project Mangers (as well as the other members of the staff) also experienced individual learning processes. In addition, the interviews suggested political dimensions both to the deliberations amongst the various members of Staff and to the discussions with the Steering Committee Chairmen. In other words, as in the case with the Steering Committee there were sub-processes specific to this level in the organisation.

Second, the chronological review in the previous chapter strongly suggests that the level of Staff (Project Manager) activity increase with time, starting from a very low level indeed in 1987 and reaching an all time high in 1995 - 1996. In this final period, the Project Manager appears to have been more active and more independent than previously and, as a consequence, acted more as driving force (see discussion on pp. 281f).

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17 For example, as noted on p. 263 the staff papers for the September 1996 meeting noted that some Board Members insisted that an exception should be made to the exception relating to temporary differences arising on initial recognition (i.e. that deferred tax should be recognised in relation to compound financial instruments).

9.4.3 The Secretary-Generals

Over time there were also changes in other Staff position. In particular two different Secretary-Generals have taken part in the process of revising IAS 12. The chronological review of the Income Tax project paints a picture where the Secretary General appears to have been more deeply involved in the project (participating in the Steering Committee meetings and in the drawing up of documents etc) during the development of E33 and E49 than in the final period. Nevertheless, even in the final period, the Secretary-General appears to have been both involved in the process and to have significantly affected the developments.

In part this may have depended on necessity, e.g. in the period when the comments to E33 were received there was no Project Manager. In fact, this also applies to the situation going into the June 1994 Board meeting. At this point the Secretary General thus acted as Project Manager. It may also have been related to other developments: as the level of activity within the IASC grew, there may have been generally less time for the Secretary General to be deeply involved in specific technical projects combined with the fact that there was a larger Secretariat with more Project Managers and a Technical Director to deal with these tasks. The roles played by the Secretary Generals may also have depended in part on the individual characteristics and interests of the Secretary-Generals.

In particular, the Secretary Generals, being the Project Manager's superiors, appear to have enjoyed the prerogative of the Project Managers' ear, thus potentially affecting the drafting of the staff papers. A salient example of this from the final stage of the project is found in the description of the background to §10 of the final standard (pp. 243-5). However, the significance of the Secretary Generals for the standard setting process extends beyond influence over the authoring of the documents. The most prominent, but also isolated, example of this is when a Board Member changed position following a letter from the Secretary-General (p. 276). In other word, some kind of influence through lobbying cannot be ignored.

9.4.4 The Technical Directors

The position of Technical Director is another staff position that appeared during the period of study. The first references to this position are found in the very beginning of the period during which E49 was developed, the Technical Director being said to have been deeply involved in drafting the revised EDs for the Steering Committee meeting in December 1992. In fact, at that point the Technical Director seems to have acted as a Project Manager. Following this, however, there are very few references to people having this position and it would appear that the Technical Directors did not significantly affect the process of revising IAS 12[18]. On the one hand this may seem surprising. On the other hand, considering the following description of the Technical Director's position, it is perhaps less so:

> The main job of the Technical Director is to make sure that good progress is made on the technical aspects of all projects on the Board's agenda and to draw up the Board agenda in consultation with the Secretary General and … to make sure that papers for the Board on the technical projects are delivered on time. (Json)

9.4.5 Discussion of observations

In summary it has been suggested that:

- The Staff of the IASC are the only participants in the process of revising IAS who were involved in these activities on a more or less continuous basis. However, over time there was a certain staff turnover, so that at one point there was almost no staff continuity (both in general and relating to the specific project).
- Over time there was a marked increase in the size of the IASC Secretariat. In addition to the various Project Managers, the Secretary-Generals also appear, in varying degrees, to have been significant for the process. The various Technical Directors, however, do not seem to have significantly affected the process.
- The Project Manager collected, prepared and distributed information to the various participants in the process. This, in turn, required interpretation of the Steering Committee/Board discussions and

18 An exception is in the period following the June 1994 approval of E49 and its release later the same year. However, the available evidence suggests that this involvement was mainly concerned with various practicalities such as circulating various drafts. At this point (when again there was no Project Manager for this project), however, it seems to have been the Secretary General that was most deeply involved in the technical matters.

decisions. It also involved identifying alternatives and implications and making recommendations on how to proceed.

- The Project Managers can be seen to have acted as significant driving force providing both momentum and direction to the standard setting process, affecting both the learning and political processes at both the Board and Steering Committee level.
- Over time there was a marked increase in project manager activities.

Some of these observations are contrasted to the previous standard setting literature in three sub-sections dealing with: (1) staff size, (2) staff turnover and (3) staff activities and significance.

(1) Staff size

Although the size of the IASC technical staff grew over the years, the IASC Secretariat remained smaller than that of the US standard setter – the FASB - which works with about 40 technical staff (http://www.fasb.org/ 041030). Furthermore, whereas the IASC Income Tax Project Manager worked more or less on his own, Beresford and van Riper report that FASB experience has shown that "a regularly assigned project team of two to five staff members yields the best results" (1992: 82). In relation to this it can also be noted that the FASB differentiate between many more Staff positions. Miller and Redding (1988: 44) list the following positions: Project Manager, Senior Technical Adviser, Assistant Project Manager, Technical Associate and Project Administrative Assistant.

To be noted in this context is perhaps also that in his review of standard setters in Canada, the UK and the US, Gorelik (1994: 109, 120) suggests that the early efforts were generally supported by a relatively small secretariat (administrative office), but that the trend, over the years has been toward more staff support. As an item of curiosity it might be noted that, in addition to operations-, education- and publication staff, the IASB lists 20 technical staff, differentiating between: Director of Technical Activities (1), Director of Research (1), Senior Project Manager (4), Project Manager (7), Assistant Project Manager (1) as well as Practice Fellow (3), Research fellow (1 part-time), Technical Associate (1) and Visiting Fellow (1) (http://www.iasb.org/about/staff_technical.asp 041030).

(2) Staff turnover

A significant turnover of IASC staff in relation to this project was observed. It has been suggested that this owed partly to the reliance of seconded staff. It is noted, however, that other authors have also observed what has been considered a high turnover among technical staff of other accounting standard setters. In summarising criticism of the earlier US standard setter (the APB) Baxter, for example, noted that its "staff were inadequate in numbers and kept changing" (1981: 4). A few years later Swieringa noted that participation in the FASB's processes was "fluid" (1987: 1). A few years further on, also on the topic of the FASB, Beresford and van Riper noted that most staff "make their contribution… within a few years " and that turnover in the technical staff is partly "institutionalized in the programs for practice, industry and faculty fellows" (1992: 82).

High turnover in the staff therefore appears not to have been something unique for the IASC. In this context, it is therefore perhaps interesting to note that Miller and Redding argue that a high turnover of staff should not be seen as a sign of instability (of the FASB):

> Given the nature of the work and the pressures that accompany it, Staff members tend to be highly mobile and energetic individuals. Resignations occur frequently, and new positions are filled quickly. This turnover is not a sign of instability but rather the qualifications of the employees and the nature of the institution. (1988: 45)

This argument, however, relies on the assumption that:

> A measure of continuity is provided by the presence of a group of long-term members (ibid).

As already noted, when the IASC project on income tax moved into its final stage there was virtually no such staff continuity.

(3) Staff activities & staff significance

Several writers on accounting standard setting have touched on the issue of the significance of the staff of a standard setter, particularly in the Anglo-American literature and particularly from a perspective that this group of participants may exercise an "undue" influence over the process. In line with the general focus on the US, the role of the Staff of the FASB appears to have particularly addressed. For example, Beresford and van Riper set out, *inter alia*, to dispel the "widespread misapprehension that the staff exercises undue influence over the board's decision making" (1992: 82). Their

arguments rest on one assumption in particular: that the staff recommendations are "challenged rigorously by board members" (ibid). As noted earlier in this chapter, to a certain extent this also appears to have been the case when the IASC Board considered proposals relating to the revision of IAS 12.

Previous writings on staff influence over the accounting standard setting process are discussed in two sub-sections. The first focuses on suggestions that the staff possess a form of power through their control over the documents. The following section then addresses what has previously been said about staff activities and the nature of their influence.

The pen as a source of influence

The fact that the staff of a standard setting body may possess some kind of (pen-)power has, for example, been (indirectly) suggested on an a-priori basis by Walker and Robinson:

> … the way issues are described and presented in discussion memoranda and exposure drafts may have a significant influence on the way others respond to those proposals. Some issues may be highlighted while others are given little attention. Potential respondents may be guided towards some positions, and away from others. (1993: 10)

In reporting his study of the process of developing IAS 37 Flower also assigned a central role to the staff of the IASC, partly because of its control over the various documents:

> The Secretariat's principal function is to prepare texts of documents for consideration by the other two bodies. The preparation of these texts is not a purely mechanical process as it often involves interpreting the views of individual members of these bodies. Hence, the Secretariat is in a strong position to influence the content of exposure drafts and standards. (1998: 17)

An example of such influence in that case was the staff gave greater prominence to one written comment on an ED in a summary of comments received:

> The Secretariat's analysis … was largely quantitative; it gave as much weight to the reply of an unknown individual as to that of the FASB. However, on the first page of its analysis, the Secretariat gave great prominence to the following excerpt from the comments of … (ibid: 12-3)

Similar instances were found in the review of the process of revising IAS 12. As noted above (pp. 158, 174), and further explored in the section on commentators below (9.7, pp. 324f), some comments/issues found their way into the deliberations despite being downplayed in staff papers. Again this thus suggests limits to control of the documents as a source of influence.

To be noted is also that although Flower suggested that the IASC Staff were in a position to heavily influence the process, he - in similarity with the previous review - added that

> There is not evidence from the IASC's files that the Secretariat abused its position in this matter (ibid: 17).

Staff activities and the nature of Staff influence

Listing a number of specific tasks, Miller and Redding (1988: 44) have argued that the duty of the staff of the FASB is "to do whatever is needed to facilitate the work of the FASB and its Members". Their list (see figure 9.6, p. 318) appears broadly in line with the tasks identified for the IASC's staff. This also applies to the following description of FASB staff activities in Beresford and van Riper:

> Board members determine the general direction of research. Staff members do the research, report their findings and make recommendations. The Board considers those recommendations and very often asks staff for additional research or to explore other directions. (1992: 82)

Beresford and van Riper also suggest that the tasks of the FASB staff include to (a) provide "carefully thought out staff memorandum to provide a basis for discussion"; and (b) hold "educational meetings" with the decision makers to ensure that they "enter a decision making public meeting with a full understanding of the background and nuances of the matters to be discussed" (ibid). Again these tasks also seem broadly in line with role suggested for the IASC's staff. The potential significance of the IASC staff papers has already been discussed above (pp. 309f). Furthermore, although the IASC did not hold specific educational meetings the review suggests that the Staff would sometimes step in to explain the issues at hand during Board and Steering Committee meetings. See, e.g., the reference to the staff explaining various concerns at the November 1993 Board meeting (p. 178) and the reference to the Project Manager explaining technical points to the Board in the quotation on page 308.

- Researching the issues at all stages in a project
- Communicating with constituents
- Facilitating communication among Board Members
- Preparing preliminary proposals for Board deliberations
- Preparing summaries of Board meetings
- Drafting publication, including discussion documents and final pronouncements
- Analyzing written and oral comments from the constituencies
- Distributing informal implementation guidance
- Speaking and otherwise representing the FASB
- Other public relations activities

Figure 9.6 FASB Staff tasks according to Miller and Redding

In contrast to the above description, which emphasises the role played by the staff in the learning aspects of the standard setting process, Miller and Redding emphasise the role played by the staff in the process of consensus-seeking, suggesting that the main task of a FASB Project Manager's is one of diplomacy:

> Perhaps the Project Managers' most difficult task is serving as the interface between Board Members in the process of developing a consensus on the issues. Specifically, the Project Manager attempts to find the compromises that will develop a sufficiently large consensus to allow a pronouncement to be issued. In doing so, the Project Manager goes between different Board Members, attempting to negotiate an acceptable position for as many of them as possible. (1988: 46)

Whereas the description of the Staff being concerned with finding "the compromises that will develop a sufficiently large consensus" also seem to fit in the description of the process of revising IAS 12, the suggestion that the Staff can be seen to act as an (active) *Negotiator* between Board Members / Representatives is perhaps less obvious on first encounter.

In the FASB case this function appears to be at least partly institutionalised through the use of pre-meetings:

> At least one week before each meeting, the [FASB] Staff gives [FASB] Board Members memorandums that identify the specific issues and other questions that are to be addressed and resolved in the public meeting. Then (usually on Monday and Tuesday), the project team holds private meetings with all Board members (in groups of one, two, or three) to gauge their reactions, understand their preliminary positions, as well as to brief them on the thoughts of the other Board members. (ibid: 67)

The IASC did not have pre-meetings. However, the procedure to request written comments from Board Members on draft documents circulated prior to Board meetings can be seen as another means of gauging reactions and understanding preliminary positions. Furthermore, sometimes the Staff notes would set out the Staff's perception of the Board opinion. It would thus seem that the differences may be smaller than it might first appear and be limited to *how* the Staff (the Project Manager) performed this function. These differences, in turn, seem primarily related to organisational differences between the IASC and the FASB. For example, the IASC Board was much larger than that of the FASB. It also only convened in one place at the time of the actual meetings. Furthermore, in the case of the IASC, the role of *Negotiator* also appears to have been partly played by the Steering Committee Chairman (see reference to "personal lobbying" on p. 301).

To be noted in this context is that Miller and Redding argue that this arrangement – with the staff acting as *Negotiators* – is preferable to the decision-makers dealing directly with each other "because they do not have to reveal to each other what concessions they are willing to make" (ibid).

In summary then, previous literature on the activities and influence of the staff of standard setting bodies also recognise that the staff may affect the learning and political aspects of the process. To be noted, however, is that the previous literature would seem to emphasise one or the other of these two roles.

9.5 The Observers

A peculiarity of the process of revising IAS 12, or more accurately the IASC, may have been that a number of individuals were directly involved in the standard setting process without being Board Representatives, Steering Committee Members or Members of the Staff. These were so called "Observers". They were allowed to participate in Board or Steering Committee discussions, but not in the related voting.

With one exception the Observers noted in the chronological review were members of, or members of staff of, various national standard setting bodies.

The exception was the IOSCO observers on the Board and on the July 1995 Steering Committee meeting[19].

The Observers on the Steering Committee appeared gradually after the project was reactivated in 1992. Their appearance was preceded by a Staff sugges-tion to the Board in October 1992 that the project be pursued jointly with other (national) standard-setting bodies, or at least, that representatives from such bodies should meet the Steering Committee to share experience on this topic (920318LCSc). Following this (in December 1992) the FASB's project manager on income taxes was invited "to assist the IASC with its taxes project and to attend the Income Tax Steering Committee" meeting (921207…). One day prior to the meeting, he also held a presentation[20] on the FASB project (ibid).

Although invited, the US project manager did not attend the following two Steering Committee meetings. However, he was kept up to date on developments and asked to provide comments on various drafts, which he did. Comments received on the December 21st 1993 draft, for example, covered eight pages and a number of topics. At least in respect of this draft he was asked to confirm a list of differences compared to SFAS 109 and to provide an indication of the acceptability of the proposals in the US. Not surprisingly then, the comments received were often of the type that a proposal may not be popular with US companies or that an issue addressed in SFAS 109 was not addressed in the IASC proposals.

The US project manager reappeared at the July 1995 meeting. In the meantime, the project manager of a concurrent Canadian income tax project became an observer on the Steering Committee in the spring of 1993. In the final period, for the July 1995 Steering Committee meeting, these two observers were also joined by observers from the UK and Australian standard setters.

Steering Committee observers generally seem to have received the same material and requests for comments as (the former) Steering Committee members. They generally seem to have responded to these requests actively,

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19 In this case the individual was employed by the Securities and Exchange Commission (SEC) in the US, which might also be considered as a national (accounting) standard setting body.

20 The presentation was scheduled for 6pm – 7.30 pm.

thereby particularly contributing to the, mainly written, discussions that followed the July 1995 Steering Committee meeting. Some of the observers were also contacted on specific issues. For example, the UK standard setter (the ASB) was contacted in relation to the issue of revaluations [I-10] and rollover relief [I-29] and the IOSCO, FASB and CICA (as well as one Board delegation) were contacted in relation to the issue of the treatment of deferred tax in situations of hyperinflation [I-17b]. Responses received from these observers were frequently detailed and lengthy.

Perhaps one of the most fascinating aspects of the chronological account is the repeated references made to the participation and influence of FASB observers. In addition to the FASB observer on the Steering Committee, the FASB also had, in its capacity of Consultative Group member, an observer status on the IASC Board. The chronological review strongly suggests that both FASB observers[21] were highly influential, particularly with regard to the shift to the balance sheet liability method [I-3] in 1992-1994 and to the discussions vis-à-vis the definition of tax base [I-25a] and the treatment of dual tax bases [I-25b] in 1995-1996. Whereas this impact would seem to have induced progress (in the sense of Board agreement on an ED) in the former period, it would seem to have hampered Board agreement on an IAS in the latter period. This was because, although supportive of the balance sheet liability method [I-3], the FASB's observers continued to remain concerned with specific proposals.

The interviewees stressed that the Steering Committee and the Board had been persuaded by the logic of the arguments presented by the knowledgeable, articulate and confident FASB observers. In the words of one interviewee (reminiscing the July 1995 Steering Committee meeting):

> What I remember most is [observer X]'s many statements about everything. He was very sure about many detailed issues …. (Nson)

One of the interviews stressed the perception that the role of the FASB observers in this process had been educatory; that they had affected the individual learning processes:

> … he [the US Project Manager] was tremendously helpful and as far as I know he was "honest" in terms of what he was telling me. In fact, what

21 While the FASB observer on the Steering Committee was a member of FASB Staff, the Board observer was a member of the FASB. However, neither were "representatives" of the FASB, i.e. it was made clear that they did not represent/present the official position of the FASB.

> was interesting at that first meeting … he was not particularly trying to sell IASC on the method they were using. He just saw his job was to come along and explain what they had done and really it was for [the Steering Committee] to decide. ……. he was there and he chipped in quite a lot during the meeting ... by, questioning a lot of the things that were being proposed in the ED … (Kson)

Not much has been written on the topic of Board and Steering Committee observers. Flower and Ebbers, however, have raised the issue of the influence of such observers within the IASC:

> … it was widely believed that the influence of the observers was much greater than might be expected. The board members probably gave great weight to the views of IOSCO, the European Commission and the FASB, since if any of these bodies were to come out strongly against an IAS, this would have had a markedly negative effect on its acceptability. (2002: 246)

In the extension, they argue that this implies a de-coupled organisation, i.e.: "that the way in which the IASC operated was not reflected in its formal organization" (ibid). In contrast to the above, however, they seem to stress the influence of such observers on the political aspects of the process, the deal-making.

9.6 The formal consultants

As noted in section 4.2.2 the IASC included a Consultative Group, whose task it was to advise the Board on, amongst other things, technical issues in specific standard setting projects and the likely acceptability of the IASC's standards. Although three Consultative Group Members appear to have played significant roles in the process of revising IAS 12, it can be argued that only one of these did so in the capacity of being a Consultative Group Member and even so, the impact through this channel was limited. In fact, all of the Consultative Group members identified as significant in the process of revising IAS 12 also had other channels of access to the process.

The three Consultative Group Members identified as having been significant in the process of revising IAS 12 are:

- ***the Financial Accounting Standards Board (FASB);***
  The influence of the FASB on the process of revising IAS 12 seems to have come mainly through its observers on the IASC Board and Steering Committee (section 9.5, pp. 319f). The review also suggests a significant indirect influence through its status as an important (perhaps the most important) national standard setter. More specifically, the chronological review contains numerous references to comparisons being made to SFAS 96 and 109.

- ***the International Organisation of Securities Commissions (IOSCO)[22]; and***
  Although the IOSCO also had Board and Steering Committee observers, its influence on the process of revising IAS 12 seems to have been mainly indirect[23], particularly through its impact on the IASC's agenda. For example, one factor identified as contributing to the project taxes being deferred in 1990 was that the IASC's resources were taken up by the C/I-project, which had higher priority. The advent of this project, in turn has been attributed to the IOSCO (see pp. 133f, 154). Similarly, when work on the project resumed following the comment period on E49, this was given high priority following the July 1995 agreement between the IASC and the IOSCO (p. 229).

- ***the International Chamber of Commerce (ICC).***
  On the one hand evidence of ICC involvement in the process of revising IAS 12 includes written comment letters on the draft EDs presented to the November 1988 and March 1993 Board meetings. An ICC Consulta-tive Group Representative also provided written comments in February 1994. On the other hand, it must be noted that in October 1992 the ICC was invited to (and accepted) to send a Member to the Taxes Steering Committee (p. 166). Hence, in similarity with the FASB and the IOSCO, the ICC had another channel of access to the process.
  The arguments presented by the ICC Consultative Group Representative and Steering Committee Member were very much the same. In fact, the

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22 The IOSCO (as well as the International Bar Association and the International Banking Associations) was invited to join the IASC's Consultative Group following a decision by the IASC Board in March 1987. It has been reported that the IASC first offered the IOSCO a Board Membership, but that this offer was not taken up (Cairns, 1998: 62).

23 An exception to this seems to be that in 1989/1990 the IOSCO reportedly suggested that IAS 12 required further improvements (than suggested by E33) (pp. 162-3).

letter prior to the March 1993 Board meeting from the Consultative Group Member was motivated in terms of the views of "its" Steering Committee Member not having been taken into consideration:

> … He has made several written suggestions most of which were not taken into account the Steering Committee. I, therefore, would like to mention again the most important one: … (9303CICC)

In November 1993 a number of Consultative Group Members are reported to have expressed concerns over the balance sheet liability method. In fact, there was reportedly "little support expressed for the balance sheet approach other than by the FASB representative" (940215AP1). One interviewee suggested that one of the ICC representatives had "made sure that that concerns were expressed" (Kson). The impact of this on the process is difficult to assess. Although it certainly didn't help, it appears to have been only indicative of the real problems.

Two interviewees remarked that the ICC had been influential on the Consultative Group partly because they represented preparers and partly because they (one of the Representatives) represented Swiss companies, which were "the only big international companies really using the IAS" (Pson) at that time.

Little has been written on the role/significance of the IASC's Consultative Group or bodies like it. In summary it might be argued that the review of IAS 12 does not suggest that this body had a significant direct role in the IASC's standard setting activities. In fact, its primary role seems to have been similar to one of the roles suggested for the Steering Committee: to allow various parties a means of participating in the IASC's activities.

9.7 The commentators

9.7.1 Introducing the commentators

Parties outside the standard setting body were invited to provide written comments on draft proposals twice: on E33 in 1989 and on E49 in 1994/5. The number of comment letters received on the two EDs totalled 44 and 73 respectively. Not only did the number of letters increase significantly between E33 and E49, there are also interesting changes in the make-up of the responding community with respect to:

- *geographical origin*; and

While there was a distinct North American dominance in the comments to E33 (43 %), there was a similar European dominance in the responses to E49 (44 %). Using the concepts of Anglo-American and Continental European cultural spheres, however, the change is less drastic.

- *type of respondent.*

While there was a distinct dominance of *IASC Member Bodies* responding to E33 (39 %), this category only provided 19 % of the comments on E49. To be noted is, however, that in terms of absolute figures there was only a decrease from 17 to 14 comment letters from Member bodies. Given that the size of the IASC membership at the time, however, both figures may be perceived as a fairly low response rates.

Instead, the responses from the previously second largest category of respondents - *individual companies* – more than doubled and became the largest respondent category (30 % of the responses to E49 compared to 23 % of the responses to E33). Furthermore, whereas six of 10 comments received from companies to E33 were from the US, only three of 22 comments from companies on E49 were from the US. Instead the number of European companies increased from two to fifteen. (See 6.5.2 pp. 155-60 & 8.2.2 pp. 219-227.)

9.7.2 Comments received

Most responses were fairly short and focused on issues for which the respondents did not agree with the proposals in the EDs. Comments received on E33 were broadly supportive of the proposal to require deferred tax accounting using the (unspecified income statement) liability method. Nevertheless, disagreements were voiced on a number of sub-issues of how to apply this approach. Comments received on E49 were somewhat less supportive. Although 40 % of the respondents were seen to support the ED, again most of these included various reservations with respect to specific issues. Moreover, about 20 % of the respondents were seen to oppose a standard based on E49. The remaining respondents (40 %) did not state whether they supported E49 or not, commenting specific issues only.

9.7.3 Significance of comments received

Comments received on the two EDs were distributed to all Board and Steering Committee Members. In addition the Staff prepared summaries of the comments and papers identifying the key concerns of the commentators. This suggest that the comments received affected the standard setting process in so far that issues raised and identified by the Staff were (re-) visited by the Staff, the Steering Committee and the Board and thus, at least potentially, affected the progression (direction and speed) of the standard setting process. For example, the many comments to E33 relating to undistributed profits of subsidiaries and associates [I-8] and to a proposed disclosure [I-15] initially seem to have swayed the positions relative those issues as work on the project resumed (p. 171).

This suggestion, however, requires at least two modifications. First, the review of the process of revising IAS 12 suggests that issues raised in comment letters might influence the process even if not picked up or emphasised in the Staff summaries. Two prime examples of this have been noted:

- Although addressed by five commentators, the Staff's list of "issues needing to be revisited in the light of comments received on E33" did not include the choice of balance sheet liability method [I-3]. Never the less, this soon emerged as the key issue as E49 was developed.
- Following E49 the FASB comment that the tax base "is cost regardless of whether that cost can ever be deducted in subsequent determinations of taxable profit" (950531C…) appears to have been disregarded initially [I-25a]. However, this very argument had a significant impact on the developments later in the process.

Second, it seems that is that large numbers of comments relating to an issue were neither *required* nor *sufficient* for an issue to be (re-)raised:

- Some of the comments that appear to have had a significant impact on the ensuing process were only made by a small number of commentators. For example, only two comment letters argued that E49 lost credibility by the many exceptions (p. 225). Similarly only two comment letters seem to have been critical to the criterion for the exception relating to investments in subsidiaries based on probability of reversal (p. 264). Also note the above reference to FASB comment regarding the definition of tax base [I-25a].

- Although a third of the comments to E49 were seen to oppose the balance sheet liability method, this issue was not revisited (p. 235).

This said, however, it should be noted that apart from overall acceptance of the balance sheet liability method, only a few comments on E49 addressed the same issue. In other words, it is not generally possible to compare the response on issues receiving many comments with the developments relating to issues receiving only a few comments. Furthermore, the fact that some of these issues (eventually) surfaced may be completely unrelated to them having been raised in an official comment on an ED. For example, as noted, in addition to submitting official comments to E49, the FASB also had observer status on the IASC Board and on the Income Tax Steering Committee. In view of the limited number of cases it is also impossible to say whether it was the power of the comments or the commentators that contributed to the noted effects of the comments received.

This said about *whether or not* comments received affected the subsequent standard setting process, more can be said about the *nature* of the potential impact. Although comments received to E33 primarily seem to have swayed the proposed positions relative those issues, i.e. affected the deal-making, comments received to E33 relating to the choice of liability method [I-3] and comments to E49 relating to the definition of tax base [I-25a], seem to have, more than anything else, jolted the learning process(es). It is perhaps tempting to think that, had the preparatory work been done properly, this should not occur. However, this disregards both the impact of outside events and the nature of the learning process, being slow and in a sense never-ending. In this respect it is perhaps indicative that these effects seem to appear with some delay, sometimes even after first having been overlooked and/or dismissed; developments in thoughts requiring time to “sink in”.

Finally, to be noted is that when the comments received affected the learning process, this gave rise to new understanding, new alternatives and/or issues. As a consequence, the standard setting process became non-linear and consideration of the effect of, e.g. written comments on EDs, complicated.

9.7.4 Discussion of observations

In summary it has been noted that the public was asked to provide written comments on two EDs in relation to this project. The number of comment letters received increased from 44 in 1989 to 73 in 1994/5. There are also changes in the make-up of the responding community. It is also suggests that the comments received had both direct effects on the proposed deals (primarily after E33) and more indirect effects, via processes of learning.

These findings are contrasted to the previous standard setting literature in three sub-sections dealing with: (1) the number of comments and composition of respondents, (2) the nature of the comments received and (3) significance of the comments

(1) Number of comments & composition of respondents

The number of comments received on E33 and E49 seem well in line with the findings reported by Kenny and Larson (1995) and Larson (1997) for other IASC projects (pp. 54-5). Although the number of comments received on E49 can be perceived as significantly higher than the average, Larson (1997) reports higher numbers of comments received for at least two projects (not counting E32) and almost the same number of comments being received to two DSOPS issued in 1994. Taken together, however, the findings might suggest that the IASC started receiving (slightly) more responses to its documents in 1994.

As noted in chapter 3, Kenny and Larson (1995) report a dominance of responses from member bodies. These accounted for 31 % of all responses, while responses from preparers (only) accounting for 23 % of the total responses. From this perspective the dominance of corporate responses to E49 is striking, potentially signalling that the IASC's process was becoming more similar to most national processes (where a preparer dominance seems to be the general rule p. 53). However, as will be indicated below, the large number of corporate responses to E49 may be related to exceptionally many such responses being received from Switzerland and the UK.

As also noted in chapter 3, the findings of Kenny and Larson (1995) suggested that there existed a core group of regular respondents (p. 55). Neither E33 nor E49 were included in these samples. However, a comparison of the noted respondents to the Income Taxes EDs shows a large correspondence with the suggested core group of respondents (figure 9.7,

pp. 331-3). The largest discrepancy is perhaps for corporate responses. Whereas 10 comments from individual companies were listed for E33 and 22 for E49, Kenny and Larson's list of core respondents (1995: 292) only included five companies. The follow-up study, however, listed 17 core-responding companies, of which over half (9) were US. A comparison of corporate responses to E33 and E49 to the core-companies identified by Larson is found in figure 9.8 (p. 334). Interestingly, only 10 of these 17 companies are represented in this sample and then mainly in the comments to E49. Furthermore, although Larson reports a distinct US influence, this is not as clear in this case, a significant number of UK and Swiss companies responding to E49. (Although seven US companies responded to E33, only two commented E49.)

In discussing corporate responses to exposure drafts issued by the IASC, Larson notes that only 16 of the 100 responding companies reported using IASs by the end of 1994 (1997: 187). Only seven of these were in the group of identified core responding companies, five being included in figure 9.8 (these are marked with bold)[24]. Larson also identifies five companies as having, or having had, a representative on the IASC Board. All of these are also included in the list below[25].

(2) Nature of comments received

In line with the suggestion that the comment letters were generally quite short it is noted that Kenny and Larson also report that respondents' comment letters tended to be "quite straightforward and often almost terse" (1993: 504). While they suggest that, as a result, the "concerns often present in content analysis" were "somewhat lessened" (ibid), the descriptions of problems associated with analysing responses to exposure drafts suggested by Walker and Robinson seems very fitting:

> …, informal discussions with current or former staff of rule-making bodies suggest that this task [summarizing submissions received] is difficult and subjective. Some responses may be vague (e.g., I wonder if anyone will benefit from this type of disclosure?). Sometimes comments on several issues will be contained within a single paragraph (e.g., I fully support the

24 No effort has been made to identify if any of the companies identified as responding to E33 and/or E49, but not included in Larson's list of core responding companies also reported according to IASs.

25 Again no effort has been made to identify if any of the companies identified as responding to E33 and/or E49, but not included in Larson's list of core responding companies, had or had had such representation.

> proposals), making it difficult to tally responses. Few respondents directly address every issue: while some may indicate agreement with all proposals not specifically mentioned in their replies; others may simply criticize proposals with which they disagree – so that a choice has to be made whether the respondents' attitudes towards remaining issues should or should not be inferred. Even counting the number of responses may require arbitrary assumptions: if an individual sends in ten responses on the letterhead of ten related companies, should they be counted as ten responses – or one? Should the collective and individual responses of organized interests such as the U.S. Ad Hoc Committee on Full-Cost Accounting or Australia's Group of 100 be counted as individual responses or aggregated as one response?) (1993: 12)

(3) The role /significance of the comments

Given the significance attached to the due process in the standard setting in general, the role played by parties outside the standard setting body through written comments has been afforded special attention in previous research (see chapter 3). Nevertheless, Weetman *et al.* argue that the role of written submissions placed on public record remains unresolved (1996: 75).

The review of the process of revising IAS 12 provides some explanations of why consideration of the effect of written comments is complicated. It is not only suggested that the impact on learning may appear with some delay, it is also suggested that this impact may significantly, but indirectly, affect the political process (the deal-making) by giving rise to new understanding, alternatives and issues.

Respondents	**E33**	**E49**	1995
Member bodies:			
American Institute of Certified Public Accountants	X	X	X
Canadian Institute of Chartered Accountants		X	X
Certified General Accountants' Association of Canada	X	X	X
Compagnie Nationale des Commissaires aux Comptes and Ordre des Experts Comptables et des Comptables Agrees (France)	X	*	X
Consultative Committee of Accountancy Bodies (UK)		X	X
Foreningen af Statsautoriserede Revisorer (Denmark)	X	*	X
Föreningen Auktoriserade Revisorer (Sweden)		X	X
Hong Kong society of Accountants	X		
Instituut der Bedrijfrevisoren (Belgium)	X		
Institut des Reviseurs d'Entreprises (Belgium)		X	X
Institut der Wirtschaftsprüfer (Germany)	X	X	X
Institute of Chartered Accountants in Ireland		X	X
Institute of Chartered Accountants of Nigeria	X		
Institute of Chartered Accountants of Pakistan	X		
Institute of Chartered Accountants of Zimbabwe	X	X	X
Institute of Certified Public Accountants of Kenya	X		
Institute of Certified Public Accountants of Singapore	X		
Institute of Chartered Accountants of Trinidad & Tobago	X		
(National Association of Accountants (USA))	X		
Institute of Management Accountants (US)		X	X
Instituto Mexicano de Contadores Publicos AC		X	
Japanese Institute of Certified Public Accountants	X	X	X
New Zealand Society of Accountants	X	X	X
South African Institute of Chartered Accountants	X		X
SchweizerisheTreuhand - und Revisionskammer	X	X	X
	18	14	16 (16)
Other accountancy body:			
Fédération des Experts Comptables Européens FEE (Europe)		X	X
New Jersey Society of Certified Public Accountants (US)		X	
		2	1 (2)
Standard Setters:			
Accounting Standards Committee (UK & Ireland)	X		
Accounting Standards Committee of the Institute of Chartered Accountants and Auditors of Thailand		X	
Australian Accounting Research Foundation	X	X	X
Consiglio Nazionale dei Dottori Commercialisti (Italy)		X	
European Commission		X	*
FASB (US)		X	X
Foreningen af Statsautoriserede Revisorer (Denmark)		X	*
Norsk Regnskaps Stiftelse (Norway)		X	
Raad voor de Jaarverslaggeving (Netherlands)	X	X	X
	3	8	3 (3)

Figure 9.7a List of commentators to E33 and E49 compared to core respondents suggested in Kenny & Larson (1995)

Respondents	**E33**	**E49**	**1995**
Securities Regulators:			
Australian Securities Commission		X	
Commission Nazionale per la Società e la Borsa CONSOB (Italy)		X	
Securities and Exchange Commission (US)	X	X	
	1	3	-
Joint:			
Arbeitsgemeinschaft für Wirtschaftliche Verwaltung (Germany)		X	
Foreningen af Statsautoriserede Revisorer (Denmark)		X	
L'ordre des Experts Comptables et des Comptables Agrées and Compagnie Nationale des Commissaires aux Comptes joint with Conseil National de la Comptabilité		X	
South African Institute of Chartered Accountants		X	
		4	
Bankers:			
British Bankers' Association	X		X
Citicorp Citibank (US)	X		X
	2		2 (4)
Industry Representative Groups:			
Association Française des Entreprisses Privées (France)		X	
Federation of Swiss Industrial Holding Companies & European Round Table		X	
Financial Executives Institute (US)	X		X
Group of 100 (Australia)		X	
International Federation of Financial Executives Institutes (IAFEI)		X	
	1	4	1
Insurers:			
Association of British Insurers (UK)		X	
Verbond van Verzekeraars (Netherlands)		X	
		2	
Companies:			
Alcan Aliminium (Canada)		X	
Allied Domecq (UK)		X	
Ascom AG (Switzerland)		X	
BAT Industries (UK)		X	
BP (UK)		X	
Broken Hill Proprietary BHP (Australia)	X	X	¤
Carlsberg (Denmark)		X	
CG Smith (South Africa)		X	
Coles Myer Ltd. (Australia)		X	¤
Household International Inc. (US)	X		
I. du Pont de Nemours & Company (US)	X		
Keramik Holding AG Laufen (Switzerland)		X	
Lafarge Coppée (France)		X	
Merck (US)		X	
Nestlé SA (Switzerland)		X	X

Figure 9.7b List of commentators to E33 and E49 compared to core respondents suggested in Kenny & Larson (1995)

Respondents	E33	E49	1995
Companies (cont):			
Oerlikon-Bührle (Switzerland)		X	
Pacific Telesis	X		
Philips International BV (Netherlands)		X	
Philip Morris (US)	X		
Royal Dutch Shell Group (UK/Netherlands)	X	X	X
Salomon (US)	X		X
Sandoz International (Switzerland)		X	
Solvay S.A. (Belgium)		X	
South African Breweries Limited (South Africa)	X	X	
Telefónica (Spain)		X	
Texaco Inc. (US)	X	X	X
Unilever PLC (UK)	X	X	
	10	22	4 (5)
Financial Analysts:			
Association for Investment Management and Research AIMR (US)		X	X
Financial Analysts Federation (US)	X		
Security Analysts Association of Japan		X	X
Society of Investment Analyst (UK)	X		
	2	2	2 (2)
Accounting firms:			
Arthur Andersen & Co (US)	X		X
Arthur Andersen (international)		X	
Coopers & Lybrand (US)/ (UK) / (Different)	X	X	X
Deloitte Touche Tohmatsu (Different)		XX	X
Ernst & Young (International) / (Different)		X	X
KPMG Denmark		X	
KPMG (UK)		X	
Hodgson Impey (UK)	X		
Price Waterhouse (US) / (not specified) /(different)	X	X	X
	4	7	5
Academic:			
American Accounting Association		X	
		1	
Individuals:			
M P Carscallen (Coppers & Lybrand, Canada)	X		
R Cotting (Switzerland)		X	
Y Dotan (Israel)		X	
Professor of Accounting Ken Most (Florida International University) (US)	X		
Selwyn MacFarlane, South African Breweries (South Africa)	X		
Willis A Smith (US)	X		X
	4	2	1 (1)

Figure 9.7c List of commentators to E33 and E49 compared to core respondents suggested in Kenny & Larson (1995)

Responding companies per country	**E33**	**E49**	***1997***
Australia:			
Broken Hill Proprietary BHP *	X	X	X
Coles Myer Ltd.		X	X
	1	*2*	*2 (2)*
Canada: Alcan Aliminium		X	
		1	*0 (1)*
France: **Lafarge Coppée**		X	X
		1	*1 (1)*
Netherlands:			
Royal Dutch Shell Group *(& UK)* *****	X	X	X
Philips International BV		X	
	1	*2*	*1 (1)*
South Africa:			
South African Breweries Limited *	X	X	X
CG Smith		X	
	1	*2*	*1 (1)*
Switzerland:			
Ascom AG		X	
Keramik Holding AG Laufen		X	
Nestlé SA *		X	X
Oerlikon-Bührle		X	
Sandoz International		X	
		5	*1 (1)*
United Kingdom:			
Allied Domecq		X	
BAT Industries		X	
BP		X	
Unilever PLC	X	X	
	1	*4*	*0(0)*
United States:			
Household International Inc.	X		
Citicorp Citibank ***** (PREVIOUSLY LISTED AS BANK)	X		X
I. du Pont de Nemours & Company	X		
Merck		X	X
Pacific Telesis	X		
Philip Morris	X		
Salomon	X		X
Texaco Inc.	X	X	X
	7	*2*	*4 (9)*
Belgium: Solvay S.A.		X	
Denmark: Carlsberg		X	
Spain: Telefónica		X	
	11**	22	10 (17)

Figure 9.8 Analysis of corporate responses to E33 and E49 by country, comparison with Larson (1997)

PART III

THE FINDINGS

Part III presents the understanding of the accounting standard setting process generated by the review of the process of revising IAS 12 (chapter 10) and discusses this in the light of previous writings in this area as well as against the stated objective and aspirations of the research project (chapter 11). A summary of the thesis is also provided at the beginning of chapter 11.

10 BEYOND THE SPECIFICS 336

11 SUMMARY & DISCUSSION 370

CHAPTER 10

BEYOND THE SPECIFICS

10.1 Introduction

One reflection following the review of the process of revising IAS 12 is that the developments towards the end of this process were quite different from those at the beginning. In the beginning the IASC adopted a wait-and-see approach, stepping back for the national processes. In this era – which includes the development of the original IAS 12, the Working Party on Deferred Tax and the development of E33 – the accounting alternatives and preferred solutions were also relatively well defined. The focus of the standard setting process seems to have been on what has been described in terms of deal-making. The main deal-making tool seems to have been the inclusion of alternatives. Admittedly, a certain part of the process also seems to have been about gathering and exchanging information on accounting alternatives. However, compared to later periods, there seems to have been no significant development of accounting thought as a result of these activities.

In the later periods, i.e. the periods during which E49 and the text for the revised Standard were developed, the IASC adopted more of a leadership role. Although the US standard setting body had come far in its work on this topic, other national standard setting bodies, such as those in Australia, Canada and the UK were only just beginning. Notably, comments to E49 included suggestions that the IASC's timing vis-à-vis the UK was "inopportune" (p. 221) and that the IASC should defer developments until the British proposals were further refined. Nevertheless, the IASC persevered, proposing to require an approach to the accounting of deferred tax that was new to most accountants in the world. As a result, in this era, neither the alternatives, nor the positions, were well defined. This, in turn, meant that, besides deal-making, learning (including issue expansion), became a significant element of the standard setting process.

Another characteristic of these later periods is that a number of factors contributed to raising the level of controversy of the standard-setting

decisions. First, a change in IASC strategy (following the *Comparability / Improvements Project*[1]) meant that the tolerance for alternatives as a means of reaching consensus was much lower. Second, the importance of the IASC and its standards was increasing. The 1995 IASC – IOSCO agreement (p. 229) in particular, suggested that what the IASC agreed on might actually matter.

The use of alternatives all but banned, the main, or perhaps, only tool or trick to reach agreement (besides conviction) seems to have been the use of exceptions. In reaching agreement on the second ED (E49) exceptions were made for a number of transactions and events. Indeed, the exceptions almost undermined all practical consequences of the proposed switch to the balance sheet liability method. When the comments to E49 were considered, the heavy use of exceptions was also identified as a problem and, for a period, attempts were made to reach agreement on a standard with fewer exceptions. To a large extents, however, these efforts failed, the revised IAS 12 making exceptions for a number of significant items.

This summary of the process of revising IAS 12 constitutes one way of understanding this specific standard setting process. In contrast, this chapter attempts to move beyond the specifics by identifying and discussing the understanding of (international) accounting standard setting that has been suggested by the review of this process. This understanding is presented in two sections. Section 10.2 first identifies what may be described as a model of an accounting standard-setting process. Section 10.3 then elaborates on this by discussing how various conditional factors may affect the specific standard-setting process.

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1 The Comparability project was concurrent with the taxes project (p. 133). In 1989 - during the comment period of the first ED (E33) - the IASC Board agreed to set up a new project: the Improvements project (p. 154). The account suggests that although the tolerance for allowing flexibility had thus been reduced already in the period E33 was produced, special factors at the Board meeting when E33 was approve, contributed to the fact that this allowed several alternative treatments (p. 152).

10.2 A model of accounting standard setting

10.2.1 Introduction

The review of the process of revising IAS 12 has led to the suggestion that the international accounting standard-setting process, indeed the accounting standard setting process in general, can be understood in terms of three parallel and interacting sub-processes: (1) a political process, (2) a learning process and (3) an executive process. In other words, it is suggested that an accounting standard can be seen as the result of the development of, and interaction between, three sub-processes. Somewhat simplistically this may be illustrated as follows:

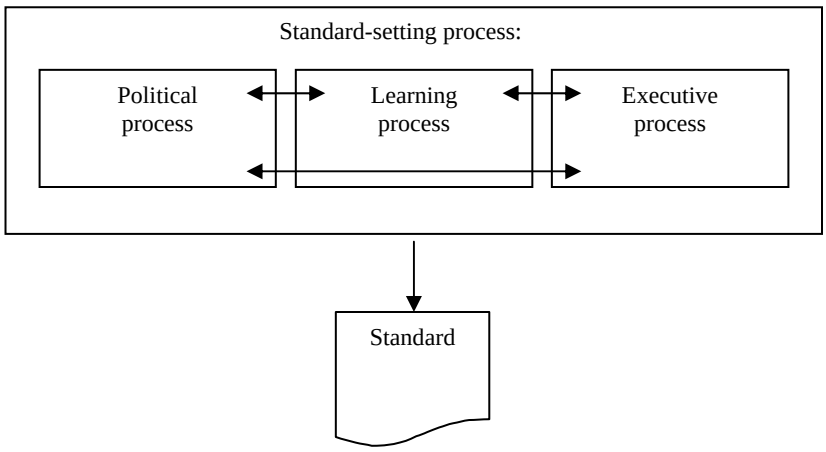

Figure 10.1 A model of the accounting standard setting process

This section expands on this idea by first specifying each of the suggested sub-processes (10.2.3–5) and then summarising the suggested interdependencies (10.2.6). This, in turn, leads to a re-drawing of the above model into one that better reflects the inter-relationships between the sub-processes (figure 10.2, p. 357).

10.2.2 The political process

Persuasion and compromise

In line with much previous literature it is suggested that significant aspects of the accounting standard setting process may be understood in terms of a political[2] process. More specifically it is suggested that the standard setting process may be understood in terms of how – in the presence of a combination of controversy and a consensus / majority-decision rule – (sufficient) *consensus* is reached through *compromise*[3], or in the terminology of chapters five through to nine, by *deal-making*[4].

Another path from controversy to consensus is, of course, *persuasion*[5]. Efforts of persuasion, however, are seen to be closely associated with the learning processes and as such, discussed in section 10.2.3 below.

Compromises

Two main types of compromise solutions ("deals") have been suggested in the review in part II:

- *flexibility, through allowed alternative treatments.*
  Allowing more than one accounting *alternative* for the accounting of essentially the same events / transaction was primarily used in developing E33, more specifically in reaching agreement on three key issues (pp. 151-2).

- *middle-ground solutions, particularly through exceptions.*
  In the case of E33, a middle-ground solution was also proposed for the recognition of assets arising from tax losses [I-7]: the adopted position "assurance beyond any reasonable doubt" was not as stringent as some

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2 Political: involving politics. Politics: competition between competing interest groups or individuals for power and leadership. (http://www.m-w.com/)

3 Compromise: settlement of differences by arbitration or by consent reached by mutual concessions. (http://www.m-w.com/)

4 See sections with the title "Perspectives on the process": 6.4.8 (pp. 150f), section 7.3.11 (pp. 209f) and section 8.3.8 (pp. 275f). Also used repeatedly in chapter 9.

5 Persuade: to move by argument. (http://www.m-w.com/) Persuasion: an act / process / instance of persuading (ibid), i.e. to change the preferences/opinions of some of the participants by way of argument.

would have wanted (realisation), yet more stringent than others wanted (probable) (p. 151).

Exceptions were heavily used in the process of reaching agreement on E49. In the end E49 proposed to make exceptions for temporary differences relating to investments in subsidiaries**,** associates and joint ventures [I-8], goodwill [I-16b,c], certain long-term assets [I-21] [I-16a] and non taxable government grants [I-22]. However, E49 did not make exceptions for temporary differences arising on inter-company transactions [I-9] or revaluations [I-10]. (See e.g. figure 7.3, p. 169 and pp. 214-5.)

The heavy use of exceptions in E49 came under attack following the comment period (pp. 225 & 256f). However, making exceptions remained a main tool for reaching consensus, the process tending to revert to the E49 solution before the standard was approved (p. 281).

Compromises have one important implication for the standard-setting process: they may lead to repeated twists and turns (even complete turnarounds) in proposed solutions (as a result of alternative rules being tried for sufficient consensus). Prominent examples of this from the studied process include:

- *revaluations [I-10]:*
  In the period in which E33 was developed no less than four positions were "tried" in relation to revaluations (figure 6.8, p. 148). A similar number of alternative positions with regard to this issue were also proposed in the ensuing period during which E49 was developed (figure 7.6, p. 188).

- *temporary differences arising on initial recognition* [I-19] etc
  This issue emerged as a consequence of the proposed change in definition of timing/temporary differences in 1992-1994. Following a certain learning process (see figure 7.10, p. 206), the IASC Board agreed that an exception be made for temporary differences arising on initial recognition of non-taxable government grants [I-22] and long-term assets [I-21]. In the period following E49, the discussion focused on whether these exceptions should be deleted, requiring instead that the tax effects be grossed-up [I-19]. The Board first decided in favour this, but later reversed this decision, the revised IAS 12 including one general

exception for temporary differences arising on initial recognition of assets and liabilities [I-21] (pp. 257f).

Compromises may also have important implications for the standard-setting product. Most importantly it must be recognised that compromises may lead to *inconsistencies* in the proposals/agreed standard, for example:

- In the case of E49 it was noted that although the ED proposed to require a completely new method of accounting for deferred tax effects, the exceptions made in the ED limited the effects of this change to the point that it was argued that it would not result in significantly different amounts being recognised in financial statements (pp. 184, 226(e)).

- The Staff argued that the position in the revised standard in relation to compound financial instruments [I-23] is very complex in that essentially an exception is made to an exception (p. 263).

The use of more than one allowed alternative as a compromise solution has one obvious important implication for the product – the standard – in that it compromises the objective of standardisation. In the case of IAS 12 this effect is evident in relation to E33 where it was argued that although the ED proposed substantial changes in relation to six issues, the proposed changes were not significant for those three issues where flexibility was retained (p. 152).

One condition for the achievement of compromises – i.e. for the political process to progress – is that the participants share a desire to reach agreement. Given the above reasoning, this suggestion might also be phrased in terms of the participants sharing an understanding that an (for them) imperfect (flexible and/or inconsistent) standard is better than no standard.

Significant roles

In trying to understand the political sub-process, three significant roles emerge: the potential *Deal-Breakers within* and *outside* the decision-making body (i.e. the IASC Board), and the negotiators, the *Deal-Makers*.

Potential Deal-Breakers within

The first type of (potential) Deal-Breaker is a member of the decision-making body who makes it known that he/she/it will vote against the

proposals (i.e. break the deal) unless a 'satisfactory' solution is found for a specific issue (the potential deal-breaking issue). The extent to which a member of the decision-making body, or a minority-group of members, can exert such deal-breaking power depends on the specific decision rule (majority or unanimity) and the make-up of the decisions-makers with regard to the specific issue, and not from the characteristics of the individual members. What is required is a situation where the required majority is not present, but lacking only a small number of votes. The review of the case of IAS 12 revised includes two prominent examples of (potential) Deal-Breakers relating to the issue of revaluations:

- *The Steering Committee Member and the issue of revaluations [I-10];*
  The review indicates that one Steering Committee Member was particularly concerned with the issue of revaluations. These sentiments emerge perhaps for the first time in relation to the developments in December 1992 when this member objected strongly to the implications of the proposed change in wording for revaluations (p. 175) and seems to have made sure that the proposals to the March 1993 Board meeting included the allowed alternative treatment in E33 (p. 185). Despite being deleted by the Board at that point, the Steering Committee's proposals to the next Board meeting again included such an allowed alternative. Again, this seems to be attributable to one Steering Committee member in particular; the documents indicating that this change was made in order to gain unanimous support for the draft from the Steering Committee (p.186). In the case of the Steering Committee, a single member could have this effect, the committee aiming for unanimous consent for the proposals submitted to the Board.

- *The Board Member and the issue of revaluations [I-10];*
  The review in chapter six suggests that in November 1988, before releasing E33, the Board agreed to amend the Steering Committee's proposed position on revaluations following strong opposition to this voiced by one Board Member (p. 147). The proposed position was made into an allowed alternative and another treatment was designated preferred treatment. Although the position in the draft ED submitted to the Board in March 1993 was identical to that in E33, the Board agreed - at this point - to delete the allowed alternative. It then, following the re-introduction of the allowed alternative by the Steering Committee in March 1994, made the same decision in June 1994. It would appear that again, one Board

> delegation in particular argued strongly against the allowed alternative (pp.185-7).
>
> To be noted is perhaps also that in the final period another Board Member made an unsuccessful attempt to make the issue of revaluations into a deal-breaking issue (footnote 34, p. 280).

Another example of a successful (potential) Deal-breaker is found in the account of developments vis-à-vis the issue of dual-tax bases and the issue of grossing-up [I-25b][I-19] in the final period. Prior to the March 1996 meeting one Board Member explicitly stated that its final vote on the Standard would depend on the adopted position relating to the issue solution for this problem (p. 260). The Board then unanimously agreed to delete the grossing-up requirement (which was in line with this Member's preferences). See also quotation by Mson on page 258.

Potential Deal-breakers outside

The second type of potential Deal-Breakers in the context of international accounting standard setting are major countries. These have a different kind of deal-breaking power in that significant differences between an international accounting standard and the corresponding national standard/practice are perceived as a potential threat to the success and/or credibility of the international accounting standard setter.

The consideration of out-side deal-breaking influence in the context of IAS 12 highlights an interesting development and, in the light of this, an interesting reflection: In the early periods the UK and the US were clearly regarded as significant countries. In the period during which the original standard was developed (1978) the IASC Board apparently instructed the Steering Committee to draw up a standard that would allow the practices in both the UK and the US (pp. 120-1). Following this, the focus of the IASC Working Party on Deferred Tax was clearly on achieving greater harmony between UK and US standards on accounting for deferred tax (p. 129). However, as long as differences remained between these two sets of standards, the related issues appear to have been more or less "untouchable"[6].

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6 First this applied both to the choice of method for deferred tax effect accounting [I-3] and the level of application of deferred tax effect accounting [I-2]. Then, following a movement away from the deferral method of tax effect accounting to the liability

When work on a second ED started in 1992, however, the level of application of deferred tax accounting [I-2] no longer seems to have been a controversial issue (figure 7.4, p. 171). In 1995, the UK standard setter even issued a discussion paper proposing to require comprehensive allocation, apparently with the motivation that this is used "internationally" (p. 219). From 1992, the focus was instead on the choice of the balance sheet liability method. Again, however, the fact that the US was on one side and the UK on the other particularly seems to have contributed to the issue being controversial. The difference, however, was that this time the issue was "touched" and controversy did not result in flexibility. Since the IASC choose the US way, special focus was very much on (at least) identifying differences between the IASC proposals and the US standards, suggesting perhaps that the US had become more important. The resistance put up by the UK, on the other hand, suggests that this country was still important (see also 2nd quotation p. 236).

To a certain extent the heart of the debate on deferred tax within the IASC seems to have been an Anglo-American debate. At the centre, from 1992 onwards, was a disagreement between the US and the UK whether deferred taxes are liabilities or not. Although hesitant at first, it grew more forceful as the UK standard setter considered the issues in more detail and arrived at the conclusion that the proposed balance sheet (approach to the) liability method was conceptually flawed. However, other Anglo-American standard setters – from Australia, Canada and South Africa – were also active, trying to make up their minds which proposals were conceptually sound and which were conceptually flawed (i.e. not in accordance with the framework). One of the reasons that the debate became so prolonged seems to have been that to a certain extent these were all significant countries. Another reason appears to have been that there were authoritative figures on both sides (see also p. 349).

The Deal-Makers

The *Deal-Makers* are individuals that, in the view of controversy, actively work to construe solutions that might achieve the required consensus. As already suggested, an alternative term might thus be Negotiators.

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method [I-3] in the US (p. 125), this applied only the issue of level of application [I-2] (pp. 142f).

This is a role that, by the design of the process is potentially most closely associated with the Staff of the standard setting body and, in the case of the IASC, with the Steering Committee Chairman:

- *The staff (project manager)*;
  The staff papers for various meetings would regularly contain recommendations on how to proceed (pp. 307-8). See also specific discussion of the suggestion that the Staff can be seen to act as an (active) *negotiator* between Board Members on pages 318-9.

- *The Steering Committee Chairman;*
  The Steering Committee chairman normally chaired the Board's discussions relating to the project, something which normally included presenting the Steering Committee's proposals to the Board (p. 291). In addition, the tasks of the Steering Committee chairman have been suggested to have included "personal lobbying" on the Board (p. 301). This, in turn, can be interpreted to include a certain measure of deal-making: "you have to identify where the difficulties are and to speak personally with various people" (ibid).

Deal-making influence can thus be seen to be primarily associated with a kind of formal /legitimate authority that lies not in the power conveyed by a position, but in the tasks associated with that position. The role of Deal-maker, however, it is not restricted to the above participants in the standard setting process. For example, from time to time various comments received from other Board Representatives and Steering Committee Members would contain suggestions of solutions that might win sufficient approval.

An important implication of the presence of Deal-Makers is that it seems to reduce the need for overt negotiations (bargaining). Instead, the political process becomes characterised by more implicit (silent) compromising. Nevertheless, the previous account of the developments in relation to IAS 12 includes several instances of various participants explicitly making (attempting to make) various issues into deal-breaking issues.

10.2.3 The learning process

Individual and collective learning

In addition to *controversies* and *compromises*, the review of the process of revising IAS 12 has also suggested that significant aspects of the accounting standard setting process may be understood in terms of *learning*. That is, in terms of increased knowledge/understanding of the issues being discussed. There are two aspects of, or levels, to this: individual and collective learning.

Individual learning

To begin with it is suggested that the process is marked by the participants in the standard setting effort gradually attaining increased knowledge and understanding of the accounting issues at the heart of the process. Although explicit examples of this from the early parts of the process of revising IAS 12 are not so striking, references to learning are frequent in both chapter seven (pp. 211f) and eight (pp. 276f). These *individual learning processes* can be seen to have been prompted by on the one hand by the political aspects of the process, and on the other by a desire, on the part of the participants, to understand the issues being deliberated and the proposals being put forward (their implications and their theoretical underpinnings).

Collective learning

One implication of the suggestion that the standard setting process is marked by individual learning processes is the related suggestion that sometimes such processes may give rise to new understanding, particularly to the "discovery" of new alternatives and/or (sub-)issues. This is what has been referred to in terms of a *collective learning process* in both chapter seven (p. 211) and eight (p. 278).

Implications of significant learning processes

One implication of individual learning processes is that, as a result, the position of the participants vis-à-vis debated issues may change over time. Such changes may, in turn, significantly affect the political sub-process, i.e. lead to further twists and turns in proposed solutions. As already noted, one interviewee discussed these effects in terms of the standard-setting process being perceived as a random process (p. 279).

The most prominent example of learning leading to twist and turns in the process of developing IAS 12 (and hence the outcome) is perhaps when a

Board Member just prior to the September 1996 Board meeting switched with regard to revaluations [I-10] (see quotation on p. 276). Another instance of an explicit reference to learning affecting the position of a Board Representative is found in relation to the issue of grossing-up [I-19] (see quotation on p. 259).

The review of the IAS 12 case also suggests that sometimes the effect of individual learning is simple to restrain the over-all standard setting process. This seems, for example, to have been the case in March and November 1993 when the Board Members indicated that they were not ready to make a decision. However, as already indicated, this was not always the case and, as a consequence, learning can not be characterised as simply a phase preceding the deal-making.

Another potential implication of significant personal and collective learning is that issues and alternatives may be neither well- nor pre-defined at the outset. As a result, confusion and misunderstandings can be expected, partly as a result of unclear terminology:

- In the case of IAS 12 this appears to have been a particular problem in the period during which E49 was developed (e.g. pp. 212f), but also in the comment period (see reference to concerns that that many commentators to E49 had not understood it, p. 238). Still, even just prior to the Board approved the revised Standard, concerns were raised over continuing confusion over what was intended with this (p. 277).

- Another example of this is found in the account of developments in relation to the issue of dual tax bases [I-25b]. With regard to this issue there is, alongside shifting positions, a striking development in the language used to describe the alternatives:
  - the issue was not addressed at all in E49;
  - the references to this issue in the papers for the November 1995 meeting were indirect and subdued;
  - in January 1996 the proposed principle was spelled out in terms of its implications (smallest deferred tax liability and asset);
  - in February 1996 the term “the most tax-efficient manner” was used ;
  - the papers for the June 1996 Board meeting this expression was replaced with the expression: “the manner that minimises the amount of income taxes payable or maximises the amount of income taxes recoverable”… (pp. 249f).

- A third example of such developments in the understanding of issues and alternatives is related to the key issue of recognition criteria to be applied to deferred tax assets, particularly those relating to tax losses [I-7]. A quotation on page 207 refers, e.g. to "spending almost an hour on, talking about what's the difference between probable and sort of more likely than not".

With time, such confusion may clear and such misunderstandings may be discovered, leading to two further (often related) types of twists and turns in the process and the proposals:

(i) as a result of confusion /misunderstandings clearing; and
Changes in position with regard to how to deal with dual tax bases (above), more than anything seems to be related to this.

(ii) as a result of new issues/alternatives emerging.
Once it was explicitly recognised that there was a choice between different liability methods, this shifted the whole focus of the debate (pp. 170-2). The developments in thought in relation to how to deal with temporary differences arising on initial recognition (non-deductible assets) [I-19] and government grants [I-22] also seem to have led to a similar shift in the discussion (e.g. p. 256).

If "undiscovered", on the other hand, such confusion and misunderstandings may be incorporated into the (proposed) rules, giving rise to, e.g. inconsistencies and what might be perceived as strange rulings. Examples from the previous case include the adopted criteria for partial application [I-2p] and the exception for revaluations [I-10] in E33 (p. 153). A more striking example is perhaps the problems in the definition of tax base in E49 which were revealed by the discussions in 1995/6 (pp. 238f and pp. 249f). Despite the fact that problems with the concept of tax base [I-25a] were recognised (although late in the process), this concept was retained (pp. 245f). The standard text, however, explicitly states that alternative interpretations of tax base are sometimes possible (p. 245). In other words, confusion may have been cleared, but the (strange) solution remains.

A key characteristic of learning

The recognition of individual learning processes as a potentially significant aspect of the accounting standard setting process would seem to suggest that it is important that the standard setting process is allowed sufficient time to avoid misunderstandings and inconsistencies being incorporated into the proposals/ standards. At the same time, however, the recognition of there, at least potentially also being a significant collective learning process, suggests that no amount of time might ever be sufficient. The process of revising IAS 12 spanned over 15 years (1981-1996), yet the chronological review suggests that there was still significant (individual and collective) learning going on even as the revised standard was being approved. In other words the learning process may not have a finishing line.

Significant roles

In trying to understand the learning aspects of the standard setting process two significant roles have emerged: the Educators and the Learners. In addition to these roles, which are foremost associated with individual learning, a third role may be discussed in relation to the collective learning process: the Inventors.

Educators and Learners

The review in part II suggest that some participants in the standard setting process are able to, or cannot avoid to – given the topic and their past experience – assume the roles of *Educators*, explaining the issues / alternatives etc. to the others. As a result, their influence is mainly educatory and seen to rest on a special form of charismatic influence (power) base which is discussed further below.

The two most striking Educators in the case of the IAS 12 are the FASB project manager at the December 1992 Steering Committee meeting (p. 175) and the FASB Board Observer at the November 1993 Board meeting (p. 178 and pp. 319f). However, they were not alone in this role. In particular one Board Representative seems to have spoken up against the balance sheet liability method (pp. 235-6). Furthermore, as indicated on page 178, the concerns expressed during the November 1993 Board meeting were "addressed by the Steering Committee Chairman and staff", suggesting that these (with time) were also in a position to play the role of Educators. Indeed, as discussed in more detail in section 9.4.2 (pp. 306f) a significant

part of the project manager's tasks can be understood in terms of facilitating individual Board and Steering Committee Members learning (e.g. pp. 310, 317).

It is in contrast to these participants, that the second role emerges. That is, even if the participants in the standard setting effort are highly qualified accountants many, if not most, of them can be characterised as *Learners* with regard to the specific standard setting topic and related issues. This means that they go through, more or less significant, individual learning processes as work on the project proceeds.

In the case of significant individual learning processes, the extent to which the Learners are able to invest time and effort into the project (a factor related to the executive aspects of the standard setting process), may affect the speed of progression for the overall process. In this context it is noted, for example, that even though the papers to the November 1993 Board meeting explicitly addressed the issue of the proposed switch to a balance sheet (approach to the liability method) the significant learning seems to have taken place during and perhaps after, rather than in preparation for, this meeting.

Through their impact on the individual learning processes Educators may propel this process forward (as would appear to have been the case e.g. in November 1993). To be noted, however, is that the Educators may also delay progression, which may be the case, for example, if their efforts lead to issues being expanded. The renewed discussion vis-à-vis the definition of tax base [I-25a] in the final period might be perceived to be a case of this (pp. 243f).

Inventors

The hypothesis that sometimes the analytical efforts of various participants will lead to a collective learning process, i.e. issue expansion, would seem to suggest, in turn, the existence of inventors (individuals whose analytical efforts led to the "discovery" of new understanding). However, no such individuals have emerged in the review of the process of revising IAS 12. Instead, such new understanding seems to have emerged through the complex and twisting learning process. In other words, more than anything, new understanding would seem to have mainly emerged from efforts of learning (trying to understand).

Charismatic authority as a source of influence

The review of IAS 12 suggests that the influence of the Educators on developments during various meetings rested primarily on a form of *charismatic authority* which, in turn, appears to have been based on a combination of three or four key factors:

(1) subject proficiency;

Even if all participants in the standard setting effort are highly qualified accountants, some may have higher subject proficiency with regard to the specific issues at hand. This quality, in turn, seems to depend on two further, but inter-related qualities: technical skills and effort (time) invested in the specific project. Technical skills, in turn, may be seen to consist of both command of issues arising with regard to the specific standard setting topic and command of the standard setter's conceptual framework.

(2) language proficiency; and

A peculiarity of an international standard setter relates to the issue of the language of communication. If deliberations are not simultaneously translated, but held in one language only, differences in skills in that language becomes a potential factor. In the case of the IASC, all deliberations were held in English.

In this context it is noted that the identified Educators in the process of revising IAS 12 were all native English speakers. In addition they were also described as articulate, eloquent and witty (pp. 175, 178, 235).

The language factor was also raised in several of the interviews. One interviewee, for example, distinguished between: the native English speakers, those with a good command of the English language, and the others. Interestingly, many, if not most, Board delegations were suggested to belong in the final category. Anecdotally the same person reflected:

> I realised, for example, once, that one of the men representing [X], was unable to understand a word of English. (Pson)

(3) cultural proficiency.

The 'stars' in this process of revising IAS 12 were not only eloquent and witty native-English speakers. They were also all involved in national standard-setting activities. In view of the suggestion that the Board's deliberations may be perceived as intimidating for those unused to

accounting standard setting discussions (p. 293), the fact that they were used to such deliberations may also have played a role.

(4) personal conviction

A fourth factor that has emerged as potentially significant in explaining the influence of Educators is that of personal conviction. Although this may be seen to be related to subject proficiency, the two are not necessarily the same.

Standard setting professionalism

The above factors appear to be highly inter-related. In fact, they may even be collapsed into a more general characteristic such as e.g. *standard setting professionalism.* Indeed, one interviewee who did not see himself as particularly influential reflected:

> There must be a difference between the "professional" standard setter (I think particularly the Americans) and the "amateurs" like myself with only his personal experience as a background. …. (Cson)

10.2.4 The executive process

Background

In addition to considering the political and learning dimensions of the accounting standard setting process it is also necessary to recognise certain executive (managerial) dimensions of this process. In other words, it is important to consider how work on the project proceeds and how this affects the conditions for the development of the political and learning processes.

Certain aspects of the executive process are obviously directly related to the organisation of the specific standard setter (e.g. the number and characteristics of the individuals involved, the extent of their involvement, the frequency of meetings etc). For example, in the case of IAS 12 revised, one interviewee argued that the time needed just for reading the material distributed prior to various meetings was too much for the part-time volunteer participants, thus affecting the level of preparations:

> I have tried (to read all papers) … that took two weeks, at least two weeks and I asked my (…) colleagues: Are you able to set off two weeks to study the documents? …and the answer was no… (Pson)

The same respondent also made the distinction between personal time and the availability of "technical support", suggesting great differences in this availability. In this context it is also noted that one of the delegations identified as having such support, raised the issue of (increasing) time requirements in its written comments prior to the June 1996 Board meeting (pp. 273-4).

However, at the same time there would appear to be certain aspects of the executive process which seem unrelated to such specific factors. The rest of this section focuses on what is perceived as some fundamental characteristics of this process.

Facilitating and restricting

If the core concern of the political process is the achievement of (sufficient) consensus and the core concern of the learning process is the achievement of (sufficient) understanding of the proposals, the core concern of the executive process is to make progress, in the sense of producing a standard that satisfies certain criteria on a timely basis. Making progress, in turn, requires a combination of both *facilitating* and *restricting* the learning and political processes. Examples of this have been discussed in relation to the role of the staff in chapter 9 (p. 310).

While it seems straightforward that progress on the standard setting process may be more easily achieved if means are found to facilitate the learning and the political sub-processes (e.g. by injecting resources, primarily expertise and time), it is perhaps less straight-forward why closure may require that these processes are also restricted. This, however, seems to be a consequence of, on the one hand the more or less perpetual nature ascribed to the learning process (p. 349), and on the other hand, of the potential interplay between the political and learning processes. From this perspective closure of an accounting standard setting project would seem to require restrictions on the subject matter (including the possibility to revisit issues), the "allowed" solutions (types of compromises) and, more generally, the time allowed for the process.

Implications of the executive process

The nature of the executive process is significant in that it affects the conditions for the development of the political and learning processes. On a fundamental level a strong executive force may (attempt to) push for closure as early as possible, thus contributing to making the learning- and political

sub-processes *parallel* rather than *sequential*. Indeed, with respect of the potentially never-ending nature of learning, progress might be seen to require such restrictions on the impact of the learning process.

As a result of the above, a strong executive force may also hinder the revision of previously made decision vis-à-vis an issue (i.e. restrict the political process) even if the learning process may have led to new insights (and with this, possibly, revised positions). This would, for example, appear to be the case in view of the developments relating to the understanding of tax base just prior to the approval of the revised standard (pp. 245f).

Alternatively, a strong executive force may also (more or less effectively) hinder such a learning process in the first place:

- In the case of revising IAS 12, for example, it is striking how, initially there appears to have been a strong and successful executive force pushing the view that the review of IAS 12 should be a limited exercise (pp. 132, 149). As noted on page 153 this can be seen to have led to a somewhat bounded learning process which, in turn, may explain why some of the proposals in E33 can be perceived as strange and/or inconsistent.

- It is also striking that, despite the fact that fundamental changes were suggested in 1992/1993, and despite the significant learning that was going on, the project pushed on with a second ED, rather than taking a step back to discussing principles in a DSOP or even a Discussion Paper (pp. 209, 215).

- Similarly, despite much opposition in comments received to E49 as well as indications that many commentators did not understand the proposals and also significant developments in the understanding vis-à-vis the proposed method of deferred tax accounting following the release of the second ED, it was successfully argued that it was not appropriate to revisit this fundamental issue in 1995/1996 (p. 235).

In this respect time restrictions appear especially significant. If time is restricted, the learning and political processes may be impeded. On the other hand, the overall process may also be delayed in anticipation of a new

meeting, to deal with outstanding issues (i.e. both the learning and political aspects of the process may hinder progress on the project).

Significant roles

Two significant supportive roles have already been suggested: the *Deal-Makers* (facilitating the political process) and the *Educators* (facilitating the learning process). A third significant facilitatory role that has emerged from the review in part two is that of *Authors* of the documents that link together the meetings that make up the standard setting process. In fact, suggested indirectly in chapter 9 in relation to the significance of the staff, this role may subsume both of the prior to roles (p. 309f). To be recognised is, however, that although many documents with a wider circulation were indeed authored by the Staff, numerous documents were also authored by various Board Representatives and Steering Committee Members, not least as part to the comment process (pp. 287, 298). In other words, although the role of Authors can be seen to be associated with formal authority (just as Deal-makers), it is not limited to this source of authority.

The recognition of the importance various restrictions on the process has also led to the suggestion of one further significant role in the accounting standard setting process: the *Referees*[7] of the meetings that make up the process. In addition to opening and closing a meeting, a Referee may (at least attempt to) restrict the subject-matter of the discussions and dictate whether or not a vote should be taken and on what. In this capacity the Steering Committee Chairman and the Chairman of the IASC appear to have a special type of influence on the process (see, e.g. the quotation referring to the actions of a wise chairman on p. 294). Furthermore, also as suggested in chapter nine, in authoring the staff documents for various meetings, the Staff/Authors can be seen to have acted as Referees of significant documents (e.g. p. 311).

In similarity with the Deal-Makers, the authority/influence of the Authors and Referees seem to rely primarily on formal authority. For example, because of the nature of the positions held by the Steering Committee Chairman, the Project Manager, the IASC Chairman and Secretary-General these could, indeed should, attempt to manage the agenda for various

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7 Referee: a sports official usually having final authority in administering a game (http://www.m-w.com/cgi-bin/dictionary).

meetings, the material prepared for those meetings and the votes called at those meetings). (As suggested above, however, Deal-Making influence might also be based on charismatic authority.)

10.2.5 Interactions

Initially it was suggested that the (international) accounting standard-setting process can be understood in terms of three parallel and interacting sub-processes. The above presentation of each of these sub-processes has specified various forms of interactions. It has, for example, been suggested that the political process may trigger individual learning processes. It has also been suggested that such individual learning processes may affect the political process in several ways:

- it may delay this as the participants make up their mind;
- it may introduce twist and turns as a result of shifting the positions of those participants;
- it may first introduce confusion and misunderstandings and then, as these are cleared, twists and turns as result of misunderstandings clearing.

In addition, it has been suggested that individual learning processes may also trigger collective learning (issue expansion) which may introduce yet a different kind of twists and turns into the political process by introducing new alternatives and issues.

Finally it has also been suggested that the executive process can be seen to affect the conditions for the development of the other two processes by both facilitating (providing additional resources) and restricting these. In particular, it was suggested that executive concerns may contribute to making the learning and political sub-processes parallel rather than sequential.

In this context is must be noted that some of the interviewees suggested that the standard-setting process has two *phases*, learning preceding deal-making (bargaining), e.g.:

> At some time around here there is also the horse-trading argument, .., with all controversial standards there comes a point when one concludes that there is no majority on the Board and then the horse-trading phase

> begins, which means … what compromises can be made in order to achieve sufficient majority without loosing the votes of those that are already in favour of the proposals. (Ison)

The previous review, however, strongly suggests a different picture. In particular, executive concerns meant that, although the voting was sometimes postponed in view of Board Members not being ready to make a decision, in general, deal-making efforts were concurrent to significant learning processes.

In view of these suggestions, a revised illustration of standard-setting process is proposed. In this model, the political and learning processes are portrayed as the heart of the process, each feeding into the other. The executive process encircles the other two processes, potentially restricting them, but also potentially facilitating (feeding into) them.

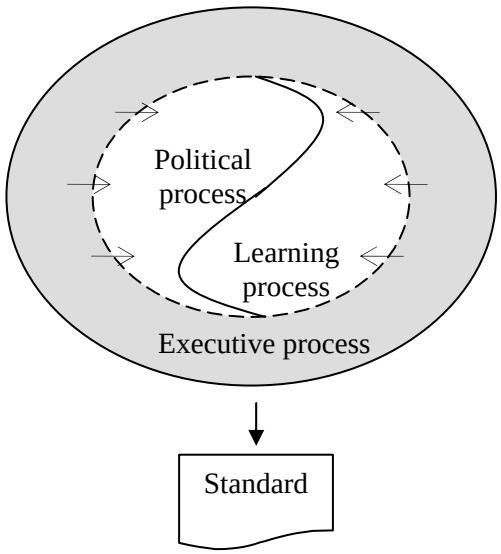

Figure 10.2 A revised model of the accounting standard setting process

10.3 Conditional factors

10.3.1 Introduction

In the previous sections of this chapter it is suggested that the (international) standard setting process (and hence the ensuing product) can be understood in terms of the developments of, and inter-relationships between, three sub-processes. In addition to understanding the nature of these fundamental processes, this chapter suggests that an understanding of an international accounting standard setting process also requires consideration of the impact of the specific context on these sub-processes, and hence the over-all process. Such contextual impact is discussed in this section in terms of three primary and two secondary conditional factors:

(1) the issues;
(2) the individuals;
(3) the organisation of the process;
(4) the standard setter's overall agenda/strategy; and
(5) other external events.

Whereas the first three factors relate to conditions internal to the specific standard setting process, the fourth is external to the process, but internal to the standard setter and the fifth external also to the standard setter.

10.3.2 The issues

The review of the process of revising IAS 12 has led to the suggestion that the nature of the issues at the heart of the standard setting process may have two important implications for the learning aspects of this process and hence for the standard setting process in general.

Complexity and relative importance of learning

The review in part II suggests that the (perceived) complexity of the issues may affect the significance of (individual and collective) learning in the specific standard setting context. Accounting for deferred tax effects is generally perceived as a complex area of accounting thought. This, in turn, raises the question if this contributed to the relative importance of learning in the case of revising IAS 12. Although this potential effect cannot be ignored

and although accounting issues can, of course, vary in degree of complexity, it is argued that two factors can be seen to contribute to raising the (perceived) complexity of technical accounting issues in general.

First, although fundamentally quite simple, the basic financial reporting system is made complex by the very fact that it is a multi-dimensional measurement system. Financial reporting is thus truly a *system*, where the various reports and measures are interrelated so that changes in one figure affect at least one other figure[8]. Complexity arises as a result of these interrelationships. Furthermore, the focus today is often on consolidated accounting, which is an extension of the basic system in which an elaborate *as-if* system of reporting is constructed[9]. The focus on consolidated accounting thus adds another layer of interrelationships to be considered, increasing the complexity further.

Second, and perhaps more important, financial reporting is also made complex by the abstract nature of the qualities it is intended to measure. Over the years different expressions for these have been formulated, but they normally include concepts such as *financial position* and *performance / profitability / value creation*. Whatever the concept used, it must be recognised that these are abstract constructs that generally cannot be uniquely defined other than in very limited contexts. This also applies to the definitions of the elements of financial statements in present day conceptual frameworks, relying on concepts such as *expected* future flows of *economic benefits* as a result of *past events*.[10] For example, different individuals may disagree on what is to be understood by something being "expected". The deferred tax debate also illustrates that one may disagree on what is to be considered to be a past event (or the relevant event).

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8 The IASC Framework emphasises this point in arguing that: "The component parts of the financial statements interrelate because they reflect different aspects of the same transactions or other events." (§ 20)

9 Consolidated accounting (group accounting) is a system for measuring and communicating the financial aspects of a group of entities as if they were one entity.

10 For example *assets* are defined as "a resource controlled by the enterprise as a result of a past event from which future economic benefits are expected to flow to the enterprise" (§49). *Liabilities* are similarly defined as "a present obligation of the enterprise arising form past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits" (ibid).

In other words, it is suggested that there are reasons to expect learning to be a significant element of most accounting standard setting processes. That is, unless strong executive forces success-fully restrict this aspect of the process.

In the particular case of revising IAS 12, a third factor also seems to have contributed to the complexity of the issues: the timing of this particular standard setting process. More specifically, the level of (perceived) complexity also seems to have been affected by the *relative infancy* of the ideas encompassed by the IASC conceptual framework at the time.[11] Whereas the concept of timing differences rests firmly on the, at the time, traditional concept of matching, the balance sheet liability method (and the concept of temporary differences) approaches the issue of deferred tax from a completely different angle, an angle that at the time represented a completely new way of thinking about these issues.

Complexity and a focus on matters of detailed application

In addition to affecting the significance of individual (and collective) learning, the review of the IAS 12 case also suggests a more fundamental impact of complexity on the nature of the learning process and, in the extension, on the whole standard setting process. In particular it is suggested that the (perceived) complexities of the issues lead to a strong tendency for individuals, in their efforts to understand the issues and proposals, to focus on specific matters of detailed application. It is as if, in view of the complexities of the financial reporting system and the abstract nature of the qualities it is intended to measure, the participants cannot form an opinion about similarly abstract principles without identifying their implications for specific transactions/events, preferably using various illustrative numerical examples to detail these implications.

Numerical examples were extensively used as a means of explaining / discussing various proposals in the case of IAS 12, both in internal deliberations and in communication with the outside world. For example:

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11 As noted in chapter 6 this was partly concurrent with the early stages of the deferred tax project, an ED being issued in March 1988 (p. 136) and the final framework being approved in April 1989 (p. 154).

- A letter from a Steering Committee Member commenting a draft ED dated December 11th 1992 continues a discussion of an example presumably discussed during the previous December 1992 Steering Committee meeting (figure 10.3, p. 362).

- A letter from the Project Manager to the Steering Committee Chairman discussing the preparations for the March 1993 Board meeting refers to the use of overheads presenting various numerical examples (including the one which was the focus of the exchange just referred to):

> *I may also prepare some overheads that provide:*
> *a. Numerical examples of the difficulties in accounting for goodwill as a timing difference.*
> *b. An overhead to demonstrate the numerical examples considered by [X] and [Y]on asset revaluations. (930308..)*

The use and importance of examples in internal deliberations is also reflected in the review of this case presented in part II, for example:

- the request for further guidance material prior to the March 1993 Board meeting (see quotation on p. 176);

- the Board's subsequent request that the Steering Committee consider the addition of a comprehensive example (ibid); and

- the various references to the November 1993 Board meeting as *the* meeting the balance sheet (approach to the) liability method was explained in detail to the Board using various numerical examples (p. 178).

Numerical examples were also used in the communication with the outside world. For example, following the above request by the Board in March 1993, two numerical examples were in an appendix to E49. At the following Board meeting (November 1993), the Board then agreed that background material on the reasons for the change to the balance sheet approach and the advantages of this approach should be distributed with the ED. From the very first draft, this information contained numerous numerical examples[12].

12 See pages 201-2 for some details relating to one such example.

To come back to [X]'s example:
Assets with historical value of 200 are revalued to a carrying value of 1'000. Tax authorities do not recognise the revaluation and the tax basis for depreciation is not changed.

Effect on accounts at the end of the life of the assets	Financial accounts	Tax accounts
Cumulated profit before taxes and depreciation	1'000	1'000
Cumulated depreciation of assets (= recovery through its use)	-1'000	-200
profit before taxes	0	800
taxes on income 40%	-320	-320
profit/loss (-) after tax	-320	480

It is true that, in this exaggerated case (cumulative revaluation to replacement value in our case rarely exceeds 30% over historical value) we show a financial loss due to taxes. But this is the economic reality.

A timing difference is an amount included in taxable income of an earlier or later year than the year in which it is recognised in financial income (…). It is also an item included in the calculation for both amounts () but for different periods. () But, in this example, the depreciation of the revaluation is never included in the tax accounts, it has no effect on taxable income and on taxes. It is not included in the calculation of both amounts but only in the calculation of accounting profit.

Figure 10.3 Excerpt from letter dated December 17th (921217L…)

In the subsequent period, the background paper was not retained. The appendix, however, remained in an expanded form. In addition, following a Staff suggestion after the November 1995 Board meeting, a number of examples were included in the text of the revised standard "in manner similar to the examples in E52, Earnings per Share" (960202…). Some of these were new, but some were also obviously based on previous examples. Although the inclusion of numerical examples in the main body of the Standard was opposed by at least one Board member, it was retained in the final version.

More input on the use, and impact, of examples on the IAS 12 process was provided in some of the interviews, e.g.:

> …. that's when, I think, we started getting into some of these more difficult issues, difficult in the sense of starting to really understand what

> problems, or what issues, this method raised… and I remember we talked about accounting about a chair….: What happens if you bought a chair and for some reason the public policy of the government of that particular country was encouraging people to stand because they thought that people sitting down would create a bad posture and so … you bought a chair, no tax deduction, you couldn't depreciate the chair, and if you sold it, you got no deduction for it. So you pay a hundred for a chair, it has a tax basis of zero. What are we going to do? Does that create a deferred tax liability or
> not? It has a book value of a hundred, it has a tax basis of zero. It would seem that you record a deferred tax liability. Do we record that deferred tax liability, if so, what's the debit? (Mson)
>
> …What happened then is I tried to convince them by … silly examples, .. (Cson)

Whereas these quotations provide an indication of how the various detailed examples were used to facilitate the participants' understanding of the matters at hand, the second quotation continues to reflect on the implications of the use of such examples on the process (and the outcome):

> … you must have seen something about government grant, … you get a tax free government grant, usually you put it to your income statement, but you can also decide, if it is an important amount, to spread it in your income statement over, say four years, …, so if this is not a taxable amount you have a [temporary] difference and if you apply the strict balance sheet method, you have to calculate a deferred tax on this difference, then I told them, this is pure non-sense, how can people give me money which I do not have to pay tax on it, but because …I do not recognise it in my books immediately, I have to calculate a deferred tax on it. … This was my first example, the second example said …
>
> …so instead of simplifying the standard, with my ideas try to convince them to simplify the standard, I complicated it, … that was my frustration at the end, every time I came with an idea and said, but if you put [this] through this standard, … in this specific situation the standard will give distorted results… But instead of changing the basic rule, they introduced an exception for this, so we added paragraphs and paragraphs and the more paragraphs you add, the more details you try to find a solution in a standard, the wronger it gets in specific cases, … (Cson)

In line with this suggestion it is argued that the tendency of the learning process to focus on issues of detail may have two important implications for the standard setting process. First, it may contribute not only to increasing

the number of issues to be considered, but also to a situation where many of the issues are intertwined, decisions pertaining to one issue having implications for other issues. This, in turn, would seem to contribute to time requirements for preparation and deliberations, i.e. to have implications for the executive aspects of the process.

Second, it is suggested that the focus on issues of detailed application in the learning process is likely to be passed on to the political sub-process. That is, once such issues have been raised in the discussions, this may open up for suggestions of allowing alternative treatments and/or making exceptions with regard to specific issues that have been discussed. This, in turn, not only opens up for inconsistencies in the final standard, it may also explain why there seems to be a tendency for accounting regulation to become rule based (rather than principles based), increasing both the length and complexity of the final standards.

10.3.3 The individuals

The significance of the individuals

The individuals actually involved in the process matter because the standard setting process is fundamentally a human process, made up of various individuals (acting in various capacities), raising and discussing their concerns vis-à-vis various accounting issues. As such it is affected by the concerns of these individuals (their subjective logics) in combination with their relative influence.

The subjective logics

A key theme arising in the review of the process of revising IAS 12 was that there was considerable concern expressed/felt by various participants over the content of the proposals. Although the literature would seem to suggest that concerns over the content of the rules may be based on *either* conceptual grounds (theoretical correctness of the proposals) *or* pragmatic grounds (primarily perceived (economic) consequences of the proposals), this distinction was found to be difficult to apply in practice. To a certain extent, in the IAS 12 case, these concerns appeared highly interrelated in that various actors could express both types of concerns. Furthermore, it was also noted that pragmatic concerns were very broad ranging, including not only concerns relating to the acceptability of the proposals on the grounds of their (economic) consequences, but also significant concerns about the

understandability of the proposals (and hence the implications for its application and, in turn, for the standardisation of accounting information) and about the justification of a proposed change (and the associated costs). In combination, however, these concerns explain why the standard-setting process can be seen to encompass both political and learning aspects.

The influence of individuals

The model of the standard setting process presented in the previous section provides a framework for discussing various *types* of influence over the standard setting process (and hence also the final product). Related to this is also the issue of various *sources* of such influence (i.e. what might be referred to as influence (power) bases).

Types of influence

The presentation of the identified three sub-processes of accounting standard setting have, in part, relied on identifying and explaining various related key roles. These roles – the potential Deal-Breakers, the Deal-Maker, the Educator, the Learner, the Author and the Referee – can also be understood as representing different types of influence on the standard setting process(es). For example, while a potential Deal-Breaker exerts direct influence on the deals being proposed/agreed, the presence of a significant Deal-Maker may (as already noted), reduce the need of overt bargaining. The influence of the Educators, on the other hand is (as the label suggests) primarily educatory. The effect on the political process is thus only indirect, to the extent that potential effects on the understanding of various issues affects the deal-making.

Although most of these suggested roles relate primarily to one of the suggested sub-processes of accounting standard setting, interrelationships between these processes sometimes make this distinction less clear. For example, although a Staff member acting as a Deal-Maker can be seen as an expression of executive concerns and as part of the executive process, the intended impact is to contribute to progress by facilitating the political process. Furthermore, the influence of any one individual may be understood in terms of several roles. For example, a member of Staff may be seen to act as a Deal-Maker, an Educator and a Referee, sometimes, but not always, in the capacity of Author. In fact, one interviewee suggested that the success of a standard setting project depends on it having a *Champion*, a role that can be seen to subsume several of the above and span over all three sub-processes:

> …so one of the big difficulties with this project was that we didn't have a champion ... who was a board member .. to go to board meetings and really argue their own corner.. (Kson)

Sources of influence

With the risk of stating the obvious, it should perhaps first be noted that influence on the standard setting process, with one exception, seems to require *active participation* in that process. The exception being the influence attached to potential Deal-Breakers outside the standard setter (p. 343).

The case of IAS 12, in turn, suggests that those who were more active were those who would be directly affected by the forthcoming IAS: the Staff, individuals from (mainly Anglo-Saxon) countries with a deferred tax tradition/standard and preparers from those countries. Still, active participation is not a sufficient criterion for influence. In relation to these various types of influence on the standard setting process, three prime sources of influence have also been suggested: potential deal-breaking power (pp. 341f), formal authority (pp. 345, 355) and charismatic authority (pp. 351f). All of these are, in a sense, relational. However, charismatic authority can also be seen to be intimately related to the individuals actually participating in the process.

Although the review suggests that different types of influence tend to be associated with a specific source of influence, e.g. Authors and Referees with formal authority, Deal-Breakers with deal-breaking power and Educators with charismatic authority, it also suggests that these relationships are not absolute

The review in part II suggests that, in the case of the IAS 12, a few individuals were particularly influential in the capacity of charismatic Educators. While this may suggest that charismatic authority is more important than formal authority – which in turn suggests that it may not be so important what capacity participation takes place – it should be noted that this may be related to the relative importance of the learning process in the case of deferred tax (see discussion in the previous section, pp. 358f) and the organisation of the IASC (next section).

10.3.4 The organisation of the process

The individuals involved in the process matter not only because it is their concerns that form the basis of the process, but also because they represent the resources (time and expertise) involved in the process. From this perspective the organisation of the process also matters to the extent that this affects the supply of these resources.

A key theme emerging from the review of the IAS 12 case with regard to this issue was that, as a result of the organisation of the IASC, resources of all forms were generally limited. This, in turn, tended to slow down the various standard setting processes and give rise to tension, e.g.:

> ... that wasn't their day job, they are busy people doing .. whatever they are doing … regular work …and this was something they did in kind of the spare time that most of [them] didn't have ... (Mson)
>
> …, for example …..two hours and then you never saw him during the three days … and you also have people doing their own work on the table of the Board (e.g. writing a report for company) … (Pson)

In trying to see beyond the specifics of the case (and the IASC organisation), however, two key themes relating to the issue of how the organisation of the resources involved in the standard setting effort affects that process have emerged:.

- ***Organisational levels introduce sub-processes***

  One theme that emerges in chapter nine is that the IASC relied on a three-layered organisation, where the decision-making body (the Board) was supported primarily by a combination of technical Staff and a (smaller) task force and that this (the additional layers) introduced sub-levels to the political, learning and executive aspects of the standard setting process.

- ***A non-continuous process***

  A second theme that has emerged from the review of the IAS 12 case relating to the impact of the organisation of the process concerns what is perceived as a general characteristic of accounting rule-making processes: the fact that they can be characterised as non-continuous processes, both in time and space. The standard setting process, in the case of IAS 12, but also more generally it would seem, consists of

> numerous meetings which are on the one hand separate, and on the other hand, linked together by numerous documents. In fact, to a certain extent issues were discussed, not only in real-time during various meetings, but through the exchange of letters/notes (and in the final stages e-mails) in between those meetings.

While this may be significant for the importance attached to, for example, those various documents (and hence the influence of authors), the key point here is that it may also have further implications. In particular, in combination with limited resources (both on an individual and organisational level) it would seem to be one further source of (repeated) twists and turns in the process (i.e. proposals). Somewhat simplified: something is proposed, this gets reflected in the documents, it thus gets focused on leading to individual (and possibly collective) learning, those with objections tend to voice this, this then gets reflected, etc. etc…

Rather than being based on specific examples, this contention is based on the recognition that comments received, both from parties external to the standard setter and from Board and Steering Committee Members, tended to focus on matters with which the respondents disagreed (e.g. p. 288 and p. 325). In line with this suggestion there were more comments from US companies to E33 than to E49 and vice versa for companies from most other countries (particularly Switzerland and the UK) (see figure 9.8, p.334).

10.3.5 The agenda, strategy and external events

The standard setter's agenda affects the priority of the standard setting project vis-à-vis other projects, hence affecting the availability of resources and thus the speed of progression of both the learning and political processes. The review of the IAS 12 case also illustrates how the overall agenda can also influence the standard setting process with regard to the acceptability of various (compromise) solutions. In this case it is, for example, striking how the tolerance for alternatives as a means for reaching consensus diminished over time. This shift in agenda, in turn, seem directly related to the IASC's overall strategy in general.

Changes in the IASC's strategy can also be seen to have had at least two further implications for the IAS 12 case. First, the adoption in the latter periods of a more of a leadership role (p. 336) seems to have increased the importance of learning in the process of revising IAS 12. Second, it may be that the apparent strengthening of the US as a significant country (pp. 343-4)

was related to a more fundamental change in IASC strategy (or vice-versa). However, it appears that over the years, convergence between international accounting standards and US GAAP, has become increasingly more important for the IASC / IASB.

Some of these changes in IASC strategy in turn, seem related to developments in the relationship with the IOSCO, developments which can be characterised as external events. In a broad sense other external events or factors also affected the process of revising IAS 12. The most obvious example is perhaps that the first ED (E33), already at the time of issue had become outdated by concurrent developments in the US. These developments, in turn, can be seen to have, although with considerable delay, triggered the substantial learning processes that characterised the ensuing periods.

The significance, or impact, of such external events can be described in terms of creating changes (instability) in the environment, i.e. the other significant factors.

CHAPTER 11

SUMMARY & DISCUSSION

11.1 Introduction

This chapter first provides a summary of the thesis as a whole. It then discusses the suggested findings in chapter 10, first in the light of previous standard setting literature (11.3, p. 379) and then against the stated objective and aspirations of the project (11.4, p. 392). In doing this, this part of the chapter moves beyond the research project as such, reflecting on the possible implications of the suggested findings. The chapter closes (11.5, p. 401) with some concluding comments.

11.2 Summary

11.2.1 Part I – The Introduction

Chapter 2 Background

A fundamental characteristic of accounting is that the production of accounting information gives rise to a large number of choices between alternative accounting policies. Accounting policy choice is complicated by a combination of two factors. First, it is not always straight-forward from a technical perspective. Second, it tends to be controversial since different parties may have both different preferences *and* incentives to contend for these preferences.

Nevertheless, standardisation of accounting practices is believed to be desirable and important. The main vehicle of attaining this has been seen, and continues to be seen, by many to be through regulation (rulemaking), particularly through accounting standard setting (accounting standards). Considerable energy and resources have been, and continue to be, expended on giving the public more uniform accounting information, at national, but increasingly more so at international levels, even at the global level. That is, considerable energy and resources have been, and continue to be, expended on accounting rule-making, particularly standard setting. Despite this, there is continuing dissatisfaction with what has been achieved, criticism being

expressed over the standard setters, their processes of setting standards as well as the standards being produced.

Against this background it is suggested that accounting regulation, especially international accounting standard setting, is a subject area that warrants investigation with a view of achieving a thorough understanding. Such an understanding may, for example, shed light on the various criticisms that continue to be directed towards standard setting efforts.

Chapter 3 Prior literature & research objective

Prior literature

The literature on accounting rule-making, particularly standard setting, is vast. However, it does not seem to provide a sufficiently detailed framework (theory) for understanding this important real-world phenomenon. In summary, the previous literature more or less simply suggests that accounting rule-making constitutes / requires a difficult balancing of both political and technical considerations. The nature or implications of this balancing act, however, do not seem to have been explored. Instead, the political aspects of accounting rule-making have received the most attention. Even so, it seems that the understanding of this aspect of the issue also remains fairly limited. In addition, investigations of accounting rule-making in the past have had a distinct national focus.

Section 3.3 (pp. 47 - 77) provides a thematic overview or what the previous literature tells us about accounting rule-making, particularly standard setting. As already noted the main body of this literature is focused on the political aspects of this phenomenon, investigating issues relating to:

- interests;
  The identified literature suggests that interests with regard to accounting policy choices are complex and hard to predict. It also suggests that there may not exist interest groups with regard to accounting policy choice based on affiliation to constituent groups such preparers, users and auditors of accounting information.

- participation in the formal lobbying process;
  A number of researchers have investigated participation in the formal lobbying process of various accounting rule-making bodies (primarily in the US and the UK, but also in Australia). In summary this research suggests that:

(1) comment letters from preparers dominate while user participation is much lower;
(2) relative participation is very low (below 1 %); and that
(3) there are significant differences between lobbyists and non-lobbyists.

In the context of the IASC there are studies indicating that: comment letters from member bodies (i.e. professional associations and organisations) dominated over comments from preparers, that there may have been a core group of regular respondents, but responses from other respondents may have been increasing.

- content of formal comment letters;
  A few studies address the content of submitted comment letters. These studies suggests that responses may be driven by the discussion in the EDs, that respondents tend to present varying positions on different issues and to provide supporting arguments, but not lengthy ones, when disagreeing with an issue.

- relative influence;
  Following the recognition of economic consequences of accounting policies the influence over the rule-making process appears to have been a fundamental concern of both research and other literature on accounting rule-making.

  Most of this research has focused on the relative influence of various constituent groups over specific accounting rule-makers. Despite of this, the findings reported with regard to this issue seem inconclusive. While some studies report that one or other constituent groups appears to have been influential, other studies argue that the final standard was no consistently aligned with the views of a particular group. These discrepancies may be related to the fact that different regulators, in different countries and at different points in time, have been studied.

  Although the focus of prior accounting standard setting research is very much on the relative influence of various constituent groups, only a few studies address the issue of *how* such influence (power) comes about/is exercised. Suggestions include that influence is institutionalised and a few references to possible power bases such as *professional competence*, *institutional position* and *communicative competence*.

  A few (mainly Australian) studies have addressed the issue of *inter-organizational conflict* over regulatory arrangements. Findings are reportedly consistent with the notion that there is such competition and that in some cases the accounting profession has prevailed and in others, it has failed to control the agenda for accounting rulemaking.

- the role / impact of formal lobbying; and
  The actual role played by formal lobbying remains largely unexplored.

- the implications of the political aspects.
  It has been suggested that the political dimensions of standard setting lead to cycles in the degree of standardisation, i.e. that preliminary material from rule-makers will tend to be followed by less prescriptive rules, which in turn, will tend to be followed by later documents which are again more prescriptive.

Much of the above literature is based on lobbying studies, an approach that has been severely criticised (p. 41). Even without this criticism, however, it may be argued that few general conclusions can be found in this literature.

A second, much smaller, body of literature takes a broader perspective to the phenomenon by focusing on the nature of the rulemaking process. This is presented in three main subsections discussing:

- organisational decision-making models;
  Two studies discuss whether the policy decisions of the FASB (US) can be explained in terms of three conceptual models of decision-making. The findings are inconclusive, which is suggested to be related to a number of weaknesses in the adopted approach.

- models of the accounting rulemaking process; and
  One small strand of previous research suggests that the rule-making process can be seen to consist of a number of phases, e.g.: (1) knowledge and awareness, (2) formation of attitudes and (3) implicit bargaining.

- factors affecting the rulemaking process.
  A few studies suggest that the standard setting process is also affected by factors relating to conditions both inside and outside the standard setter. Factors suggested relating to the standard setter include: the priority assigned to the project (and linked to this the availability of resources); the organisation of the standard setter (the role of and interaction between its various bodies) and the influence of certain key individuals. Factors suggested relating to conditions outside the standard setter include: the priority assigned to the project; (expected) changes in regulatory arrangements; and other outside events affecting the other factors.

Objective

The overall objective for the research project reported in this thesis was formulated in terms of contributing to the understanding of the international accounting standards setting process. The fundamental research questions for this project were phrased in terms of: *How are international accounting standards set? What factors and/or forces affect the standard setting process? How? With what consequences?*

Chapter 4 Methodology

The stated research objective has been approached through a qualitative case study of one case of setting an international accounting standard: *IAS 12 (revised), Income Taxes*. This project was added to the IASC's agenda in March 1987. The revised standard was agreed by the IASC Board almost ten years later (September 1996).

The empirical design can be described in terms of three steps. First the process of setting an International Accounting Standard (i.e. revising IAS 12) was mapped using first material from the standard-setter's archives and then interviewing thus identified key individuals. These maps were then used as a basis for generating ideas about (theory on) the accounting standard setting process. As a third and final step, these ideas have been contrasted to the previous literature.

11.2.2 Part II – The specific process

Chapter 5 Introducing the case
Chapter 6 -8 The chronological account
Chapter 9 The participants and their roles

Part II contains an account of the studied standard setting process. Apart from a general introduction to the case, this account has been structured into three chronological chapters, describing three main periods of the process of revising IAS 12:

- **1981 – 1990 Developing the first ED (E33)**
  In 1981 - the same year as the original standard IAS 12, Accounting for deferred tax became effective - the IASC invited three standard setting bodies to participate in a "Working Party on Deferred Tax". The Working Party reported in 1984 recommending that IAS 12 be revised. A project to revise IAS 12, however, was not added to the IASC's agenda until three years later in 1987. An

ED (E33) was approved a year later (1988). A few months after the comment deadline (autumn of 1989), the project was deferred in the spring of 1990.

- **1992 – 1994 Developing the second ED (E49)**
  Work on the project was resumed in the autumn of 1992. At the time there seems to have been general agreement that a second ED should be published. Although many participants seem to have expected another fairly straightforward process, this was not the case. E49, which was published two years later, was very different from its predecessor, proposing to require a method of deferred tax accounting that was new to most accountants in the world.

- **1994 – 1996 Developing the revised Standard**
  The process of moving from the end of the comment period on E49 (end of May 1995) to a final revised standard took one year and four months; IAS 12 (revised) being approved at the end of September 1996. During this period the IASC Board discussed this project during four meetings. These discussions are reported to have been lengthy, sometimes heated and to have covered many technical issues. For many issues the discussions first took the proposed text for the final standard away from the position in E49, only to revert back again before the final standard was revised.

The descriptions (interpretations) in chapters six, seven and eight focus on developments pertaining to identified key (accounting) issues, with an objective to describe the main "story line" for each period from this perspective. To a large extent these descriptions disregard *who* it was that did *what*. In contrast, a final chapter (nine) address the roles played by various participants in the process.

11.2.3 Part III – The Findings

Chapter 10 Beyond the specifics

Chapter 10 presents the understanding of international accounting standard setting that has been generated by the study of the process of revising IAS 12. This understanding is presented in the form of a suggestion that the setting international accounting standards – indeed the setting of accounting standards in general – may be understood in terms of three parallel and interacting sub-processes: (1) a political process, (2) a learning process and (3) an executive process. In other words, it is suggested that an accounting standard can be seen as the result of the development of, and interaction between, these three sub-processes. The proposed model of accounting standard setting is summarised in figure 10.2 on page 357.

It is also suggested that, in addition to understanding the nature of these fundamental processes, and the way they interact, an understanding of (international) accounting standard setting also requires consideration of how the specific context affects the identified sub-processes. This is discussed in terms of five conditional factors.

The processes of accounting standard setting

(i) The political process

The political process is discussed in terms of *persuasion* and *compromise.* While persuasion is suggested to be closely related to (and hence discussed in the context of) the learning process, two types of compromise solutions ("deals") are suggested: (1) the introduction of *flexibility* / use of *alternatives* and (2) adopting *middle-ground solutions*, primarily in the form of *exceptions*.

Three potential roles are suggested as significant for understanding the compromise aspects of the political process:

- the potential Deal-Breakers within the decision-making body;
- the potential Deal-Breakers outside the decision-making body; and
- the Deal-Makers (Negotiators).

(ii) The learning process

It is suggested that significant aspects of the accounting standard setting process may be understood in terms of both *individual* and *collective* learning. While such processes can be seen to be triggered by the political process, they can also be seen to have numerous potential implications for the political process. As a result, the political and learning processes are portrayed as the heart of the standard setting process in figure 10.2, each feeding into the other.

Two potential roles are suggested as significant for understanding the learning aspects of the process: the Educators and the Learners.

(iii) The executive process

Finally, it is also suggested that significant aspects of the standard setting process may be understood in terms of how work on the project proceeds. It is suggested that the core concern of the executive process is *progress* (in comparison to *compromise* and *understanding*) and that progress requires a combination of both *facilitating* and *restricting* the learning and political

processes. As a result, the executive process encircles the other two processes in figure 10.2.

While the roles of Deal-Maker and Educator are also suggested to be significant for the executive process, two further roles are specifically suggested here: the Authors and the Referees.

Conditional factors

(1) The issues

It is suggested that the nature of the issues which the standard setting process deals with may have two important implications for the learning aspects of this process and hence for the standard setting process in general:

- Complexity and relative importance of learning
  On the one hand the review suggests that the (perceived) complexity of the issues may affect the significance of (individual and collective) learning in the specific standard setting context. On the other hand, it also suggests that at least two factors contribute to making most accounting issues relatively complex (and hence to making learning a significant aspect of accounting standard setting in general).

- Complexity and a focus on matters of detailed application
  It is also suggested that the complexities of the issues lead to a strong tendency for individuals, in their efforts to understand the issues, to focus on specific matters of detailed application. This characteristic of the individual learning process, in turn, has important implications for the standard setting process as a whole in that it is likely to be passed on to the deliberations as a whole (increasing the number of issues to be dealt with) and hence also to the political sub-process, opening up for various compromise solutions.

(2) The individuals

It is also suggested that the concerns and (relative) influence of the individuals involved in the actual standard setting effort must be taken into consideration. With regard to the issue of influence, it is suggested that the key roles suggested in relation to the identified sub-processes of accounting standard setting can be seen to represent different *types* of influence on the accounting standard setting process (and hence the final product). In addition

three *sources* of authority/influence are suggested: formal authority, deal-breaking authority and charismatic authority.

In the case of the IASC and IAS 12, charismatic Educators seem to have been especially important. It is suggested, however, that this may be related to the influence of both the first and the third contextual factor:

(3) The organisation of the process.

The organisation of the process also matters to the extent it affects the supply of resources (time and expertise) involved in the process. A key point in the review of the process of revising IAS 12 was that, as a result of the organisation of the IASC, such resources were limited.

On a more fundamental level it is suggested that:

- organisational levels introduce sub-levels to the political-, learning- and executive processes; and
- in practice the standard setting process is non-continuous, consisting of numerous meetings linked together by even more numerous documents. This may be significant for the importance attached to those various documents (and hence the influence of Authors). In combination with limited resources, this may also seem to be one further source of (repeated) turns and twists in the process (i.e. proposals).

(4) the standard setter's overall agenda/strategy; and

It is suggested that the standard setter's agenda/strategy may affect the specific standard setting project in three ways: (i) by affecting the availability of resources for the project, (ii) by affecting the acceptability of various (compromise) solutions and, more fundamentally, and (iii) by affectting the importance of learning in the standard setting process.

(5) other external events.

It is suggested that a model for understanding accounting standard setting must also allow for the impact of external events creating changes (instability) in the other significant factors.

11.3 Discussion of the suggested findings in relation to previous literature

11.3.1 Introduction

This section discusses the suggested findings in relation to the previous standard-setting literature.[1] On the one hand the suggestions in chapter 10 contrast to this literature in several important ways. These will be identified in the following sub-sections. On the other hand, the main difference can be argued to lie in the comprehensive nature of the proposed model rather than in the detailed suggestions. In line with this it is suggested that, in general, the previous literature would seem to support, rather than contradict, the suggestions in chapter 10. Often, however, this support is found in more or less scattered, even indirect and anecdotal, remarks in various sources discussing accounting standard setting.

11.3.2 The model of accounting standard setting

The suggestion that the accounting standard setting process can be understood in terms of the developments of, and interplay between, three sub-processes contrasts to the previous accounting standard setting literature in two main ways. First, while the previous literature has discussed the accounting standard setting process in terms of both a political process and a learning process, these suggestions have not generally been linked together. While some authors seem to have pushed one perspective, others seem to have focused on the other perspective (see below). In contrast, this model identifies both aspects as central. In addition, it also raises a third aspect: that represented by the executive process.

A second characteristic of the suggested model is that it emphasises that these aspects of the over-all process are parallel and interacting. In contrast, the previous accounting standard setting literature has tended to discuss these aspects in terms of *phases* in the standard setting process (pp. 69-73)

1 As noted on p. 84, the ambition was for a long time to remain inductive in the sense of letting data speak. As a consequence an in-depth review of prior literature was not made until the time had come to make comparisons with prior research. However, much of the literature was also read prior to this point. It is therefore unavoidable that the ideas presented in previous writings may have affected the interpretation of the empirical material

without emphasising the *interdependencies* between the various aspects of the over-all process.

Some of the previous accounting standard setting literature identified in chapter three had been inspired by models of organizational decision-making. The model of the accounting standard setting process suggested in the previous chapter, with its emphasis of three different sub-processes, may be seen to shed some light on the suggestion (in the organizational decision-making literature) that the rational actor-, the organizational process- and the political actor models (pp. 66-69) are not necessarily to be seen as alternatives:

> One of the points of Allison's (1971) analysis of the Cuban missile crisis is that it is not necessary to choose between analytical frameworks. Each may be partly true in a particular situation, and once can obtain a better understanding of the organization by trying to use all of the models rather than by choosing among them. This point is different than saying that some organizations are characterized more by the political model and others by the rational model. Allison's argument is that insight can be gained form the application of all the frameworks in the same situation. This statement is true, but only within limits. At some point, the various perspectives will begin to make different predictions about what will occur. (Pfeffer, 1981: 29-30)

While this argument can be seen to support the suggestion to take a more comprehensive view (rather than to investigate the application of e.g. the political model of decision-making), it also again points to what is perceived as a main contribution of the suggested findings: the presentation of a comprehensive model of the accounting rule-making process, an analytical framework that not only recognizes these various aspects of this process, but details the interaction between them.

With regard to the organizational decision-making literature section 3.3 also notes a fourth category of such models: the decision-process / decision-making models. On the one hand, the account of the IASC's standard setting process in relation to IAS 12 seems to fit the description of such processes suggested by March (1966) (see quotation and footnote on pp. 68-9). On the other hand, March's suggestion that "(t)he concept of power does not contribute much to our understanding of systems that can be represented in any of these ways" (ibid: 340), stands in some contrast to the suggestions in chapter 10. It seems, however, that the latter suggestion was founded in concerns of testing the model and predicting outcomes:

> Such descriptions of social choice have two general implication. On the one hand, if a system has the properties ……, power will be a substantially useless concept. In such systems, the measurement of power is feasible, but it is not valuable in calculating predictions.
> On the other hand, the process models – and particularly the decision-making process models – look technically more difficult with regard to estimation and testing than the more complex modifications of the force model. We want to include many more discrete and nominal variables, many more discontinuous functions, and many more rare combinations of events. (ibid)

11.3.3 The political process

Although the previous literature tends to emphasise the political aspects of accounting rule-making, even presume that accounting rule-making is political, surprisingly few sources discuss the characteristics of the political aspects of the process and/or the implications for the end product . However, what there is, seems to support the suggestions in section 10.2.2 (pp. 339f).

The nature of the political process – persuasion and compromise

In line with the suggestion that the persuasion aspects of the political process are perhaps closely associated with the learning process, prior writings on the political aspects of the accounting standard setting process seem to focus primarily on the compromise aspects. For example, writing on accounting rule-making in a FASB context, both Beresford and Miller and Redding identify compromises as an essential part of this process:

> At that point, …, we stepped back and considered the package of tentative decisions reached to date. ….. As it turned out, a majority voted in favor of that package of decision. I can assure you that each assenting Board member made a significant compromise in order to support those tentative decisions. (Beresford, 1988: 6)

> When reaching an agreement among four Board Members to get a majority vote, it is virtually always necessary that each of them give up something that he would otherwise prefer to be a part of the answer. Thus, each Board Member must enter deliberations on a project with an idea of which points are most important and least important; then, as the debate ensues, the struggle becomes one of attempting to preserve the most important, even if it means letting the others fall aside. This compromising is a critical part of politics. (Miller & Redding, 1988: 26)

No extensive discussion of the nature of various compromise solutions has been found. Beresford argues, however, that the objective is not to "'split the difference' between competing views" but to achieve the "mission of improving financial reporting in general" and described this as "a very human, judgmental process" (1988: 5).

The nature of the political process – significant roles

Potential Deal-breakers

The two suggested roles of potential Deal-Breakers can be contrasted to Rahman's (1998) account for how a minority was able to influence a UN standard setting process. The focus of Rahman's analysis (pp. 62f), however, is skewed somewhat differently, addressing the management of base values (power bases).

Deal-Makers

The role of Deal-Makers in the political process is similar to Miller and Redding's description of FASB staff acting as *go-betweens (negotiators)* (p. 318). In similarity with this source, it has been argued that the existence of such Deal-Makers potentially reduces the need for overt bargaining. In contrast, however, it is argued that this is a role that also can be played by other participants than members of Staff.

Implications for the standard-setting process – turn & twists

The suggested implications of compromise on the standard setting process in the form of repeated turns and twists do not seem to have been explicitly discussed previously. However, Miller and Redding's (1988: 27) argument that, as a result of the need to compromise, it is inevitable that the standard setter's position on an issue will change (because of shifts in power and priorities), might be construed as related to this.

Implications for the proposals/standards

The suggestion that the political aspects of the standard setting process will tend to lead to inconsistencies in the proposals/standards is also found in Miller and Redding (1988: 27):

> First, and perhaps most important, politics tend to make generally accepted accounting principles **logically inconsistent** because …

In addition Beresford, as well as Miller and Redding, both propose a further consequence of the need to compromise:

> It is fair to say that every Board member disagrees with some aspects of the overall decisions on individual issues (Beresford, 1988: 7)
>
> ...someone, or indeed everyone, will be unhappy with any rule (Miller & Redding, 1988: 27).

11.3.4 The learning process

Learning as a significant part of the standard setting process

A meticulous reading of the previous standard setting literature reveals that several sources also suggest a notion of there being an element of learning involved in standard setting. One such example is when Sutton suggests that pre-exposure draft lobbying may be easier than post-exposure draft lobbying because, at that point views may still be "crystallizing" (1984: 88). Another example is when Nobes notes that the arguments relating to a specific standard setting issue gradually became clear as the issue was discussed by the standard setter over a period of time (1992b:154).

A somewhat less indirect reference to learning in accounting standard setting is, for example, found in the statement that the FASB staff regularly hold educational meetings for its board members (p. 317). A similarly more direct reference to learning, and its potentially significant consequences for the standard setting process, is also found in the following statement:

> Our deliberative process provides education for the Board, education that frequently changes views as more is learned. (Beresford, 1988: 2)

To a certain extent the notion of learning as an inherent part of the standard setting process is also explicitly recognized in the strand of previous research produced by Hussein, Jönsson and Zetterlund (pp. 69f). In contrast to these models of the accounting standard setting process, however, chapter ten argues that learning may be about more than knowledge / awareness / attitude formation, new understanding (issue expansion) may also be generated. Furthermore, in contrast to the account in the previous chapter, these models do not really contribute to the understanding of the significance of learning for the nature of the process and its finished product.

The nature of the learning process & its implications

The idea of learning as a significant element of accounting standard setting appears to be the most explored in the writings of a FASB Board member. Swieringa has repeatedly argued that the standard setting process can be understood as an iterative learning process (e.g. 1988: 56) where "(t)entative conclusions are reached for some issues and then are reconsidered as subsequent issues are considered" (1987: 3). As a consequence, it is suggested that the standard setting process becomes non-linear, characterized by "*twirls, crinkles, chugs and puffs*" [2] (1987: 3-4) (1989: 182-3). The latter suggestion seems well in line with the above discussion regard the implications of learning.

Swieringa has also described the learning process in terms of problems being ill-defined, information having to be obtained and alternatives to be fashioned (1989: 182). This too seems well in line with the suggestions regarding potential confusion and misunderstanding and regarding new understandings and alternatives emerging with time.

11.3.5 The executive process

As noted initially the executive aspects of the accounting standard setting process generally do not seem to have been specifically addressed in the previous literature, the exception being discussions vis-à-vis the influence of the staff of a standard setter in chapter nine (pp. 305f). The suggestions in chapter ten, however, extend beyond that.

11.3.6 Conditional factors

Conditional factors affecting the rulemaking process have not been extensively discussed in previous literature. As noted in chapter 3 (pp. 73f), however, Cottingham and Hussey (2001) have identified a number of "intervening conditions" affecting the development of an accounting standard in the UK, including: (1) the level of priority, (2) resources attached to the project, (3) legal impediments, (4) changes in the regulatory arrangements and (5) external events. Although there are many overlaps in the understanding of the process suggested by these factors, the factors in the previous chapter are cut along somewhat different dimensions.

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2 This characterization is a quotation from the title of a contemporary article on the FASB's loan fee project (1987: 3-4).

The suggestions regarding conditional factors may also be contrasted to the strand of research represented by Hussein, Jönsson and Zetterlund (pp. 69f). For example, Hussein's model suggests that attitudes formation is affected by (1) the perceived characteristics of various solutions, (2) the social structure and norms of various groups, (3) results of experimentation and (4) experience with similar methods (figure 3.3 p. 70). Again, although there are overlaps in the understanding of the process, the identified factors are cut along different dimensions.

The following sub-sections discuss the extent to which the suggested conditional factors have been discussed in the previous literature.

11.3.7 The issues

Complexity and the relative importance of learning

References to the complexity of the accounting standard setting issues tend to appear in one strand of literature on accounting regulation in particular - discussions of the relative advantages of private versus public standard setting, e.g.:

> Much of financial reporting concerns highly technical mattes. It is likely that the typical member of the legislature will not be well informed on these matters and will not be unhappy to pass the responsibility to another body, which, possessing the necessary technical competence, is likely to do a far better job. (Flower & Ebbers, 2002: 76)

Related to the suggestion that the (perceived) complexity of the accounting issues may contribute to individual and collective learning being a significant element of the standard setting process, it is noted that *conceptual difficulties* have been identified as a factor hindering the accounting standard setting process. Cottingham and Hussey refer to "technical diffi-culties" (2001: 114) as an intervening factor delaying developments with regard to a UK standard setting process. Gordon and Morris similarly identify "(a)mbiguities about the nature of equity accounting" (1996: 167) as a force delaying standardization with regard to this issue in Australia. An interesting implication of the latter study is that it can be seen to suggest that conceptual

issues (concerns) have become more important with time[3] which, in turn, may suggest that the associated learning have become more pronounced too.

Complexity and a focus on matters of detailed application

Although the notion of individual learning being a significant element of standard setting thus does not appear to have been extensively explored in the previous literature, this does contain various references to a need to make abstract principles tangible. For example, in defending the role of conceptual frameworks Gerboth refers to "the mistaken notion that it is possible to avoid, minimize, or control debate on basic issues by prior agreement on abstract principles" (1987: 1-2). It is also present in the following reflection on the problems of writing accounting standards:

> If they are broad enough to cover the variety of circumstance, they become platitudinous and admit the very disparity of treatments they were designed to avoid; if they are narrow enough to exclude this, then all sorts of hard cases will come up with a silly result.
> (Morison, 1977: 6 in Baxter 1981: 7)

The suggested tendency to use simple (numerical) examples in accounting standard setting discussions has also been noted in the research presented by Jönsson and in the writings of FASB Board member Swieringa:

> Two striking features in the currency case were that …and that simple numerical examples were used to illustrate arguments. It seems that the problem is so abstract that one cannot 'see' the consequences of different solutions without illustrations, neither can one expect to convince anybody that one is right. (Jönsson, 1988: 203-4)
>
> Those [early] stages often reflect the use of examples and analogies to help define the scope of the project and to determine whether issues are limited to specific items or are broader. Examples and analogies are used to abstract the essential features of the items being discussed. (Swieringa, 1989: 184).

Jönsson also emphasises that this tendency does not reflect a lack of technical competence of the participants:

> This holds in spite of the fact that it is professional people involved. The degree of abstraction is extremely high even if it might appear to be a relatively concrete problem to the causal observer. This deceptive

3 Reflecting on the background to this phenomenon, the authors suggest that equity accounting, like consolidation accounting, was introduced in English-speaking countries without extensive analysis of the basic rationales.

> concretion might be a general explanation why the outsider seems to believe that all accounting problems are simple and why accountants have these difficulties in explaining accounting problems. How do you explain complexity in simple terms? How do you formulate a simple rule to be applied to complex cases? (1988: 204)

The power of these numerical examples – their potential effects on both the (individual and collective) understanding of the issues and the over-all process – is made particularly clear in Swieringa's (1988, 1989) account of the FASB Income tax project. In particular this account explains how an example – developed by the staff following a request from the Board to search for situations analogous to recognising tax loss carryforwards [I-7] –

> changed the focus [of the discussions] from probability assessment to the role of future events in recognizing and measuring tax assets and liabilities (ibid, 1989: 184).

In comparison with the suggestions in the previous chapter, however, these previous writers neither suggest nor emphasise that the tendency to focus on matters of detailed application may be passed on to the political sub-process and that this may be fundamental for understanding the accounting standard setting process as a whole, as well as the ensuing product.

11.3.8 The individuals

The significance of the individuals

A number of authors on accounting standard setting have suggested that understanding the role of key individuals may be important in order to understand the accounting standard setting process. Flower suggests that individual Steering Committee representatives were influential:

> …, although the Steering Committee as a committee played a relatively minor role, this comment does not apply to individual committee member. Four members in particular were very active in communicating their views to the Secretariat, including the Committee Chairman, who since he was also a Board member, was clearly the single most influential individual in the whole process. (1998: 17-18)

Hope and Gray (1982) (p. 60) similarly suggest that the chairman of the standard setter may have significantly affected the UK process on developing a standard on research and development expenditures. Walker and Robinson (1994b: 135) (p. 64) similarly suggest that certain individuals significantly affected an Australian process on cash flow reporting.

Cottingham and Hussey also emphasise the importance of certain key individuals. Although the comment is made in relation to the issue of time management (p. 74), it seems to have a wider applicability:

> This judgement as to the appropriate time was not exercised through formal procedures, but through the knowledge, experience and informal soundings of the part-time, voluntary committee members of the ASC. As senior people in their own employing institution, they had ample opportunity to discuss with people outside the committee attitudes to related party disclosures and to assess likely responses to any initiative. In the words of a similar research study it is possible that 'the most critical events in the development of rules on RPTs arose from interactions between key players' (Walker and Robinson, 1994[a], p. 35). (2001: 113)

Nevertheless, the role of individuals do not appear to have been explored to any depth in the previous accounting standard setting literature.

The influence of individuals

As noted on page 58, Hope and Gray attempted, but abandoned a typological approach to investigate influence over an accounting rule-making process. They suggested, however, that such an approach might be fruitful, given "some model of the …policy making process" (1982: 534). Such a model has been developed in chapter ten and as a next step, certain types of influence have been suggested.

In briefly reviewing previous writings on different types of power in sociology and political science literature, Hope and Gray (1982) start by noting "that there are thousands of possible typologies and choosing between them depends upon the selection of numerous possible criteria" (ibid: 533). Following this, however, they refer to a number of types power, primarily *competent authority* ("that exerted by an acknowledged expert, or by the force of persuasive arguments") and *legitimate authority* ("that wielded by an individual or group to whom power has been granted") but also: *force*, *manipulation*, *coercion* and *inducement* (ibid: 533-4). French and Raven list five similar bases of power:

> By the basis of power we mean the relationship between O and P which is the source of that power. … These five bases of O's power are:
> (1) **reward power**, based on P's perception that O has the ability to mediate rewards for him;
> (2) **coercive power**, based on P's perception that O has the ability to mediate punishments for him;

> (3) **legitimate power**, based on the perception by P that O has a legitimate right to prescribe behavior for him;
> (4) **referent power**, based on P's identification with O;
> (5) **expert power**, based on the perception that O has some special knowledge or expertedness… (1959: 321-2)

The suggestions in the previous chapter relating to *charismatic authority* seem related to the above concepts of *competent authority* and *expert power*. The discussion in chapter ten places this type of influence outside the political process (in the learning process). This, in turn may be in line with the suggestion that "expert power results in primary social influence on P's cognitive structure" (ibid: 325).

Influence on the political process, however, is discussed in terms of deal-breaking and deal-making influence. It seems possible that these types of influence may also be discussed in terms of manipulation / coercion / inducement, depending on the specific definitions of these latter concepts. A thorough discussion of this, however, would require an in-depth investigation of what has been suggested to be a very rich body of literature.

Although no other explicit discussions of various *types* of influence on the standard setting process have been identified, it is noted that a number of authors on accounting standard setting have, more or less loosely, suggested various *sources* of authority in the accounting standard setting process.

Some suggestions seem related to the concept of formal authority (and the roles of Authors and Referees) suggested above. Consider, for example, the following a priori reasoning by Walker and Robinson:

> The procedures adopted by different bodies to consider proposals may also affect the influence of individual members. For example, a member may have less influence on the content of rules if he simply has a vote within a formal meeting then if he was given responsibility for chairing a project team to undertake a preliminary review of a proposed rule.
> (1993: 26)

Suggestions related to the concept of *charismatic authority* based on subject-, language- and cultural proficiency, however, appear to be more numerous. In discussing the deliberations of the Swedish standard setter, for example, Zetterlund (1998: 147) reports that the accountants (auditors) were perceived as having had relatively more influence, because they had invested more

time in the work with the issues. This seems in line with the suggestion of subject proficiency being an important source of authority.

Related to the suggestion that language proficiency is another such source, it is noted that Taylor (1987), Chandler (1992) and Flower (1998), all identify *language skills* as an important factor, e.g.:

> Although English is fairly well-established as the international language of business and accountancy, persons in non-English speaking countries are clearly at a disadvantage when it comes to commenting on IASC documents and influencing the whole IASC process. Language is almost certainly a major factor in the poor representation of Latin countries on the IASC Board and in its activities in general. (Flower, 1998: 8)

Walker and Robinson use a somewhat wider concept in suggesting (a priori) that *persuasive skills* (1993: 25) may be an important factor in explaining relative influence of individuals.

Another perspective on the issue of why certain individuals, or rather delegations, seem to have more influence is suggested by Wallace (1990). From a contingency theory perspective, he suggests that the organisation of the IASC assumed non-pecuniary contributions and that all members could not be expected to contribute equally, each having different *capabilities to set standards*:

> An underlying assumption of the small budget and administrative machinery is that the IASC can draw on the knowledge, perspectives, experience and resources of its many member-bodies especially those of its Board members. ….. But members do not and cannot contribute equally to the resolution of IASC's problems. For example, the extent of participation in IASC's technical committees, and 'procedural due process' depends on the extent of standard-setting experience of a member country. (ibid: 5)

Wallace further suggested three categories of IASC Members in this respect, differentiating between countries:

1) with developed standard-setting procedures (Australia, Canada, the UK, the Netherlands, and the US);
2) that simply adopt pre-existing standards (e.g. Cyprus, Trinidad, and Zimbabwe); and countries
3) that blend standards from outside sources into their internally generated standards (e.g. Egypt, France, India, Japan and Singapore) (ibid: 5-6).

This reasoning seems close to the suggested concept of *standard setting professionalism*, or even the more limited concepts of *subject-* and *cultural proficiency*.

In summary then, the literature would seem to support the suggestion that some form of charismatic authority may be an important source of authority in the standard setting process. In contrast to the previous chapter, however, the previous literature neither explains the nature of this influence on the process nor (with the exception of Wallace) the mechanisms that contribute to making this source of influence important.

11.3.9 The organization of the process

The suggestions in section 10.3.4 (pp. 367f) regarding the impact on the standard setting process of the fact that this is non-continuous have similarities with the reasoning in relation to the cyclical model of standard setting (p. 65). In that context, however, the suggested impact is seen as a result of political forces, not of the organisation of the process.

11.3.10 Agenda, Strategy & external events

Agenda

Cottingham and Hussey (2001) also suggest that the standard setter's overall agenda matters for the shaping of a specific standard setting process. In fact, one of their main arguments seems to be that the standard-setting process they studied was affected by the priority – and hence availability of resources – assigned to the project (pp. 73f). The suggestions in 10.3.5 (pp. 368f), however, are broader than that, recognising also the potential impact on the tolerance of alternative compromise solutions.

Strategy

The notion of the IASC adopting different strategies vis-à-vis its standard setting endeavours has been addressed by several authors. In 1998 the IASC Strategy Working Party summarised these thoughts by contrasting the concept of *harmoniser* with that of *catalyst*:

> In its early years, IASC acted mainly as a harmoniser – a body that selects an accounting treatment that exists at the national level in some countries and then seeks worldwide acceptance of that treatment, perhaps with some modification. … In more recent times, it has begun to combine that

> role with the role of a catalyst – a co-ordinator of national initiatives and an initiator of new work at the national level. (IASC, 1998b: 5)

In 1982 two papers were published discussing the need of the IASC to change strategy (Choi & Bavishi, 1982; Daley & Mueller, 1982). Although not discussed explicitly, at least one of these papers seems to recognise that such a change would have implications for the (nature of the) IASC's standard setting process:

> IASC would have to become a leader in dealing with accounting issues. This last step has huge costs, since the IASC would run the risk of exposing itself to disenchantment by members and may possibly lose support. Furthermore, IASC operations would have to be expanded significantly, including adequate research. Again, this would be very costly. (Daley & Mueller, 1982: 50)

External events

References to external events appear quite frequently in accounts of standard setting processes (p. 74) Repeated references to the impact of such non-controllable events significantly affecting the standard setting process suggests that there is a non-negligible element of surprise and unpredictability involved in the accounting standard setting process.

11.4 Concluding discussion

11.4.1 The research objective revisited

The overall objective for the research project was formulated in terms of contributing to the understanding of the international accounting standard setting process. This was understood in terms of developing the present theory of (ideas on) international accounting standard setting beyond general suggestions that this is political, or even that it constitutes a complex balancing of technical and political considerations. The fundamental research questions for this project were phrased in terms of: *How are international accounting standards set? What factors and/or forces affect the standard setting process? How? With what consequences?*

The suggestions in chapter ten can be seen as a model (analytical framework) for understanding the (international) accounting standard setting process. This model identifies, three fundamental sub-processes – and related to that, different sources of influence – and a number of conditional

factors. It might thus be argued that the stated objective has been achieved. This suggestion, however, requires several modifications. One of these concerns the extent to which the findings in this study can be reasoned to have more general applicability.

On the one hand the leap from the case of revising IAS 12 to the setting of international accounting standards in general (not specific to the IASC), or even accounting standards in general, may seem enormous. On the other hand, there is nothing in the material suggesting that the three sub-processes are specific to this one case, or even to the case of *international* accounting standard setting. Indeed, they seem fundamental to any decision-making process that involves issues of some complexity and is extended over time.

What may differ, however, is the *relative significance* and the *specific* nature of the sub-processes. In the context of the suggested model this is particularly addressed in terms of the impact of five conditional factors. It is also here one has the most reason to consider the extent to which the findings have been driven by the specific case.

Already in chapter 4 it was suggested that the selected case could be considered both extreme and/or critical (p. 89) in terms of representing a relatively *more controversial* standard setting project. Can this have affected the importance attached to political and/or learning processes? Moreover, as already noted in chapter 10 (p. 358) accounting for deferred tax effects is generally perceived as a relatively more complex area of accounting thought. This, in turn, raises the question if this contributed to the relative importance of learning (and the related focus on matters of detail) in the case of revising IAS 12 (especially since this coincided with the adoption of the IASC's conceptual framework). Although this potential effect cannot be ignored, it is argued that many accounting issues can be considered rather complex owing both to the characteristics of the accounting system and to the abstract nature of the qualities it is intended to measure (p. 359).

Instead, the area where one has particular reason to consider the impact of the specific case on the suggested findings, may concern the suggestions regarding the *relative influence* (types of influence and sources of authority) on the process. In the case of IAS 12 and the IASC, several factors appear to have contributed to a situation where many participants were at a dis-advantage in respect of subject proficiency. Many of those involved in the standard setting activities had restrictions on the amount of effort they could

put into the standard setting activities. In addition, many had not previously, or recently, considered the issue of deferred tax in great detail, or even in relation to the conceptual framework, which was still rather new. As a result, higher subject proficiency, both with regard to issues specific to deferred tax and with regard to the conceptual framework in general, seems to have become a key source of authority. In a context with a smaller body of mainly full-time decision-makers (e.g. the IASB), other sources of authority may be more prevalent. Furthermore, in a situation like the present (p. 16) one may wonder about the potential (external) deal-breaking power of, for example, the EU.

11.4.2 Implications of proposed findings

This section attempts to address the important question concerning the implications of the proposals in chapter 10. It does this by returning to the project's background, noting that the research was motivated in terms of a better understanding of accounting rule-making, especially international accounting standard setting, potentially shedding light on the various criticisms that continue to be directed at accounting standard setting bodies, their processes of developing standards and the standards themselves. Inevitably, some of these criticisms are intertwined. For reasons of presentation, however, a separation is attempted.

Shedding light on the criticism of standard-setting bodies?

Criticism against standard-setting bodies generally tends to focus on their legitimacy, particularly the issue of the relative influence of various constituent (or interest) groups. In line with this various national standard setters have been accused of being "dominated" by the profession, "captured" by the preparers of accounting, and/or of the staff having "undue" influence. The major criticism directed at the IASC, however, has concerned the perceived strong influence of Anglo-American accounting practices on IASs.

Such allegations of undue influence presume some kind of value judgement, a subject area outside the bounds of the present study. However, the model for understanding accounting standard setting developed in chapters 10 provides an analytical framework for approaching such issues. As already noted it suggests that it is possible to distinguish between, not only various types of influence on the various sub-processes of accounting standard setting, but also between different sources of authority. Although, the

suggested key roles and the associated sources of authority may still need to be refined, these findings seem to provide a more profound framework for such discussions than the more or less simplistic political (or force) models (footnote p. 68) implicit in much of the former standard setting literature.

Shedding light on the criticism of the standard-setting process?

A frequent criticism directed at standard-setting efforts is that it takes too long. The suggestion that the standard-setting process cannot be characterised as a simple choice-process, or even as a "mere" political process, but also may involve significant *learning* that interacts with, and complicates the political process, provides an explanation not only for why accounting standard-setting typically takes time, but also for why it tends to be characterised by twists and turns.

More specifically, it should be noted that the suggestions in chapter 10 include that both the political and learning processes contribute to making twists and turns a key characteristic of the standard setting process:

- the political process may lead to repeated twists and turns in proposed solutions as a result of alternative rules being tried for sufficient consensus (p. 340);
- individual learning processes may lead to revised positions vis-à-vis debated issues (and hence to twists and turns, p. 346);
- individual learning processes may also lead to confusion and misunderstandings, which, if cleared, may lead to yet a different kind of twists and turns (p. 348); and
- collective learning may lead to issue expansion, which, in turn, may significantly shift the political process (p. 348).

In addition, it was also suggested that the organisation of the process, particularly in the form of a non-continuous process, may also contribute to such twists and turns (pp. 367-8).

Although the recognition that individual and collective learning may constitute a significant part of the standard setting process may be taken to suggest that such processes should be allowed to take time, it is suggested in chapter 10 that it may be that there is no natural finishing line for the associated learning and hence that no amount of time may ever be sufficient (p. 349).

The IASC's process has been criticised for being superficial. The description of the process of revising IAS 12 both provides some support for this

and, at the same time, suggests that the IASC Board thoroughly debated and contemplated its standard setting decisions. The key to this riddle is perhaps provided in the suggestion that sometimes the Learners (p. 349) – in the case of the IASC and the case of IAS 12 – were not as prepared as they perhaps might have been in a different situation (owing perhaps primarily to organisational factors, but also to the IASC's agenda). This, in turn, seems to have affected their individual learning processes and hence also not only the collective learning process, but also the political and the executive processes.

Shedding light on the criticism of the standards?

The products of the accounting standard setting process – the accounting standards - have also received their fair share of criticism. Accounting standards have generally been criticised for being too many, too complicated and too detailed (p. 26).

In relation to these concerns it is noted that the understanding of accounting standard setting suggested in chapter 10 includes suggestions that both core processes of accounting standard setting contribute to making accounting standards complicated (in terms of detail and otherwise):

- *Individual and collective learning*
  As a result of individual and collective learning, neither issues, nor alternatives, may be well defined. Hence confusion and misunderstandings can be expected. If "undiscovered", these will be incorporated into the rules, thus giving rise to inconsistencies and/or what might otherwise be perceived as strange rulings.
  It is also suggested that there is a tendency for individuals, in their analytical efforts to understand the issues, to focus on matters of detailed application thus contributing to increasing the amount of detail to these discussions.

- *The political process*
  It is suggested that the political process – through its reliance on compromises – is likely to lead to *inconsistencies* in the rules (e.g. in the form of making exceptions). Such compromises can be seen to increase both the complexity of the standards in general and to the level of detail. To the extent alternatives are used to achieve consensus, the political process is also likely to introduce *flexibility* in the rules. This too, can be perceived as complexity.

> A key argument in chapter ten is that the consensus (majority) decision-rule can be seen to contribute to this: if the required majority is not present, minorities can get their way (e.g. by introducing alternatives and/or exceptions for issues of detailed application) by making various (sub-)issues into potential deal-breaking issues. Hence also the suggestion that the tendency to focus on issues of detailed application in the learning aspects of the process is likely to be passed on to the political sub-process and, in the end, the standard.

In fact, it might be argued that all three sub-processes have this effect; the executive process, through its emphasis on progress contributing to *restrict* the learning process and to *facilitate* the finding of viable compromises.

In view of these conclusions, the suggestion in chapter eight that, even as late as just prior to the approval of the revised standard, concerns were raised over continuing confusion over what was intended (p. 277), are not surprising. In fact, the suggested model for understanding accounting standard setting paints a very sombre picture of the prospects for accounting standards in that it suggests that detailed (rule-based) standards are to be expected, as are inconsistencies, confusion and misunderstandings.

11.4.3 Discussion of future research topics

Although it is suggested that the model of the accounting standard setting process generated from the review of one case of international accounting standard setting may have more general applicability, this model and the related suggestions may, of course, be considerably refined. This section suggests some future research topics in view of the findings. In doing this, it also raises some concerns that the undertaken research has given rise to.

The model of accounting standard-setting process

It has been suggested (p. 380) that the proposed model of the accounting standard setting process can be seen as a model detailing the interaction between various fundamental models of decision-making. It is not clear, however, whether this represents something different from the decision process /decision-making models, or provides an explanation of this model in terms the political and rational actor models. In any case it may be that further insights into the standard setting process could be gained by investigating this literature in more depth.

The political aspects of accounting standard setting

The reported study explicitly avoided adopting a political framework, striving instead for an inductive approach. The emphasis of the political aspects of accounting standard setting in the findings, however, suggest that it may be warranted to ask whether further insights can be gained by applying frameworks and theory of politics from other strands of social research, e.g. from the organisational-decision making literature, but also from sociology and political science.

Although this approach has been tried in the past (e.g. Hope and Gray, 1982) it may be that such an approach could now – given the proposed model of the rule-making process – add further nuances to the understanding of the political game than provided by the suggestions relating to potential Deal-breakers and Deal-makers. For example, it may be that the understanding of various sources of authority may be expanded by relating to the typology literature (ibid: 533) and, related to that, the literature on power bases. For example, French and Raven (1959: 326) indicate that organisational theorists have already extensively discussed the nature of expert power, also addressing the notion of informational power (the influence of the content of a communication). Moreover, Mintzberg suggests three prime bases of power: the control of a resource, a technical skill and a body of knowledge (1983: 354), all of which seem applicable to the accounting rule-making process.

Such an approach, however, might require real-time access to the process (i.e. observation/participation). One should perhaps also pause to consider whether a more refined model can be expected to be useful and/or interesting.

Also in relation to the political aspects of the standard setting process it is noted that our understanding of preferences with regard to accounting policy choices (standards) remains severely limited, both in a national and an international context. It may be that progression in this area requires a movement away from relatively (simple) hypothesis based on notions of self-interests and economic consequences.
In the context of the political aspects of the process one important limitation of the undertaken research must also (finally) be addressed. While some previous literature explicitly discusses the distribution of power over accounting rule-making, this issue has not been specifically addressed in the present study (leaving an area yet to be addressed). Two alternative models

regarding the distribution of power (influence) are discussed in the literature: the pluralism model (broad distribution) and the élistist model (more narrow distribution) (e.g. Fogarty et al, 1994: 30). Although the account in part II might seem to suggest a fairly narrow participation, such conclusions would, of course, require further investigations encompassing either more standard setting efforts or an alternative research approach altogether (see discussions relating to the three dimensions of power on p. 41 and relating to the reputational method on p. 58).

Another significant aspect to address would also seem to be how the nature / role of the political aspects of the standard setting process are affected by a *smaller*, *full-time* (professional) standard setting body where the decision-makers cannot be perceived to represent sectional interests in the way they could in the IASC. As already suggested (p. 394), institutional changes may also affect the possibility of significant countries (regions) exerting outside deal-breaking influence.

The learning aspects of accounting standard setting

As in the case of the political sub-process, one might ask if further nuances (beyond the suggestions relating to the influence of Educators and Learners) be added to the understanding of the learning processes. However, given the potentially significant implications for the standards setting process and the product, further investigations into the factors affecting this sub-process seem warranted. For example, in the IAS 12 case the significant Educators were identified as mainly (1) Anglo-American (2) professional standard setters. Their influence was suggested to rest on a blend of primarily subject-, language-, and cultural proficiency. As already suggested, however, the importance of learning in this case, and the related importance of such competences, may be related to specific factors in the IAS 12 case. It may well be that both the importance, and nature of the learning process, as well as sources of authority / influence structures, may be different in the context of a smaller body of mainly full-time professional standard setters.

On the same theme, but from a broader perspective, it might also be noted that the review in part II suggests that, over the years, there was significant collective learning vis-à-vis if, and if so how, to report deferred tax effects. A circumstance that has not previously been commented is that these developments of accounting thought took place in the world of the standard setters and were discussed primarily by standard-setters, with represent-tatives of big accounting firms and, to a lesser extent, representatives of

preparers and, to a much lesser extent, representatives of users (analysts). They did not take place in the halls of the accounting academia or with accounting academics. In fact, there are no references to accounting academics at all in part II. Indeed it seems that the standard-setters, not the accounting academics, "own" accounting thought and that accounting theory (for all practical purposes) is the standard setters' conceptual frameworks.

Given the impact of the discussion of economic consequences in the accounting rule-making literature of the 1970s on the focus of accounting research (with the accounting academia turning its back on issues relating to appropriate accounting policies, p. 30) this set-up is perhaps not surprising. It does, however, stands in some contrast to (at least) the Swedish experience of national accounting rule-making in the past. It also makes one wonder what the role of accounting academics and accounting research is.

Related to this, one may similarly consider if a new profession and/or constituent group has emerged: *the accounting standard setter*. If so: *What are their interests? What is their role in society at large and for the development of accounting theory in particular?*

The executive aspects of accounting standard setting

As already noted the previous accounting standard setting literature does not appear to (at least explicitly) encompass the executive aspects of the standard setting process and how this affects the process and the ensuing product. At the same time, the review of the IAS 12 case suggests an increasing importance of this process (the executive force), with considerable implications for the conditions for the two core processes: learning and deal-making. These changes, in turn, seem related to a combination of an increase on the staff side and changes in IASC strategy, changes which have been taken one step further with the transformation of the IASC into the IASB. How will further emphasis on progress affect concerns of understanding (the learning process) and acceptability (the political process)?

11.5 Concluding comment

As noted initially, present day accounting is typically criticised for having become too difficult. Although some would seem to blame this on the increasing complexity of business activities, others have pointed at the new (complex and detailed) rules for accounting. The understanding of

accounting standard setting reported in this thesis provides a suggestion for why such accounting rules will tend to be complex in term of level of detail, inconsistencies etc. It also suggests that they will tend to be imprecise in that uncertainty and confusion over what is intended not only may, but can be expected to, remain even after many years of deliberations. This, in turn, raises some fundamental questions about the prospects of accounting standard setting: *How are these complex and imprecise rules (to be) applied and interpreted? What are the long-term implications for the credibility / acceptability of accounting standard setting?*

In fact, as already noted, the suggested model of accounting standard setting can be seen to paint a sombre picture of the prospects for accounting standards. Some may also argue that the suggested model (the theory) is disappointing, being too complex both for testing and making any other predictions than that detailed standards are to be expected, as are inconsistencies, confusion and misunderstandings. It is hoped, however, that it provides further insight and/or new perspectives into the problems involved in accounting rule-making.

APPENDIX

A large number of technical issues were addressed in the process of revising IAS 12. Appendix 1 contains a list of identified issues (with the codes used to keep track of them). The identified issues are further explained Appendix 2. This appendix, particularly the discussion in section 3, Fundamental issues (pp. 411f), is supported by a number of numerical examples which are presented separately in Appendix 3.

A1 IDENTIFIED ISSUES 403

A2 THE ISSUES..... 407

A3 NUMERICAL EXAMPLES 431

APPENDIX 1

IDENTIFIED ISSUES

A1.1 Introduction

One of the most striking observations early on in the research process was the large number of technical issues addressed in the process of revising IAS 12. Prior to the first Steering Committee meeting in 1988 the staff identified no less than 13 key issues to be considered in discussing the revision of IAS 12. With time the number of issues increased; from time to time the impression was almost that there would be no end to the number of issues raised and discussed in this process.

With time, the original list of issues (which was based on the discussions in previous literature) also soon became cluttered as new issues (and sub-issues) were added. After a while it was also recognised that, in some cases, some of categories were not necessary. For example, tax loss carrybacks [I-6] were hardly ever discussed as a separate issue. Instead, the issue of tax-loss carryforwards [I-7] was used to code all references to the tax-loss issues. There were also instances when it was realised that an issue had been added twice (!) to the list. For example, references to the issue of roll-over relief were found to have been coded [I-29] (as a separate issue) or [I-11c] (as a sub-issue to tax credits). In some cases issues evolved. For example, the issue of how to treat temporary differences arising on long-term assets on initial recognition [I-21] was later re-phrased in terms of grossing-up [I-19].

In the list of issues (and their related codes) presented in the following section the issues have been sorted differentiating between *fundamental issues*, *issues of detailed application*, *presentation issues* and *related issues*. The identified issues are further explained Appendix 2.

A1.2 The sorted list of identified technical issues

Fundamental issues

I-0 Nature of income taxes: expense / distribution of income

If expense, then:
I-1 Tax effect accounting / tax payable method

If tax effect accounting, then:
I-2 Comprehensive / partial allocation
I-3 Deferral method / liability method
I-3L Income statement liability method / Balance sheet liability method
I-4 Non-discounting / discounting
I-5 Recognition criteria
I-5a - tax assets
I-5c - business combinations
I-5pu - previously unrecognised tax assets

If liability method, then:
I-12 Tax rate
I-12a - choice of tax rate
I-12b - change in the rate of tax
I-12c - graduated tax rates
I-12d - dual tax rates
I-12e - dependence on amount distributed
I-12f - substantive enactment

If balance sheet liability method, then
I-25 Tax base
I-25a - definition
I-25b - dual tax bases
I-25c - of liabilities
I-25d - of assets
I-26 Temporary differences
I-27 Other differences

Issues of detailed application

I-8 Investments in
I-8s subsidiaries
I-8b branches,
I-8a associates
I-8j joint ventures

I-9 Inter-company transactions

I-10 Revaluations of assets

I-16 Business combinations
I-16a fair value adjustments
I-16b goodwill
I-16c negative goodwill
I-16d unrecognised tax benefits at acquirer...

I-17 Exchange differences
I-17a Differences arising on the translation of financial statements of foreign subsidiaries
I-17b Hyperinflation
I-17c Exchange differences on translation of foreign deferred tax liabilities / assets
~~I-31 exchange differences translation deferred foreign tax liabilities~~

I-18 Intangible assets

I-19 Grossing-up
I-21 Long-term assets on initial recognition
I-22 Government grants
I-23 Liabilities & compound financial instruments

I-24 Super deductions

I-28 Discontinued operations

I-30 direct to equity
I-30b backward tracing

I-40 reassessment

Presentation issues

I-13 Classification of deferred tax balances (presentation)
I-13b deferred tax balances separately from shareholders' interest
I-13cn current / non-current distinction
I-13oe ordinary / extraordinary distinction
I-14 Offsetting (presentation)
I-15 Disclosure

Related issues

I-6 Tax loss carry-backs
I-7 Tax loss carry-forwards
I-11 Tax credits:
I-11a Investment tax credits
I-11b Tax credits expenses
I-11c Rollover relief
~~I-29 roll-over relief~~
I-20 Exceptions

APPENDIX 2

THE ISSUES

A2.1 Introduction

The purpose of this appendix is to briefly explain some of the identified issues in relation to the accounting for income tax (Appendix 1). In doing this, this appendix thus moves beyond the more general introduction to the debate on accounting for income tax presented in section 5.2 (pp. 117f).

As suggested in that section, this debate has its origin in the fact that the income tax payable for a certain period is generally determined by applying a tax rate to a net income figure (taxable income) based on similar, but not identical, accounting policies as those used in the preparation of the financial statements. In the absence of differences between financial and tax accounting policies, accounting for income tax is not problematic. The income tax expense for a period equals the amount of taxes payable for that period, which equals the established tax rate applied to the reported pre-tax income. The existence of various differences between financial and tax accounting policies, however, has given rise to a discussion of whether the income tax amounts reported in the financial statements (i.e. the reported income tax expense and related assets & liabilities) be based on the taxes payable for that period, or some other amount that also takes future (deferred) tax effects into account.

This appendix starts by explaining what is meant by differences between financial and tax accounting policies (A2.2, pp. 408f). Following the structure set out in Appendix 1, the rest of this appendix then discusses some *fundamental issues* (A2.3, pp.411f), some issues related to matters of *detailed application* (A2.4, pp. 422) and financial statement *presentation* (A2.5, pp. 428). Section A2.6 (p. 430), discusses issues relating to *tax losses and tax credits*, a particular and significant *related issue*. The appendix, particularly the discussion in A2.3, is supported by a number of numerical examples which are presented in Appendix 3.

A2.2 Differences between financial and tax accounting policies

A2.2.1 Timing and permanent differences

The amount of income tax payable for a certain period is usually determined by applying a tax rate to the taxable income for the period. Taxable income for the period in turn, is generally calculated by determining taxable revenues and deductible expenses for the period as defined by the local tax code. Although the calculation of taxable income is often based on financial accounting policies, there are normally a number of differences between the tax and financial accounting policies so that taxable income for a period is seldom equal to the pre-tax income reported in the financial income statement for that period. [1]

For example, tax policies may require or allow some revenues and/or expenses to be included in taxable income in a later, or earlier period, than they are recognised in the financial statements. For example, although financial accounting policies usually require revenue to be recognised in the period goods or services are delivered (the period of performance), tax policies may require or allow recognition in the period payment is received (which is usually later, but may be earlier) (example 1). Similarly, expenses for warranties are usually deductible when honoured, although financial accounting policies normally require such expenses to be recognised in the same period as the related sale (example 2). Whereas the first difference in accounting policy may be understood in terms of the tax authorities wanting to *facilitate* the collection of tax, the second difference may be explained in terms of the tax authorities wanting to *avoid abuse*.

Another common difference between financial and tax accounting policies concerns expenditures relating to non-current assets. Tax policies frequently allow such expenditures to recognised as deductible expenses earlier than under financial accounting policies, i.e. tax authorities frequently allow some form of accelerated depreciation (example 3). This difference can be understood in terms of the authorities wanting to *advance* a certain *goal* (e.g. to promote (certain kinds of) investments).

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1 In practical terms the pre-tax income in the financial income statement is taken as a starting point to which a number of adjustments are made, reflecting these differences in accounting policies.

The above examples of differences between financial and tax policies give rise to what is generally referred to as *timing differences*; the same amount of revenue and/or expense is ultimately included in taxable income as in the determination of pre-tax financial income, it is only a question of when this happens.

In most countries, there are also cases where certain revenues and expenses that are recognised in the financial income statements may not be recognised in calculating taxable income at any time (or vice versa). In contrast to the above, these differences give rise to *permanent differences* between financial pre-tax income and taxable income. Frequently cited examples include donations (if not tax deductible) and interest on government bonds (if not taxable).

A2.2.2 Temporary differences

Whereas earlier literature on accounting for income tax tend to focus on the concepts of *timing* and *permanent* differences, more recent discussions tend to rely on the concept of *temporary* differences between financial and tax accounting. In comparison with the two previous concepts, which focus on the income statement (reported revenues and expenses), the focus of this concept is on the balance sheet. In other words, whereas timing/permanent differences are associates with various income and expense items, temporary differences are associated with various assets and liabilities.

IAS 12 (revised) defines temporary differences in terms of the difference between the carrying value of an asset/liability in the balance sheet and its *tax base*. This definition is problematic in that it rests on the notion that there exists something (uniquely identifiable) called a tax base, which is not normally the case.[2]

IAS 12 (revised) defines tax base as the amount "attributed" to an asset/liability "for tax purposes" (§5). More specific guidance, specifies that:

> The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an enterprise when it recovers the carrying amount of the asset. (§7)

---

2 As already noted, income tax payable is normally determined by applying the tax rate to taxable income, a figure normally derived by making more or less numerous adjustments to reported pre-tax financial income. Normally this exercise does not involve establishing a specific/associated tax balance sheet.

> The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. In the case of revenue which is received in advance, the tax base of the resulting liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods (§8)

To be noted is perhaps that the examples provided in IAS 12 (revised) indicate that in various cases a balance sheet item may have more than one tax base. For example, in the case of accrued non-deductible expenses (example 7) it is suggested that the tax base can be considered to be either the carrying value, or nil (in which case the tax rate is also considered to be nil).

As revealed by the chronological account in part II the concepts of temporary difference and tax base were much discussed during the development of E49 and the final standard. In the end it was even suggested that there may exist different definitions. For example, it was suggested that the view on which the revised standard is based could have been expressed more easily by defining temporary difference as the amount that will be taxable when an asset is realised (taxable temporary difference) or deductible when a liability is settled (deductible temporary difference).[3]

In similarity with timing and permanent differences, temporary differences arise as a result of differences between tax and financial accounting policies. For example, if accelerated depreciation is applied for tax purposes, the tax base for an asset is often lower than its carrying value. Similarly, if a company reports a provision for warranties (deductible when honoured rather then in the period of the related sale), the tax base of that liability is considered to be zero, giving rise to a temporary difference. In fact, all timing differences give rise to temporary differences.

In addition, however, some permanent differences also give rise to temporary differences. In particular this happens when expenditures that will eventually be recorded as (non-deductible) expenses in the income statement

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3 This, however, does not solve all problems, since some items are considered to have a tax base, but are not recognised as assets and liabilities in the financial balance sheet. IAS 12 (revised) cites the case of expenditures recognised as an expense in the financial income statement as they are incurred, but not deductible until a later period.

are recorded as an asset in the balance sheet (or when non-taxable income is recorded as a liability, i.e. when permanent differences will appear at a later stage). This situation, in turn, seems to arise in three cases:

- when an investment is made and the related expenses are not deductible at any time, neither through depreciation as the asset is used, nor on disposal (example 5) [4];
- in the case of pre-payment of non-tax deductible expenses (example 7) or non-taxable income; and
- as a result of fair value adjustments in applying the purchase method in drawing up consolidated accounts (example 8).

In all these cases, a temporary difference arises on initial recognition of the related balance sheet item.

A second type of situation where permanent differences give rise to temporary differences arises when the clean surplus assumption of accounting is violated. This is particularly the case of revaluations (example 4).

A2.3 Fundamental issues

A2.3.1 Introduction

This section addresses some of the fundamental issues that arise in relation to accounting for deferred tax effect. These include three measurement issues and one recognition issue:

A2.3.2 the choice of method for accounting for deferred tax effects [I-3];
A2.3.3 the level of application of deferred tax effect accounting [I-2];
A2.3.4 whether or not to take the time value of money into consideration, i.e. the issue of discounting [I-4]; and
A2.3.5 which deferred tax liabilities and assets to recognise in the accounting [I-5].

A2.3.2 Method of accounting for deferred tax effects [I-3]

The issue

The literature distinguishes between three main alternative methods of tax effect accounting:

- the deferral method;

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4 The literature suggests that in some countries the cost of intangible assets is never deductible.

- the (unspecified *or* income statement) liability method; and
- the balance sheet liability method (*or* the asset and liability method).

Some sources also discuss a forth method: the net-of-tax method. However, as will be explained below, the net-of-tax method is not a method for calculating (i.e. measuring) deferred tax.

This section first attempts to (briefly) explain the fundamental logic of the various alternatives. A final sub-section then provides a comparison of the methods. These sub-sections are perhaps best read in conjunction with the numerical examples in Appendix 3, which illustrate the various methods in respect of various differences between financial and tax accounting policies.

The deferral method

Under the deferral method, deferred tax expense for a period is calculated by applying the current tax rate to all timing differences (see A2.2.1) arising in that period (and the historical tax rate to all timing differences reversing in that period). (See examples 1-3).

The focus is on the income statement and the purpose is to determine/record the tax expense related to the revenues and expenses recognised in that statement, disregarding the fact that, in reality, they may give rise to tax consequences in other periods (taxation may be deferred[5]). The objective of this method can thus be described in terms of achieving a correct *matching* of tax expense and reported pre-tax income. Since the method applies the tax rate applicable in the period the items (revenue/expense) are recognised in the income statement, one might also argue that this method recognises the tax effects of a transaction/event *as if* there had been no timing differences between tax and financial accounting policies.

Under this view, differences between tax expense and tax payable for the period represent deferred tax charges or deferred tax credits. These are reported in the balance sheet as deferred tax balances, but they are not considered to represent obligations to pay or rights to receive money. Hence, recognised amounts are not adjusted for changes in tax rates.

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5 Taxation may also occur prior to the items being recognised in the financial income statements.

The (income statement) liability method

The income statement liability method also involves recognising deferred tax based on the concept of timing differences. In contrast to the deferral method, however, the *expected* future tax effects of recognised revenues and expenses are recognised, i.e. the expected future tax rate is applied. The deferred tax balances are considered to be assets and liabilities and recognised amounts are adjusted for changes in tax rates (in expectations), should they arise.[6] (See examples 1-3).

The primary objective of the (income statement) liability method sometimes described in terms of reporting the liabilities for taxes payable in future periods and assets representing advance payment of future taxes *that the recognised revenue and expenses* are expected to give rise to. Although this suggests more of a balance sheet focus than under the deferral method, it may thus also be argued that the focus is thus still on the income statement and on achieving accrual based accounting.

The net-of-tax method

The net-of-tax method also involves recognising deferred tax for timing differences. Under the net-of-tax method, however, future tax effects of timing differences are neither considered to be deferred tax charges/credits nor liabilities/assets. Instead, they are seen as adjustments to the carrying amount of the related assets and liabilities. (See examples 1 & 3).

The literature includes two competing explanations as to why the carrying amount of assets and liabilities should be adjusted:

- the carrying amount of an asset should be reduced if its realisation will give rise to tax payments; and
- any asset provides two types of future benefits – one type pertains to the future use of the asset to produce a product or service – another is tax deductibility; as the deductibility of an asset is used up, a portion of the cost of the asset is also used up. (FASB, 1983:14)

There are two alternatives for the reporting of the tax effects in the income statement:

- as tax expense; and

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6 This is, in fact, the main (and only) difference between the deferral method and the (income statement) liability method, so that in fact they only give rise to different accounting figures in the event of changes in tax rate.

- combined with the income statement line items to which the timing difference relates.

In the latter case, the tax expense would equal taxes payable for the period.

It would appear that under the net-of-tax method, the choice of tax rate (in view of changing tax rates) is not given. As a result it might be argued that the net-of-tax method is not a method for calculating deferred tax, but about presentation. Because of this, this method is not included in the comparison below.

The balance sheet liability method (asset-and-liability method)

Under the balance sheet liability method deferred tax expense (income) is derived as the change in recognised deferred tax liabilities and/or assets. These balance sheet items, in turn, are calculated by applying the expected future tax rate to all temporary differences (see A2.2.2 above). (The balance sheet liability method is illustrated in all examples in appendix 3.)

In similarity with the (income statement) liability method, the objective of this method is described in terms of identifying the liabilities for taxes payable in future periods and assets representing advance payment of future taxes. In contrast to the income statement liability method, however, the focus is not on what future tax effects recognised *revenues* and *expenses* are expected to give rise to. Instead, this method focuses on identifying and recognising all tax effects (even if these are deferred) of recognised transactions/events. Technically this is done by focusing on recognised assets and liabilities and asking what future tax effects these are expected to give rise to. A fundamental assumption is that all assets will sooner or later be realised[7] and all liabilities will sooner or later be settled and it is argued that the related tax consequences, given settlement at the carrying value[8], should be recognised.

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7 This notion is not limited to the idea that all assets will be sold, the carrying value of an asset can also be recovered through use.

8 Given the historical cost basis of much accounting, many assets may be expected to be recovered at a value greater than the carrying value. However, taking such expectations into consideration would involve moving beyond the principle of accounting for *past* transactions and events.

Comparison of alternative deferred tax accounting methods

Based on the above, and the related numerical examples in appendix 3, a comparison of the three main alternative methods has been attempted. This comparison distinguishes between three cases (figure A2.1 p. 418):

A situations with timing differences only and no change in tax rate;
B situations with timing differences, but a change in tax rate; and
C situations with permanent difference giving rise to temporary differences.

As already noted, all timing differences give rise to temporary differences. In the simple case with timing differences only[9] and no changes in tax rate (case A), it is thus irrelevant which method of deferred tax accounting that is used. Furthermore, in this case, deferred tax accounting can be understood in terms of drawing up the financial statements *as if there were no timing differences*. Example 1A, 2A & 3A (in Appendix 3) show that, in the presence of timing differences, non-recognition of deferred tax effects give rise to variations (reflecting the difference in timing) in the reported tax expense expressed as a percentage of pre-tax income. Recognition of deferred tax effects, on the other hand, gives rise to an accounting as if there had been no timing differences, i.e. the reported tax expense is the same in each period and equal to the tax rate. In these scenarios accounting for deferred tax effects is all about timing, deferred tax expense totals to zero and the total tax expense over the life of the enterprise is equal to taxes payable for the same periods.

In a situation with timing differences only, but changes in tax rates (case B), the deferral method and the two liabilities methods no longer give rise to the same accounting. In the case of expected rising tax rates, the deferral method initially gives rise to lower deferred tax amounts than the two liabilities methods. In the case lower tax rates are expected, the opposite will be true. Since the deferral method does not take expected changes in tax rate into consideration, this creates a mismatch between taxes actually payable and deferred tax when timing differences reverse (they do not offset each other). This may make interpretation of reported income tax expense for that period somewhat complex. On the other hand, if changes in tax rates are expected, the reported income tax expense for a period under the liabilities methods will reflect this expected mix in tax rates. See examples 1B, 2B &3B.

9 I.e. no permanent differences.

The application of the balance sheet liability method gives rise to different numbers from either of the other two methods of accounting for deferred tax where differences between tax and accounting policies give rise to temporary, but not timing differences (case C). As argued above (p. 411) this primarily happens when expenditures that will eventually be recorded as (non-deductible) expenses in the income statement are recorded as an asset in the balance sheet (or when non-taxable income is recorded as a liability), i.e. when permanent differences will appear at a later stage.

All of these cases have in common that the temporary differences arise on initial recognition of the related balance sheet item. As illustrated in examples 5, 6 & 7, the effect of applying the balance sheet liability method in these cases depends on how the related deferred tax is initially accounted for. If, a related deferred tax liability is recognised by recording an expense in the period of acquisition of an asset, this leads to the shifting of the effect on reported tax effect from the period in which there are permanent differences to the period of acquisition. If, on the other hand, the related tax liability is added to the carrying value of the balance sheet item (i.e. this value is grossed-up), the application of the balance sheet liability method gives rise to an accounting *as if* there were no permanent differences. To be noted is perhaps that this implies not only that the tax expense as a percentage of pre-tax income is the same for all periods and equal to the tax rate. It also implies that over-all deferred tax is not zero so that over the life of the company reported tax expense is not equal to the taxes payable, but to the amount of taxes payable *if* (example 5) the depreciations had been tax deductible / (example 6) a larger, but taxable grant had been received / (example 7) a larger, but deductible expense had been pre-paid.[10] In these cases, the application of deferred tax accounting is no longer about shifting the timing of recorded tax expense, but about affecting the total amount of taxes reported.

The analysis of the case of revaluations (example 4) – being the primary other case where the application of the balance sheet liability method gives rise to different numbers – gives rise to a similar conclusion: that the recognition of deferred tax gives rise to an accounting as if the related depreciations had been deductible.

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10 As illustrated in the related examples this is not entirely correct since the recognition of deferred tax does not take the time value of money into consideration.

The analyses in relation to example 8 similarly suggests that recognition of deferred tax in relation to fair value adjustments on consolidation is not fundamentally about matching or accrual accounting, but about achieving an *as if* accounting. In this case one may argue that it is about reporting the same tax expense *as if* a direct (not an indirect) acquisition had been made, or *as if* the tax accounting principles had been the same as the financial accounting principles (i.e. tax being based on group net income and tax deductibility being based on implied fair values of assets/liabilities).

To be noted is perhaps that although IAS 12 (revised) requires the use of the balance sheet liability method, it contains a general exception for temporary differences arising on initial recognition (except those arising as a result of fair value adjustments arising on business acquisitions)[11]. In effect, with two important exceptions, this seems to eliminate most situations where the balance sheet liability method gives rise to different numbers from the income statement liability method. The exceptions are *revaluations* [I-10] (A2.4.2, pp. 422f) and *fair value adjustments arising on consolidation* [I-16c] (A2.4.4, pp. 424f).

11 No deferred tax shall be recognised in relation to goodwill on consolidation (A2.4.5, p. 425).

<table>
<tr><th>Case</th><th>Taxes payable method</th><th>Deferral method</th><th>ISLM</th><th>BSLM</th></tr>
<tr><td>A) Timing differences</td><td>Variations in reported tax expense (as a percentage of pre-tax income) reflecting timing differences</td><td colspan="3">Reported tax expense same in all periods and equal to tax rate applied to pre-tax income. Timing differences in payment of income tax do not affect reported tax expense.</td></tr>
<tr><td>B) Timing differences

Change in tax rate</td><td>Variations in reported tax expense (as a percentage of pre-tax income) reflecting timing differences</td><td>Effects of changes in tax rate affect income statement in year timing differences reverse</td><td colspan="2">Effects of changes in tax rate affect income statement in year timing differences originate or in year of changes in expectations.</td></tr>
<tr><td>C) Permanent differences giving rise to temporary differences

No change in tax rate</td><td colspan="3">Variations in reported tax expense (as a percentage of pre-tax income) reflecting permanent differences</td><td>Reported tax expense same in all periods and equal to tax rate applied to pre-tax income.</td></tr>
</table>

Figure A2.1 Comparison of the taxes payable method and three alternative methods of accounting for deferred tax effects

A2.3.3 The level of application of tax effect accounting [1-2]

Another fundamental measurement issue concerns the level of application of tax effect accounting: whether the expected deferred tax effects of all, or only some, recognised transactions and events (i.e. timing or temporary differences) should be accounted for. This is generally described as the choice between comprehensive and partial application of tax effect accounting [I-2].

Under comprehensive application, tax effect accounting is applied to all recognised transactions and events (timing/temporary differences). This approach is often argued in terms of *all* timing/temporary differences giving rise to future tax effects as they reverse. Under partial application, tax effect accounting is applied to some, but not all, timing or temporary differences.

If partial application is allowed or required, a related sub-issue concerns the choice of criteria for the transactions and events (or timing/temporary differences) to be included/excluded from the calculation of future tax effects [I-2p]. A number of versions of partial application are discussed in the literature. For example, it is sometimes argued that the related tax effect should not be recognised if the timing/temporary difference is not expected to reverse for a very long time. Undistributed profits in subsidiaries [I-8] (see A2.4.7 below) is often used as an example of a case where the reversal is seen to be both under management control and often unlikely for a long period of time.

Sometimes the focus is on the sum of differences of a certain kind, suggesting that the tax effect should not be recognised for timing/temporary differences that *in aggregate* are not expected to reverse (i.e. cases where reversing differences are replaced by future originating differences of the same type). This is, for example, often the case with timing/temporary differences arising from accelerated depreciation for tax purposes (see example 3 C).

A2.3.4 Discounting [I-4]

Another fundamental measurement issue that is discussed from time to time is whether or not to take the time value of money into consideration in accounting for deferred tax. In other words, whether deferred tax assets and liabilities should be reported at discounted or non-discounted values.

Use of discounted values is often argued on the grounds of leading to a fairer presentation. Generally, non-recognition of the time value of money (i.e. the use of non-discounted values) leads to the reporting of larger deferred tax assets and liabilities. Example 5B illustrates how this, in the case of grossing-up can lead to the recognition of assets at an amount above their fair value. Example 7(B&C) illustrates how this, and, in the case of fair-value adjustments on consolidation, leads to the reporting of goodwill. It was the realisation of this effect, and its particular importance in some types of

acquisitions, that led the Swedish standard setter to require discounting in certain cases (where the valuation of deferred tax effects significantly affected the purchase price).[12]

Discounting, however, is often rejected on the grounds that those benefits are outweighed by the complexity and costs of applying discounting in practice. The use of discounting in financial accounting is also argued to be an important issue that should not be considered for deferred taxes alone[13]. Along these lines IAS 12 (revised) prohibits discounting of deferred tax items.

A2.3.5 Recognition criteria for deferred tax liabilities and assets [I-5]

Tax effect accounting is essentially about accounting for expected future (deferred) tax effects of recognised transactions and events. Part of the deferred tax problem is that the realisation of these effects depends, to a greater or lesser extent, on future events[14], including on the one hand, whether or not the enterprise continues to operate and the extent to which tax regulations remain the same and on the other hand, to a certain extent, whether or not the enterprise will report a taxable income or loss in the relevant future periods. An added complexity is perhaps that these contingencies look somewhat different for deferred tax liabilities and assets.
On the one hand the reversal of a taxable timing/temporary difference (deferred tax liabilities) will lead to the reporting of taxable revenue. Although this does not automatically lead to the enterprise having to pay income tax[15], it can be argued that, assuming no other future event or

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12 This exception was first found in a standard on consolidated accounting (RR 1:96) and later transferred to a new standard on deferred tax (RR 9, 1999).

13 The IASC did, in fact, initiate a project on Present Value (Discounting). This project, however, was discontinued in 2001. The issues, however, are now dealt within an IASB research topic (Accounting Measurement), i.e. a topic on which there is active research, "with the intention that, when preparatory work is concluded, they should be moved to the IASB's main agenda" (http://www.iasb.org/current/research_topics.asp.).

14 This problem, however, is not unique to this accounting issue.

15 This depends on whether or not the enterprise reports a taxable income for the relevant period. If it does, income tax payable for that period will be higher. If the enterprise reports a tax loss, no tax will be payable for that period. In fact the company may even enjoy a tax refund of taxes paid, or a reduction of future taxes.

transaction than the reversal of the timing/temporary difference reflected in the accounting, the company will pay income tax in the future.

On the other hand, the reversal of a deductible timing/temporary difference (deferred tax asset) will give rise to the reporting of a deductible expense in a future period. If taxable income for that period is positive, this gives rise to a tax saving. If the enterprise reports a tax loss, a tax saving may still be realised, but through a tax loss carryback. Lacking that opportunity, its realisation may be more uncertain, depending on the possibilities to carry a tax loss forward *and* the reporting of taxable income in those future periods to which the tax loss may be carried. In general, the realisation of deferred tax assets thus seem to be associated with more uncertainty than deferred tax liabilities (at least to the extent that these are not expected to be realised in period for which there are also reversing taxable timing/temporary differences).

Since there is an element of uncertainty as to whether deferred tax effects will be realised, a fundamental issue concerns the criteria which have to be satisfied before a potential future deferred tax effect is recognised in the accounting. The issue of recognition criteria arises both for deferred tax assets and liabilities arising on timing/temporary differences and for deferred tax assets relating to tax losses. The latter issue, however, is discussed separately in section A2.5 (pp. 428-9).

The IASC Framework for the Preparation and Presentation of Financial Statements from July 1989[16] identifies two general recognition criteria. One of these is that the item can be *measured reliably*. The other is that it is *probable* that any future economic benefit associated with the item will flow to or from the enterprise. If an item does not meet these criteria, it should not be reflected in the accounts. These general criteria were agreed on roughly at the time of E33 (the first exposure draft in the process of revising IAS 12). Other thresholds suggested in the literature include that there is a *reasonable expectation* and that there is *assurance beyond reasonable doubt*.

Related issues concern the treatment of (1) previously unrecognised assets (liabilities) (i.e. assets for which the recognition criteria become satisfied)

However, in these cases, the tax loss will be lower than it had otherwise been and the refund or reduction of taxes will be lower than they would otherwise have been.

16 Exposure draft dated May 1988.

and (2) previously recognised assets (liabilities) for which the recognition criteria are no longer satisfied.

A2.4 Detailed issues

A2.4.1 Introduction

The timing/temporary differences related to certain types of transactions and events have given rise to specific debates. The following cases are explained below:

- differences arising on revaluation of assets [I-10];
- differences arising on initial recognition of a transaction or event that is not a business combination (incl. differences arising on government grants) [I-19][I-21][I-22];
- differences arising as a consequence of fair value adjustments in business combinations [I-16a];
- differences arising on goodwill and negative goodwill of business combinations [I-16b,c]; and
- differences arising on investments in subsidiaries, associates and joint ventures [I-8].

A2.4.2 Revaluation of assets [I-10]

Some accounting regimes allow or require certain assets to be revalued to an amount in excess of its previous carrying value (normally fair value). When a corresponding adjustment is not made for tax purposes (which is normally the case), the issue arises of whether or not to account for deferred tax.

As illustrated in example 4 this issue is further complicated by the fact that in many cases the revaluation is not reported in the income statement, but credited directly to equity (shareholders' interest). Although some will argue that in this case revaluations does not give rise to timing differences (only permanent differences), the issue if deferred tax should be recognised in relation to revaluations was discussed prior to the appearance of the balance sheet liability method.

On the one hand, there were those who argued that a revaluation is not an event that gives rise to additional tax charges in the future and thus that no deferred tax should be recognised. On the other hand, arguments for recognising deferred tax included that equity would otherwise be overstated:

if an unrealised gain is recognised it is appropriate to also recognise the tax effect related to its realisation.

Up until the advent of the balance sheet liability method, most people seem to have thought of realisation in terms of selling the asset only. Following the introduction of the concept of temporary differences, however, proponents of comprehensive tax effect accounting (i.e. for the recognition of deferred tax effects related to revaluations) argue that the economic benefits embedded in the carrying value of a revalued asset will be realised, if not by sale, through use in the operations of the entity. Under this view, there is little room for arguing for a partial application (i.e. for an exception relating to revaluations). (This point is specifically illustrated in example 4, section A3.7.4 (see pp. 478f).)

A2.4.3 Temporary differences arising on initial recognition [I-19][I-21][I-22]

As noted above, sometimes temporary differences arise on the initial recognition of a balance sheet item, e.g. when the expenditure for an asset is not tax deductible (example 5), as a consequence of the accounting for government grants (example 6) and in the case of pre-paid non-tax deductible expenses (example 7).

Since these cases do not give rise to timing differences, they were not generally discussed prior to the introduction of the balance sheet liability method. However, following the introduction of the concept of temporary differences, the issue of how to deal with these temporary differences arose. In principle three alternative solutions have been discussed:

- by recording a corresponding deferred tax expense /income in the period of initial acquisition;
- by adjusting the carrying value of the related balance sheet items (grossing-up treatment); and
- making an exception (i.e. non recognition of deferred tax).

IAS 12 revised provides a general exception for all temporary differences arising on the initial recognition of an asset or liability in a transaction which:

i) is not a business combination; and
ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss). (§15, §24)

A2.4.4 Fair value adjustments arising on business combinations [I-16a]

Under the purchase accounting method for business combinations an investment in a subsidiary is not recorded as a single line item in the consolidated balance sheet. Instead, the assets and liabilities of the subsidiary are recorded at their fair values. In cases where the group is not the tax subject - which would appear to be the case in most tax jurisdictions - the tax base of those assets and liabilities will be unaffected. Such assets and liabilities will therefore often be recorded at amounts in excess of their tax base in the consolidated accounting.

Purchase accounting of business combinations thus gives rise to situations similar to those created by revaluations in excess of historical cost. In subsequent periods, there will be the same type of difference between the pre-tax income and taxable income arising because of differences in depreciation charges. Similarly, if such an asset is sold, different gains will be recorded in the consolidated financial statements and the tax accounting.

As in the case of revaluations, the issue of whether or not to recognise deferred tax effects in relation to fair value adjustments (the application of the purchase method of accounting for business combinations) was discussed even prior to the advent of the balance sheet liability method and the concept of temporary differences. For example, the US standard APB Opinion No.16 on Business Combinations from 1970 states that the tax status of acquired assets and liabilities is a factor that should be considered in allocating the purchase price in applying the purchase method. It also states that in cases where the tax base of an asset is lower than the fair value, this should be adjusted downward. Although the relevant paragraph concludes that "since differences between amounts assigned and tax bases are not timing differences … , the acquiring corporation should not record deferred tax accounts at the date of acquisition" (§89), the prescribed solution can be seen to be a version of tax effect accounting using the net-of-tax method. An obvious alternative would, of course, be a gross reporting of fair values determined under the presumption of full tax deductibility and a related “deferred tax liability”. This was, for example, the required treatment under the Swedish business combinations standard between 1996 and 1999[17].

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17 In 1999, this was replaced by a standard specifically addressing the issue of deferred tax.

Under the balance sheet liability method, fair value adjustments arising on business combinations accounted for under the purchase method give rise to temporary differences and hence, unless an exception is made to the general principle, a deferred tax liability should be recognised. This deferred tax liability can be understood as follows: since the asset is not fully deductible, the recovery of the carrying value of the asset will give rise to taxable income and hence to future income tax payable and hence a deferred tax liability should be recognised (otherwise equity will be overstated).

This issue is illustrated in example 8. The analyses show that in this context accounting for deferred tax accounting is not about deferral accounting in terms of shifting the timing of reported tax expense. Instead the total reported tax expense is affected; if deferred tax is recognised on fair value adjustments, the total tax expense reported is the same as if a direct acquisition had been made. (As illustrated in 8 C&D, this is not entirely correct unless the recognition of deferred tax takes the time value of money into consideration.)

The original IAS 12 from 1981 does not address this issue. Nor does the original IAS 22, *Business Combinations*, from 1983 or E33 from 1989. However, IAS 22 (revised) from 1993 states that a tax asset or liability should be "determined after allowing for the effect of restating identifiable assets and liabilities to their fair values" (§39), suggesting that deferred tax is assumed to be recognised at the date of acquisition. E49, which was published a year later, also clearly states that the use of fair values in purchase accounting gives rise to temporary differences for which deferred tax should be accounted (§ 17 e). The revised IAS 12 adopts the same position, adding that "the resulting deferred tax liability affects goodwill" (§19).

A2.4.5 Goodwill arising on business combinations [I-16b]

Under purchase accounting for business combinations, any excess of acquisition cost for a subsidiary over the net amount of assets and liabilities recorded at fair values, is attributed to “goodwill” and regarded as an intangible asset.

Goodwill arising on business combinations is found in the financial accounting for groups. In most countries, however, groups do not pay income tax, the individual enterprises do. As a consequence,

amortisation/write-downs of such goodwill is generally not tax deductible and, as a further consequence, give rise to permanent (not timing) differences between pre-tax accounting income and taxable income. As a result, these differences do not give rise to deferred tax accounting under a timing difference approach, such as the income statement liability method.

The treatment of goodwill under the balance sheet liability method depends on the tax base of goodwill, which is generally considered to be zero.[18] Under this view, it is argued that a deferred tax liability should be recognised (since the recovery of the asset - through use or, through disposal, should it be possible - will give rise to taxable income and tax payable.). In this case, the income statement and balance sheet liability methods thus prescribe different solutions. However, IAS 12 (revised) makes an exception for temporary differences arising on goodwill, arguing that "goodwill is a residual and the recognition of the deferred tax liability would increase the carrying amount of goodwill" (E49, §27).

A2.4.6 Negative goodwill arising on business combinations [I-16c]

Under purchase accounting for business combinations, if the acquisition cost is less than the net amount of assets and liabilities, this negative difference has been attributed to “negative goodwill”. Historically such negative goodwill has been either eliminated by reducing the recorded values of certain assets, or reported as negative goodwill (a provision for future losses to be released over a number of years). The case for negative goodwill basically echoes that for goodwill and IAS 12 (revised) also makes an exception for temporary differences arising on negative goodwill

A2.4.7 Investments in subsidiaries, associated companies and joint ventures [I-8]

Investments in subsidiaries, associated companies and joint ventures do not normally give rise to any deferred tax accounting issues when these investments are carried at cost, which is often the case in the parent's / investor's financial statements. The situation is different, however, if these entities are accounted for using the equity method or the proportionate

18 Some have argued that the tax base of goodwill is the same as cost, since the cost of goodwill is indirectly deductible on disposal of the acquired business. However, this argument is not made in the case of other assets acquired through the business combination.

consolidation method, which is often the case in consolidated (group) accounting.

Historically the debate has focused on timing differences that may arise as the group's portion of the net income of its subsidiaries, associates and joint ventures are included in the (consolidated) income statement. Timing differences arise if, for example, the distribution of such profits (through dividends) gives rise to income taxes consequences. In many cases, this is not the case as dividends received from subsidiaries are not taxable income. Hence, the issue of whether or not to account for the potential future tax effects relating to this type of timing difference is only applicable in a limited number of cases. Historically the focus has thus been on the level of application of tax effect accounting [I-2] with regard to these particular timing differences. Historically arguments can be found advocating:

- *comprehensive application of tax effect accounting*:
  The taxes that would be payable on the distribution of such profits should be recognised in full when the profits are initially recognised in the (consolidated) financial income statements.

- *partial application of tax effect accounting:* and
  The taxes that would be payable on the distribution of such profits should be recognised when it is probable that the profits will be distributed (and hence that the tax effect will be realised).

- *taxes payable method.*
  The taxes that would be payable on the distribution of such profits should only be recognised when paid.

Following the introduction of the balance sheet liability method the focus is now on temporary differences arising on these various types of investments. Such temporary differences may arise not only as a result of undistributed profits[19]. For example, such differences may arise as the effects of the translation of foreign investments are taken directly to equity. Again,

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19 The consolidated balance sheet does not include a line item: investments in subsidiaries. Instead, the carrying value of the group's interest in a subsidiary can be determined a) by subtracting the carrying value of the group's interest in the subsidiary's liabilities from the carrying value of the group's interest in the subsidiary's assets or b) by identifying the subsidiary's contribution to group equity following the acquisition.

however, the focus has been on the level of application of tax effect accounting.

The position in IAS 12 (revised) adopts a form of partial application of tax effect accounting, namely that deferred tax should be recognised for all temporary differences arising from investments in subsidiaries, associates, joint ventures and branches, except when

- the parent/investor is able to control the timing of the reversal of the temporary difference; and
- it is probable that the temporary difference will not reverse in the foreseeable future.

Although the same principles should apply for temporary differences arising on investments in subsidiaries, associates and branches, the related guidance makes it clear that, in general, an investor does not have control over an investee.

A2.5 Issues relating to financial statement presentation

Discussions relating to the presentation of (deferred) income taxes in the income statement have related to the separate presentation of tax expense relating to extraordinary/unusual items.

Early discussions relating to the presentation of (deferred) income taxes in the balance sheet have related to the presentation of deferred tax balances (separate from equity/ shareholders' interests). Although a number of issues relating to the presentation of tax assets and liabilities in the balance sheet can be identified in more recent discussions, two issues have been particularly debated:

- the use and application of a current/non-current distinction; and
- the use of off-setting in the reporting of deferred tax assets and liabilities.

The current/non-current distinction [I-13cn]

In some cases, an enterprise uses a current/non-current distinction in the reporting of assets and liabilities in the balance sheet. In such cases the question arises of whether or not to distinguish between current and non-current tax assets and liabilities and if so on what basis.

It is the basis to be used to distinguish between current and non-current deferred tax assets and liabilities arising on timing/temporary differences that is particularly debated. In principle there appears to be two alternatives:

- based on the probable time of reversal of the underlying difference; and
- based on the classification of the related asset or liability.

IAS 12 (revised) requires that, if an enterprise uses a current/non-current distinction in the balance sheet, deferred tax assets and liabilities should be classified as non-current (§70).

Off-setting tax assets and liabilities [I-14]

Offsetting means that instead of reporting both an asset and a liability, a net amount of either an asset or a liability is reported. The key issues concern whether offsetting of deferred tax assets and liabilities should be allowed or required and if so, in what circumstances.

In the revised IAS 12, the rules on the use offsetting cover no less than six paragraphs. Separate standard paragraphs set out when current and deferred tax assets and liabilities respectively should be offset. The criteria refer both to a legally enforceable right to set off and to an intention to settle on a net basis or to realise and settle simultaneously.

A2.6 Issues relating to tax losses and credits [I-7]

Tax legislation sometimes allow enterprises that report a tax loss (a negative taxable income[20]) a refund of income tax payable relating to earlier periods and/or a deduction from taxable income in later accounting periods. The first case is normally referred to as a tax loss carryback and the latter as a tax loss carryforward.

There seems to be general agreement that the benefit from a tax loss carryback should be recognised in the period of the loss. This is also the position adopted in both the original IAS 12 and the revised standard. There is less agreement, however, on when the (potential) tax benefit relating to a tax loss carryforward should be recognised: in the period of the loss, in the

20 US literature uses the expression "net operating loss".

period it is realised or some other period, e.g. when its realisation satisfies some recognition criterion (probable, assurance beyond reasonable doubt).

To be noted in this context is perhaps that the mere fact that an enterprise has incurred a tax loss is normally seen to raise doubts about whether the enterprise will generate sufficient taxable income in the future to realise that benefit. Furthermore, in some countries there are restrictions on the use of tax loss carryforwards that may raise further doubts about the possibility of realising the potential benefit. There may, for examples, be restrictions on the number of future periods to which the loss may be carried forward. There may also be certain conditions attached to the future use of losses carried forward. Another type of restriction is that a tax loss may only be carried forward if all possibilities to carry back have been exhausted.

APPENDIX 3

NUMERICAL EXAMPLES

A3.1 Introduction

This appendix contains numerical examples that illustrate the various methods of accounting for deferred tax effects (A2.3.2 p. 312). Although lengthy in terms of number of pages, the text (the reasoning) in this appendix has been kept at a minimum. It is thus best read in conjunction with Appendix 2 (particularly A2.3.2). The next section sets out the case on which the following examples are then based:

Example		Section	Pages
1	Revenue is taxed when realised	A3.4	436-
2	Expense is tax deductible when paid	A3.5	447-
3	Accelerated depreciation for tax purposes	A3.6	457-
4	Revaluations	A3.7	473-
5	Non-deductible asset	A3.8	480-
6	Government grants	A3.9	488-
7	Pre-paid non-tax deductible expense	A3.10	497-

Section A3.3 describes an extended base case which is used in example

8	Fair value adjustments arising on business acquisitions	A3.11	503-

A3.2 The base case

The numerical examples illustrating the different methods of accounting for deferred tax effects in this appendix are all based on the following base case. This case, which is a development of a case often used at the Stockholm School of Economics, tells the story of a newly formed company, investing in an asset of some kind (e.g. a machine) that contributes to the earning of revenue during four years. After these years the asset is assumed to be both useless and worthless. It is also assumed that:

- equity at the start is 100;
- the investment in the asset is 100, it is paid in cash at the beginning of year 1;
- the annual revenue during the four years is 100, 90 % of these are received in the same year that they are earned, the rest in the following year;

- other operating expenses amount to 66 each year, 80 % of these are paid in the same year that they are incurred, the rest in the next year;
- the tax rate applied to taxable income in calculating taxes payable is 30 % and that income tax payable for a period is paid in full at the end of that period (or in rare cases received);
- straight line depreciation over useful life is applied for both financial and tax reporting, it is also assumed that no other differences exist between financial and tax reporting policies; and that
- the company does not invest in any other assets during these years, nor does it make any dividend payments or receive any equity- contributions.

Under these assumptions the following financial statements would arise:

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Cash flow from operations	34.5	31.3	31.3	31.3	-3.2	125.2
Investment in machine	-100.0					-100.0
Net cash flow	*-65.5*	*31.3*	*31.3*	*31.3*	*-3.2*	*25.2*

Figure A3.2a Cash flow statements base case

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Income tax payable	-2.7	-2.7	-2.7	-2.7		-10.8
Net income	*6.3*	*6.3*	*6.3*	*6.3*		*25.2*
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.2b Income statements base case

Balance sheets	**Year**					
at the end of each year	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	34.5	65.8	97.1	128.4	125.2
Total assets	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.2	25.2
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*

Figure A3.2c Balance sheets base case

In words, over the life-time of this project the company generates a total of 25.2 in net income and net cash flow so that, once the receivables and payables from year four are settled, the company has 125.2 in cash, financed by 100 of paid-in-capital and 125.2 in retained earnings.

Although some might object to the perceived complexity of the base case, it is very much a simplification of a real-world situation. For example, the sales and operating expenses are assumed to be the same for each year and the cash generated by the project is neither used for another investment (so that the company has only one project) nor for dividend payments.

In this base-case scenario the company's investment in the asset (machine) generates an internal rate of return of 10.1% (i.e. the discounted value of the cash flow from operations in figure A3.2-1a is 100 at this discount rate), assuming all payments except the investment occur at end of each year. With the risk of stating the obvious it should perhaps be pointed out that the present value of the investment in the company is not the same as the present value of the company's investment in the asset. With zero dividend payments until the end of year 5, it is 77.5. In order to make the present value of an investment in the company equal to the present value of the investment in the asset, one can, for example, assume that the surplus cash in the company is invested so that it generates (interest-)revenue equal to the rate of return of the original investment. Such an extended base case model is presented in section A3.3 (p. 434).

To be noted is also that the assumptions in each of the following cases, where various differences between tax and accounting policies are introduced, affect the timing and/or the amount of taxes payable. In a real-life situation this would most likely affect the price of the investment (assuming unchanged required rate of return and perfect markets). This, in turn would have further effects on cash flows. For reasons of simplicity, however, in most of the following examples, the base case is not adjusted (i.e. the price of the investment is not adjusted to reflect the same internal rate of return as in the above case).

In other words, for reasons of simplicity, the cases are not strictly comparable. To achieve this, the price would have to be adjusted and the extended base case model used. Under these assumptions, one would achieve a situation where the total net income / final equity would always be the same. This, however, is not the point here. Instead each example should be read separately, the focus being on the comparison of the various methods of reporting income tax in the specific context.

A3.3 The extended base case

This example is based on the same assumptions as above with the addition that surplus cash generates (taxable) interest revenue equal to the required rate of return. Under these assumptions the following financial statements are produced:

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Interest payments	0.0	5.0	10.0	15.5	21.5	51.9
Income tax	-2.7	-4.2	-5.7	-7.3	-6.5	-26.4
Cash flow from operations	34.5	34.8	38.3	42.1	11.9	161.5
Investment in machine	-100.0					-100.0
Net cash flow	*-65.5*	*34.8*	*38.3*	*42.1*	*11.9*	*61.5*

Figure A3.3a Cash flow statements extended base case

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Operating income	9.0	9.0	9.0	9.0	0.0	36.0
Interest income	0.0	5.0	10.0	15.5	21.5	51.9
Pre-tax income	9.0	14.0	19.0	24.5	21.5	87.9
Income tax (machine)	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Income tax (interest)	0.0	-1.5	-3.0	-4.6	-6.5	-15.6
Income tax payable	-2.7	-4.2	-5.7	-7.3	-6.5	-26.4
Net income	*6.3*	*9.8*	*13.3*	*17.1*	*15.1*	*61.5*
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0	30.0	30.0

Figure A3.3b Income statements extended base case

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	34.5	69.3	107.5	149.7	161.5
Total assets	*100.0*	*119.5*	*129.3*	*142.5*	*159.7*	*161.5*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	16.1	29.3	46.5	61.5
Total equity	100.0	106.3	116.1	129.3	146.5	161.5
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*129.3*	*142.5*	*159.7*	*161.5*

Figure A3.3c Balance sheets extended base case

As can be seen below, these assumptions generate a situation where the cash generated by the investment soon takes over as the main source of value creation (interest income). This cash is perhaps best thought of as a simplification representing other parallel projects that might be expected in a more realistic setting. The case, however, remains a simplification, not the least because all assumed expectations are realised.

A3.4 Example 1 – Revenue is taxed when realised

A3.4.1 Tax rates remain unchanged

Introduction

Assume that, as a means of facilitating the collection of tax, revenue is taxed (included in taxable income) when it is received. This will affect the timing of taxes payable (but not the total sum) and hence the timing of the cash flows for the company: [1]

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable revenues	90.0	100.0	100.0	100.0	10.0	400.0
Deductible						
- depreciation	-25.0	-25.0	-25.0	-25.0	0.0	-100.0
- operating expenses	-66.0	-66.0	-66.0	-66.0	0.0	-264.0
Taxable income	*-1.0*	*9.0*	*9.0*	*9.0*	*10.0*	*36.0*
Income tax payable	**0.3**	-2.7	-2.7	-2.7	**-3.0**	-10.8

Figure A3.4-1a Taxes payable example 1A

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	**0.3**	-2.7	-2.7	-2.7	**-3.0**	-10.8
Cash flow from operations	**37.5**	31.3	31.3	31.3	**-6.2**	125.2
Investment in machine	-100.0					-100.0
Net cash flow	***-62.5***	*31.3*	*31.3*	*31.3*	***-6.2***	*25.2*

Figure A3.4-1b Cash flows example 1A

1 Assuming no change to the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, price of the investment would have to be 101.14 to give a zero NPV. In accordance with the argument in A3.2 these added complexities are disregarded. A price of 100 gives an internal rate of return of 10.5 %.

Assuming no change to the required rate of return, these changes in the timing of the cash flows affect the present value of the investment, which in turn, might affect the price of the investment, giving rise to further changes in the cash flows[2] etc.. For the sake of simplicity these added complexities are disregarded: it is thus presumed that the price of the investment is unaffected[3].

Taxes payable method

Although the total tax expense remains 30% of pre-tax income, this is not the case in each period. Initially, the reported tax expense will be lower than the tax rate applied to pre-tax financial income. In this particular case, this is followed by a number of years where differences cancel out, so that reported tax expense equals the tax rate applied to pre-tax financial income. Eventually, however, the situation reverses:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	**0.3**	-2.7	-2.7	-2.7	**-3.0**	-10.8
Net income	***9.3***	*6.3*	*6.3*	*6.3*	***-3.0***	*25.2*
Tax expense % pre-tax income	**-3.3**	30.0	30.0	30.0	**NA**	30.0

Figure A3.4-2a Income statements example 1A – taxes payable method

As a result, of lower initial tax expense charges, reported net income (and hence equity) will initially be higher compared to a situation with no timing differences. However, because there is a difference in timing of the tax payments only, in the end reported equity (total net income) is unaffected.

2 Unless it is assumed that any surplus cash is invested to generate the required rate of return.

3 This case reflects a required rate of return amounting to 10.5%.

Balance sheets	**Year**					
at the end of each year	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	**37.5**	**68.8**	**100.1**	**131.4**	125.2
Total assets	*100.0*	***122.5***	***128.8***	***135.1***	***141.4***	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**9.3**	**15.6**	**21.9**	**28.2**	25.2
Total equity	100.0	**109.3**	**115.6**	**121.9**	**128.2**	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***122.5***	***128.8***	***135.1***	***141.4***	*125.2*

Figure A3.4-2b Balance sheets example 1A – taxes payable method

Deferral method

In year 1 the enterprise recognises revenue of 100. However, only 90 are received in this year. This means that the revenue reported in income statement for year 1 includes 10 that are not taxable until year 2; there is a (originating) timing difference of 10. Under the deferral method the (deferred/future) tax effect of receiving these 10 (which are recognised as income in year 1) is recognised as a "deferred tax expense" in the income statement for year 1 and as a “deferred tax credit” in the balance sheet at the end of year 1.

Taxable income for year 2 will include the above 10, thus affecting income tax payable. This effect, however, will be offset by releasing the deferred tax credit set up the previous year (hence the income statement for year 2 will report no tax effect relating to the settlement of accounts receivable). At the same time, however, revenue of year 2 includes 10 that are not taxable until year 3. Since the related tax effect should be recognised in year 2, a new deferred tax credit is set up. This continues until year 5 when no revenue is recognised in the financial accounts:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	-10	-10	-10	-10		-40
Deferred tax expense	-3	-3	-3	-3		-12
Reversing timing difference		+10	+10	+10	+10	-40
Release of deferred tax liability		+3	+3	+3	+3	+12
Net effect on tax expense	*-3*	*0*	*0*	*0*	*+3*	*0*

Figure A3.4-3a Calculation of deferred tax example 1A – deferral method

As a consequence of the accounting for deferred tax effects, the reported tax expense in each period is the same as the tax rate multiplied by the pre-tax financial income[4], i.e. as if there were no timing differences:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	0.3	-2.7	-2.7	-2.7	-3.0	-10.8
Deferred tax	**-3.0**	0.0	0.0	0.0	**3.0**	0.0
Tax expense	**-2.7**	-2.7	-2.7	-2.7	**0.0**	-10.8
Net income	***6.3***	*6.3*	*6.3*	*6.3*	***0.0***	*25.2*
Tax expense % pre-tax income	**30.0**	30.0	30.0	30.0	**NA**	30.0

Figure A3.4-3b Income statements example 1A – deferral method

In this case, this has the consequence that reported net income is first lower and then higher than under the taxes payable method, with the effect that reported equity is also initially lower:

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.5	68.8	100.1	131.4	125.2
Total assets	*100.0*	*122.5*	*128.8*	*135.1*	*141.4*	*125.2*

4 This would not hold in the presence of permanent differences.

Balance sheets	**Year**					
at the end of each year	**0**	**1**	**2**	**3**	**4**	**5**
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**6.3**	**12.6**	**18.9**	**25.2**	25.2
Total equity	100.0	**106.3**	**112.6**	**118.9**	**125.2**	125.2
Deferred tax		**3.0**	**3.0**	**3.0**	**3.0**	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.5*	*128.8*	*135.1*	*141.4*	*125.2*

Figure A3.4-3c Balance sheets example 1A – deferral method

(Income statement) liability method

In a situation with unchanged tax rates, this method gives rise to exactly the same figures as the deferral method. The only difference being that the provision for deferred tax is regarded as a deferred tax *liability*.

Net-of-tax method

In this simple case this method gives rise to exactly the same equity and net income figures as both the deferral- and (income statement) liability methods. There are differences in presentation however.

There are two alternatives for the reporting of the tax effects in the income statement. It can either be reported as a) tax expense (in which case the income statements will look as under the deferral and (income statement) liability method) or b) combined with the income statement line items to which the timing difference relates (in this case, operating expense). In this case the reported tax expense in each period would equal taxes payable.

In the balance sheet the deferred tax effects are recognised not as a deferred tax credit/liability, but by reducing the carrying amount of the related asset (i.e. accounts receivable).

Balance sheet liability method

The financial statements are the same as under the income statement liability method (see above), however, the underlying explanations for (and hence the calculations of) the numbers are different:

The balance sheet for the end of year 1 includes accounts receivable of 10. Since the realisation of this asset will give rise to taxable income of 10 and tax payable of 3 in the next period, a corresponding deferred tax liability

should be recognised. The same applies to year 2, 3 and 4. End of year 5 there is no taxable temporary difference. Hence, no deferred tax liability should be recognised.

In year 1 there is an increase in the total deferred tax liability of 3, hence a deferred tax expense of three should be reported. In years 2, 3 and 4 there is no such change, hence no deferred tax expense is reported. In year 5, there is a decrease of the deferred tax liability, leading to the recognition of a deferred income tax expense for the period:

Calculation of deferred tax	**Year**				
	1	**2**	**3**	**4**	**5**
Taxable temporary difference	10	10	10	10	0
Deferred tax liability	3	3	3	3	0
Deferred tax liability end or period	3	3	3	3	0
Deferred tax liability beginning of period	0	3	3	3	3
Deferred tax expense	*3*	*0*	*0*	*0*	*-3*

Figure A3.4-4 Calculation of deferred tax example 1A – balance sheet liability method

Summary

In the situation that revenue is included in taxable income when it is received rather than when it is earned (and that it is received after it is earned), taxes payable for a period will initially be lower than the tax rate applied to the pre-tax earnings reported for that period. However, since it is a matter of a difference in timing only, on an over-all basis tax payments and tax expense equal the tax-rate applied to pre-tax earnings.

Application of deferred tax reporting –the deferral method or either of the liability methods – leads to an accounting *as if* there were no timing differences. In other words, lacking permanent differences reported tax expense is the same as the tax rate applied to the pre-tax financial income in all periods. In practical terms, in this case, the application of deferred tax accounting means that reported tax expense is first lower and then higher than under the taxes payable method.

In this simple case with timing differences and unchanged tax rates, the various methods of accounting for deferred tax effects give rise to the same figures. This, however, is not the case if tax rates change.

A3.4.2 Changes in tax rates

Introduction

Keep all the assumptions of the previous case, but that relating to constant tax rates. Assume instead that the tax rate is 30% in years 1, 2 and 3, but 40% in years 4 and 5. This, of course, increases taxes payable (from a total of -10.8 to -12.7) [5]. Assuming again that this does not affect the price of the investment[6], the cash flows for the company are accordingly reduced:

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable income	-1.0	9.0	9.0	9.0	10.0	36.0
Tax payable for the period	0.3	-2.7	-2.7	**-3.6**	**-4.0**	**-12.7**

Figure A3.4-5a Calculation of taxes payable example 1B

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Interest payments	0.0	0.0	0.0	0.0	0.0	0.0
Income tax	0.3	-2.7	-2.7	**-3.6**	**-4.0**	**-12.7**
Cash flow from operations	37.5	31.3	31.3	**30.4**	**-7.2**	**123.3**
Investment in machine	-100.0					-100.0
Net cash flow	*-62.5*	*31.3*	*31.3*	***30.4***	***-7.2***	***23.3***

Figure A3.4-5b Cash flows example 1B

5 Assuming no change to the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, price of the investment would have to be 99.5 to give a zero NPV. In accordance with the argument in A3.2 these added complexities are disregarded. A price of 100 gives an internal rate of return of 9.9 %.

6 The investment now gives an internal rate of return of 9.88 %.

Taxes payable method

As in the case with constant tax rates, the accounting under the taxes payable method reflect the timing differences, reported tax expense seemingly unrelated to reported pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	0.3	-2.7	-2.7	**-3.6**	**-4.0**	**-12.7**
Net income	*9.3*	*6.3*	*6.3*	***5.4***	***-4.0***	***23.3***
Tax expense % pre-tax income	-3.3	30.0	30.0	**40.0**	**NA**	**35.3**

Figure A3.4-6a Income statements example 1B – taxes payable method

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.5	68.8	100.1	**130.5**	**123.3**
Total assets	*100.0*	*122.5*	*128.8*	*135.1*	***140.5***	***123.3***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		9.3	15.6	21.9	**27.3**	**23.3**
Total equity	100.0	109.3	115.6	121.9	**127.3**	**123.3**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.5*	*128.8*	*135.1*	***140.5***	***123.3***

Figure A3.4-6b Balance sheets example 1B – taxes payable method

Deferral method

The deferral method does not take (expected) changes in tax rates into consideration. However, once the revised tax rate is in effect, calculation of deferred tax expense will be affected (year 4):

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	-10	-10	-10	-10		-40
Deferred tax expense	-3	-3	-3	**-4**		-13
Reversing timing difference		10	10	10	10	40
Release of deferred tax liability		3	3	3	**4**	13
Net effect on tax expense	*-3*	*0*	*0*	***-1***	***4***	*0*

Figure A3.4-7a Calculation of deferred tax example 1B – deferral method

Because (expected) changes in tax rates are not taken into consideration there will be a mismatch between the effect of the reversing timing difference on taxable income in year 4 (this will give rise to taxes payable of 4) and the supposedly offsetting release of the deferred tax credit (3). In this case (with an increase in tax charges), taxes payable will be higher than the deferred tax income, increasing the tax expense for that year:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	0.3	-2.7	-2.7	-3.6	-4.0	-12.7
Deferred tax	**-3.0**	**0.0**	**0.0**	**-1.0**	**4.0**	**0.0**
Tax expense	**-2.7**	**-2.7**	**-2.7**	**-4.6**	**0.0**	**-12.7**
Net income	***6.3***	***6.3***	***6.3***	***4.4***	***0.0***	*23.3*
Tax expense % pre-tax financial income	30.0	30.0	30.0	51.1	NA	35.3

Figure A3.4-7b Income statements example 1B – deferral method

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.5	68.8	100.1	130.5	123.3
Total assets	*100.0*	*122.5*	*128.8*	*135.1*	*140.5*	*123.3*

Balance sheets	**Year**					
at the end of each year	**0**	**1**	**2**	**3**	**4**	**5**
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	23.3	23.3
Total equity	100.0	106.3	112.6	118.9	123.3	123.3
Provision for deferred tax		3.0	3.0	3.0	4.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.5*	*128.8*	*135.1*	*140.5*	*123.3*

Figure A3.4-7c Balance sheets example 1B – deferral method

(Income statement) liability method

The calculation of deferred tax under this method depend on when the change in tax rate for year four and five becomes "expected". Assuming that the change in tax rate for year 4 is expected in year 3, the deferred tax expense charged in relation to the originating timing difference in year 3 amounts to 4:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	-10	-10	-10	-10		-40
Deferred tax expense	-3	-3	**-4**	-4		**-14**
Reversing timing difference		10	10	10	10	-40
Release of deferred tax liability		3	3	**4**	4	**14**
Net effect on tax expense	*-3*	*0*	***-1***	***0***	*4*	*0*

Figure A3.4-8a Calculation of deferred tax example 1B – income statement liability method

In contrast to the deferral method there is thus no mismatch in year 4. However, the calculation of the tax expense for year 3 takes the expected future (higher) tax charge related to year three's revenues into consideration, so that the reported tax charge amounts to 41.1% of reported pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	0.3	-2.7	-2.7	-3.6	-4.0	-12.7
Deferred tax	-3.0	0.0	**-1.0**	**0.0**	4.0	0.0
Tax expense	-2.7	-2.7	**-3.7**	**-3.6**	0.0	-12.7
Net income	*6.3*	*6.3*	*5.3*	*5.4*	*0.0*	*23.3*
Tax expense % pre-tax income	30.0	30.0	**41.1**	**40.0**	NA	35.3

Figure A3.4-8b Income statements ex. 1B – income statement liability method

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.5	68.8	100.1	130.5	123.3
Total assets	*100.0*	*122.5*	*128.8*	*135.1*	*140.5*	*123.3*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	**17.9**	**23.3**	23.3
Total equity	100.0	106.3	112.6	**117.9**	**123.3**	123.3
Deferred tax		3.0	3.0	**4.0**	4.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.5*	*128.8*	*135.1*	*140.5*	*123.3*

Figure A3.4-8c Balance sheets example 1B – income statement liability method

Balance sheet liability method

The financial statements are the same as under the income statement liability method, the underlying explanations for the numbers are different (see above).

Summary

When there is a change in tax rates, the deferral method no longer gives rise to the same figures as the liability methods. In this case with timing (temporary) differences and an increase in tax rates, reported tax expense is initially lower under the deferral method in comparison with the balance sheet methods (i.e. reported net income and equity are higher).

A3.5 Example 2 - Expense is tax deductible when paid

A3.5.1 Unchanged tax rates

Introduction

Assume that, as a means of avoiding abuse, expenses (other than depreciation on assets) are tax deductible in the period when they are paid. Also assume that, in cases with taxable loss, the tax authorities will provide a payment (refund) of tax[1]. This will affect the timing (but not the total sum) of taxes payable and hence the timing of the cash flows for the company. As in the previous case these changes affect the present value of the investment (assuming unchanged required rate of return), which might affect the price of the investment, which would further affect the cash flows. Again, however, these added complexities are disregarded.[2]

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable revenues	100.0	100.0	100.0	100.0	0.0	400.0
Deductible						
- depreciation	-25.0	-25.0	-25.0	-25.0	0.0	-100.0
- operating expenses	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Taxable income	*22.2*	*9.0*	*9.0*	*9.0*	*-13.2*	*36.0*
Tax payable for the period	***-6.7***	***-2.7***	***-2.7***	***-2.7***	***4.0***	***-10.8***

Figure A3.5-1a Taxes payable example 2A

1 This would, for example, be the case in a system allowing tax losses to be carried back.

2 Assuming no change in the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, the price of the investment would have to be 98.5 to give a zero NPV. Under the above assumptions the investment generates an internal rate of return of 9.5 %.

Cash flow statements	Year 1	2	3	4	5	Total
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	**-6.7**	-2.7	-2.7	-2.7	**4.0**	**-10.8**
Cash flow from operations	**30.5**	31.3	31.3	31.3	**0.8**	**125.2**
Investment in machine	-100.0					-100.0
Net cash flow	***-69.5***	*31.3*	*31.3*	*31.3*	***0.8***	***25.2***

Figure A3.5-1b Cash flows example 2A

Taxes payable method

If no attempt is made to account for deferred tax effects, the following financial income statements arise:

Income statements	Year 1	2	3	4	5	Total
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	**-6.7**	-2.7	-2.7	-2.7	**4.0**	-10.8
Net income	***2.3***	*6.3*	*6.3*	*6.3*	***4.0***	*25.2*
Tax expense % pre-tax income	**74.0**	30.0	30.0	30.0	**NA**	30.0

Figure A3.5-2a Income statements example 2A – taxes payable method

Although the total tax expense remains 30% of pre-tax income, this is not the case in each period. Initially, the reported tax expense is higher than the tax rate applied to pre-tax financial income (since the tax deduction of some expenses is deferred). Again, in this particular case this is followed by a number of years where differences cancel out, so that reported tax expense equals the tax rate applied to pre-tax financial income. Eventually, however, the situation reverses. In fact, although no revenues or expenses are recognised in the income statement for year five, the payment of 13.2 (relating to operating expenses for year four) during this year gives rise to a deductible tax expense in this year, which in turn gives rise to a positive taxes payable amount. Hence, a net profit is reported in the final year.

Because the reported income tax expense is initially lower (than if there had been no timing differences), reported equity is also lower until the effects on the income statement reverse:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	30.5	61.8	93.1	124.4	125.2
Total assets	*100.0*	*115.5*	*121.8*	*128.1*	*134.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**2.3**	**8.6**	**14.9**	**21.2**	25.2
Total equity	100.0	**102.3**	**108.6**	**114.9**	**121.2**	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100*	***115.5***	***121.8***	***128.1***	***134.4***	*125.2*

Figure A3.5-2b Balance sheets example 2A – taxes payable method

Deferral method

In year 1 the enterprise recognises other operating expenses of 66. However, only 52.8 of these are paid in this year. This means that other operating expenses reported in income statement for year 1 includes 13.2 that are not deductible until year 2; there is a (originating) timing difference of 13.2. Under the deferral method, the future tax saving of paying these 13.2 in the future is recognised as a "deferred tax income" (or positive deferred tax expense) in the income statement and as a deferred tax debit in the balance sheet.

Taxable income for year 2 will be reduced with the above 13.2, thus affecting income tax payable with +4.0. However, this effect will be offset as the deferred tax debit is written off. At the same time, recognised expenses for year 2 include another 13.2 that are not deductible until year 3. Since the related tax saving should be recognised in year 2, a new deferred tax asset is recognised and so on until year 5:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	13.2	13.2	13.2	13.2		52.8
Deferred tax expense	4.0	4.0	4.0	4.0		15.8
Reversing timing difference		-13.2	-13.2	-13.2	-13.2	-52.8
Write off of deferred tax asset		-4.0	-4.0	-4.0	-4.0	-15.8
Net effect on tax expense	*4.0*	*0.0*	*0.0*	*0.0*	*-4.0*	*0.0*

Figure A3.5-3a Calculation of deferred tax example 2A – deferral method

As a consequence, reported tax expense in each period is the same as the tax rate multiplied by the pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	-6.7	-2.7	-2.7	-2.7	4.0	-10.8
Deferred tax	**4.0**	0.0	0.0	0.0	**-4.0**	0.0
Tax expense	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Net income	***6.3***	*6.3*	*6.3*	*6.3*	*0.0*	*25.2*
Tax expense % pre-tax income	**30.0**	30.0	30.0	30.0	**NA**	30.0

Figure A3.5-3b Income statements example 2A – deferral method

As a consequence equity is also the same as if there had been no timing-differences:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Deferred tax		**4.0**	**4.0**	**4.0**	**4.0**	**0.0**
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	30.5	61.8	93.1	124.4	125.2
Total assets	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.2	25.2
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*

Figure A3.5-3c Balance sheets example 2B – deferral method

(Income statement) liability method

In a situation with unchanged tax rates, this method gives rise to exactly the same figures as the deferral method. The only difference being that the deferred tax debit is regarded as a deferred tax asset.

Balance sheet liability method

The financial statements are the same as under the deferral and income statement liability methods (see above). However, the underlying explanations and the calculations are different.

The balance sheet for the end of year 1 includes a liability of 13.2, representting the amount due to be paid to suppliers in year 2. The settlement of this payable will give rise to a deductible expense of 13.2 and a reduction of tax payable of 4.0 in the next period. A deferred tax asset of 4.0 should therefore be recognised. The same applies to year 2, 3 and 4.

In year 1 there is an increase in the total deferred tax asset of 4.0, hence a deferred tax income of 4.0 should be reported (this is denoted as a negative expense in the table below). In years 2, 3 & 4 there is no such change, hence no deferred tax income is reported.

In year 5 there is no taxable temporary difference. Hence, no deferred tax asset should be recognised. The decrease in this asset increases the deferred income tax expense for the period with 4.0:

Calculation of deferred tax	**Year**				
	1	**2**	**3**	**4**	**5**
Deductible temporary difference	13.2	13.2	13.2	13.2	0.0
Deferred tax asset	4.0	4.0	4.0	4.0	0.0
Deferred tax asset end of period	4.0	4.0	4.0	4.0	0.0
Deferred tax liability beginning of period	0.0	4.0	4.0	4.0	4.0
Deferred tax expense	*4.0*	*0.0*	*0.0*	*0.0*	*-4.0*

Figure A3.5-4 Calculation of deferred tax example 2A – b.sheet liability method

Summary

In the situation when an expense is tax deductible when it is paid rather than when it is incurred (and that this is afterwards), taxes payable for a period will initially be higher than the taxrate applied to the pre-tax financial income. As a consequence, reported equity will be lower than if there had been no timing differences. Application of deferred tax reporting –the deferral method or either of the liability methods – leads to an accounting as if there were no timing differences (leading to higher net income initially and lower later on). In this simple case with timing differences and unchanged tax rates, the various methods of tax effect accounting

fundamentally give rise to the same figures. This, however, is not the case if tax rates change (see next sub-section).

A3.5.2 Changes in tax rates

Introduction

Keep all the assumptions of the previous case, but that relating to constant tax rates. Assume instead that the tax rate is 30% in years 1, 2 and 3, but 40% in years 4 and 5. This decreases taxes payable in years 4 and 5 and hence also the cash flows for the company. [3]

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable income	22.2	9.0	9.0	9.0	-13.2	36.0
Tax payable for the period	-6.7	-2.7	-2.7	**-3.6**	**5.3**	**-10.4**

Figure A3.5-5a Calculation of taxes payable example 2B

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-6.7	-2.7	-2.7	**-3.6**	**5.3**	**-10.4**
Cash flow from operations	30.5	31.3	31.3	**30.4**	**2.1**	**125.6**
Investment in machine	-100.0					-100.0
Net cash flow	*-69.5*	*31.3*	*31.3*	***30.4***	***2.1***	***25.6***

Figure A3.5-5b Cash flows example 2B

3 Assuming no change in the required rate of return these changes affect the present value of the investment, which might affect its price. Assuming the same discount rate as in the base case, the price of the investment would have to be 98.7 to give a zero NPV. Under the above assumptions the investment generates an internal rate of return of 9.6 %.

Taxes payable method

As in the case with constant tax rates, the accounting under the taxes payable method reflect the timing differences, reported tax expense seemingly unrelated to reported pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	-6.7	-2.7	-2.7	**-3.6**	**5.3**	**-10.4**
Net income	*2.3*	*6.3*	*6.3*	***5.4***	***5.3***	***25.6***
Tax expense % pre-tax income	74.0	30.0	30.0	**40.0**	**NA**	**28.8**

Figure A3.5-6a Income statements example 2B – taxes payable method

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	30.5	61.8	93.1	**123.5**	**125.6**
Total assets	*100.0*	*115.5*	*121.8*	*128.1*	***133.5***	***125.6***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		2.3	8.6	14.9	**20.3**	**25.6**
Total equity	100.0	102.3	108.6	114.9	**120.3**	**125.6**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100*	*115.5*	*121.8*	*128.1*	***133.5***	***125.6***

Figure A3.5-6b Balance sheets example 2B – taxes payable method

Deferral method

The deferral method does not take (expected) changes in tax rates into consideration. However, once the revised tax rate is in effect, calculation of deferred tax expense will be affected (year 4): Because (expected) changes in tax rates are not taken into consideration there will be a mismatch between the effect of the reversing timing difference on taxable income (+5.3) in year 4 and the supposedly offsetting release of the deferred tax credit (-4). In this case (with an increase in tax charges), the former effect is higher than the latter, so that the net-effect on tax expense in that year is positive:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	13.2	13.2	13.2	13.2		52.8
Deferred tax expense	4.0	4.0	4.0	**5.3**		**17.2**
Reversing timing difference		-13.2	-13.2	-13.2	-13.2	-52.8
Write off of deferred tax asset		-4.0	-4.0	-4.0	**-5.3**	**-17.2**
Net effect on tax expense	*4.0*	*0.0*	*0.0*	***1.3***	***-5.3***	***0.0***

Figure A3.5-7a Calculation of deferred tax example 2B – deferral method

Under the deferral method, the change in tax rate is reflected in the income statement in the year it becomes effective. In this particular case the total tax charge is also lower than both of the tax rates, some expenses now giving rise to larger deductions (than in the case with unchanged tax rates):

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	-6.7	-2.7	-2.7	**-3.6**	**5.3**	**-10.4**
Deferred tax	4.0	0.0	0.0	**1.3**	**-5.3**	0.0
Tax expense	-2.7	-2.7	-2.7	**-2.3**	**0.0**	**-10.4**
Net income	*6.3*	*6.3*	*6.3*	*6.7*	*0.0*	*25.6*
Tax expense % pre-tax income	30.0	30.0	30.0	**25.3**	**NA**	28.8

Figure A3.5-7b Income statements example 2B – deferral method

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Deferred tax debit		4.0	4.0	4.0	5.3	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	30.5	61.8	93.1	123.5	125.6
Total assets	*100.0*	*119.5*	*125.8*	*132.1*	*138.8*	*125.6*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.6	25.6
Total equity	100.0	106.3	112.6	118.9	125.6	125.6
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*132.1*	*138.8*	*125.6*

Figure A3.3-7c Balance sheets example 2B – deferral method

(Income statement) liability method

Assuming that the change in tax rate in year 4 is expected in year 3, the deferred tax expense calculated in relation to the originating timing difference in year 3 amounts to 5.3. In other words, in contrast to the deferral method, there is no mismatch in year 4. Instead, the effects of the expected changes in tax rate are recognised in the same year as the changes become expected:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing difference	13.2	13.2	13.2	13.2		52.8
Deferred tax expense	4.0	4.0	**5.3**	5.3		18.5
Reversing timing difference		-13.2	-13.2	-13.2	-13.2	-52.8
Write off of deferred tax asset		-4.0	-4.0	**-5.3**	-5.3	-18.5
Net effect on tax expense	*4.0*	*0.0*	***1.3***	*0.0*	*-5.3*	*0.0*

Figure A3.5-8a Calculation of deferred tax example 2B – income statement liability method

As a consequence reported equity at the end of year 4 is higher than under the taxes payable method:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax financial income	9.0	9.0	9.0	9.0	0.0	36.0
Taxes payable	-6.7	-2.7	-2.7	-3.6	5.3	-10.4
Deferred tax	**4.0**	**0.0**	**1.3**	**0.0**	**-5.3**	**0.0**
Net income	*6.3*	*6.3*	*7.6*	*5.4*	*0.0*	*25.6*
Tax expense % pre-tax income	30.0	30.0	**15.3**	**40.0**	NA	28.8

Figure A3.5-8b Income statements example 2B – i. statement liability method

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Deferred tax asset		4.0	4.0	**5.3**	**5.3**	**0.0**
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	30.5	61.8	93.1	123.5	125.6
Total assets	*100.0*	*119.5*	*125.8*	***133.4***	***138.8***	*125.6*

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	**20.2**	**25.6**	25.6
Total equity	100.0	106.3	112.6	**120.2**	**125.6**	125.6
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	***133.4***	***138.8***	*125.6*

Figure A3.5-8c Balance sheets example 2B – income statement liability method

Balance sheet liability method

The financial statements are the same as under the income statement liability method, again, however, the underlying explanations and hence the calculations are different (see above).

Summary

When there is a change in tax rates, the deferral method no longer gives rise to the same figures as the liability methods. The deferral method shows the impact of changes in expectations in the period these become known (expected). Under either of the liability methods, the tax effects of an expected change in tax rate are reflected immediately.

A3.6 Example 3 - Accelerated depreciation

A3.6.1 Unchanged tax rates

Introduction

In contrast with the base case assume that the expense relating to the investment in the machine is tax deductible over three years. As in the previous examples (with unchanged tax rates), this will affect the timing (but not the total sum) of taxes payable[1]:

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable revenues	100.0	100.0	100.0	100.0		400.0
Deductible						
- depreciation	**-33.3**	**-33.3**	**-33.3**	**0.0**		-100.0
- operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Taxable income	***0.7***	***0.7***	***0.7***	***34.0***		*36.0*
Tax payable for the period	***-0.2***	***-0.2***	***-0.2***	***-10.2***		*-10.8*

Figure A3.6-1a Taxes payable example 3A

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	**-0.2**	**-0.2**	**-0.2**	**-10.2**	0.0	-10.8
Cash flow from operations	**37.0**	**33.8**	**33.8**	**23.8**	-3.2	125.2
Investment in machine	-100.0					-100.0
Net cash flow	***-63.0***	***33.8***	***33.8***	***23.8***	*-3.2*	*25.2*

Figure A3.6-1b Cash flows example 3A

1 Assuming no change in the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, the price of the investment would have to be 101.5 to give a zero NPV. Under the above assumptions the investment generates an internal rate of return of 10.6 %.

Taxes payable method

If no attempt is made to account for deferred tax effects, the following financial income statements arise:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	**-0.2**	**-0.2**	**-0.2**	**-10.2**		-10.8
Net income	***8.8***	***8.8***	***8.8***	***-1.2***		*25.2*
Tax expense % pre-tax income	**2.2**	**2.2**	**2.2**	**113.3**		30.0

Figure A3.6-2a Income statements example 3A – taxes payable method

Although the total tax expense remains 30% of pre-tax income, this is not the case in each period. In year 1, tax expense is only 2.2% of reported pre-tax income (Taxable income has been affected by depreciation of 33.2, which is 8.3 more than the depreciation recognised in the income statement. The additional depreciation reduces the tax payable for the period by 2.5 so that the tax payable for year 1 is 0.2.) On the other hand, in year 4 reported tax expense is significantly higher than the tax rate, taxable income not having been reduced by any depreciation charges. As a result, reported net income (and hence also equity) is initially higher than in the absence of timing differences. As the asset becomes fully depreciated from a tax perspective, however, the situation reverses.

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	**37.0**	**70.8**	**104.6**	128.4	125.2
Total assets	*100.0*	***122.0***	***130.8***	***139.6***	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**8.8**	**17.6**	**26.4**	25.2	25.2
Total equity	100.0	**108.8**	**117.6**	**126.4**	125.2	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***122.0***	***130.8***	***139.6***	*138.4*	*125.2*

Figure A3.6-2b Balance sheets example 3A – taxes payable method

Deferral method

The accelerated depreciation under tax law gives rise to a timing difference of 8.3 in years 1, 2 and 3 respectively, these are then reversed in year 4. Under the deferral method a deferred tax expense of 2.5 should be charged to income in the first three years (offsetting the reduction in tax payable compared to the base case). Hence reported income is initially lower than under the taxes payable method.

The accumulated 7.5 should also be recognised as a provision for deferred tax (a deferred tax credit) in the balance sheet, to be released in year 4 (when 25 are recognised as depreciation in the financial statements, but not in the calculation of taxable income). In other words, with time, the situation reverses, reported net income under the deferral method being higher than under the taxes payable method.

In summary, in this case the financial reports under the deferral method are the same as if there were no timing differences between financial and tax accounting policies.

Calculation of deferred tax:	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing differences	-8.3	-8.3	-8.3			-25.0
Deferred tax expense	-2.5	-2.5	-2.5			-7.5
Reversing timing difference				25.0		25.0
Release of deferred tax liability				7.5		7.5
Net effect on deferred tax expense	*-2.5*	*-2.5*	*-2.5*	*7.5*	*0.0*	*0.0*

Figure A3.6-3a Calculation of deferred tax example 3A – deferral method

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-0.2	-0.2	-0.2	-10.2		-10.8
Deferred tax	**-2.5**	**-2.5**	**-2.5**	**7.5**		0.0
Tax expense	**-2.7**	**-2.7**	**-2.7**	**-2.7**		-10.8
Net income	*6.3*	*6.3*	*6.3*	*6.3*		*25.2*
Tax expense % pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.6-3b Income statements example 3A – deferral method

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	128.4	125.2
Total assets	*100.0*	*122.0*	*130.8*	*139.6*	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**6.3**	**12.6**	**18.9**	**25.2**	**25.2**
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Deferred tax		**2.5**	**5.0**	**7.5**	**0.0**	**0.0**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.0*	*130.8*	*139.6*	*138.4*	*125.2*

Figure A3.6-3c Balance sheets example 3A – deferral method

(Income statement) liability method

In a situation with unchanged tax rates, this method gives rise to exactly the same figures as the deferral method. The only difference being that the provision for deferred tax is regarded as a deferred tax liability.

Net-of-tax method

As noted in example 1, in a simple case based on timing differences and unchanged tax rates the net-of-tax method gives rise to exactly the same equity and net income figures as the deferral and (income statement) liability methods. There are differences in presentation however.

There are two alternatives for the reporting of the tax effects in the income statement. It can either be reported as tax expense (in which case the income statements will look as under the deferral and (income statement) liability method, see figure A3.6-3b) or combined with the income statement line items to which the timing difference relates (in this case this would be depreciation). Under the latter case the reported tax expense in each period would equal taxes payable:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Deferred tax effect	-2.5	-2.5	-2.5	7.5		0.0
Depreciation	-27.5	-27.5	-27.5	-17.5		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	6.5	6.5	6.5	16.5		36.0
Taxes payable	-0.2	-0.2	-0.2	-10.2		-10.8
Net income	*6.3*	*6.3*	*6.3*	*6.3*		*25.2*
Tax expense % pre-tax income	3.1	3.1	3.1	61.8		30.0

Figure A3.6-4a Income statements example 3A – net-of-tax (alt 2)

In the balance sheet the deferred tax effect (2.5) related to the originating timing differences (8.3) in years 1, 2 and 3 reduce the carrying amount of the related asset:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		**72.5**	**45.0**	**17.5**	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	128.4	125.2
Total assets	*100.0*	***119.5***	***125.8***	***132.1***	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.2	25.2
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*

Figure A3.6-4b Balance sheets example 3A – Net of tax

Balance sheet liability method

Again the financial statements are the same as under the deferral and income statement liability methods (see above), however the underlying explanations and calculations differ:

The balance sheet for the end of year one includes a machine with a carrying value of 75. As the economic benefits embedded in this machine are realised, they will give rise to taxable revenue and, depending on the tax status of the asset, possibly a liability to pay income tax. In cases where the recovery of the asset has future (deferred) tax effects, a provision should be set up for this liability. At the end of year 1 the tax base of the asset is 66.7 (100 -

deductible depreciation in year 1). Realisation of the carrying value of 75 is therefore expected to give rise to a future taxable income of 8.3 (75 -66.7). In other words, there is a taxable temporary difference of 8.3. A provision for a deferred tax liability of 2.5 (8.3 * tax rate) should therefore be recognised.

End of year 2, the carrying value of the machine is 50 and the tax base is 33.3 (66.7 - tax deductible depreciation in year 2). There is thus a taxable temporary difference of 16.7. End of year 3, the carrying value of the machine is 25. The tax base is 0. There is thus a taxable temporary difference of 25. End of year 4, both the carrying value and the tax base are 0. There is thus no taxable temporary difference.

Calculation of deferred tax	**Year 1**	**2**	**3**	**4**	**5**
Carrying value of machine	75.0	50.0	25.0	0.0	0.0
Tax base of machine	66.7	33.3	0.0	0.0	0.0
Deductible temporary difference	8.3	16.7	25.0	0.0	0.0
Deferred tax liability	2.5	5.0	7.5	0.0	0.0
Deferred tax liability end of period	2.5	5.0	7.5	0.0	0.0
Deferred tax liability beginning of period	0.0	2.5	5.0	7.5	0.0
Deferred tax expense (income)	*-2.5*	*-2.5*	*-2.5*	*7.5*	*0.0*

Figure A3.6-5 Calculation of deferred tax example 3– temp. difference approach

Summary

In the situation where the expense relating to the investment in the machine is tax deductible over three years, but recognised over four years in the financial statements ("accelerated depreciation for tax purposes"), net income (and hence equity) is initially higher under the taxes payable method compared to the base case with no timing differences. Since it's a case of *timing* differences, in the end the situation reverses, the company paying the majority of its tax relating to this project in its final year. Although pre-tax income is the same for all periods, this leads to a situation where the company reports a net-loss for the final year.

Application of the various methods for accounting for deferred tax effects counteracts the effects of the timing differences. Not only is the reported tax expense (and hence the net income) the same for all periods, there is no reduction in reported equity in the final period. In this simple case with unchanged tax rates the various methods of tax effect accounting give rise to

the same figures. This, however, is not the case if tax rates change (see next section).

A3.6.2 Changes in tax rates

Introduction

Keep all the assumptions of the previous case, but that relating to constant tax rates. Assume instead that the tax rate is 30% in years 1, 2 and 3, but 40% in years 4 and 5. This decreases taxes payable in years 4 and 5 and hence also the cash flows for the company: [2]

Calculation of taxes payable	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Taxable income	0.7	0.7	0.7	34.0	0.0	36.0
Tax payable for the period	-0.2	-0.2	-0.2	**-13.6**	0.0	**-14.2**

Figure A3.6-6a Taxes payable example 3B

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-0.2	-0.2	-0.2	**-13.6**	0.0	**-14.2**
Cash flow from operations	37.0	33.8	33.8	**20.4**	-3.2	**121.8**
Investment in machine	-100.0					-100.0
Net cash flow	*-63.0*	*33.8*	*33.8*	***20.4***	*-3.2*	***21.8***

Figure A3.6-6b Cash flows example 3B

[2] Assuming no change in the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, the price of the investment would have to be 98.4 to give a zero NPV. Under the above assumptions the investment generates an internal rate of return of 9.4 %.

Taxes payable method

As in the case with constant tax rates, the accounting under the taxes payable method reflect the timing differences, reported tax expense seemingly unrelated to reported pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-0.2	-0.2	-0.2	**-13.6**		**-14.2**
Net income	*8.8*	*8.8*	*8.8*	***-4.6***		***21.8***
Tax expense % pre-tax income	2.2	2.2	2.2	**151.1**		**39.4**

Figure A3.6-7a Income statements example 3B – taxes payable method

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	**125.0**	**121.8**
Total assets	*100.0*	*122.0*	*130.8*	*139.6*	***135.0***	***121.8***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		8.8	17.6	26.4	**21.8**	**21.8**
Total equity	100.0	108.8	117.6	126.4	**121.8**	**121.8**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.0*	*130.8*	*139.6*	***135.0***	***121.8***

Figure A3.6-7b Balance sheets example 3B – taxes payable method

Deferral method

The deferral method does not take (expected) changes in tax rates into consideration. Only once the revised tax rate is in effect is the calculation of deferred tax expense affected. Since this is in year 4, a year in which there is no originating timing difference, there is no effect on the calculation of deferred tax:

Calculation of deferred tax:	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing differences	-8.3	-8.3	-8.3			-25.0
Deferred tax expense	-2.5	-2.5	-2.5			-7.5
Reversing timing difference				25.0		25.0
Release of deferred tax liability				7.5		7.5
Net effect on deferred tax expense	*-2.5*	*-2.5*	*-2.5*	*7.5*	*0.0*	*0.0*

Figure A3.6-8a Calculation of deferred tax example 3B – deferral method

Because (expected) changes in tax rates are not taken into consideration there will be a mismatch between the effect of the reversing timing difference on taxable income in year 4 and the supposedly offsetting release of the deferred tax credit. In this case (with an increase in tax charges), taxes payable will be higher than the deferred tax income, increasing the tax expense:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-0.2	-0.2	-0.2	-13.6		-14.2
Deferred tax	**-2.5**	**-2.5**	**-2.5**	**7.5**		0.0
Tax expense	**-2.7**	**-2.7**	**-2.7**	**-6.1**		-14.2
Net income	***6.3***	***6.3***	***6.3***	***2.9***		*21.8*
Tax expense % pre-tax income	30.0	30.0	30.0	**67.8**		39.4

Figure A3.6-8b Income statements example 3B– deferral method

Compared to the taxes payable method, the tax expense is higher initially, which also gives lower net income figures in years 1, 2 & 3. Since no consideration is made of expected changes in tax rate, the effect of the rise in tax rate is reflected in the year of the adjustment only.

In the balance sheet application of the deferral method leads to lower equity figures in years 1, 2 & 3 (owing to the recognition of a deferred tax credit).

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	125.0	121.8
Total assets	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**6.3**	**12.6**	**18.9**	21.8	21.8
Total equity	100.0	**106.3**	**112.6**	**118.9**	121.8	121.8
Deferred tax		**2.5**	**5.0**	**7.5**	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*

Figure A3.6-8c Balance sheets example 3B – deferral method

(Income statement) liability method

The calculation of deferred tax under this method depends on when the change in tax rate for year four and five becomes "expected". If the change in tax rate is expected already in year 1), the deferred tax calculations would take this into consideration, and the deferred tax charges in years 1, 2 and 3 would all be the same based on the expected future tax rate of 40%:

Calculation of deferred tax:	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing differences	-8.3	-8.3	-8.3			-25.0
Deferred tax expense	**-3.3**	**-3.3**	**-3.3**			**-10.0**
Reversing timing difference				25.0		25.0
Release of deferred tax liability				**10.0**		**10.0**
Deferred tax expense (income)	***-3.3***	***-3.3***	***-3.3***	***10.0***		*0.0*

Figure A3.6-9a Calculation of deferred tax example 3B – i.s liability method

In this scenario, the reversing timing differences in year 4 would offset the increase in taxes payable, so that reported tax expense for that year would equal the tax rate:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-0.2	-0.2	-0.2	-13.6		-14.2
Deferred tax	**-3.3**	**-3.3**	**-3.3**	**10.0**		**0.0**
Tax expense	**-3.5**	**-3.5**	**-3.5**	**-3.6**		-14.2
Net income	***5.5***	***5.5***	***5.5***	***5.4***		*21.8*
Tax expense						
% pre-tax income	**39.3**	**39.3**	**39.3**	**40.0**		**39.4**

Figure A3.6-9b Income statements example 3B – income statement liability method

In a situation with an expected raise in tax levels, the application of the (income statement) liability method gives rise to higher deferred tax charges and hence lower net income figures and lower equity, compared to the application of the deferral method:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	125.0	121.8
Total assets	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**5.5**	**10.9**	**16.4**	21.8	21.8
Total equity	100.0	**105.5**	**110.9**	**116.4**	121.8	121.8
Deferred tax liability		**3.3**	**6.7**	**10.0**	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*

Figure A3.6-9c Balance sheets example 3B – income statement liability method

If the change in tax rate in year 4 is only announced in year 3 (and not expected for other reasons), the calculations of deferred tax in years 1 and 2 cannot take this into consideration. Hence, an adjustment is necessary in year 3:

Calculation of deferred tax:	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing differences	-8.3	-8.3	-8.3			-25.0
Deferred tax expense	-2.5	-2.5	-3.3			-8.3
Adjustment :						
Acc. Timing differences			**-16.7**			**-16.7**
Related adjustment			**-1.7**			**-1.7**
Reversing timing difference				25.0		25.0
Release of deferred tax liability				10.0		10.0
Deferred tax expense (income)	*-2.5*	*-2.5*	*-5.0*	*10.0*		*0.0*

Figure A3.6-10a Calculation of deferred tax example 3B – income statement liability method (changes in tax rate not expected)

Under this scenario, the recorded tax expense matches the tax rate in years 1, 2 & 4, but not year 3, when the reported tax expense is unusually high (because, given the announcement of the change in tax rate, the previously reported tax expense was too low):

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-0.2	-0.2	-0.2	-13.6		-14.2
Deferred tax	**-2.5**	**-2.5**	**-5.0**	**10.0**		0.0
Tax expense	**-2.7**	**-2.7**	**-5.2**	**-3.6**		-14.2
Net income	***6.3***	***6.3***	***3.8***	***5.4***		*21.8*
Tax expense % pre-tax income	**30.0**	**30.0**	**57.8**	**40.0**		39.4

Figure A3.6-10b Income statements example 3B – income statement liability method (changes in tax rate not expected)

In contrast with the previous example, equity is here initially higher (due to lower deferred tax liabilities):

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	37.0	70.8	104.6	125.0	121.8
Total assets	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**6.3**	**12.6**	16.4	21.8	21.8
Total equity	100.0	**106.3**	**112.6**	116.4	121.8	121.8
Deferred tax liability		**2.5**	**5.0**	10.0	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*122.0*	*130.8*	*139.6*	*135.0*	*121.8*

Figure A3.6-10c Balance sheets example 3B – income statement liability method (changes in tax rate not expected)

Balance sheet liability method

The financial statements are the same as under the income statement liability method, however the explanations for and calculations of the numbers are different (see above).

Summary

When there is a change in tax rates, the deferral method no longer gives rise to the same figures as the liability methods, the effect of the change in tax rate hitting the income statement in the year of the change rather than in the year there is a change in expectations.

A3.6.3 The effects of a going concern

Introduction

Accelerated depreciation for tax purposes seems to be one of the most pervasive timing differences. Often discussions of this issue take into consideration the effects of companies running on a going concern basis (and not consisting of single projects as in the base case). In this section the base case is modified by assuming that, beginning of year 1 the company starts up a project in each year so that from year 4 the company consists of a portfolio of four projects in four different stages. For reasons of simplicity all projects are assumed to be identical.

Taxes payable method

If no attempt is made to account for deferred tax effects, the following income statements arise:

Income statements	**Year**				
	1	**2**	**3**	**4**	**5 …**
Revenue	100.0	200.0	300.0	400.0	400.0
Depreciation	-25.0	-50.0	-75.0	-100.0	-100.0
Other operating expenses	-66.0	-132.0	-198.0	-264.0	-264.0
Pre-tax income	9.0	18.0	27.0	36.0	36.0
Taxes payable	-0.2	-0.4	-0.6	-10.8	-10.8
Net income	*8.8*	*17.6*	*26.4*	*25.2*	*25.2*
Tax expense % pre-tax income	2.2	2.2	2.2	30.0	30.0

Figure A3.6-11a Income statements example 3C – taxes payable method

Once the company reaches a situation where it has a full set of projects (one in each stage), the differences in accounting policies related to these project cancel out so that taxes payable equals the tax rate applied to the pre-tax income.

Balance sheets	**Year**				
End of period	**1**	**2**	**3**	**4**	**5**
Machine	75.0	125.0	150.0	150.0	150.0
Receivables	10.0	20.0	30.0	40.0	40.0
Cash	37.0	7.8	12.4	40.8	66.0
Total assets	*122.0*	*152.8*	*192.4*	*230.8*	*256.0*
Paid in capital	100.0	100.0	100.0	100.0	100.0
Retained earnings	8.8	26.4	52.8	78.0	103.2
Total equity	108.8	126.4	152.8	178.0	203.2
Payables	13.2	26.4	39.6	52.8	52.8
Total equity & liabilities	*122.0*	*152.8*	*192.4*	*230.8*	*256.0*

Figure A3.6-11b Balance sheets example 3C – taxes payable method

Deferred tax accounting

As illustrated in the original case, accelerated depreciation under tax law gives rise timing difference years 1, 2 and 3 which reverse in year 4. Alternatively, it can also be argued that there are temporary differences in years 1, 2 and 3 of the projects. Whatever the reasoning, however, under an assumption of unchanged tax rate, the various methods of tax effect accounting give rise to the same numbers:

Income statements	**Year**				
	1	**2**	**3**	**4**	**5…**
Revenue	100.0	200.0	300.0	400.0	400.0
Depreciation	-25.0	-50.0	-75.0	-100.0	-100.0
Other operating expenses	-66.0	-132.0	-198.0	-264.0	-264.0
Pre-tax income	9.0	18.0	27.0	36.0	36.0
Taxes payable	-0.2	-0.4	-0.6	-10.8	-10.8
Deferred tax	**-2.5**	**-5.0**	**-7.5**	0.0	0.0
Tax expense	**-2.7**	**-5.4**	**-8.1**	-10.8	-10.8
Net income	***6.3***	***12.6***	***18.9***	*25.2*	*25.2*
Tax expense % pre-tax income	**30.0**	**30.0**	**30.0**	30.0	30.0

Figure A3.6-12a Income statements example 3C – deferred tax accounting

In the income statements the application of deferred tax accounting only affects the reported tax expense for the first three years. In the balance sheets, however, the effect is to "permanently" reduce equity (owing to the recognition of a deferred tax liability):

Balance sheets	**Year**						
End of period	**1**	**2**	**3**	**4**	**5**	**6**	**7**
Machine	75.0	125.0	150.0	150.0	150.0	150.0	150.0
Receivables	10.0	20.0	30.0	40.0	40.0	40.0	40.0
Cash	37.0	7.8	12.4	40.8	66.0	91.2	116.4
Total assets	*122.0*	*152.8*	*192.4*	*230.8*	*256.0*	*281.2*	*306.4*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings	**6,3**	**18,9**	**37,8**	**63,0**	**88,2**	**113,4**	**138,6**
Total equity	**106,3**	**118,9**	**137,8**	**163,0**	**188,2**	**213,4**	**238,6**
Deferred tax	**2.5**	**7.5**	**15.0**	**15.0**	**15.0**	**15.0**	**15.0**
Payables	13.2	26.4	39.6	52.8	52.8	52.8	52.8
Total equity & liabilities	*122.0*	*152.8*	*192.4*	*230.8*	*256.0*	*281.2*	*306.4*

Figure A3.6-12b Balance sheets example 3C – taxes payable method

Sometimes it is argued that such a deferred tax liability will never lead to tax payments. This is true in the sense that tax is paid on a net basis and reversing timing differences are cancelled out by new originating timing differences[3]. As such this item is somewhat, but not completely, different from the item beneath it in the balance sheet (payables). Under the specified

3 Under the assumption of going concern (above). It may also hold in a situation where the company cease to invest because of profitability problems (i.e. the firm ceases to invest in new project because it is making a loss).

assumptions the reported payables will also converge to a steady amount. To be noted, however, is that there is a significant difference in that each year the company settles its payables (i.e. there are related cash flows).

If annual investments increase, then the recorded deferred tax (liability) will increase accordingly.

A3.7 Example 4 – Revaluations

A3.7.1 Introduction

Assume that, end of year 2 there is a dramatic positive change in the market for the company's product, with the implication that sales (and related expenses) for the remaining two years increasing by 50%, giving the following cash flows:

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Extra			45.0	50.0	5.0	100.0
Received from customers	90.0	100.0	145.0	150.0	15.0	500.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Extra			-26.4	-33.0	-6.6	-66.0
Payment to suppliers etc	-52.8	-66.0	-92.4	-99.0	-19.8	-330.0
Income tax payable	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Extra	0.0	0.0	-5.1	-5.1	0.0	-10.2
Income tax	-2.7	-2.7	-7.8	-7.8	0.0	-21.0
Cash flow from operations	34.5	31.3	44.8	43.2	-4.8	149.0
Investment in machine	-100.0					-100.0
Net cash flow	*-65.5*	*31.3*	*44.8*	*43.2*	*-4.8*	*49.0*

Figure A3.7-1 Cash flows example 4

In comparison with the base-case cash from customers increases with 100, payments to suppliers with 66, giving a net increase in cash flows before tax of 34 and 23.8 after tax. This, in turn, increases the value of the related asset. Whereas the fair / market value of the asset at the end of year 2 (under an unchanged discount rate) can be assumed to be 84.7, the value of the asset to the company under the revised circumstances would only be 75.7. This value is lower[1] than the previous owing to lower deductible depreciation and hence higher tax payments (than in the case of a new acquisition) (figure A3.7-2).

[1] 84.7 – 75.7 = 9 = PV of additional tax payments

Cash flows and present value calculations	**Year 1**	**2**	**3**	**4**	**5**	**Total**
New acquisition						
Received from customers			135.0	150.0	15.0	300.0
Payment to suppliers etc			-79.2	-99.0	-19.8	-198.0
Income tax			-2.6	-2.6	0.0	-5.2
Net cash flow			*53.2*	*48.4*	*-4.8*	*96.8*
Present value end of year 2						84.7
Value to the company						
Received from customers			135.0	150.0	15.0	300.0
Payment to suppliers etc			-79.2	-99.0	-19.8	-198.0
Income tax			-7.8	-7.8	0.0	-15.6
Net cash flow			*48.0*	*43.2*	*-4.8*	*86.4*
Present value end year 2						75.7

Figure A3.7-2 Cash flows and present value calculations example 4

If the company does nothing, the company's unexpected good fortune in years 3 and 4 (or wise investment in year 1) leads to higher reported profits in these years the income statement, with related changes to the cash and equity position in the balance sheet:

Income statements	**Years 1**	**2**	**3**	**4**	**5**	**Total**
Revenue	100.0	100.0	**150.0**	**150.0**		**500.0**
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	**-99.0**	**-99.0**		**-330.0**
Pre-tax income	9.0	9.0	**26.0**	**26.0**		**70.0**
Income tax payable	-2.7	-2.7	**-7.8**	**-7.8**		**-21.0**
Net income	*6.3*	*6.3*	***18.2***	***18.2***		***49.0***
Tax expense % of pre tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.7-3a Income statements example 4 – no revaluation

Balance sheets at the end of each year	**1**	**2**	**3**	**4**	**5**
Machine	75,0	50,0	25,0	0,0	0,0
Receivables	10,0	10,0	15,0	15,0	0,0
Cash	34,5	65,8	**110,6**	**153,8**	**149,0**
Total assets	*119,5*	*125,8*	*150,6*	*168,8*	*149,0*
Paid in capital	100,0	100,0	100,0	100,0	100,0
Retained earnings	6,3	12,6	**30,8**	**49,0**	**49,0**
Total equity	106,3	112,6	**130,8**	**149,0**	**149,0**
Payables	13,2	13,2	19,8	19,9	0,0
Total equity & liabilities	*119,5*	*125,8*	*150,6*	*168,8*	*149,0*

Figure A3.7-3b Balance sheets example 4 – no revaluation

In this scenario the carrying value of the asset is 50.0 at the end of year 2, 25.7 less than its fair value. 20.9 of these can be attributed to the revised expectations (i.e. this is the PV of net additional cash flows).

In some accounting regimes an alternative would be to revalue the asset above cost to reflect its significantly higher value. (IAS 16, for example, identifies revaluation to fair (market) value as an allowed alternative for the measurement of property, plant and equipment subsequent to initial recognition). In most cases, it seems that a corresponding adjustment would not be made for tax purposes, taxes payable being unaffected by this accounting treatment.

A3.7.2 Taxes payable method

Under the assumption that the asset is revalued to its estimated market value at the end of year 2 (50.0+34.7=84.7) and that this revaluation is taken directly to equity, the additional depreciation charges in the income statements for years 3 and 4 will reduce the reported net income for these years, with the added effect that, if no deferred tax is recognised, the reported tax expense as a percentage of pre-tax income will be higher than the actual tax rate for periods 3 and 4 as well as over the life of the company. An added effect of the revaluation is that the income statements for years 3 and 4 no longer reflect higher profitability. Indeed, owing to the additional depreciations, the opposite is true:

Income statements	Years					Total
	1	2	3	4	5	
Revenue	100,0	100,0	150,0	150,0		500,0
Depreciation	-25,0	-25,0	-25,0	-25,0		-100,0
Additional depreciation			**-17,3**	**-17,3**		**-34,7**
Depreciation	-25,0	-25,0	**-42,3**	**-42,3**		**-134,7**
Other operating expenses	-66,0	-66,0	-99,0	-99,0		-330,0
Pre-tax income	9,0	9,0	**8,7**	**8,7**		**35,3**
Income tax payable	-2,7	-2,7	-7,8	-7,8		-21,0
Net income	*6,3*	*6,3*	**0,9**	**0,9**		**14,3**
Tax expense % of pre-tax income	30,0	30,0	**90.1**	**90.1**		**59.5**

Figure A3.7-4a Income statements example 4 – taxes payable

Balance sheets at the end of each year	1	2	3	4	5
Machine	75.0	**84.7**	**42.3**	0.0	0.0
Receivables	10.0	10.0	15.0	15.0	0.0
Cash	34.5	65.8	110.6	153.8	149.0
Total assets	*119.5*	***160.5***	***167.9***	*168.8*	*149.0*
Paid in capital	100.0	100.0	100.0	100.0	100.0
Revaluation surplus		**34.7**	**17.3**	0.0	0.0
Retained earnings	6.3	12.6	30.8	49.0	49.0
Total equity	106.3	**147.3**	**148.1**	149.0	149.0
Payables	13.2	13.2	19.8	19.9	0.0
Total equity & liabilities	*119.5*	***160.5***	***167.9***	*168.8*	*149.0*

Figure A3.7-4b Balance sheets example 4 – taxes payable

A3.7.3 Deferral and (income statement) liability method

When accounted for directly to equity it may be argued that the revaluation does not give rise to timing differences (only a permanent differences arising from the non-deductible depreciation on the revaluation) and hence that no deferred tax should be reported. The financial statements under this view are the same as under the application of the taxes payable method.

An alternative view is that the mere fact that the appreciation is accounted for as it is (i.e. directly to equity and not via the income statement), should not be allowed to affect the decision as to whether or not to account for deferred tax. This, however, does not necessarily mean that deferred tax should be recognised under a timing differences approach. One view is that, since the revaluation is never included in taxable income and the additional depreciations are never tax deductible, a revaluation does not give rise to timing differences, but two permanent differences that cancel each other out. Under this view, no deferred tax should be recognised and the financial statements would be as under the taxes payable method.

Yet another alternative (but perhaps questionable) view is that a timing difference arises in the year the revaluation is recognised and reverses as the revalued amount is depreciated (or on sale of the asset). Under this view, deferred tax is recognised under both the deferral and the (income statement) liability methods:

Calculation of deferred tax	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Originating timing differences		34.7				34.7
Deferred tax income		10.4				10.4
Reversing timing differences			-17.3	-17.3		-34.7
Deferred tax expense			-5.2	-5.2		-10.4

Figure A3.7-5a Calculation of deferred tax example 4 – timing differences approach alt 3

The deferred tax relating to the recognition of a deferred tax liability on the revaluation is not reported in the income statement. Instead, it reduces the revaluation surplus of reported equity:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	150.0	150.0		500.0
Depreciation	-25.0	-25.0	-42.3	-42.3		-134.7
Other operating expenses	-66.0	-66.0	-99.0	-99.0		-330.0
Pre-tax income	9.0	9.0	8.7	8.7		35.3
Taxes payable	-2.7	-2.7	-7.8	-7.8		-21.0
Deferred tax	0.0	0.0	**5.2**	**5.2**		**10.4**
Tax expense	-2.7	-2.7	**-2.6**	**-2.6**		**-10.6**
Net income	*6.3*	*6.3*	*6.1*	*6.1*		*24.7*
Tax expense % of pre tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.7-5b Income statements example 4 – timing differences approach alt 3

Under this method, the tax expense reported for the period equals 30% of the pre-tax financial income for the period. Because of the initial treatment of the deferred tax liability relating to the revaluation, the total tax *expense* is not equal to (but less than) the total tax *payable* for the period, but to the taxes that would have been payable if the revaluation had been recognised as taxable income and the related depreciations as a deductible expense (i.e. if there had been no differences in tax and accounting policies).

As far as the balance sheet is concerned equity is reduced with the amount recognised as deferred tax:

Balance sheets at the end of each year	**1**	**2**	**3**	**4**	**5**
Machine	75.0	84.7	42.3	0.0	0.0
Receivables	10.0	10.0	15.0	15.0	0.0
Cash	34.5	65.8	110.6	153.8	149.0
Total assets	*119.5*	*160.5*	*167.9*	*168.8*	*149.0*
Paid in capital	100.0	100.0	100.0	100.0	100.0
Revaluation surplus		**24,3**	**12,1**	0,0	0,0
Retained earnings	6.3	12,6	30,8	49,0	49,0
Total equity	106.3	**136,9**	**142,9**	149,0	149,0
Deferred tax		**10,4**	**5,2**	0,0	0,0
Payables	13.2	13.2	19.8	19.9	0.0
Total equity & liabilities	*119.5*	***160.5***	***167.9***	*168.8*	*149.0*

Figure A3.7 – 5c Balance sheets example 4 – timing differences approach alt 3

A3.7.4 Balance sheet liability method

Under the temporary differences approach there is no discussion, deferred tax should be recognised as in figures A3.7-5b & c, but based on the following calculations:

Calculation of deferred tax	**Year**				
	1	**2**	**3**	**4**	**5**
Carrying value of machine	75.0	84.7	42.3	0.0	0.0
Tax base of machine	75.0	50.0	25.0	0.0	0.0
Taxable temporary difference	0.0	34.7	17.3	0.0	0.0
Deferred tax liability	0.0	10.4	5.2	0.0	0.0
Deferred tax liability end of period	0.0	10.4	5.2	0.0	0.0
Deferred tax liability beginning of period	0.0	0.0	10.4	5.2	0.0
Deferred tax expense (income)	0.0	-10.4*	5.2	5.2	0.0

Figure A3.7-6 Calculation of deferred tax example 4A – temporary differences
** not recognised in income statement*

A common argument is that recognition of deferred tax expense in relation to revaluations does not make sense, since the revaluation per se does not affect taxes payable. The counter-argument under the balance sheet liability method, however, is that *if* a revaluation is made to reflect expected higher future cash flows and these increased cash flows will give rise to taxable income against which there will be no tax deductions in the form of depreciations, then these future tax effects should also be recognised. In other words, in this case, the release of 5.2 in years 3 and 4 can be seen to offset the additional tax payable recognised in these years (5.1 see figure A3.7-1). To get an exact match, the revaluation would have to be made with 34 (being the undiscounted sum of the additional pre-tax cash flows for the company expected as a consequence of the change in circumstances, i.e. 100 - 66). This would give a carrying value of 84 end of year 2 and a tax liability of 10.2 (which equals the undiscounted sum of additional tax cash outflows). To be noted, however, is that the comment above remains:
Because of the initial treatment of the deferred tax liability relating to the revaluation, the total reported tax expense is not equal to the total tax payable for the period, but to the taxes that would have been payable if there had been no differences in tax and accounting policies.

A3.8 Example 5 – Non-deductible asset

A3.8.1 Introduction

Assume that the expenditure for the asset are not tax deductible at any time, neither through depreciation as the asset is used, nor on disposal. In contrast to previous examples this will affect not only the timing, but also the sum of taxes payable:

Calculation of taxes payable	**Year 1**	**2**	**3**	**4**	**5**	**Total**
New case:						
Taxable revenues	100.0	100.0	100.0	100.0		400.0
Deductible operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Taxable income	*34.0*	*34.0*	*34.0*	*34.0*		*136.0*
Tax payable	10.2	10.2	10.2	10.2		40.8
Base case:						
Tax payable	2.7	2.7	2.7	2.7		10.8
Difference	***7.5***	***7.5***	***7.5***	***7.5***		***30.0***
PV*						23.7

Figure A3.8-1 Calculations of taxes payable – example 5A
** given the same required rate of return*

Under this scenario the investment brings 30 less in cash flows to the company. If the time value of money is ignored, this suggests that a rational investor would not be prepared to pay more than 70 (100 * (1 - tax rate)) for the asset that (s)he would be prepared to pay 100 for if deprecations over 4 years were tax deductible. As suggested by the figure above, however, in a more realistic scenario it is likely that the price would be 76.3 (100 - 23.7)[1].[2]

Example 5A starts the exploration of the issue of non-deductible assets by disregarding the complication of there being a time-value attached to cash flows, assuming that the asset is acquired for 70. Example B then continues

1 Price for deductible asset – present value of the difference in tax payments. This gives a zero NPV for the company at a discount rate of 10.1 %.

2 The discussion of this example deviates from the previous examples in that the effects on the price of the investment of the added assumptions is considered. Whereas these effects are small in examples 1 – 3, they are significant in this case.

the discussion by considering the situation if the asset is acquired for 76.3. This disposition has been chosen because today's accounting system fundamentally ignores the time value of money. Or, in other words, because the rules make sense if the time-value of money is disregarded. Example 5B then illustrates what happens when these rules are applied to business deals which do not ignore the time value of money.

A3.8.2 A) The asset is acquired for 70

Introduction

If the asset is acquired for 70 (instead of 100), the total net cash flows (and net profit) of the company will be the same as in the base case:

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	**-10.2**	**-10.2**	**-10.2**	**-10.2**	**0.0**	**-40.8**
Cash flow from operations	**27.0**	**23.8**	**23.8**	**23.8**	**-3.2**	**95.2**
Investment in machine	**-70.0**					**-70.0**
Net cash flow	***-43.0***	***23.8***	***23.8***	***23.8***	***-3.2***	***25.2***

Figure A3.8-2 Cash flow statements example 5A

Taxes payable method

As a consequence of the non-deductibility of the asset, the reported tax expense in each period is higher than the tax rate multiplied by the pre-tax income (in this case it is 61.8 %):

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-17.5	-17.5	-17.5	-17.5		-70.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	16.5	16.5	16.5	16.5		66.0
Income tax	-10.2	-10.2	-10.2	-10.2		-40.8
Net income	*6.3*	*6.3*	*6.3*	*6.3*		*25.2*
Tax expense % pre-tax income	61.8	61.8	61.8	61.8		61.8

Figure A3.8-3a Income statements example 5A – taxes payable method

Balance sheets End of period	Year 1 beg.	1	2	3	4	5
Machine	70.0	52.5	35.0	17.5	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	30.0	57.0	80.8	104.6	128.4	125.2
Total assets	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.2	25.2
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*132.1*	*138.4*	*125.2*

Figure A3.8-3b Balance sheets example 5A – taxes payable method

Deferral and (income statement) balance sheet methods

Each year there is a difference between taxable income and pre-tax financial income of 17.5 (the depreciation recognised in the financial accounting). This is a permanent difference (it does not reverse) and hence no deferred tax is recognised under either of the deferred tax methods that are based on timing differences. The financial statements are the same as those reported under the taxes payable method (figures A3.8-3a&b).

Balance sheet liability method

At the point in time (beginning of year 1) when the machine is acquired, this is recognised as an asset of 70 in the balance sheet. As the economic benefits embedded in this machine are realised, they will give rise to taxable revenue and an obligation to pay income tax which cannot be offset by deductible depreciation charges. This suggests that a provision for deferred tax (future tax obligations) should be recognised. Under the balance sheet liability method this is calculated by applying the tax rate to the temporary difference (carrying value – tax base).

Technically this deferred tax liability could be accounted for (on initial recognition) in either of two ways:

(I) as an expense in the period of the acquisition; or

(II) as an increase in the carrying value of the asset.

Since the first way involves recognising all future tax payments (related to the non-deductibility of the asset) as an expense in the period of acquisition,

this is not generally considered to be an alternative[3]. Under the second method, the future tax obligations increase the carrying value of the asset (this is sometimes called "grossing-up" the carrying value). The future tax payments are then recognised as an expense over the life of the asset (as depreciations).

Under this approach the asset is recorded as the sum of the consideration paid and the product of the tax rate applied to the carrying value [4], i.e.

Carrying value = price paid + (tax rate * carrying value)

This simplifies to:

Carrying value = price paid / (1 - tax rate)
100 = 70 / (1 - 0.3)

In other words, this method implies recognising the asset at the amount it (given rational markets/actors) would have cost, had its cost been tax deductible and, at the same time, also recognising the difference (i.e. the future tax obligations that one incurs by buying a non-deductible asset) as a liability.

This method of accounting has two effects. On the one hand operating income is decreased (through higher depreciation charges). On the other, the reported total tax expense of the company is also decreased (through the release of the deferred tax liability), so that the reported net income is unaffected. Under this alternative, tax expense as a percentage of pre-tax income is the same for all periods and equal to the tax rate. To be noted, however, is that over-all deferred tax does not equal zero, but positive 30 so that over the life of the company reported tax expense is not equal to the taxes actually payable (tax payments –40.8), *but to the amount of taxes that would have been payable if the depreciations had been tax deductible* (-10.8):

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3 See example 6 (pp. 488f) for an illustration of this principle.

4 This is a simplification of: Book value = Price paid + (tax rate * (Book value – tax base). Tax base in this example is 0.

Income statements	Year 1	2	3	4	5	Total
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	9.0	9.0	9.0	9.0		36.0
Taxes payable	-10.2	-10.2	-10.2	-10.2		-40.8
Deferred tax	**7.5**	**7.5**	**7.5**	**7.5**		**30.0**
Tax expense	-2.7	-2.7	-2.7	-2.7		-10.8
Net income	*6.3*	*6.3*	*6.3*	*6.3*		*25.2*
Tax expense % pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.8-4a Income statements example 5A – balance sheet liability method

In this case, the application of deferred tax accounting is thus about drawing up the financial statements as if there were no differences between financial and tax accounting policies (not just as if there were no timing differences). As a result, it is no longer about shifting the timing of recorded tax expense, but about the total amount of taxes reported.

Balance sheets End of period	Year 0	1	2	3	4	5
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	57.0	80.8	104.6	128.4	125.2
Total assets	*100.0*	*142.0*	*140.8*	*139.6*	*138.4*	*125.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	18.9	25.2	25.2
Total equity	100.0	106.3	112.6	118.9	125.2	125.2
Deferred tax		22.5	15.0	7.5	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*142.0*	*140.8*	*139.6*	*138.4*	*125.2*

Figure A3.8-4b Balance sheets example 5A – balance sheet liability method (alt II)

Summary

Under the taxes payable method, the non-deductibility of the asset (the depreciations related to the asset) results in the reported tax expense in each period (taxes payable) being much higher than the tax rate multiplied by the pre-tax income. Since the non-deductibility of the asset does not give rise to any timing differences, the same thing happens under both of the timing

differences based approaches to deferred tax. Under the temporary difference approach, however, it is argued that a provision for future tax obligations should be made reflecting the fact that as the economic benefits embedded in the machine are realised, they will give rise to taxable revenue which cannot be offset by deductible depreciation charges. Under this alternative the tax expense as a percentage of pre-tax income is the same for all periods and equal to the tax rate. To be noted, however, is that over-all deferred tax is a positive amount so that over the life of the company reported tax expense is not equal to the taxes actually paid, but to the amount of taxes payable if the depreciations had been tax deductible.

A3.8.3 B) The asset is acquired for 76.3

The previous example was based on the assumption that the asset was acquired for 70, being the price for the deductible asset less additional tax payments envisaged as a result of the change in tax status for the asset. As already noted this ignores the time value of money. If instead it is assumed that the price is 76.3 (the price for the deductible asset less the present value of the additional tax payments), the total cash flows will be reduced accordingly[5]:

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-10.2	-10.2	-10.2	-10.2	0.0	-40.8
Cash flow from operations	27.0	23.8	23.8	23.8	-3.2	95.2
Investment in machine	**-76.3**					**-76.3**
Net cash flow	***-49.3***	*23.8*	*23.8*	*23.8*	*-3.2*	***18.9***

Figure A3.8-5 Cash flow statements example 5B

Taxes payable method

As a consequence of the higher acquisition price the income statements report higher depreciation charges. Taxes payable, however, are the same as in the previous case (being unaffected by the depreciations). Again, as a

5 70 - 76.3 = 6.3 = 25.2 - 18.9

result of the non-deductibility of the asset, the reported tax expense in each period is higher than the tax rate multiplied by the pre-tax income:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	**-19.1**	**-19.1**	**-19.1**	**-19.1**		**-76.3**
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	**14.9**	**14.9**	**14.9**	**14.9**		**59.7**
Income tax	-10.2	-10.2	-10.2	-10.2		-40.8
Net income	***4.7***	***4.7***	***4.7***	***4.7***		***18.9***
Tax expense % pre-tax income	**68.3**	**68.3**	**68.3**	**68.3**		**68.3**

Figure A3.8-6a Income statements example 5B – taxes payable method

The higher acquisition price is also reflected in the balance sheets. Compared to the previous case reported equity is lower (due to lower net income for each year):

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		**57.2**	**38.1**	**19.1**	**0.0**	**0.0**
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	**50.7**	**74.5**	**98.3**	**122.1**	**118.9**
Total assets	*100.0*	***117.9***	***122.7***	***127.4***	***132.1***	***118.9***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**4.7**	**9.5**	**14.2**	**18.9**	**18.9**
Total equity	100.0	**104.7**	**109.5**	**114.2**	**118.9**	**118.9**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***117.9***	***122.7***	***127.4***	***132.1***	***118.9***

Figure A3.8-6b Balance sheets example 5B – taxes payable method

Balance sheet liability method

Following the same logic as discussed in example 5A, this method would produce the following financial statements:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	**-27.2**	**-27.2**	**-27.2**	**-27.2**		**-108.9**
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	**6.8**	**6.8**	**6.8**	**6.8**		**27.1**
Taxes payable	-10.2	-10.2	-10.2	-10.2		-40.8
Deferred tax	**8.2**	**8.2**	**8.2**	**8.2**		**32.7**
Tax expense	-2.0	-2.0	-2.0	-2.0		-8.1
Net income	*4.7*	*4.7*	*4.7*	*4.7*		*18.9*
Tax expense						
% pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.8-7a Income statements example 5B – balance sheet liability method

Balance sheets	**Year**					
End of period	**1 beg**	**1**	**2**	**3**	**4**	**5**
Machine	108.9	**81.7**	**54.5**	**27.2**	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	23.7	**50.7**	**74.5**	**98.3**	**122.1**	**118.9**
Total assets	*132.7*	***142.4***	***139.0***	***135.6***	***132.1***	***118.9***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**4.7**	**9.5**	**14.2**	**18.9**	**18.9**
Total equity	100.0	**104.7**	**109.5**	**114.2**	**118.9**	**118.9**
Deferred tax	32.7	**24.5**	**16.3**	**8.2**	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***142.4***	***139.0***	***135.6***	***132.1***	***118.9***

Figure A3.8-7b Balance sheets example 5B – balance sheet liability method

Compared to the previous case, (owing to the non-recognition of the time value of money) the deferred tax liability is higher, leading to the recognition of the asset at an amount higher than the fair value of the asset had the acquisition cost been deductible in the form of depreciations over four years. This, in turn, gives rise to higher depreciation charges and lower pre-tax income.

A3.9 Example 6 - Government grants

A3.9.1 Introduction

Assume that the enterprise receives a government grant of 8 when it acquires the machine, a grant which does not enter into the determination of taxable income when it is received (or any other period) and does not reduce the tax deductibility of the acquisition cost of the machine. As a result the calculations of taxable income and taxes payable are unaffected. However, the cash flow for year 1 (and hence the total) is affected (increased by 8): [1]

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Cash flow from operations	34.5	31.3	31.3	31.3	-3.2	125.2
Investment in machine	-100.0					-100.0
Government grant	**8.0**					**8.0**
Net cash flow	***-57.5***	*31.3*	*31.3*	*31.3*	*-3.2*	***33.2***

Figure A3.9-1 Cash flows – example 6

This example is somewhat complicated by the fact that the grant can be accounted for in either of two ways in the balance sheet: as a deferred income or by reducing the carrying value of the asset (IAS 20). One may think of these alternatives as a choice between reporting the asset on a gross or net basis. In either case the related income is recognised in the income statement on a systematic basis over the useful life of the asset.

A3.9.2 Taxes payable method

Irrespective of how the grant is recognised in the balance sheet, the future income statements will report the same operating / pre-tax income. Partly

1 Assuming no change to the required rate of return, these changes affect the present value of the investment, which might affect the price of the investment. Assuming the same discount rate as in the base case, price of the investment would have to be 110.5 to give a zero NPV. In accordance with the argument in A3.2 these added complexities are disregarded. A price of 100 gives an internal rate of return of 14.2 %.

depending on how the grant is recorded in the balance sheet *depreciations* or *other income* will be affected[2]:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other income	**2.0**	**2.0**	**2.0**	**2.0**		**8.0**
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	11.0	11.0	11.0	11.0		44.0
Taxes payable	-2.7	-2.7	-2.7	-2.7		-10.8
Net income	*8.3*	*8.3*	*8.3*	*8.3*		*33.2*
Tax expense % pre-tax income	24.5	24.5	24.5	24.5		24.5

Figure A3.9-2a Income statements ex 6 – taxes payable method deferred income alternative 1

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	**-23.0**	**-23.0**	**-23.0**	**-23.0**		**-92.0**
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	11.0	11.0	11.0	11.0		44.0

Figure A3.9-2b Income statements ex 6 – taxes payable method reduced carrying value or deferred income alternative 2

The total net income is increased by the same amount as total cash flows. Because of the non-taxable income reported in the income statement (permanent difference), the tax expense appears to be less than the pre tax income multiplied by the tax rate.

Depending on the accounting principles applied the balance sheet may take any of two appearances. If the grant is recognised as deferred income it will look as follows:

2 IAS 20 argues that grants related to income may be presented either as a credit in the income statement, e.g. under a general heading such as “other income”, or deducted in reporting the related expense, which would be depreciations in this case (§ 29-31).

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	*127.5*	*133.8*	*140.1*	*146.4*	*133.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		8.3	16.6	24.9	33.2	33.2
Total equity	100.0	108.3	116.6	124.9	133.2	133.2
Government grant		**6.0**	**4.0**	**2.0**	**0.0**	**0.0**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*127.5*	*133.8*	*140.1*	*146.4*	*133.2*

Figure A3.9-3a Balance sheets ex 6 – taxes payable method, deferred income

If the grant is recognised by reducing the carrying value of the machine, the following balance sheets will be produced:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		**69.0**	**46.0**	**23.0**	**0.0**	**0.0**
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	*121.5*	*129.8*	*138.1*	*146.4*	*133.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		8.3	16.6	24.9	33.2	33.2
Total equity	100.0	108.3	116.6	124.9	133.2	133.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***121.5***	***129.8***	***138.1***	*146.4*	*133.2*

Figure A3.9-3b Balance sheets example 6 – taxes payable method, reduced carrying values

A3.9.3 Timing difference approaches

Regardless of how the grant is accounted for, each year there will be a difference between taxable income and pre-tax financial income of 2. In the first case this is the "other income" which is non-taxable. In the second case this is the difference between financial accounting depreciation and the tax deductible depreciation. Whatever the case, this is a permanent difference (it does not reverse) and hence no deferred tax is recognised. The financial statements are the same as those reported under the taxes payable method.

A3.9.4 Balance sheet liability method

The accounting for deferred tax differs somewhat depending on how the grant is accounted for: as deferred income or through a reduction in the carrying value of the related asset.

Deferred income

On initial recognition, the carrying value of the deferred income (a liability) is 8. IAS 12 (revised) defines the tax base of "pre-paid revenue" as the carrying amount, less any amount of the revenue that will not be taxable in future periods. In other words, on initial recognition of the deferred income there is a temporary difference, related to which deferred tax asset should be recognised.

As in the previous case there are, technically, two ways of recognising this deferred tax asset: (1) as deferred tax income in the period the grant is received and (2) as an increase in the carrying value of the deferred income.

(1) deferred tax asset recognised as deferred tax income immediately

In the first case, the deferred tax asset is recognised as deferred tax *income* in the period the grant is given (year 1). As a result, net income for this period is higher than under both the taxes payable method and the alternative (see below). In the following years, the decrease in the deferred tax asset is recognised as deferred tax expense so that in all other periods, net income is lower than under the taxes payable method and, all in all, deferred income tax amounts to zero:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other income	2.0	2.0	2.0	2.0		8.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	11.0	11.0	11.0	11.0		44.0
Taxes payable	-2.7	-2.7	-2.7	-2.7		-10.8
Deferred tax	**1.8**	**-0.6**	**-0.6**	**-0.6**		**0.0**
Net income	***10.1***	***7.7***	***7.7***	***7.7***		*33.2*
Tax expense % pre-tax income	8.2	30.0	30.0	30.0		24.5

Figure A3.9-4a Income statements – example 6 – temporary difference approach – deferred income alt 1

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Deferred tax		**1.8**	**1.2**	**0.6**	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	***129.3***	***135.0***	***140.7***	*146.4*	*133.2*
Paid in capital	100.0	**100.0**	**100.0**	**100.0**	100.0	100.0
Retained earnings		**10.1**	**17.8**	**25.5**	33.2	33.2
Total equity	100.0	110.1	117.8	125.5	133.2	133.2
Government grant		6.0	4.0	2.0	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***129.3***	***135.0***	***140.7***	*146.4*	*133.2*

Figure A3.9-4b Balance sheets – example 6 – temporary difference approach – deferred income alt 1

(2) deferred tax asset recognised by grossing up the grant

Alternatively the future tax benefits are recorded by increasing the carrying value of the grant (the deferred income/liability representing the grant). The future tax benefits are then recognised over the life of the related asset. This method of accounting can be seen as an expression for the view that the grant received is higher than the actual payment received (because of the income not being taxable income).

As in the previous case, the carrying value of the grant is recorded as the sum of the grant received and the product of the tax rate applied to the carrying value [3], which simplifies to:

Carrying value = grant received / (1- tax rate).
11.4 = 8 / (1 - 0.3)

In other words, this method is based on the assumption that receiving eight as non-taxable income is the same as receiving 11.4 as taxable income[4].This gives rise to the following financial statements:

3 This is a simplification of:
Carrying value = grant received + (tax rate * (carrying value – tax base)). Tax base in this example is 0.

4 As in the previous case this ignores the time value of money.

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other income	**2.9**	**2.9**	**2.9**	**2.9**		**11.4**
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	11.9	11.9	11.9	11.9		47.4
Taxes payable	-2.7	-2.7	-2.7	-2.7		-10.8
Deferred income tax	**-0.9**	**-0.9**	**-0.9**	**-0.9**		**-3.4**
Tax expense	-3.6	-3.6	-3.6	-3.6		-14.2
Net income	***8.3***	***8.3***	***8.3***	***8.3***		*33.2*
Tax expense % pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.9-5a Income statements – example 6 – temporary difference approach – deferred income alt 2

In contrast to the accounting under the taxes payable method, reported tax expense amounts to 30 % of pre-tax income in all periods. This is because the total deferred tax is not equal to zero (but –3.4), which also means that the reported total tax expense is not equal to total taxes paid, but to the amount of tax that would have been paid, had the grant been taxable. Net income (equity) is affected as are the value of the recorded deferred tax asset and the recognised deferred income:

Balance sheets	**Year**					
End of period	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Deferred tax		**2.6**	**1.7**	**0.9**	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	***130.1***	***135.5***	***141.0***	*146.4*	*133.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		**8.3**	**16.6**	**24.9**	33.2	33.2
Total equity	100.0	**108.3**	**116.6**	**124.9**	133.2	133.2
Government grant		8.6	5.7	2.9	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***130.1***	***135.5***	***141.0***	*146.4*	*133.2*

Figure A3.9-5b Balance sheets – ex – temp. diff approach – deferred income alt 2

Reduced carrying value

On initial recognition, the carrying value of the machine is 92, however, the tax base is 100, there is thus a temporary difference of 8 on which deferred tax should be recognised. In other words, when the 92 are recovered, 100

will be deductible, suggesting the existence of future tax savings (a deferred tax asset) of 2.4 (0.3 * (92 - 100)). As in the previous case, technically the initial recognition of the deferred tax asset could be accounted for in two ways:

(1) as a (deferred tax) income in the period of the acquisition; or
(2) as a decrease in the carrying value of the asset.

(1) Deferred tax asset recognised as deferred tax income immediately

As in the previous case, if the deferred tax asset is booked against deferred expense (income), the tax saving due to the tax status of the grant is recognised in the period of the grant, rather than over the life of the asset. The only difference compared with the previous case, is how the pre-tax income is reported. Under this alternative depreciation charges would be -23 each year (total -92). In the previous case, depreciation charges were the same as if the asset had been acquired for 100. On the other hand, each year other income of 2 was reported.

In the balance sheet, the total assets are decreased as a result of the lower carrying value of the machine:

Balance sheets	**Year**					
End of period	**1 beg**	**1**	**2**	**3**	**4**	**5**
Machine	**92.0**	**69.0**	**46.0**	**23.0**	0.0	0.0
Deferred tax		1.8	1.2	0.6	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	8.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	***123.3***	***131.0***	***138.7***	*146.4*	*133.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		10.1	17.8	25.5	33.2	33.2
Total equity	100.0	110.1	117.8	125.5	133.2	133.2
Government grant		0.0	0.0	0.0	0.0	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	***123.3***	***131.0***	***138.7***	*146.4*	*133.2*

Figure A3.9-6 Balance sheets ex 6 – temporary difference approach – reduced carrying value – alternative 1

(2) Deferred tax asset recognised as a further decrease in asset value

An alternative treatment is to further reduce the carrying value of the asset . The carrying value of the grant is calculated as in the previous case (11.4 = 8 / (1-0.3)). This time, however, this amount reduces the carrying value of the asset (100 – 11.4 =86.4).

Again, the only difference compared with the previous case, is how the pre-tax income is reported (in this case a net amount is reported as depreciation):

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	**-22.1**	**-22.1**	**-22.1**	**-22.1**		**-88.6**
Other income						
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Pre-tax income	**11.9**	**11.9**	**11.9**	**11.9**		**47.4**
Taxes payable	-2.7	-2.7	-2.7	-2.7		-10.8
Deferred income tax	**-0.9**	**-0.9**	**-0.9**	**-0.9**		**-3.4**
Tax expense	-3.6	-3.6	-3.6	-3.6		-14.2
Net income	***8.3***	***8.3***	***8.3***	***8.3***		***33.2***
Tax expense % pre-tax income	30.0	30.0	30.0	30.0		30.0

Figure A3.9-7a Income statements example 6 – temporary difference approach – reduced carrying value – alt 2

In the balance sheets the carrying value of the machine, and hence also total assets, differs from the previous alternative:

Balance sheets	**Year**					
End of period	**1 beg**	**1**	**2**	**3**	**4**	**5**
Machine	**88.6**	**66.4**	**44.3**	**22.1**	0.0	0.0
Deferred tax	**3.4**	**2.6**	**1.7**	**0.9**	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	8.0	42.5	73.8	105.1	136.4	133.2
Total assets	*100.0*	***121.5***	***129.8***	***138.1***	*146.4*	*133.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		8.3	16.6	24.9	33.2	33.2
Total equity	100.0	108.3	116.6	124.9	133.2	133.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*121.5*	*129.8*	*138.1*	*146.4*	*133.2*

Figure A3.9-7b Balance sheets example 6 – temporary difference approach – reduced carrying value – alt 2

A3.9.5 Summary

On the surface this example appears to be somewhat complicated by the fact that the grant can be accounted for in either of two ways in the balance sheet. However, the above review illustrates that, in fact, this does not really complicated the analysis. Under the taxes payable method, the receipt of the

non-taxable government grant will give rise to a situation where the tax expense (taxes payable) is less than the pre-tax income multiplied by the tax rate. This will also be the case under the deferral method and the (income statement) liability method since, regardless how the grant is accounted for there will be no timing differences. Under the balance sheet liability method, however, a temporary difference will arise regardless if the grant is accounted for as deferred income or by reducing the carrying value of the asset. Technically there are two ways of recognising the deferred tax asset:

(1) as a (deferred tax) income in the period of the acquisition; or

(2) as an increase in the carrying value of the deferred income/further reduction of the carrying value of the asset.

The first alternative implies recognising all future tax effects associated with the non-taxable grant in the period of the grant. Under the second alternative, the deferred income tax charge is the same in all periods so that the reported tax expense equals the pre-tax income multiplied by the tax rate in all periods. As a result, however, total deferred income tax is non-zero and the total tax expense reported is not equal to total taxes paid, but to the amount of tax that would have been paid if the grant had been taxable. In other words, under this method, deferred tax accounting achieves an accounting as if there had been no differences (at all) between financial and tax accounting principles.

A3.10 Example 7 - Pre-paid non-tax deductible expense

A3.10.1 Introduction

Assume that, in addition to the assumptions in the base case, at end of year 2 the company makes a pre-payment of 5 relating to a planned activity (e.g. personnel party) for the following year. In the balance sheet for year 2 these pre-paid expenditures are recognised as an asset. In year 3, the party is held, the asset is written-off and the expenditures are recognised as an expense in the income statement. Further assume that these expenses are non-deductible for tax purposes. [1]

Although these added assumptions do not affect taxable income or taxes payable, they reduce the cash flow from operations in year 2 (and hence the total cash flows):

Cash flow statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	**-71,0**	-66,0	-66.0	-13.2	**-269.0**
Income tax	-2.7	-2.7	-2.7	-2.7	0.0	-10.8
Cash flow from operations	34.5	**26.3**	31.3	31.3	-3.2	**120.2**
Investment in machine	-100.0					-100.0
Net cash flow	*-65.5*	*26.3*	***31.3***	*31.3*	*-3.2*	***20.2***

Figure A3.10-1b Cash flow statements– example 7

A3.10.2 Taxes payable method

As a result of the non-deductibility of 5 of the operating expenses reported in year 3, the tax expense for that year is higher than the tax rate applied to the reported pre-tax income:

1 Assuming no change to the required rate of return, these changes affect the present value of the investment (at least if the party is deemed to be related to this). This, in turn, might affect the price of the investment. Assuming the same discount rate as in the base case, price of the investment would have to be 94.6 to give a zero NPV. In accordance with the argument in A3.2 these added complexities are disregarded. A price of 100 gives an internal rate of return of 8.1 %.

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	**-71.0**	-66.0		**-269.0**
Pre-tax income	9.0	9.0	**4.0**	9.0		**31.0**
Income tax payable	-2.7	-2.7	-2.7	-2.7		-13.8
Net income	*6.3*	*6.3*	*1.3*	*6.3*		*22.2*
Tax expense % of pre-tax income	30.0	30.0	**67.5**	30.0		**34.8**

Figure A3.10-2a Income statements – example 7 taxes payable method

However, if the pre-tax income is adjusted for permanent differences, this discrepancy is eliminated:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Adjusted pre-tax income			9.0			36.0
Tax expense % of pre-tax income			30.0			30.0

Figure A3.10-2b Income statements – example 7 taxes p method – additional info

The balance sheets for the company will look as follows:

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Pre-paid expense			**5.0**			
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	34.5	**60.8**	**92.1**	**123.4**	**120.2**
Total assets	*100.0*	*119.5*	***125.8***	***127.1***	***133.4***	***120.2***
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	12.6	**13.9**	**20.2**	**20.2**
Total equity	100.0	106.3	112.6	**113.9**	**120.2**	**120.2**
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	***125.8***	***127.1***	***133.4***	***120.2***

Figure A3.10-2c Balance sheets – example 7 taxes payable method

A3.10.3 Deferral method and (income statement) liability method

Deferred tax expense calculations are based on timing differences. In this case, however, there are not timing differences. Hence, no deferred tax is recognised.

A3.10.4 Balance sheet liability method

Under the balance sheet liability method the question arises whether there exists a temporary difference relating to the pre-paid expense. This, in turn, depends on what is considered to be its tax base. IAS 12 (revised) defines the tax base of an asset as "the amount that will be deductible for tax purposes against any taxable economic benefit that will flow to an enterprise when it recovers the carrying amount of the asset" (§7). When the asset is realised (the party is held), no expenses will be deductible for tax purposes. The tax base of this asset would thus seem to be zero, suggesting that there exists a temporary difference of 5 and that a deferred tax liability should be recognised at the end of year 2.

As in examples 5 & 6 there are two ways of recognising this deferred tax liability: 1) by also recognising a corresponding income tax expense in year 2 and 2) by grossing-up the carrying value of the related asset.

I) As an expense in the period of the acquisition

Under this alternative it might be argued that there exists a temporary difference of 5 at the end of year 2, giving rise to the recognition of deferred tax liability of 1.5. Since the deferred tax liability was zero at the end of year 2, the increase in this liability should be recognised as a deferred tax expense:

Calculation of deferred tax	**Year 1**	**2**	**3**	**4**	**5**
Temporary difference		5	0		
Deferred tax liability		1.5	0		
Deferred tax liability end of period		1.5	0		
Deferred tax liability beginning of period		0	1.5		
Deferred tax expense		-1.5	1.5		

Figure A3.10-3a Calculation of deferred tax – example 7 balance sheet liability method

This logic leads to the following income statements:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	-71.0	-66.0		-264.0
Pre-tax financial income	9.0	9.0	4.0	9.0		36.0
Income tax payable	-2.7	-2.7	-2.7	-2.7		-10.8
Deferred income tax		**-1.5**	**1.5**			**0.0**
Tax expense	-2.7	-4.2	-1.2	-2.7		-10.8
Net income	*6.3*	***4.8***	***2.8***	*6.3*		*20.2*
Tax expense % of pre-tax income	30.0	**46.7**	**30.0**	30.0		**34.8**

Figure A3.10-3b Income statements – example 7 balance sheet liability method

In comparison with the income statements under the taxes payable method, there is a shift from year 3 to year 2; a higher tax expense is reported in year 2 (the year of the payment of the non-deductible expenditures being the year in which the non-deductible asset is recognised) rather than year 3 (the year in which the related asset is used, the non-deductible expenditure is expensed).

Balance sheets	**Year**					
at the end of each year	**0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	0.0
Pre-paid expense			**5.0**			
Receivables		10.0	10.0	10.0	10.0	0.0
Cash	100.0	34.5	60.8	**92.1**	**123.4**	**120.2**
Total assets	*100.0*	*119.5*	*125.8*	*127.1*	*133.4*	*120.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	**11.6**	**13.9**	**20.2**	**20.2**
Total equity	100.0	106.3	**109.6**	**113.9**	**120.2**	**120.2**
Deferred tax			**1.5**			
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*100.0*	*119.5*	*125.8*	*127.1*	*133.4*	*120.2*

Figure A3.10-3c Balance sheets – example 7 balance sheet liability method

2) Grossing-up the carrying value of the asset

As also discussed in examples 5 & 6, the deferred tax liability may also be recognised by grossing-up the carrying value of the related asset. Following

the same logic as before the pre-paid expense would be recognised at 7.1 since the deferred tax liability would be 2.1 (= 5 / (1-0.3)). This would give the following financial statements:

Income statements	**Year**					**Total**
	1	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-25.0	-25.0	-25.0	-25.0		-100.0
Other operating expenses	-66.0	-66.0	**-73.1**	-66.0		**-271.1**
Pre-tax financial income	9.0	9.0	**1.9**	9.0		**28.9**
Income tax payable	-2.7	-2.7	-2.7	-2.7		-13.8
Deferred income tax			**2.1**			**2.1**
Tax expense	-2.7	-2.7	**-0.6**	-2.7		-8.7
Net income	*6.3*	*6.3*	***1.3***	*6.3*		*20.2*
Tax expense % of pre-tax income	30.0	30.0	**30.0**	30.0		**30.0**

Figure A3.10-4a Income statements – example 7 balance sheet liability method (grossing up)

Balance sheets at the end of each year	**Year 0**	**1**	**2**	**3**	**4**	**5**
Machine		75.0	50.0	25.0	0.0	
Pre-paid expense			**7.1**			
Receivables		10.0	10.0	10.0	10.0	
Cash	100.0	34.5	60.8	92.1	123.4	120.2
Total assets	*100.0*	*119.5*	***127.9***	*127.1*	*133.4*	*120.2*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	**12.6**	13.9	20.2	20.2
Total equity	100.0	106.3	**112.6**	113.9	120.2	120.2
Deferred tax			**2.1**			
Payables		13.2	13.2	13.2	13.2	
Total equity & liabilities	*100.0*	*119.5*	***127.9***	*127.1*	*133.4*	*122.2*

Figure A3.10-4b Balance sheets – example 7 balance sheet liability method (grossing-up)

The net income figures (and hence also equity) are the same as under the taxes payable method. However, the make-up of net income differs. As a result the total reported tax expense equals the tax rate applied to the pre-tax income. Total deferred income tax, however, is a non-zero amount, so that total reported tax expense is no longer equal to the total income taxes paid.

To be noted is perhaps that discussions relating to a similar example seem to have given rise to the recognition that an asset may have more than one tax base (see e.g. p. 249). It may, for example, be argued that the tax base of the asset (the pre-paid party) is not zero, but in fact equal to its carrying value. Consider, for example the case that the party is cancelled and a 100% fund is made (or even if a 90% refund is made and the 10% loss is deductible for tax purposes).

A3.11 Example 8 - Fair value adjustments arising on business acquisitions

A3.11.1 Introduction

Assume that, instead of investing 100 in the asset through a direct acquisition of this asset, the company makes an indirect acquisition of the same asset by purchasing the shares in another company that owns the asset. Further assume that this company (company S) acquired the asset six years ago for 150 and assumed a useful life of 10, so that the carrying value in the company's balance sheet is 60 (with annual depreciations of 15 for another four years). Also assume that the deal has been structured so that the company's sole asset, at the time of the purchase, is this asset and that it is equity financed, i.e. that the balance sheet of the company at the time of the purchase looks as follows[1]:

Balance sheets **Company S** **at the time of purchase**	**Year** **6**
Machine	60.0
Receivables	
Cash	
Total assets	*60.0*
Paid in capital	60.0
Retained earnings	
Total equity	*60.0*
Payables	
Total equity & liabilities	*60.0*

Figure A3.11-1a Balance sheet company S at the time of purchase example 8

Assuming that the assumptions of the base case still hold, the financial statements for company S for the following four years would look as follows in the absence of differences between financial and tax reporting policies taxes:

1 Assume that the accounts receivable and payable have been settled prior to the year end and that the accumulated earnings have been distributed to the prior owners. (Keeping all other assumptions this example can be seen to reflect a 14 % required rate of return.)

Income statements Company S	**Year 1**	**2**	**3**	**4**	**Total**	**Base case**
Revenue	100.0	100.0	100.0	100.0	400.0	400.0
Depreciation	-15.0	-15.0	-15.0	-15.0	-60.0	-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0	-264.0	-264.0
Pre-tax income	19.0	19.0	19.0	19.0	76.0	36.0
Income tax payable	-5.7	-5.7	-5.7	-5.7	-22.8	-10.8
Net income	*13.3*	*13.3*	*13.3*	*13.3*	*53.2*	*25.2*
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0	30.0	30.0

Figure A3.11-1b Income statements company S example 8

Having lower depreciation charges (10 each year, 40 in total), the company reports a higher pre-tax income (than in the original case) and hence endures higher income tax charges (3 each year, 12 in total). Because of the differences in taxes payable, net cash flow from operations each year is reduced:

Cash flow statements Company S	**Year 1**	**2**	**3**	**4**	**5**	**Total**
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Income tax	-5.7	-5.7	-5.7	-5.7	0.0	-22.8
Cash flow from operations	31.5	28.3	28.3	28.3	-3.2	113.2
Net cash flow	*31.5*	*28.3*	*28.3*	*28.3*	*-3.2*	*113.2*

Figure A3.11-1c Cash flow statements company S example 8

Since the company already owns the asset, however, cash flows in year one (and hence over-all cash-flows) are much higher than in the base case (where an investment is made) so that unless the company makes dividend payments, it will accumulate 113.2 in cash over the four years (compared to 25.2 in the original case). 60 of these represent the equity at the beginning of the year 1, the remaining 53.2 represent the profits made during these years:

Balance sheets Company S	**Year 6**	**1**	**2**	**3**	**4**	**5**
Machine	60.0	45.0	30.0	15.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash		31.5	59.8	88.1	116.4	113.2
Total assets	*60.0*	*86.5*	*99.8*	*113.1*	*126.4*	*113.2*
Paid in capital	60.0	60.0	60.0	60.0	60.0	60.0
Retained earnings		**13.3**	**26.6**	**39.9**	**53.2**	**53.2**
Total equity	60.0	73.3	86.6	99.9	113.2	113.2
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*60.0*	*86.5*	*99.8*	*113.1*	*126.4*	*113.2*

Figure A3.11-1d Balance sheets company S example 8

In order to determine how the financial statements for the investing company (Company I) will look, the price of the shares must be known. The determination of this price, however, requires consideration of a number of factors. For example, although the investment in both cases give rise to pre-tax cash flows of 136 (400 - 264), the taxes payable in the case of an indirect investment 12 higher than in the case of a direct investment[2]. Under the same required rate of return as the base case the present value of these differences in payments is 9.5, suggesting that, the investing company should perhaps not be prepared to pay more than 90.5 for the shares.

In addition, however, it should also be recognised that an indirect acquisition puts the earnings/cash-flows in another legal entity and that tax consequences of a transfer of these to the investing company must be considered. To further complicate things, such earnings can be realised in a number of ways (dividends, divestment of the company or liquidation of the company). Ideally a tax system should be neutral to the manner of realisation and it might be assumed that the tax system would either tax such payments (e.g. tax on dividends received from subsidiaries and profits made on the sale of shares in a subsidiary) or not. For reasons of simplicity, it is assumed that these payments do not give rise to tax consequences.

However, the fact that the earnings may be realised in a number of ways still leaves one problematic dimension: the consideration of the time value of

2 12 being the tax rate (30%) times the difference in deductibility (40 = 100 - 60).

money. The investing company can realise its investment in S through yearly distributions of earnings or at the end (of year 5) through a liquidation or sale. If there is a positive time value of money the expected rate of recovery will affect the present value of the investment. For example, a payment of 113.2 at the end of year 5 has a present value of 70.1 (to be compared with the present value for company S of 90.5, previous page). On the other hand, with a dividend payout ratio of 100% combined with a realisation of 60 at the end of year five, the present value of the investment is 79.2.

Only if it is assumed that any surplus cash generated by company S can be invested so that it generates the required rate of return, is the present value of the investment in S unaffected by the manner (timing) of its realisation and equal to the present value of the machine for company S, which is 90.5 in this scenario. Under this revised scenario (this is the extended base case presented in section A3.3, pp. 434ff), and under the assumption that Company I recovers its investment in S at the end of year 5, the financial statements for Company S will look as follows:

Income statements	**Year**					**Total**
Company S	**1**	**2**	**3**	**4**	**5**	
Revenue	100.0	100.0	100.0	100.0		400.0
Depreciation	-15.0	-15.0	-15.0	-15.0		-60.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0		-264.0
Interest income	**0.0**	**4.5**	**9.1**	**14.0**	**19.5**	**47.1**
Pre-tax income	19.0	23.5	28.1	33.0	19.5	123.1
Income tax (machine)	-5.7	-5.7	-5.7	-5.7	0.0	-22.8
Income tax (interest)	0.0	**-1.4**	**-2.7**	**-4.2**	**-5.9**	**-14.1**
Income tax payable	-5.7	-7.1	-8.4	-9.9	-5.9	-36.9
Net income	*13.3*	*16.5*	*19.6*	*23.1*	*13.7*	*86.2*
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0	30.0	30.0

Figure A3.11-2a Income statements company S alternative example 8

Cash flow statements	**Year**					**Total**
Company S	**1**	**2**	**3**	**4**	**5**	
Received from customers	90.0	100.0	100.0	100.0	10.0	400.0
Payment to suppliers etc	-52.8	-66.0	-66.0	-66.0	-13.2	-264.0
Interest payments	**0.0**	**4.5**	**9.1**	**14.0**	**19.5**	**47.1**
Income tax payable	-5.7	-7.1	-8.4	-9.9	-5.9	-36.9
Cash flow from operations	*31.5*	*31.5*	*34.6*	*38.1*	*10.5*	*146.2*
Liquidation dividend					-86.2	-86.2
Liquidation					-60.0	-60.0
Net cash flow	*31.5*	*31.5*	*34.6*	*38.1*	*-135.7*	*0.0*

Figure A3.11-2b Cash flow statements company S alternative example 8

Balance sheets	**Year**					
Company S	**6**	**1**	**2**	**3**	**4**	**5**
Machine	60.0	45.0	30.0	15.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	0.0
Cash		31.5	63.0	97.6	135.7	0.0
Total assets	*60.0*	*86.5*	*103.0*	*122.6*	*145.7*	*0.0*
Paid in capital	60.0	60.0	60.0	60.0	60.0	0.0
Retained earnings		13.3	29.8	49.4	72.5	0.0
Total equity	60.0	73.3	89.8	109.4	132.5	0.0
Payables		13.2	13.2	13.2	13.2	0.0
Total equity & liabilities	*60.0*	*86.5*	*103.0*	*122.6*	*145.7*	*0.0*

Figure A3.11-2c Balance sheets company S alternative example 8

Under the same assumptions the financial statements of the investing company will look as follow:

Income statements	**Year**					**Total**
Company I	**1**	**2**	**3**	**4**	**5**	
Revenue						
Depreciation						
Other operating expenses						
Operating income						
Interest income	1.4	1.5	1.7	1.8	2.0	8.3
Dividends					86.2	86.2
Net loss sale of shares					-30.5	-30.5
Pre-tax income	1.4	1.5	1.7	1.8	*57.7*	*64.0*
Income tax payable (interest)	-0.4	-0.5	-0.5	-0.5	-0.6	-2.5
Net income	*1.0*	*1.1*	*1.2*	*1.3*	*57.1*	*61.5*
Tax expense %						
of pre-tax income	30.0	30.0	30.0	30.0	1.0	3.9

Figure A3.11-3a Income statements company I example 8

Cash flow statements Company I	Year 1	2	3	4	5	Total
Received from customers						
Payment to suppliers etc						
Dividends received	0.0	0.0	0.0	0.0	86.2	86.2
Interest received	1.4	1.5	1.7	1.8	2.0	8.3
Income tax	-0.4	-0.5	-0.5	-0.5	-0.6	-2.5
Cash flow from operations	1.0	1.1	1.2	1.3	87.6	92.0
Investment in shares	-90.5				60.0	-30.5
Net cash flow	*-89.5*	*1.1*	*1.2*	*1.3*	*147.6*	*61.5*

Figure A3.11-3b Cash flow statements company I example 8

Balance sheets Company I	Year 1 beg.	1	2	3	4	5
Machine						
Shares		90.5	90.5	90.5	90.5	0.0
Receivables						
Cash	100.0	10.5	11.5	12.7	13.9	161.5
Total assets	*100.0*	*101.0*	*102.0*	*103.2*	*104.4*	*161.5*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		1.0	2.0	3.2	4.4	61.5
Total equity	100.0	101.0	102.0	103.2	104.4	161.5
Payables						
Total equity & liabilities	*100.0*	*101.0*	*102.0*	*103.2*	*104.4*	*161.5*

Figure A3.11-3c Balance sheets company I example 8

These should be compared to the financial statements for the extended base case (figure A3.3 pp. 434-5). Although there are significant differences in the make-up and timing of the cash-flows, the end situation is the same: cash of 161.5 which is entirely equity financed (100 paid in capital, 61.5 retained earnings). The assumption that surplus cash earns interest corresponding to the required rate of return also makes sure that the present value of both investments are the same.

A3.11.2 Consolidated financial statements

Lack of information in the financial statements for the investing company are presumably at least one of the reasons for the development of so called consolidated financial statements. For example, the income statements in figure A3.11-3a suggest that (almost) no value is being created in periods 1-4 and all the value is created in period 5 when, in fact, the opposite might be argued.

Under the purchase method of consolidation, indirect purchases of (net)assets through the acquisition of subsidiaries are reported by recognising the acquired assets and liabilities in the balance sheet. A key element of this method of drawing up consolidated financial statements thus concerns how to determine the value at which indirectly acquired assets and liabilities should be recognised.

In this context, the particular issue is whether or not, and if so, how, to take differences in tax status into account. Different solutions have been suggested. The following sub-sections first illustrate three alternative solutions, of which one takes such differences into consideration through the recognition of deferred tax (C). The final sub-section completes the analysis by considering this method of accounting if discounting is used (D).

(A) Assets recognised at their implicit (net) purchase price

One approach to the purchase method is to recognise acquired assets at their presumed de facto purchase price, i.e. after consideration of difference in tax status. Compared with the revised base case (a direct purchase), the machine would be recorded at 90.5 at the time of acquisition. This would yield the following consolidated financial statements:

Consolidated income statements	**Year 1**	**2**	**3**	**4**	**Total**	**Base (1-4)**
Revenue	100.0	100.0	100.0	100.0	400,0	400,0
Depreciation	**-22,6**	**-22,6**	**-22,6**	**-22,6**	**-90,5**	-100,0
Other operating expenses	-66.0	-66.0	-66.0	-66.0	-264,0	-264,0
Operating income	11.4	11.4	11.4	11.4	45,5	36,0
Interest income	1.4	6.0	10,7	15,9	34,0	30,4
Pre-tax income	12.7	17.4	22,1	27,2	79,5	66,4
Income tax (payable)	-6.1	-7.5	-8,9	-10,5	-33,0	-19,9
Net income	*6.6*	*9.9*	*13,2*	16.8	*46,5*	*46,5*
Tax expense % of pre-tax income	48.0	43,1	40.4	38.4	41.5	30.0

Figure A3.11-6a Consolidated income statements example 8 – taxes payable method, alt A (reduced carrying values) [3]

3 No consolidated income statement would be prepared for year 5, the subsidiary having been liquidated before the end of the financial year.

Balance sheets at the end of each year	**Beg. 1**	**1**	**2**	**3**	**4**	**Base Case (4)**
Machine	90.5	67.9	45.3	22.6	0.0	0.0
Receivables	0.0	10.0	10.0	10.0	10.0	10.0
Cash	9.5	42.0	74.5	110.3	149.7	149.7
Total assets	*100.0*	*119.8*	*129.7*	*142.9*	*159.7*	*159.7*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings	0.0	6.6	16.5	29.7	46.5	46.5
Total equity	100.0	106.6	116.5	129.7	146.5	146.5
Payables	0.0	13.2	13.2	13.2	13.2	13.2
Total equity & liabilities	*100.0*	*119.8*	*129.7*	*142.9*	*159.7*	*159.7*

Figure A3.11-6b Consolidated balance sheets example 8 – taxes payable method, alt A (reduced carrying values) [4]

The differences on the assets' side of the balance sheet at the beginning of year 1 reflects the reality of the situation: in one case (indirect acquisition) the machine has been acquired for 90.5 leaving 9.5 in cash, in the other (direct acquisition) it has been acquired for 100, leaving zero in cash. Although the cash position is thus initially better in the case of an indirect acquisition, lower depreciation charges lead to higher tax payments each year which lead to lower net cash flows (which, in turn lead to lower interest income), so that at the end of year 4, the financial position (for the group) is the same as in the case of a direct acquisition (the revised base case). Although the reported total net income for the four years is the same as in the base case, the make-up and timing differs (operating income being lower and income tax expense being higher).

4 No consolidated income statement would be prepared for year 5, the subsidiary having been liquidated before the end of the financial year.

(B) Assets recognised at their fair value, no consideration of tax

As an alternative it has been suggested that the indirectly acquired assets should be recognised at their fair (market) value (i.e. in this case 100). The question then arises of how to deal with the fact that the price paid is, in fact, only 90.5. One solution is to record the difference between the fair value of the machine and the purchase price of the company (9.5) as deferred income (or "badwill") to be released over the remaining four years. (Another solution is to reduce the carrying value of the acquired assets, which would puts us back in example A.)

In comparison with the previous case the consolidated financial statements are more similar to the (revised) base case in so far as recorded depreciations relating to the machine and the carrying value of the machine are the same. However, differences still persist in the make-up of operating and net-income owing to the release of badwill and differences in recorded tax expense:

Consolidated Income statements	**Year 1**	**2**	**3**	**4**	**Total**	**Base case' (1-4)**
Revenue	100.0	100.0	100.0	100.0	400.0	400.0
Depreciation (machine)	**-25.0**	**-25.0**	**-25.0**	**-25.0**	**-100.0**	-100.0
Deprecation (badwill)	**2.4**	**2.4**	**2.4**	**2.4**	**9.5**	
Other operating expenses	-66.0	-66.0	-66.0	-66.0	-264.0	-264.0
Operating income	11.4	11.4	11.4	11.4	45.5	36.0
Interest income	1.4	6.0	10.7	15.9	34.0	30.4
Pre-tax income	12.7	17.4	22.1	27.2	79.5	66.4
Income tax payable	-6.1	-7.5	-8.9	-10.5	-33.0	-19.9
Net income	*6.6*	*9.9*	*13.2*	*16.8*	*46.5*	*46.5*
Tax expense % of pre-tax income	48.0	43.1	40.4	38.4	41.5	30.0

Figure A3.11-7a Consolidated income statements example 8 – taxes payable method, alt B (recognition of badwill)

Balance sheets at the end of each year	**Beg. 1**	**1**	**2**	**3**	**4**	**Base Case 4**
Machine	**100.0**	**75.0**	**50.0**	**25.0**	**0.0**	0.0
Receivables	0.0	10.0	10.0	10.0	10.0	10.0
Cash	9.5	42.0	74.5	110.3	149.7	149.7
Total assets	*109.5*	*127.0*	*134.5*	*145.3*	*159.7*	*159.7*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.6	16.5	29.7	46.5	46.5
Total equity	100.0	106.6	116.5	129.7	146.5	146.5
Badwill	**9.5**	**7.1**	**4.7**	**2.4**	**0.0**	
Payables		13.2	13.2	13.2	13.2	13.2
Total equity & liabilities	*109.5*	*127.0*	*134.5*	*145.3*	*159.7*	*159.7*

Figure A3.11-7b Consolidated balance sheets example 8 – taxes payable method, alt B (recognition of badwill)

(C) Consideration of differences in tax status

As an alternative to the prior case it may be argued that the differences in tax status must be taken into consideration. One way of doing this is to record the acquired asset at its fair value in a direct exchange and at the same time record a credit in the form of, not a deferred income, but a deferred tax liability, representing the reduction in the price paid due to the additional future tax payments expected as a consequence of the indirect acquisition.

A characteristic of the balance sheet liability method is that it automatically leads to this solution: if the asset is recognised at 100 in the consolidated balance sheet, there is a temporary difference of 40 (the tax base of the asset is 60). Accordingly the balance sheet liability method stipulates that a deferred tax liability of 12 should be recognised (being the additional tax payments endured as a result of the indirect acquisition).

Under the purchase method this leads to the recording of goodwill of 2.5[5].

5 Goodwill is a residual: purchase price – acquired net assets. In this case: 90.5 - 100 + 12 = 2.5.

The consolidated financial statements depend on the adopted treatment of goodwill. Although a number of alternative treatments exist, the example proceeds under the presumption that it is depreciated over the remaining four years. These assumptions give the following consolidated financial statements:

Consolidated Income statements	**Year 1**	**2**	**3**	**4**	**Total**	**Base Case (1-4)**
Revenue	100.0	100.0	100.0	100.0	400.0	400.0
Depreciation machine	-25.0	-25.0	-25.0	-25.0	-100.0	-100.0
Depreciation goodwill	**-0.6**	**-0.6**	**-0.6**	**-0.6**	**-2.5**	
Depreciation	-25.6	-25.6	-25.6	-25.6	-102.5	-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0	-264.0	-264.0
Operating income	8.4	8.4	8.4	8.4	33.5	36.0
Interest income	1.4	6.0	10.7	15.9	34.0	30.4
Pre-tax income	9.7	14.4	19.1	24.2	67.5	66.4
Income tax (payable)	-6.1	-7.5	-8.9	-10.5	-33.0	-19.9
Income tax (deferred)	3.0	3.0	3.0	3.0	12.0	
Income tax expense	-3.1	-4.5	-5.9	-7.5	-21.0	-19.9
Net income	*6.6*	*9.9*	*13.2*	*16.8*	*46.5*	*46.5*
Tax expense % of pre-tax income	31.9	31.3	31.0	30.8	31.1	30.0

Figure A3.11-8a Consolidated income statements example 8 – consideration of deferred tax

If the goodwill is depreciated over four years, this decrease the pre-tax income with depreciation charges on the goodwill. As a result of this (permanent) difference, the recorded income tax expense does not equal the tax rate:

	Year 1	**2**	**3**	**4**	**Total**	**Base Case (1-4)**
Pre-tax income before goodwill depreciation	10.4	15.0	19.7	24.9	70.0	10.4
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0	30.0	30.0

Figure A3.11-8b Addition to consolidated income statements example 8 – consideration of deferred tax

Although taxes payable still correspond to 47.5% of the pre-tax income, the recorded tax expense now corresponds to 30% of the pre-tax income adjusted for permanent differences. In other words, owing to the recognition of a deferred tax liability of 12 in connection with the (indirect) acquisition of the asset, the total tax expense for the over-all period is 12 less than the actual tax payments.

The asset side of the consolidated balance sheet is here the same as in the (B) case (showing the same asset values as in the case of a direct acquisition), with the exception that there is also a goodwill amount. The credit side, however, differs in that it now shows a deferred tax liability rather than a deferred income:

Balance sheets at the end of each year	**Beg. 1**	**1**	**2**	**3**	**4**	**Base Case 4**
Goodwill	2.5	1.9	1.3	0.6		
Machine	100.0	75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	10.0
Cash	9.5	42.0	74.5	110.3	149.7	149.7
Total assets	*112.0*	*128.8*	*135.7*	*145.9*	*159.7*	*159.7*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings	0.0	6.6	16.5	29.7	46.5	46.5
Total equity	100.0	106.6	116.5	129.7	146.5	146.5
Deferred tax	**12.0**	9.0	6.0	3.0	0.0	
Payables		13.2	13.2	13.2	13.2	13.2
Total equity & liabilities	*112.0*	*128.8*	*135.7*	*145.9*	*159.7*	*159.7*

Figure A3.11-8c Consolidated balance sheet example 8 – consideration of deferred tax

To be noted is perhaps that the goodwill in this case corresponds to the time value of the tax payments, i.e. to the difference between 12 and 9.5. [6] This issue is further explored in the following sub-section.

6 Johansson (1998) suggests that, at least technically, an alternative would be to gross-up the carrying value of the acquired asset, i.e. to record the asset in the consolidated balance sheet at a higher value than its fair value in a direct

(D) Consideration of tax at discounted values

An alternative to the above is to recognise the initial "deferred tax liability" at its discounted amount (9.5). [7] Under this alternative, no goodwill arises and the reported pre-tax income, tax expense, net income and equity is the same *as if* the assets/liabilities had been taken over through a direct purchase (figures A3.11-9 a&b):

Consolidated Income statements	**Year 1**	**2**	**3**	**4**	**Total**	**Base case (1-4)**
Revenue	100.0	100.0	100.0	100.0	400.0	400.0
Depreciation (machine)	-25.0	-25.0	-25.0	-25.0	-100.0	-100.0
Other operating expenses	-66.0	-66.0	-66.0	-66.0	-264.0	-264.0
Operating income	9.0	9.0	9.0	9.0	36.0	36.0
Interest income	1.4	6.0	10.7	15.9	34.0	30.4
Interest expense	-1.4	-1.1	-0.7	-0.4	-3.6	
Pre-tax income	9.0	14.0	19.0	24.5	66.4	66.4
Income tax (payable)	-6.1	-7.5	-8.9	-10.5	-33.0	-19.9
Income tax (deferred)	3.4	3.3	3.2	3.1	13.1	
Income tax expense	-2.7	-4.2	5.7	-7.3	-19.0	-19.9
Net income	*6.3*	9.8	*13.3*	*17.1*	*46.5*	*46.5*
Tax expense % of pre-tax income	30.0	30.0	30.0	30.0	30.0	30.0

Figure A3.11-9a Consolidated income statements example 8 - recognition of deferred tax (discounted values)

In line with this reported consolidated tax expense is 13.1 less than the taxes payable for the period.

acquisition. He further discusses whether it would be possible to avoid a write-down of this asset with the argument that the deferred tax liability is over-stated.

7 This alternative essentially follows a suggestion made and illustrated by Johansson (1998).

Balance sheets at the end of each year	**Beg. 1**	**1**	**2**	**3**	**4**	**Base Case 4**
Machine	100.0	75.0	50.0	25.0	0.0	0.0
Receivables		10.0	10.0	10.0	10.0	10.0
Cash	9.5	42.0	74.5	110.3	149.7	149.7
Total assets	*109.5*	*127.0*	*134.5*	*145.3*	*159.7*	*159.7*
Paid in capital	100.0	100.0	100.0	100.0	100.0	100.0
Retained earnings		6.3	16.1	29.3	46.5	46.5
Total equity	100.0	106.3	116.1	129.3	146.5	146.5
Deferred tax	9.5	7.5	5.2	2.7	0.0	
Payables		13.2	13.2	13.2	13.2	13.2
Total equity & liabilities	*109.5*	*127.0*	*134.5*	*145.3*	*159.7*	*159.7*

Figure A3.11-9b Consolidated balance sheets example 8 - recognition of deferred tax (discounted values)

Using a similar example Johansson (1998) argues that without discounting deferred tax liabilities on fair value adjustments on consolidation tend to be overvalued, and hence also the related goodwill. He also points out that there is a risk for significant overvaluation when the gap between the fair value and the carrying value is large for significant items in the balance sheet, which may be the case, for example, in real-estate companies. (This argument was the reason why an earlier Swedish standard on deferred taxes deviated from IAS 12 revised on the issue of discounting, allowing discounting in certain cases.)

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