

IMPACT OF FLEXIBILITY IN ACCOUNTING ON FINANCIAL REPORTING

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ABSTRACT: *This essay explores the nature of flexibility in accounting, why it exists and its consequences for financial reporting. Flexibility in accounting (as opposed to rigidity or uniformity in accounting) offers preparers of accounting reports the ability to make acceptable adaptations or variations including the use of estimates including fair values, multiple and varied types of measurements, judgments and invoke “materiality” thresholds to record and report information. Flexibility offers the reporting managers opportunities to exercise professional judgment and discretion in determining the proper recording of transactions offered by accounting standards (Rooijen, 2002; Parfet, 2000). Financial reporting regulators (e.g., Levitt, (1998: 2), a former Chairman of the American Securities and Exchange Commission) also support flexibility in accounting, although they have been constrained to observe that in some cases, preparers of financial statements have exploited the allowed flexibility to create illusions in their financial reports; illusions that are anything but true and fair reporting (Levitt, 1998). In particular, some public companies (such as Enron) have been known to abuse the legitimate flexibility in the application of accounting standards to produce financial results that distort performance and even slide down the slippery slope to fraud.*

KEYWORDS. Flexibility in Accounting; estimates; measurements in accounting; fair value estimates; accounting choices; materiality

INTRODUCTION

The *Conceptual Framework* of the International Accounting Standards Board (IASB) recognises the flexibility inherent in financial reporting and makes bold to say: “To a large extent, financial statements that conform to the International Financial Reporting Standards (IFRS) are based on estimates, judgments and models rather than exact depictions of reality.” (Chapter 1: The objective of general-purpose financial reporting). Seeing that accounting numbers are estimates and therefore in a “grey” area, David (2004) suggests that executives have tremendous opportunity to manipulate their accounting numbers which invariably incorporate estimates. Considering the vast number of accounting estimates permitted, allowed, or required by almost all the IFRS and the opportunities created by them for management bias, the obvious question is: why does such flexibility exist? Mulford and Comiskey (2002:26) ask and answer the same question thus:

For valid reasons, flexibility in financial reporting exists. It will and should remain as long as circumstances and conditions across companies and industries vary. The existence of flexibility in the choice and application of accounting policies, however, should not result in misleading financial statements. Rather than using that flexibility to mislead financial statement users, companies should employ it to provide a fair presentation of their financial results and financial position.

Healy and Wahlen (1999:366) answer the same question; they suggest that if financial reports are to convey managers' information on the firms' performance, standards must permit managers to exercise judgment in financial reporting. Managers can then use their knowledge about the business and its opportunities to select reporting methods, estimates, and disclosures that match the firms' business economics, potentially increasing the value of accounting as a form of communication. However, because auditing is imperfect, management's use of judgment also creates opportunities for some level of improprieties, such as earnings management in which managers choose reporting methods and estimates that do not accurately reflect their firms' underlying economics. Indeed, there is a genuine fear that companies will exploit allowed flexibilities as opportunity for earnings management in order to achieve pre-determined targets which can eventually slide down the slippery slope to earnings fraud. This essay explores the nature of flexibility in accounting, why it exists and its consequences for financial reporting. Accounting standards create flexibility; they permit preparers of financial reports to use or make (i) estimates, (ii) "fair values," (iii) multiple types of measurements (iv) "judgements" in recognising, valuing and presenting financial statements and (v) to make measurement decisions around the concept of "materiality".

Estimates in financial statements

In financial statements, the carrying amounts of assets, liabilities, income, or expenses for the period or at a particular point, where such amounts cannot be measured with precision, are determined using accounting estimates. Indeed, apart from cash in local currency, almost all assets and liability amounts recognised in financial statements today reflect some estimates of the future (Barth, 2006) which may be manipulated through accounting estimates (David, 2004:81-82). Entities can use the provisions for estimates in accounting standards to inflate, or deflate the earnings and cash flows they report.

The IFRS require or allow estimates in almost all standards. None of the standards define "estimates" specifically, although when an electronic key word search for the word "estimate" (and its derivatives, such as "estimated", "estimating", and "estimations") is conducted on a digital copy of the IFRS issued by IASB, almost two thousand "hits" are obtained.

The nearest to a definition of accounting estimates is found in *IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors (paragraph 5)*: A change in accounting estimate is an adjustment of the carrying amount of an asset or liability, or the amount of the periodic consumption of an asset, the results from the assessment of the present status of, and expected future benefits and obligations associated with assets and liabilities. Change in accounting estimates result from new information or new developments and accordingly are not corrections of errors (IASB, 2010: IAS 8 paragraph 5). However, the International Standards on Auditing (ISA) 540 define accounting estimates as "an approximation of the amount of an item in the absence of a precise means of measurement". On the nature of accounting estimates, ISA 540 (paragraphs 2-4) indicates that:

1. Some financial statement items cannot be measured precisely, but can only be estimated; such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which, as a consequence affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation

uncertainty in turn, affects the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.

2. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate
3. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements.
4. A low estimation uncertainty gives rise to lower risks of material misstatement. Areas of low estimation uncertainty include (i) Accounting estimates arising in entities that engage in business activities that are not complex, (ii) Accounting estimates that are frequently made and updated because they relate to routine transactions, and (iii) Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities.
5. For some accounting estimates, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, for example: Accounting estimates relating to the outcome of litigation.
6. Typical examples of situations where accounting estimates, other than fair value accounting estimates, may be required include: (i) Allowance for doubtful accounts. (ii) Inventory obsolescence. (iii) Warranty obligations. (iv) Depreciation method or asset useful life. (v) Provision against the carrying amount of an investment where there is uncertainty regarding its recoverability. (vi) Outcome of long-term contracts. (vii) Costs arising from litigation settlements and judgments.

From the above explanations of the nature of accounting estimates, it should be clear that accounting estimates add to the flexibility inherent in financial statements. This flexibility has the purpose of providing relevant information to the users of financial statements on which to base their economic decisions. It may be concluded that the large number of allowed accounting estimates found in the IFRS and the nature of accounting estimates could pose a risk of management bias, i.e., a lack of neutrality by management in the preparation of information; a risk that estimates may be used to manipulate financial statements through, for example, managing or smoothening earnings.

Measurements in Accounting

The IASB allows flexibility of measurements in accounting; however, the historical cost is the main convention for accounting measurements. IFRS permits the revaluation of intangible assets, property, plant and equipment (PPE), investment property and inventories in certain industries. IFRS also requires the measurement at fair value of certain categories of financial

instruments and certain biological assets. In particular, the IASB's principles of accounting measurements are that:

(a) The objective of measurement is to contribute to the faithful representation of relevant information about:

(i) The resources of the entity, claims against the entity and changes in resources and claims; and

(ii) How efficiently and effectively the entity's management and governing board have discharged their responsibilities in the use of the entity's resources.

(b) A single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.

(c) When selecting which measurement to use for a particular item, the IASB urges preparers to consider what information that measurement will produce in the statement of financial position and the income statement and other comprehensive income (OCI).

(d) The relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement: (i) for a particular asset should depend on how that asset contributes to future cash flows; and (ii) for a particular liability, should depend on how the entity will settle or fulfil that liability.

(e) The number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained.

(f) The benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

A comment on these measurement principles is appropriate: Financial reporting attempts to measure inherently abstract and debatable concepts such as income and net assets; and it has particular features that make it to some extent inevitably subjective, and even arbitrary. The IASB's existing *Conceptual Framework (paragraphs 4.55 and 4.56)* observe that a range of measurement methods are employed to different degrees and in varying combinations in financial statements, including:

i. **Historical cost.** Assets are recorded at the amount of cash or cash equivalent paid or fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation.

ii. **Current cost.** Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

iii. **Realisable (settlement) value.** Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values, that is, the undiscounted amount of cash or cash equivalents expected to satisfy the liabilities in the normal course of business.

iv. **Present value.** Assets are carried at the present discounted value of future net cash inflows that the item is expected to generate in the normal course of business.

Fair value is not included in this list, although it is used in several IASB standards. Present value is listed as if it were a separate measurement basis in itself, rather than a technique that can be used to estimate measurements under several different bases.

The differences in measurement bases do not result from differences specified in the *Conceptual Framework*. Rather, they result from conventions and differences in practice that have evolved over time. Thus, when viewed in terms of the *Conceptual Framework*, these differences cause financial statements to be internally inconsistent. Not only is the use of multiple measurement bases conceptually unappealing, it also creates difficulties for financial statement users. Measuring financial statement amounts in different ways complicates the interpretation of accounting summary amounts such as the income and the financial position statements (Barth, 2007).

Thus, under existing requirements, the amount presented as total net assets has little meaning because it is an aggregation of items measured using various and different measurements. Not only are the measurement requirements varied, they can be equally confusing to the extent that within an entity's accounts, same elements may be measured differently. For example:

- i. Plant and equipment may be measured on different bases (i.e., on a cost model or revaluation model);
- ii. Non-current assets are valued at different bases (e.g., plant & equipment can be measured at historical cost or at a revaluation; biological assets must be carried at fair value);
- iii. Liabilities are measured on different bases (e.g., pension scheme liabilities must be discounted, deferred tax liabilities must not);
- iv. Fair value can be measured in different ways (e.g., sometimes market value, sometimes depreciated replacement costs); and
- v. The effects of inflation are treated in different ways (e.g., sometimes reflecting the changing value of money, sometimes not).

Appendix 1 summarises specific requirements when the IFRS specify different measurements for different categories of assets and liabilities.

Fair value estimates

Fair value is “the price that would be received to sell an asset or paid to transfer a liability (exit price) in an orderly transaction (not a forced sale) between market participants at the measurement date (i.e., the current price)” (IASB, 2012: IFRS 13). The key principle is that fair value is the exit price from the perspective of market participants who hold the asset or owe the liability at the measurement date. Because it is market participants' perspective-based rather than on the entity itself, fair value is not affected by the entity's intentions towards the asset, liability or equity item that is being fair-valued.

Ball (2006) argues that fair value accounting incorporates more-timely information about economic gains and losses on securities, derivatives and other transactions into the financial statements. Also, fair value accounting attempts to incorporate more-timely information about contemporary economic losses (“impairments”) on long-term tangible and intangible assets. Thus, fair value measurements incorporate more information into financial statements. More information usually makes accounting numbers, such as earnings, more informative. In line with this argument, Barth, Landsman, Lang, and Williams (2012) argue that fair value accounting reduces the possibility of discretionary earnings management, given that all gains and losses are immediately recognized.

Apparently persuaded by the modern finance theory, the IFRS are imbued with fair value accounting (FVA) to a significant extent. FVA is permitted or required in more than twenty of the IASB's standards (see Appendix 2). In spite of the above noted and as pointed out by Ball (2006), there are mixed views on fair value accounting. The fundamental case in favour of fair value accounting is obvious to most economists; fair value incorporates market information into the financial statements. Incorporating more information in the financial statements, by definition, makes them more informative, with potential advantages to investors and, other things being equal, makes them more useful for purposes of contracting with lenders, managers and other parties. Moreover, fair value meets the conceptual framework criteria in terms of qualitative characteristics of accounting information better than other measurement bases. In fact, fair values (a) are relevant, (b) can be faithful representations of assets and liabilities, and (c) are neutral, timely and comparable (Barth (2007); (see Table 2.2, below).

Table 1: Fair values and qualitative characteristics of accounting information

Advantages	Disadvantages
<ul style="list-style-type: none"> • Fair values are relevant because they reflect present economic conditions relating to economic resources and obligations, i.e., the conditions under which financial statement users will make their decisions. • Fair values can be faithful representation of assets and liabilities, because they reflect risk and probability-weighted assessments of expected future cash inflows and outflows. • Fair values are unbiased and therefore neutral. • Fair values are timely because they reflect changes in economic conditions when those conditions change. • Fair values are comparable because the fair value of any particular asset or liability depends only on the characteristics of the asset or liability, not on the characteristics of the entity that holds the asset or liability or when it was acquired. • Fair values enhance consistency because they reflect the same type of information in every period 	<ul style="list-style-type: none"> • Lack a clear definition of fair value • Lack verifiability • Management competence to determine fair value estimates in illiquid markets • Potential circularity of reflecting fair values in financial statements when the objective is to provide financial statement users with information to make economic decisions that include assessing the value of the entity

Source: Barth (2007): Standard-setting measurement issues and the relevance of research, *Accounting and Business Research Special Issue: International Accounting Policy Forum*.

Despite these advantages, fair value measurement is not a panacea. There are many potential problems with fair value in practice, including the lack of a clear definition of fair value, and market illiquidity as emerged during the 2008-2009 credit crunch in the developed western countries. Other concerns include, lack of verifiability, the ability of management to determine fair value estimates, and the potential circularity of reflecting fair values in financial statements

when the objective is to provide financial statement users with information to make economic decisions that include assessing the value of the entity. These issues are clarified in the following paragraphs:

Although the measurement objective of “fair value” is clearly stated, its definition lacks sufficient specificity to ensure consistent application. The concept is extremely subjective and theoretical. The IASB definition of fair value mentions three different notions: “value”, “price”, and “fair value”. From a valuation standpoint, “value” should be distinguished from “price”, as it reflects the opinion of a given investor regarding the estimated future return on an asset. There are as many opinions on the value of an asset as there are potential investors. On the other hand, “price” is a fact and not an opinion. “Fair value”, in contrast, is the theoretical price that the company *could* obtain if it decided to sell an asset or settle a liability under certain conditions. Fair value is actually an opinion on a hypothetical fact, and referring to it as a market value does not make it any less theoretical.

Regarding verifiability of fair value, verifiability is a component of faithful representation. A concern over verifiability of fair value often is expressed in relation to assets and liabilities that do not have observable market prices. For such assets and liabilities, fair value must be estimated, which raises the possibility that the estimates may not be verifiable. The verifiability and therefore, reliability of fair value depends on the asset being valued and the existence of a market on which it could theoretically be traded. It is relatively easy to apply fair value in the case of listed securities; but it is problematic to value assets and liabilities not listed on an active market or with known prices. In reality, most reported assets and liabilities do not have market quoted prices or known prices; so fair value needs to be estimated. Thus, professional judgment is required in valuing most of the assets and liabilities in the statement of financial position at fair value; which increases subjectivity, and possibilities of managing earnings.

Another problem with fair value arises in the case of illiquid markets. For example, in the recent financial crisis, in Europe, banks sold a lot of (financial) assets because of an urgent need for liquidity due to the threat of bankruptcy. Although there was a market price for these (financial) assets, it is probable that technically, the market was in a “forced sale mode”, enabling forced sale prices. Generally, forced sale prices are not an ethical measure of the fair value of these assets for other parties. "The basic idea is that banks may have sold assets at a price below the fundamental value and that the price from these (forced) sales then became relevant to other institutions that are required by fair value accounting to set their assets at these value" (Laux & Leuz, 2009: 826-834; Allen & Carletti, 2008; Plantin, Sapiro, & Shin, 2008). Furthermore, IFRS prescribes an impairment test whenever the value of an asset or liability is changed. As a result, earnings become liable to be volatile and thus less predictable; an unwanted situation; these prompts and entices management to smooth earnings.

Lastly, concerning potential circularity, it is unlikely that even if all recognised assets and liabilities are measured at fair value, recognised equity would equal the market value of equity. This is because only assets and liabilities that meet *the Conceptual Framework* definitions are to be recognised. Market value of equity reflects investors’ assessments of, among other things, growth options and managerial skill that do not meet the asset definitions (Barth 2007). According to Barth (2007), notwithstanding the above, the use of fair value minimises the undesirable effects of the mixed measurement approach to financial reporting that we have

today. Support for fair value accounting is also backed by a study on mark-to-market accounting standards carried out by the US SEC (US SEC, 2008)¹

Despite its pervasiveness, fair value is directly one of the main disadvantages of IFRS mentioned by Ball (2006). The fact that fair value is an estimation, or a valuation process done by the management of the company; becomes an exercise of professional judgment. This is a very subjective process, which enhances possibilities of earnings management. For these reasons, the fair value aspect is seen as a disadvantage of IFRS, regarding the informative value of financial statements, since it may lead to even more earnings management rather than a decrease in them.

Flexibility around accounting choices

Accounting standards have traditionally provided management with latitude to exercise judgment and discretion. More recently, standards have permitted managers to exercise increased levels of discretion with respect to how information in published financial statements is portrayed. For example, the classification of financial assets and financial liabilities at fair value through the Income Statement is largely dependent on managerial choices in their expected use, measurement, and evaluation of these assets and liabilities (IFRS 9 *Financial Instruments* & IAS 39 *Financial Instruments: Recognition and Measurement*). Similarly, IAS 36 *Impairment of Assets* (paragraph 80(a)) requires managers to exercise discretion by allocating goodwill to the cash generating unit that represents “the lowest level within the entity at which the goodwill is monitored for internal management purposes.” Furthermore, managers are to test whether goodwill has been impaired “at a level that reflects the way an entity manages its operations” (IAS 36, paragraph 82). This management approach (Hoy & Hughes, 2012) is also seen in *IFRS 8: Operating Segments*; wherein corporate management is required to disclose the bases on which it makes resource allocation decisions and evaluates the performance of operating segments.

Managers use these allowed “subjectivities” or latitudes to exercise judgment and discretion. This occurs in areas such as the timing of accruals, manipulation of the cost base of assets acquired individually and in business combinations, the modification of depreciation schedules, revenue recognition, inventories, stock options, lease expenses, fair value estimates, and changes in accounting policies (Nelson, Elliott, & Tarpley, 2003; Libby & Seybert, 2009). Furthermore, IAS 8 (paragraph 11) mentions another level for applying judgment: it makes reference to considerations of the definitions, recognition criteria and measurements concepts in *The Conceptual Framework*. The IFRS only specify a measurement objective, such as fair value measurements (*IAS 39: Financial Instruments; Recognition and Measurement*); contingent liabilities (*IFRS 3; Business Combinations*); provisions involving a large population of items (*IAS 37; Provisions, Contingent Assets and Contingent Liabilities*); choice of depreciation and amortization methods (*IAS 38, Intangible Assets*); defined pension plans (*IAS 19, Employee Benefits*); and impairment of assets and value in use (*IAS 36 Impairment of Assets and IAS 39*).

¹ US SEC (Securities and Exchange Commission) (2008) Report and Recommendations Pursuant to Section 133 of the Emergency Economic Stabilization Act of 2008: Study on Mark-to-Market Accounting, December, 2008

In other words, IFRS leaves it up to firms to make any accounting choices that do not contravene the principles established in the standards. The accounting choices regarding the recognition of actuarial gains and losses provide a useful example in this regard. According to IAS 19; *Employee Benefits*, the adoption of the corridor approach can smooth actuarial gains and losses; the results affect net income for the part that exceeds the “corridor” of plus or minus 10% of the maximum between the Projected Benefit Obligation and the Fair Value of the assets of the plan. Alternatively, the income statement can directly recognize the gains and losses. As a third choice, actuarial gains and losses can be recognized fully and immediately transferred into equity and, hence, without affecting the income statement. Similarly, IAS 16: *Property, Plant and Equipment* equally enable different accounting choices such as the cost method and the revaluation method for the accounting of tangible assets. Principles based standards leave more room for discretion, judgment and interpretation by the preparers, including the presentation and disclosure, classification, recognition and “de-recognition”, and measurement of transactions and accounts.

Materiality

The concept of materiality is of critical importance in the preparation of financial statements. It impacts on many decisions such as how an entity should recognise, measure, and disclose specific transactions and information in the financial statements; whether misstatements require correction and whether assets and liabilities or items of income or expense should be separately presented. Reflecting its importance to the financial reporting process, the IFRSs make several references to the application of the concept of materiality.

Levitt (1998) identified “materiality” as one of the items used by companies to adjust earnings to desired levels. Levitt (1998) noted that materiality helps to build flexibility into financial reporting but companies abuse it to adjust earnings to meet analysts’ forecasts. The allowed flexibility relating to materiality is based on the idea that some items may be so insignificant that they are not worth measuring with exact precision. Indeed, the enforcement goal of financial reporting regulators is to promote “transparent, timely and reliable financial statements” (Levitt, 1998:2). However, financial statements of a company need not, and as a practical matter, cannot be perfectly accurate down to the last penny (Brennan & Gray, 2005). Preparation of financial statements is a complex process and requires the exercise of professional judgment. In recognition of this fact, financial reporting regulators do not mandate perfection in financial reporting; rather they require that financial statements be accurate in “all material respects” (IAS 1). Materiality recognises that some discrepancies are so minor, that they have no reporting significance.

Companies can abuse this flexibility built into financial reporting by intentionally not recording “small errors” within a defined percentage ceiling; auditors will not scrutinize such “small errors” because they are immaterial. Management will excuse errors by arguing that their effect on the bottom line is so small as not to matter. These “small errors” build up and can mislead the stock market and other stakeholders. The quote below from the November 9th, 2001 edition of *The New York Times* in relation to Enron audit illustrates this point:

The remainder of the earnings reductions of \$92 million from 1997 through 2000 came from what Enron called “prior year proposed audit adjustment and reclassifications,” which appear

to have been changes previously recommended by Arthur Andersen, Enron's auditors, but not made because the auditors were persuaded the amounts were immaterial (Oppel & Sorkin, 2001). Invariably the items disclosed in financial statements are often determined by their materiality, thus, the content of financial statements is, in part, as a result of judgments exercised around materiality. Materiality is also crucial in what is to be disclosed in financial statements. Accounting regulations apply different rules, approaches and requirements for material and immaterial items. For example, as indicated above, *IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors* states that accounting policies specified by the IFRS need not be applied when the effect of applying them is immaterial. Similarly, *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* only require material contingent liabilities to be disclosed.

The IASB has provided adequate guidelines regarding "materiality": The definition of materiality in IAS 1:7 puts emphasis on whether an item "could influence the economic decisions that users make". Based on the definition of materiality therefore, the primary consideration in determining whether an item is material is whether its omission or misstatement could influence the economic decisions that users make. Secondly, the definition of "material" identifies the attributes of size and nature, and specifies that items should be judged in the surrounding circumstances of their omission or misstatement. That is, both quantitative and qualitative factors are relevant to materiality decisions. Quantitative thresholds ("rules of thumb") can be a useful starting point of materiality analysis, but the nature of, and circumstances surrounding an item should be taken into account. Consequently, each entity must make an assessment according to its own particular circumstances.

Examples of common transactions and outcomes where materiality judgments are usually particularly sensitive, and thus, where the adjudged materiality threshold may be lower, include, among others: (a) breaches of legal and/or regulatory requirements (b) transactions with related parties, including key management personnel's compensation; (c) an unusual or non-recurring transaction(s)/balance(s); (d) an error that results in a reversal of a trend - for example, a loss being turned into a profit or *vice versa*; and (e) an error that impacts on ratios or other metrics used to evaluate, for example, compliance with debt covenants.

SUMMARY AND CONCLUSION

Flexibility enables each company to apply or adapt an accounting method that suits its unique circumstances and communicates useful information to financial statement users for making economic decisions. As a consequence, each company makes significant accounting judgments and estimates: fair value estimates, impairment tests, assumptions about future income taxes, revenue recognition criteria, et cetera. Without flexibility, it would be necessary to have in place, a 'rulebook' that would be so incredibly detailed to capture all possible transactions and scenarios conceivable in all companies; that would be too cumbersome to be of any value. Hence, the accounting standards provide only guidance and allow flexibility. However, flexibility by its nature, enables the use of estimates, judgments, *etc.*, that are subjective and require assumptions about matters that are highly uncertain and which can vary widely to the extent that a slight change in these assumptions may have a large impact on reported financial outcomes; these prompts regulators to require companies to disclose the key judgments and critical accounting estimates that significantly impact financial results.

Principles-based standards which allow extensive flexibility, such as the IFRS, in effect give only general or generic guidance that enable financial statement preparers and auditors to rely heavily on the exercise of professional judgment and the use of private information for their application. Heavy reliance on professional judgment by financial statement preparers leaves room for abuse; and for it (the abuse) to be accommodated by auditors. It can also result in more pressure on preparers to use, and auditors to accept, risky accounting (Sherman & Young, 2001) and other aggressive accounting treatments such as earnings management and aggressive revenue measurement and recognition. Thus, the use of accounting flexibility at the same time gives management an ample opportunity to manipulate, smooth or manage earnings.

Flexibility can be a good or a bad thing. As averred to earlier, flexibility in accounting allows it to keep pace with business innovations and is therefore required and necessary in financial reporting. However, preparers of financial statements have exploited the allowed flexibility to create illusions in their financial reports; illusions that are anything but true and fair reporting, thereby abusing legitimate flexibility in the application of accounting standards and producing financial results that distort performance.

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Appendix 1: Summary of IFRS Measurement Requirements

- Goods and services received in share-based payment transactions are measured at fair value where this can be measured reliably; otherwise, they are measured at fair value of the equity instruments granted. Transactions with employees and others providing similar services are to be measured at fair value of equity instruments granted (IFRS 2).
- The initial cost of assets and liabilities acquired in a business combination is their fair value at the date of acquisition (IFRS 3). Fair value in this context can be measured by, among other things: market value; present value; selling price less the cost of disposal plus reasonable profit allowance; current replacement cost; depreciated replacement cost; reference to an active market; and the amount that a third party would charge.
- With some exceptions, internally generated intangibles are not recognised; where they are recognised, they are measured at historical cost. Internally generated intangibles acquired in a business combination are, subject to conditions, recognised and measured at fair value at the date of the combination (IFRS 3).
- Exploration and evaluation assets for mineral resources may be carried at either historical cost or fair value (IFRS 6); mineral resources (mines, oil and gas wells), other than exploration and evaluation assets are not covered by IFRS, which means that they can be measured on various bases.
- Financial assets are measured at fair value or amortised cost (IFRS 9:5).
- Inventories are measured at the lower of cost and net realisable value (IAS 2:9).
- Construction contracts must be carried at historical cost plus a portion of expected profit (IAS 11).
- Pension scheme liabilities must be measured by the projected unit credit method of actuarial calculation, which uses discounting (IAS 26); deferred tax liabilities must not be discounted (IAS 12).
- Intangible assets and property, plant and equipment (PPE) are measured at either cost model or revaluation model (IAS 38:72 and IAS 16:29).
- Assets on finance lease must be carried at the lower of fair value at the date of acquisition and the discounted value of minimum lease payments to date, less subsequent depreciation (IAS 17).
- The liability for a finance lease must be stated at the lower of the related assets' fair value at the date of the acquisition and the discounted value of the minimum lease payments at that date, less amounts written back so as to produce a constant periodic rate of interest on the remaining balance (IAS 17).
- Investments in associates are measured using the equity method (IAS 28:13).
- The historical cost of a fixed asset is its gross cost less depreciation, calculated taking into account its remaining useful life and its likely residual value at end of it. However, if the asset's recoverable amount is less than its depreciated historical cost; it must be written down to its recoverable amount, which is the higher of its net fair value and its value in use (IAS 36).
- Pension scheme assets are measured at fair value (IAS 19; IAS 26).
- Provisions must be stated at the best estimate of the expenditure required, where its effect would be material (IAS 37).
- Investment property is measured using the cost model or the fair value model (IAS 40:30).
- Agricultural produce at the point of harvest and biological assets when they relate to agricultural activity are measured at fair values less cost to sell (IAS 41:12).

- Non-current assets held for sale are measured at the lower of the carrying amount (determined in accordance with other standards (e.g., AS 16) and fair value less costs to sell (IFRS 5:15).
- Financial statements of companies that report in the currency of a hyperinflationary economy must be restated in terms of current purchasing power. Financial statements of companies that report in less than hyperinflationary currency is not restated (IAS 29).

Appendix 2: Fair value Requirements in IFRS

- IFRS 2 requires share-based payments (stock, options, etc.) to be accounted for at fair value.
- IFRS 3 requires minority interest to be recorded at fair value and assumes that the contingent consideration, assets acquired, including goodwill, and liabilities transferred; warranty liabilities, (in a business combination) are measured at fair value.
- IFRS 5: Non-current assets held for sale and discontinued operations are required to be reported at fair value.
- IFRS 9 requires entities to recognise and measure all financial instruments i.e., investments in debt and equity instruments at fair value, even if those instruments are not quoted in an active market.
- IFRS 10 Investments in subsidiaries by investment entities are carried in the consolidated financial statements at fair value. .
- IAS 16 provides a fair value option for property, plant and equipment.
- IAS 18: Revenue be recorded at fair value.
- IAS 19 requires that defined benefit plan assets be measured at fair value.
- IAS 26 requires retirement benefit plan investments be measured at fair value.
- IAS 28 Investments in associates and joint ventures- held by mutual funds and similar entities are accounted for at fair value.
- IAS 32 Hybrid financial instruments are presented at fair value.
- IAS 36 requires asset impairments (and impairment reversals) adjusted to fair value.
- IAS 38 requires intangible asset impairments adjusted to fair value and also provides for intangibles to be re-valued to market price, if available (i.e., at fair value).
- IAS 39 requires financial instruments other than loans and receivables that are not held for trading, securities held to maturity; financial guarantee contracts to be accounted for at fair value.
- IAS 40 provides a fair value option for investment property.
- IAS 41 requires biological assets and agricultural produce to be measured at fair value.